

# 2012 outlook

Global Insurance Center

## Canadian life insurance outlook

### Uncertainty persists, but insurers can prosper

#### Market summary

In the uncertain economic climate, life insurers in Canada confront a tricky balancing act in 2012 – managing both capital and risk in the highly competitive environment, while repositioning strategically for future growth.

Sustained competition from both domestic and US life insurers continues to pressure the operating results and capital levels of many Canadian life insurers. Additional challenges include a low interest rate environment and related concerns over the compression of spreads, unpredictable equity markets and their impact on hedging costs and reserves and investors in companies strongly emphasizing their need for higher returns. Complicating these issues is a regulatory regime that appears ever more rigorous.

In this environment, insurers must focus on earnings improvement, while simultaneously preserving their credit ratings and capital levels – not easy given the economic impediments to organic growth, such as persistently lower discretionary income in Canada intensifying the competition for what is now a smaller share of the market. Consequently, Canadian life insurers may need to improve their earnings prospects through such non-organic means as an opportunistic merger or acquisition, while building the case for future organic growth.

Canadian life insurers are increasingly risk averse, fostering changes in the design of life insurance product features. Within the market, retirement account assets are still in recovery mode due to significant losses sustained in 2008, hindering ongoing development of the retirement income market. After a modest increase in 2010, variable annuity sales fell in the first half of 2011, and in the second half of the year were expected to remain flat, as economic conditions worsened. On the bright side, both universal life and whole life

Given the economic, regulatory and uncertain growth prospects confronting the market, five issues are expected to command management's focus in 2012:

1. Manage the company for the current volatile market and low-interest rate environment
2. Get a firmer grasp on cost containment
3. Understand and prepare for the impact of accounting and regulatory convergence
4. Drive efficiency and risk management improvement through technology
5. Embrace the Internet

products experienced an uptick in sales in 2011, compensating somewhat for the lower sales in other product categories.

With these and other fundamentals remaining unchanged in 2012, minimal industry growth is expected, i.e., net premiums are likely to hold at 2011 levels.

At the same time, Canadian regulators have increased their scrutiny of the life insurance market, given significant capital pressures straining some life insurers in this volatile economy. Canadian life insurers nonetheless may be in a better position than their US counterparts to take advantage of expansion opportunities in the US, Europe and other areas troubled by recent market unrest. Larger and well-capitalized insurers may explore options for both organic growth and strategic acquisitions in those regions, although some foreign markets are becoming less attractive due to their own uncertain economic circumstances and increased competition.

### **Manage the company for the current volatile market and low-interest-rate environment**

After the much-discussed possibility of an interest rate hike in September 2011, the Bank of Canada left the

rate unchanged. This came as no surprise, since the US Federal Open Market Committee (FOMC) made an unprecedented announcement just a month earlier, locking in a low-interest-rate environment until 2013.

After the recession was declared "officially over," interest rates in Canada experienced a small increase, although many Canadian and US life insurers had expected a higher increase to return rates closer to normal. Then, in September 2011, the US Federal Reserve announced "Operation Twist," a stimulus plan expected to lower long-term interest rates further, which exacerbated the situation.

The relatively low-interest-rate environment at present increases the risk of spread compression for existing products. At the same time, efforts to increase the sale of universal life insurance and fixed and variable annuities have been affected by re-pricing initiatives that aim for lower risk-taking product designs. In the last decade, some insurers have chased yield at the cost of assuming greater risk, resulting in both realized and unrealized losses during the credit crisis of 2008.

Insurers may now shy away from taking on more risk, wishing to avoid a replay of the tumultuous events. Simpler approaches to improving results, such as increasing the asset portfolio duration

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of the General Account, may achieve the desired intent for some insurers. For others, the volatile equity markets and low-interest-rate environment may compel them to unload some risks taken previously. Insurers are re-examining their product strategies and may re-price certain products or eliminate them altogether.

A more sophisticated approach to protect an insurer's surplus position and simultaneously promote growth despite the interest-rate and market risks would be to improve the asset/liability matching and management process, which can reduce variability in surplus and prepare for possible future interest rate changes.

While interest rates are likely to remain low for awhile, they could climb rapidly depending on the economic outlook and decisions taken by the Central Bank. Understanding the interaction of the asset and liability cash flows under different scenarios will help life insurers prepare for continued economic uncertainty and also assist in determining how to effectively communicate the associated volatility in quarterly financial results to the market and regulators.

