2014 EY US property-casualty insurance outlook

Market summary
Changing external forces and stronger international operating fundamentals will characterize the 2014 property-casualty insurance market environment in the United States. These evolving forces include the economic environment, interest rate conditions, the industry’s capital position and its effect on competition, and the pace of technological change. Other pressures include the increasing empowerment and marketplace expectations of the consumer, the stricter regulatory environment and the increasing frequency and volatility of catastrophes. These forces are expected to have an even greater impact in 2014 on the performance opportunities for US property-casualty insurance companies and on their strategic decisions.

In contrast, these forces have not had as great an impact in 2013. The economy and interest rate trends appear stable, if not improving; catastrophe experience has been moderate, at a time when pricing for reinsurance protection is improving; and capital levels continue to increase on pace with premiums. Nevertheless, these issues remain volatile and their impact should not be underestimated in 2014.
External forces in 2014

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Stronger internal operating fundamentals

Stronger internal operating fundamentals are supporting a sustainable recovery in the US property-casualty industry. Evidence of this improvement is reflected in the stock valuations for publicly traded US property-casualty companies, which have rebounded after several years of subpar performance. Since 2010, best-performing insurers have steadily improved their core financial performance.

The magnitude of these improvements had been obscured by the financial impact of periodic catastrophes and net loss reserve releases in recent years. Other factors were the slow recovery in the industry’s exposure growth and its investment performance in the still weak economy. While recent GDP growth remains well below historical trends, growth is expected to continue in 2014. Investment yields increased in mid-2013, albeit slightly, and overall investment income levels may improve further in late 2014 or early 2015.

To a large degree, the improvement in the industry’s core financial performance is driven by the re-emergence of pricing and underwriting discipline, surpassing loss cost growth and widening operating margins. This is particularly evident in workers’ compensation, where strong pricing and moderating loss performance are combining to turn operating results in the direction of underwriting profitability. Best-performing companies are taking steps beyond pricing and underwriting discipline, leveraging data and enhanced analytics to refine their market segmentation strategies across all lines. Such insurers have seized regional and sector growth opportunities domestically and globally. They are also leveraging technology to improve distribution and operating efficiencies and to achieve greater access to consumers and the commercial marketplace.
While recent GDP growth remains well below historical trends, expectations for 2014 indicate continuing economic growth.

Many successful insurers are in various stages of implementing a customer-centric business model, as opposed to a product-centric model. This new model compels a fundamental realignment and integration of internal technology to reach consumers and commercial customers. In this regard, high-performing companies are recruiting executive talent who have experience with advanced technologies. These insurers see closer alignment of technology with commercial objectives as a strategic imperative.

The improvement in external market conditions may provide the opportunity for insurers to widen their performance advantage, despite ongoing marketplace fragility and the need for continuing vigilance in facing economic, competitive and regulatory challenges. Strong capital ratios relative to premium and loss growth, which typically stimulate competition, may relax current pricing discipline, as may the growing importance of distribution aggregators, comparative raters and direct marketing to consumers. These developments tend to emphasize price comparisons rather than service and product distinctions.

Similarly, slower loss growth, a consequence of the sluggish economy, may increase loss cost inflation and cause adverse claims experience. Changes implemented in the health care arena, for example, may shift the control of pricing to government and large health care providers, resulting in medical cost inflation for the rest of the marketplace. The variability of regional weather-related losses and emerging coverage challenges likewise make it difficult to effectively manage and mitigate these exposures. The possibility of volatile investment performance and inflation further pressures effective balance sheet management. Lastly, heightened governance reporting at state, federal and international levels may stress the capacity of company management teams to provide the high volume of requested information.

To solidify recent gains and defend against new risks and challenges, US property-casualty companies must augment their focus on margin protection and operating effectiveness in 2014. Successful companies must:

- Double down on broad-based, transformative technology with high ROI impact
- Adopt a complete range of enterprise data excellence
- Invest in innovation of product development processes and delivery to meet rising demand for protection
- Exploit segment differences for targeted growth strategies
- Get out in front of emerging investment challenges
- Prepare for escalation of governance and accountability
1. Double down on broad-based, transformative technology with high ROI impact

In a continuing low interest rate environment, insurers need to increase internal investment in technology and operating capabilities. A rare opportunity exists to broadly transform technology, replacing core engines with fully integrated, cost-effective cloud-based systems for distribution, underwriting, product development and claims. Making such investments, companies can drive down frictional operating costs, increase access to data and information across organizational silos, and enhance speed to market to improve profitability in the increasingly price-competitive environment.

An important catalyst for these investments is the imperative to replace the traditional product-centric model with a customer-centric model. Straight-through processing can strengthen the value proposition with agents, and mobile technology can reach and service markets that increasingly demand convenience and a flexible interface. The latter can be leveraged across all steps in the value chain, such as direct channels and agent-powered distribution, as well as claims.

