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# 2008 outlook

Global Insurance Center

# Property/casualty industry outlook

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In spite of another year of great earnings and strong balance sheets, the near future is likely to challenge the property/casualty (P/C) industry's fundamentals. Many companies today are having difficulty achieving topline targets on a regular basis, with signals of margin compression around the corner. This is occurring in the face of relatively benign loss trends in both core and catastrophe lines.



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In the first half of 2007, net written premium growth of 0.1% was the weakest in two decades, according to Insurance Services Office statistics. This highlights the importance of maintaining and managing profitability, which was a topic of discussion in our 2007 Outlook. Companies need to make dramatic changes and seek alternative growth strategies if they are to survive the complex business environment that lies ahead. With market challenges only intensifying, there is a particularly fertile window of opportunity for companies to deploy capital and differentiate themselves through innovation.

The six topics selected for this year's list include:

- ▶ Striving for Growth
- ▶ Operational Transformation
- ▶ Catastrophe Solutions
- ▶ Financial Events
- ▶ Solvency II
- ▶ International Financial Reporting Standards (IFRS)

#### **Striving for Growth**

As we look back, the P/C insurance industry experienced one of the best years ever in 2006, with overall profitability reaching its highest level since 1988. It comes as no surprise that this stellar underwriting performance, with a combined ratio of 92.4, will be difficult to sustain. In recent years, companies have benefited from a combination of the run-off of hard market premiums, benign loss trends, and the absence of major catastrophes. Net income after taxes (or profits) rose 5.5% to US\$30.6 billion during the first half of 2007, according to the Insurance Information Institute. However, the compound annual growth rate for premiums over the next five years is only expected to increase 2.6%, reaching US\$739.9 billion by the end of 2011, as cited by Datamonitor.

We expect margin compression to accelerate in 2008. While favorable underlying loss trends have enabled the cost of manufacturing to remain steady, core pricing has continued to erode. With increasing competition in property catastrophe insurance lines to deploy excess capital, future financial results will clearly be dominated by soft market pricing. However, stronger balance sheets and an accumulation of capital (policyholder surplus exceeded US\$10.5 trillion at 30 June 2007) will enable insurers to deploy the excess through share buybacks, boosting dividends, entrance into emerging markets or accelerated merger and acquisition (M&A) activity.

In this current market and these prevailing conditions, consolidation is becoming more of a reality. Domestic players have become attractive valuation targets with the declining value of the US dollar while at the same time, European companies may be turning to the US for growth. This would be an interesting turnabout after the combination of the severe soft market in the late 1990s and terrorism events made the US a less than attractive market.

For those companies who cannot play the M&A card, innovation remains the likely source of growth. Significant opportunities exist including: optimizing profitability through the broader use of outsourcing, a deeper understanding of customers' needs, stronger value propositions and more sophisticated distribution strategies. Leadership is a requirement in the industry to make the right decisions and navigate the fine line between innovation and acceptable risk-taking.

#### **Operational Transformation**

The search for growth and profitability is driving companies to focus on better business alignment and expense control. Ultimately, streamlining internal operations will result in efficiencies, as well as improved internal controls and risk management

functions. However, this will require consolidating infrastructure in the areas of technology, operations, real estate, human resources, shared services, procurement and finance. As insurers seek to improve their agility, and reduce costs and complexity, they will move to consolidate and optimize their core operations. This will lead to a better understanding of what investments are needed to drive value for the future, rather than conducting across-the-board cuts.

Cost management and operational transformation will provide a platform for growth and diversification. In 2008 insurers will take a harder look at evaluating outsourcing and offshoring, particularly for back-office functions and customer-facing business processes. The industry projects that outsourcing contracts will double by 2010 to over US\$6 billion. The right strategic sourcing initiatives can yield operational and technological advantages while building relationships that will set the stage for continuous improvement.

Another critical aspect of operational transformation is the need to effectively reduce, manage, and justify expenses through a formal strategic cost management program. This begins with the first contact point (distribution, marketing, channel management, sales and product development) continues through middle-office processes (underwriting, operations, claims, administration, and performance management) and ends with traditional back-office services (payroll processing, IT, risk management, human resources and compliance).

#### **Catastrophe Solutions**

The property catastrophe insurance business continues to experience rapid changes. Recent innovations in insurance financing have accelerated the flow of capital within the industry. This coupled with the erratic nature of catastrophes once again challenges companies to respond to market conditions with more speed and more precision.

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Furthermore, regulatory and rating agency scrutiny have become more intense. Demands are being placed on insurers that require solutions to satisfy a multitude of stakeholders, including regulators, investors, and policyholders. Companies continue to struggle to find the appropriate balance and make the necessary operational improvements to navigate this turbulent environment.

In 2008 we believe that insurers must continue to invest in their ability to understand catastrophe risk and improve underwriting performance. This involves an investment in people, new systems and new operational procedures. It also involves the innovation of new products and new ways of making strategic decisions.

The impending soft market conditions will once again test each company's ability to maintain underwriting discipline and make reasonable profits. Those that strive to improve their underwriting and risk management procedures will position themselves to make decisions with more efficiency and more clarity going forward. Companies that can make the necessary adjustments now to navigate effectively the ever-changing regulatory and rating agency environment will prosper.