New asset classes and innovative financial instruments may assist insurers to improve their financial results. To avoid the dangers of the recent financial crisis, insurers need to more fully comprehend the structure and safeguards surrounding these assets.

Insurers also can better evaluate investment opportunities by using a variety of stress scenarios to understand counterparty risks, correlations in credit risk, capital requirements and cash flows. Deeper evaluation of risk-adjusted returns can bolster confidence regarding a sufficient return on the asset risks.

Managing the company through the described volatility associated with the low interest rate and, in some cases, a low growth environment has further implications for the organization's systems, processes and people that insurers must consider. Insurers will need to evaluate their culture and people strategies to better align their organizations to their new realities.

### **Get a firmer grasp on cost containment**

As the economic crisis ended, many financial institutions, including life insurers, adjusted their cost structures in areas deemed to present quick positive results, such as personnel, communications and travel expenses. By and large, the overall sense was that

the Canadian economy had absorbed the shocks relatively well; consequently, more sophisticated cost analysis and cost-containment measures would not be necessary. Nevertheless, the prolonged downturn and the unrelenting pressure on economic results through 2011 compelled management to further streamline their cost structures, a trend that is likely to continue in 2012.

After a period of consolidation involving mergers, acquisitions and demutualizations, many Canadian life insurers are beset by a large number of legacy administration systems, in addition to multiple system management contracts, manual controls and redundant processes. As they seek cost economies, life insurers may be surprised to learn the potential savings offered in this area. Companies that can afford to invest capital may seize opportunities to restructure their systems, eliminate manual and redundant processes and reduce unnecessary support contracts. Such actions can lead to significant annual savings.

Another incentive to modernize and enhance internal administration systems is the opportunity to integrate these systems with modern predictive analysis and scenario-testing tools and processes that could generate competitive advantages in the marketplace.



## Understand and prepare for the impact of accounting and regulatory convergence

In the next few years, Canadian life insurers will confront challenges from ongoing changes in regulatory and accounting standards. Insurers will need to create products and services suitable to the new regimes, leverage distribution channels to increase their top-line growth and reduce costs to bolster bottom-line earnings. This evolving regulatory landscape creates both opportunities and stress for the Canadian life insurance industry.

The rapid move toward the international convergence of accounting regulations and technical standards has recently slowed as the standard setting bodies struggle to agree on certain key issues. The reasons include the inherent complexity of convergence, its impact on insurers and the need for further analysis in the uncertain economy. As a result, Canadian life insurers may continue to be at a disadvantage during a market downturn, when compared to their US counterparts. Present US GAAP (generally accepted accounting principles) does not reflect the current economic changes in net income.

Solvency and regulatory capital regime convergence are other high priority regulatory issues confronting the

market. As European insurers prepare to adopt a new, principles-based solvency and regulatory capital framework (Solvency II), questions surround the US. Regulatory uncertainty is expected to persist through 2012, given the present contentious reform efforts and the attempts by competing interests to converge systems.

The primary regulator of the life insurance industry in Canada is the Office of the Superintendent of Financial Institutions (OSFI). It has repeatedly indicated that the regulatory requirements in Canada are robust and well-developed to ensure protection of both insureds and insurers, and prevent unreasonable risk taking. However, many insurers perceive certain aspects of the framework as onerous, putting Canadian life insurers at a competitive disadvantage to their US counterparts. In recent years, OSFI has declared its intention to introduce revised regulatory requirements, with the current thinking that such a regime is principles based.

European insurers have been diligently working to implement Solvency II, which is slated to become effective in January 2014. Canadian life insurers are expected to experience many of the challenges confronting the US life insurance industry though perhaps not in the same time frame. Should Canada not have a regulatory system

that qualifies for Solvency II equivalence when that framework goes into effect, a variety of issues will arise for both Canadian subsidiaries of European insurers and Canadian insurers with business in Europe. For instance, insurers may need to restructure operations.

Additionally, merger and acquisition opportunities may arise if European insurers decide the capital requirements for Canadian operations are too high, assuming they have to hold the amounts as required by Solvency II. With regard to equivalency status for Canada, companies that could potentially be affected may want to prepare for either possibility.

OSFI and Canadian life insurers, especially those with interests in Europe and the US, are closely monitoring these developments. Canadian regulators also are considering changes to their declared plan to come up with an improved regulatory regime for Canada in the coming years.

While capital rules are in place for variable annuity products, perhaps in anticipation of its plan, OSFI has increased focus on such rules, particularly given the volatility in the markets and existing guarantees on in-force business. It has indicated that it will be examining these rules, noting



that the complexity of the issues (e.g., appropriate credit for hedging, etc.) could result in the process potentially taking years to complete.