A recent EY survey of global insurance executives, *Insurance in a digital world: the time is now*, highlights both progress and continuing challenges. Insurers acknowledge a low level of digital sophistication and a dire need to take action, with 57% of respondents expressing their intentions to develop a business case for transforming their organizational structure to support digital strategies, and 78% anticipating this development within the next three years. While the respondents have high expectations for change, they noted both legacy technology and cultural constraints, with 79% acknowledging spending less than 10% of their business and IT development budgets on digital initiatives. Nevertheless, 40% indicated they have senior management support to transform their technology, as well as a digital sponsor within the C-suite.

Assisting the argument for transformation is the need to enrich the customer experience, the growing importance of intermediaries and agents as digital customers, and the communications and customer experiences brought about by mobile devices and social media, which have fundamentally changed consumer expectations. Coupling processes and technology with advanced analytics will guide meaningful improvements.
2. **Adopt a complete range of enterprise data excellence**

In 2013, many insurers began the transformation of data and information systems. Aware that legacy data may contain errors or be otherwise unreliable and of little strategic use, these companies invested in “enterprise data excellence,” a process often under the governance of a chief data officer that encompasses five levels of data management and implementation:

1. **Enterprise intelligence establishes common standards and policies under a common architecture.** Integrated systems are aligned with business priorities, linking source data through operations to final reporting needs to simplify, optimize and improve the existing infrastructure and meet the demands of ever-changing requirements. Companies rethink how data is captured, stored and used by the business and executive leadership, turning data into a strategic business asset.

2. **Enhanced analytics includes technology applications that monitor systems and provide analytics support with minimal intervention or frictional cost.** Companies define data enrichment strategies involving both internal and external data. Analytics turns this data into information for decision-making purposes, such as a faster response to emerging claims issues.

3. **Predictive analytics to optimize risk and capital analysis.** Such tools should be integrated across the value chain, from distribution, underwriting and business processes to claims and investment applications.

4. **Data governance to define and optimize data ownership and controls under a chief data officer.** This role has transformed from an internal servicing function to a strategic resource providing actionable reporting. A robust data governance framework supports clear data ownership, standards and policies. Effective processes and procedures are established for the capture, movement, usage, storage and disposal of information.

5. **Data security to protect against an exponential rise in cyber attacks, both from within and outside the country.** In 2013, many US insurance companies were hit by cyber attacks, whereby hackers stole names, Social Security numbers and other identifying information. In 2013, computer security experts discovered the existence of a highly sophisticated group of hackers for hire, operating in conjunction with foreign operations. Government action in the wake of these events was inevitable. In February 2013, President Barack Obama signed an executive order addressing information sharing, privacy, and adoption of cybersecurity practices. Subsequently, the Obama Administration reached out to the insurance industry about its cybersecurity.

While many companies have established some level of competence in these areas, the approach is fragmented and incomplete. Companies that improve data management at all five levels of enterprise data excellence will outperform competitors in 2014 and beyond.
In 2013, many insurers began the transformation of data and information systems.

3. Invest in innovation of product development processes and delivery to meet rising demand for protection

Highly disruptive technologies are changing products, services and customer interactions across the economy. Consequently, new risks and insurance needs are emerging for consumers and the commercial marketplace. In many cases, these risks have a legislative or legal foundation for defining risk and coverage needs, thereby increasing awareness and focusing demand. To improve their ability to design and develop new products quickly and efficiently, as well as improve speed to market, many companies are leveraging technology and enhanced customer-centric processes.

Risks requiring broader, cost-effective insurance industry solutions include:

- **Cyber insurance.** The rapid increase in hacking incidents and data privacy liabilities has surpassed the ability of most commercial enterprises to keep pace. Insurers can provide increased coverage and loss mitigation services, applying data analytics and other technologies to assist insureds.

- **Catastrophe insurance.** The increasing uncertainty and volatility of catastrophes has heightened the demand for broader risk protection. The potential emergence of a private flood market augmenting the national flood insurance apparatus is a case in point. The rising flood exposure has also spawned greater demand for contingent business interruption coverage, particularly for supply chain exposures. Insurers also need to prepare for private terrorism coverage exposures, given a potentially limited federal backstop.

- **Workers’ compensation.** The changing health care market, particularly new services in partnership with employers for accelerated rehabilitation and cost-effective traumatic injury medical services, is demanding more effective insurance solutions.
- **Nanotechnology.** The emerging applications of nanotechnology in the manufacture or use of medicine, cosmetics, drug delivery, robotics, materials science and other products and systems create potential liability exposures. Examples include bodily injury (analogous to asbestos exposure) and environmental damage from nanoparticles escaping uncontrolled into the air or water supply. The lack of any meaningful history with this technology, as well as with the materials involved, indicate the potential risks cannot easily be assessed.