The never-ending cycle of hard and soft markets that plague the property catastrophe industry shows no signs of abating. Companies that can innovate new solutions within this fundamental framework will eventually differentiate themselves.

#### **Financial Events**

Over the past five years there has been an increase in alternative asset investment, representing an increasing portion of P/C company investment portfolios. P/C insurers traditionally invested in high-quality corporate bonds, municipal bonds and other bond structures. There is now greater emphasis on private equity, hedge funds, real estate and other related classes. Some institutions have changed their risk

management and oversight activities to give them a better view of these more complex risks, while others have not. Those organizations which have the people, systems and processes to capture and understand and manage the risks from these new asset classes will have a competitive advantage.

The criticality of this has been highlighted through the recent credit market turmoil. Since many credit exposures are being repackaged through securitizations and investments are increasingly being made through funds or other indirect investment vehicles, it is becoming more difficult to understand the underlying risks, and credit risk has become more opaque and uncertain. This has been abundantly clear in the subprime mortgage market, where the stress is compounded by the fact that many of these instruments contain features that add further uncertainty in value and cash flows, and where many exposures were obscured behind highly rated securitization structures.

While P/C companies have not been significant direct holders of subprime debt, we have seen increasing exposures to alternative investments. It is too early to understand the potential impact of the current credit stresses on the broader credit markets. In this environment, companies may become more cautious in taking on additional credit exposures and others will choose to sit on the sidelines. For some, it may be a buying opportunity to take advantage of significantly widening credit spreads and liquidity premiums. One thing is certain; it is time to take action and focus on creating greater transparency and building risk infrastructure commensurate with the nature of these increasingly important asset classes. This includes enhancing the sophistication of risk management and risk measurement capabilities to improve our understanding of aggregate portfolio risks and to upgrade risk controlling, risk reporting and credit risk monitoring activities.

#### **Solvency II**

US insurers, which are slowly moving to economic capital methodologies, are closely watching as regulatory developments in Europe continue to evolve. Conversion to an economic capital-type standard such as Solvency II will be a huge challenge, with far-reaching implications for the industry. The implementation deadline for this risk-based capital regulatory model was recently moved back to 2012 because the tight timeframe was viewed as unrealistic. Even with a two-year extension, companies need to act now, rather than wait on the sidelines for further guidance, because significant improvements to systems, processes and data will be needed.

Solvency II is creating a capital environment which directly addresses the cost/benefit of taking risk. The goal is to link required capital more closely to risks incurred, with greater focus on insurance companies' risk profiles. The Solvency II directive issued on 10 July 2007 states that the responsibility for an insurer's financial soundness will be pushed back firmly to its management, where it belongs.

In short, companies that employ risk management controls and data governance to effectively manage risk will be rewarded. While current projects already touch on areas affected by Solvency II, significant data and systems improvements will be needed. The convergence of accounting, risk and actuarial information will challenge traditional models currently in use and lead to more sophisticated methodologies. In particular, areas of coverage where data is sparse (terrorism insurance or political risk insurance for example) may become less attractive as the inability to use an internal model may lead to higher capital requirements.

#### **International Financial Reporting Standards (IFRS)**

As we look ahead to the possibility of a new fair value type accounting standard, both in

Europe and in the US, the message is clear: a major, fundamental change in financial reporting for insurers is now on the horizon. The IASB issued a Phase II Discussion Paper (DP) on accounting for insurance contracts in May, invited comments to be submitted by November, and expects to issue an exposure draft in 2009. Although the date for implementation will follow sometime after 2009, it is not too soon for US insurers to begin examining the impact of the preliminary views (as stated in the DP) to their financial systems and statements. The implementation effort required for insurers is expected to be enormous. Companies should begin developing a plan that includes steps to assess the impact of the proposals on their financial statements, educate key employees and constituents, and evaluate the readiness of their organization for implementation.

A more urgent development for US insurers was the SEC's press release on 17 November 2007, announcing approval of rule amendments supporting the use of IFRS in preparation of financial statements by foreign private issuers in the US—noting that the statements will be accepted without reconciliation to US GAAP if they are prepared using IFRS as issued by the IASB. Final rules have not yet been issued but will take effect 60 days after they are published in the Federal Register and apply to financial

statements covering years ended after 15 November 2007. The release also announced that the SEC would convene two round tables (on 13 December and 17 December) to collect more feedback from the public on the issue of giving US domestic issuers the same option that foreign issuers have in our markets to use either IFRS or US GAAP for financial statements filed with the SEC.

Many European companies have been pilot testing fair value approaches for years. They have begun calculating economic capital and market consistent embedded value results in recent years, but are still years away from being ready to make the full switch to exit value reporting as defined in the IASB DP. In the US, the coming year marks another important milestone in the journey to fair value reporting, as FAS 157 establishes a hierarchy for all fair value measures under current US GAAP, and FAS 159 provides for the first time the option of accounting for most financial instruments, including many insurance contracts, at fair value under US GAAP. Although the implementation of FAS 157 and 159 is moving more US insurers toward fair value, domestic companies are less prepared for a switch to a fair value type of reporting for insurance liabilities. The recent events should be a wake-up call to US insurers that they need to begin preparing for these changes.

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