On the accounting and financial reporting front, Canadian life insurers seem to have received a reprieve, at least for a while, as the International Financial Reporting Standards (IFRS) on insurance contract accounting have been delayed. IFRS standards setters are in the process now of reviewing concerns voiced by insurers and investors over the volatility and capital impact of the proposed new standard, which is now expected in late 2012 or 2013, with an effective application date in 2015. The new standard, coupled with the changes in the financial instruments accounting standard that is expected to be implemented at the same time, is sure to bring significant changes in the way insurers measure their liabilities and crystallize their earnings.

Canadian life insurers reported their first annual IFRS financial results at the end of 2011. Since IFRS allows Canadian life insurers to continue the same accounting for their insurance contracts, not much will change from historical Canadian GAAP, where market changes are reflected immediately through net income.

From a competitive standpoint, reporting under IFRS contrasts with requirements for US life insurers. IFRS requires that market volatility be reflected immediately in an insurer's results. US companies, on the other hand, use US GAAP, which generally disregards short-term volatility and leaves it unrecognized, with the expectation that insurers will make a profit over the long run. Understanding the effects of these differences, and ensuring they are well known and explained to markets, will help to level the playing field.

While various accounting and regulatory standards may converge in the long run, meaningful differences are likely to linger in 2012 and for some years after. Canadian life insurers thus may continue to be at a disadvantage with regard to US companies during deteriorating market conditions; nevertheless, they can rapidly seize an advantageous position once markets expand and interest rates increase.

### **Drive efficiency and risk management improvement through technology**

Analytical and predictive modeling techniques continue to improve, creating opportunities for increased sales, improved efficiency and expanded

capabilities for all life insurers. For instance, predictive modeling can improve underwriting speed and accuracy, a boon to life insurance underwriters that must undertake a broad array of time-consuming and expensive medical tests. Any hold-up between the filing of an application and its acceptance reduces the number of policies that can be issued.

While automated underwriting and straight-through processing can reduce this delay by eliminating many manual and duplicative processes, predictive modeling applies business rules and external information to further speed underwriting decisions. Moreover, the information provided on policyholder behavior can assist target marketing initiatives, pinpointing individuals most likely to buy a particular product.

Life insurers can take a page from other industries that have used analytical tools with great success. Banks in Canada, for instance, have long aimed their products at people who have recently purchased a home. By targeting their life insurance marketing to consumers who are likely to buy products at a particular time in their lives, and leveraging this information with social media and other Internet strategies, predictive modeling can effectively reach new customers such as young and middle-market consumers.

## Embrace the Internet

For certain industries, transacting on the Internet is a sure strategy. For instance, large retailers can capture additional sales online augmenting business at traditional brick and mortar stores, the latter aimed more at customers wanting personal interactions. Other traditional companies that have experienced robust online transaction volumes include television, radio and newspapers, while some enterprises such Amazon.com and others maintain pure online sales models and strategies.

By contrast, life insurance companies seem wedded to very traditional sales approaches – an agent solicits information about a family's financial needs, offers advice and product solutions, an application is written, the paperwork is sent to the insurance company and the policy is issued. By and large, the industry's Internet presence seems confined to financial calculators of insurance needs, sales lead-generating educational materials and product information and proprietary Internet applications that support the sales force through online insurance application forms and illustrations. This approach seems outdated in the current Information Age.

Perhaps life insurers are lagging in their embrace of the Internet because of the nature of the industry's products and services, not to mention the complexities and subjectivity of underwriting.

Despite these possible impediments, opportunities exist to reach out to a new generation of insurance buyers, who are young, well-versed in the Internet and at ease transacting in this environment. Such self-sufficient consumers spend a significant portion of their time transacting online.

While life insurance in its current form may not lend itself to Internet sales, insurers should evaluate ways to make better use of the Internet, building a better brand and developing stronger connections with consumers. It soon will be possible for consumers to submit applications online to several insurers, receive competitive quotes in return and, armed with information from the insurers' websites, determine which insurer is the best fit from a product and price standpoint. Insurers that create incentives for consumers to transact online, much like airlines presently do, may lead to lower premium options compared to purchasing insurance solely through an agent.

Building on an Internet sales presence is social media. Most companies can now be followed on LinkedIn, Facebook and Twitter, each playing an ever-increasing role in personal and business decisions. These new types of media will proliferate, presenting future opportunities for sales of life insurance.





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