- **Sensor technology.** The use of sensors in telematics and in consumer and industrial products can create increasingly integrated exposure information for insurers, while enhancing the ability to provide more cost-effective and targeted risk protection for customers.

Emerging technologies and products have led insurance and reinsurance organizations to establish centers of science to explore new approaches to risk measurement and mitigation. Companies are increasingly seeking executive talent that can drive and lead such new thinking and new approaches.

Customer perceptions of new or changing risks will guide coverage enhancements, possibly opening the market to new entrants that understand these risks. To effectively compete in this environment, companies will need to rationalize their current and often complex portfolios of products, employing technology to simplify the delivery and processing of their product offerings, in addition to improving their response times.
4. Exploit segment differences for targeted growth strategies

In 2014, companies exploiting pockets of opportunity (global, geographic, product and demographic) will achieve superior opportunities for growth and bottom-line performance. Nevertheless, the economic recovery and the competitive environment remain fragile in the United States. Economic differences exist at both state and regional levels, increasing volatility in cost drivers and affecting the competitive dynamics in market segments:

- Specialty markets (particularly excess and surplus lines markets) are experiencing an upsurge, with premiums shifting from standard markets. Pricing has firmed across the spectrum, and the competitive marketplace is being transformed with new entrants and products. These markets require a specialized understanding of risk. Success requires adequate pricing discipline, as well as sufficient experience and analytical capabilities.

- Workers’ compensation performance is broadly turning the corner toward improved growth and cost containment. Loss frequency for lost-time cases is trending downward, medical costs appear relatively contained and premium growth is accelerating. Trends vary significantly by state and industry type and are affected by different regulatory interventions and economic drivers. For example, California’s premium growth rates are more than double the national average, yet loss frequency appears to be on the rise, in contrast to rest of the country.

- Companies need to exploit regional differences in economic growth and underwriting prospects. Strong economic performance in the middle of the country surpasses the performance on either coast. Economic fundamentals are expected to improve in the West and Southeast in 2014, led by California and Florida. Population and employment drivers, industry-specific economic trends, changing competition, and a volatile regulatory and political environment also produce disparate opportunities and risks.
Alternative capital structures are reshaping both the primary and reinsurance markets, presenting opportunities and challenges. Insurers and customers are increasingly using captives and alternative risk retention vehicles as long-term capital management solutions, rather than as opportunistic vehicles to escape price distortions. The expanded presence of third-party capital and the development of capital market alternatives in the reinsurance marketplace (led by the property catastrophe market) are restructuring the supply and demand relationships. The increase in capital has already pushed reinsurance rates lower, and it may put downward pressure on primary pricing for property coverage, as well. Although alternative capital has largely been confined to catastrophic property risks, additional products and applications for third-party capital are possible. These changes challenge fundamental assumptions of pricing and market dynamics, opening up new growth possibilities while constraining otherwise traditional market areas.

Merger and acquisition activity offers the opportunity to immediately increase market share in existing business segments and gain scale in attractive new markets. The recent recovery in equity values has the potential to increase capital for acquisitions and buyer confidence. Companies seeking to rapidly exploit emerging segment opportunities are eyeing established teams and specialty-oriented vehicles to gain speed to market. That said, M&A presents diverse risks requiring specialized due diligence and analytics.

Exploiting segment opportunities to achieve growth requires advanced analytics and real-time information on competitors and segment dynamics. A granular view of regional and demographic factors, as well as a systematic focus on known and emerging competitor activities, is needed. Capturing, analyzing and integrating internal and external information generated across a company’s operating areas is invaluable in accurately assessing new business opportunities while protecting the existing customer base.
A greater emphasis on risk and capital management exists in the industry, driven by unanticipated losses on both the asset and liability sides of the balance sheet.

5. Get out in front of emerging investment challenges

The challenging investment environment is expected to persist in 2014. In 2013, core investment income performance deteriorated, with yields at record lows. Across the industry, 85% of investments are in fixed income instruments. The tax-equivalent book yield on all invested assets for the US property-casualty sector fell by 70 basis points (or 14%) from 2008 through 2012. A decline of another 20 basis points in 2013 is anticipated. Nevertheless, the recent 100-basis-point upswing in yields that began in May 2013 may indicate more favorable investment income trends ahead. Still, embedded portfolio yields will continue to fall as maturing investments roll over at the still-low rates, and the potential for higher interest rates invites additional challenges.

Companies have sought refuge by altering traditional investment allocations. Across the industry, positions in common stock, lower-rated bonds and alternative investing vehicles are increasing, while the allocation to traditional higher-rated bonds is declining. The industry seeks to diversify investment exposure and moderately increase yields by incrementally expanding its positions in equities and lower correlated alternative investment classes, such as commodities and hedge funds. Nevertheless, these efforts are constrained by accounting treatment, capital charges and the need to develop more robust risk analyses of different asset classes.

A greater emphasis on risk and capital management exists in the industry, driven by unanticipated losses on both the asset and liability sides of the balance sheet. To support decisions and respond to increased scrutiny from regulators and rating agencies, many insurers have embraced economic capital modeling and economic scenario modeling in their enterprise risk management frameworks.

To test their resilience to a sudden rise in interest rates, given the prolonged period of low rates, boards of directors, risk committees and chief risk officers should engage further in such structured exercises as stress tests, scenario planning and counterparty exposure reviews.

Changes in policy and leadership at the Federal Reserve in 2014 add another level of complexity. Expectations of economic recovery, the tapering of the accommodative monetary policy and reduced market interventions have alternated with expressions of caution and continued easing. This uncertainty is fueling volatility in a range of markets, such as global emerging market debt and domestic municipal bonds.

Economic capital modeling and enterprise risk management tools are essential to survival in this uncertain environment. Economic modeling on a global basis is a necessary component of both investment and liability management as global economies become increasingly interdependent.
6. Prepare for escalation of governance and accountability

Regulatory pressures like solvency-focused initiatives, accounting changes and new federal oversight groups continue to intensify for insurers. Greater regulatory intervention, not less, is the trend. Insurers are tasked with committing resources to their Own Risk and Solvency Assessment (ORSA), the NAIC’s model law on governance, and to the accounting changes for insurance contracts that are necessary to align GAAP with international accounting standards. Moves by federal oversight bodies to introduce their own market-specific requirements are likely to create additional challenges. The burdens caused by regulatory change affect how companies organize data, choose technologies and implement processes.

Insurers have long faced a complex regulatory environment, but changes in recent years add layers of complexity. While regulatory initiatives are diverse in scope, common themes include the need for a clearer picture of enterprise risk, greater transparency of operational effectiveness and a focus on enhanced governance and accountability. Timing to implement these regulatory changes remains uncertain, and the real push to improve governance structures may come from within the insurance organization.

There is a developing need for detailed record-keeping and reporting capabilities relating to the specific characteristics of individual securities and securities transactions. This includes a thorough examination of funds and unit-linked securities, as well as measurement of concentration risk. While structured securities relating to credit default obligations and subprime mortgages were in focus during the 2008-09 financial crisis, new securities risks are emerging, such as synthetic investment portfolios, repurchase agreements and securitized insurance risks. These investment activities may invite substantial regulations as part of the development of rules governing systemically important financial institutions (SIFIs).

Insurers are expected to implement their ORSA frameworks in 2014 and their related reporting the following year. Solvency-focused regulations raise important questions about which internal processes need to be changed in risk governance and risk management. Insurers confront an immediate need to focus on data quality and data governance to meet the demands for more risk-sensitive measures and reporting.

Insurers must dedicate scarce financial and actuarial resources to other efforts, such as the converging guidelines for insurance contracts under US GAAP and IFRS. Implementation of the proposed FASB/IASB insurance contracts standard is the most significant change in the insurance industry in the past two decades. Under the new models, insurance contracts
must ensure that incurred claim liabilities are discounted to reflect the time value of money. Re-projecting future cash flows at each reporting date requires detailed, accurate data and modeling, at a time when actuarial resources and systems may be strained.

The Federal Insurance Office (FIO) and the Financial Stability Oversight Council (FSOC) are also expected to pressure insurer resources. The FIO, established by the Dodd-Frank Wall Street Reform and Consumer Protection Act, has an objective of monitoring all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or in the US financial system.

Dodd-Frank is also responsible for the creation of the FSOC, charged with identifying risks to US financial stability presented by large, interconnected financial institutions. The FSOC issued its final rules on the designation of SIFIs in the spring of 2012 and designated three non-bank institutions (AIG, Prudential Financial and GE Capital) in June 2013. Insurers receiving the designation will be subject to both state-based regulation and federal regulation (by the Federal Reserve Board).

The complexity of cross-border supervision and regulation is a major challenge for multinational insurers. Broader designation of global systemically important financial institutions (G-SIFIs) or global systemically important insurers (G-SIIs) may result in a common standard for capital measurement and a common framework for capital regulation. The Basel, Switzerland-based Financial Stability Board, using IAIS assessment methodology, identified an initial list of nine G-SIIs, which includes three US companies – AIG, Prudential Financial and MetLife.

Certainly, as this report indicates, the trend is toward improved governance and risk management systems. For insurers, risk is the essential element of the business, and a clear understanding of it should be a business imperative.

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