

2012 outlook

Global Insurance Center

US property-casualty insurance outlook

Flexible strategies in a fluctuating economy

Market summary

Ongoing uncertainty over volatile economic conditions continues to impact buyers of insurance products and services, with less than favorable implications for the US property-casualty insurance industry. Global and US economies have fluctuated between slight growth and quick recession, with economic fragility increasing in the last half of 2011. This low premium growth environment is expected to persist through 2012, adversely affecting insurer profitability and potentially resulting in the fifth year in a row of negative performance. Overall, loss reserves and premium rate adequacies are trending downward, average investment yields are in decline and volatile capital markets challenge effective risk and capital management. At the same time, the scale and efficiency of insurer operating structures are eroding the ability of many companies to respond to emerging opportunities.

As the US property-casualty industry confronts these macroeconomic conditions, it is also challenged by regulation and an uncertain governance and compliance agenda. Demanding global and US risk management requirements have not yet been implemented due to their respective review and comment periods. Nonetheless, it is anticipated that they will require US insurers to measure and articulate risk using new analytical systems that involve substantial revisions to current risk and capital management strategies.

In this environment, insurers should consider strategic approaches that are flexible – capable of responding to economic pressures as they emerge, intensify or weaken. Industry winners will depend on investments in core systems, information resources and skillful management processes. By better understanding changing insurance buying behavior and demographics and increasing their reliance on business analytics, insurers can achieve a sustainable competitive advantage.

Ernst & Young believes that five broad needs are emerging to command management's attention:

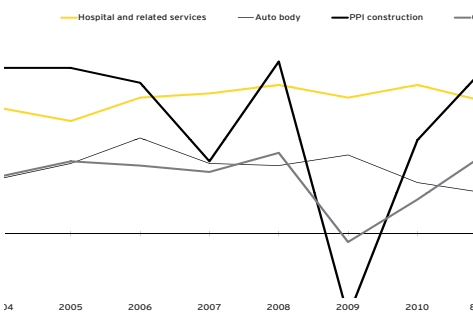
- ▶ Execute flexible approaches to manage uncertain economic conditions
- ▶ Anticipate, understand and address the impact of prospective regulations
- ▶ Comprehend and act upon changing insurance buying behaviors
- ▶ Increase investments in core systems to bolster growth and profitability
- ▶ Apply business analytics to address difficult top-line growth conditions

Execute flexible approaches to manage uncertain economic conditions

Forecasts for growth in real gross domestic product in 2012 have been inconsistent. The timing and level of economic recovery creates premium and loss exposures, in addition to shifting investment income. For instance, investment yields on Treasuries have fallen dramatically since mid-2011 and are projected to remain low into 2013. Other possible inflection points in 2012 include tort and loss-cost trends. Loss frequency for liability lines is eroding, while inflation in loss severity is increasing (see graph below).

Selected loss drivers

(Year-over-year change in index)



Source: Bureau of Labor Statistics, Consumer Price Index and Producer Price Index

Natural catastrophe losses between 2008 through 2011 are driving revisions in catastrophe risk analysis and modeling. An expected increase in inland losses from tropical storms raises contingent business interruption exposures, requiring reconsideration of catastrophe management and pricing. Terrorism risk may also have an impact, even without terrorism losses, given federal budget cuts and the emergence of homegrown terrorists. The growing cyber insurance market adds another layer of catastrophe risk volatility, in terms of loss accumulation from an especially virulent and contagious computer virus.

Despite price firming in specific commercial lines and markets in the second half of 2011, the property-casualty underwriting cycle remains volatile. Underwriting profitability has not deteriorated to the lows of previous cycles, and substantial unused underwriting

capacity remains in the industry. Although some premium and loss drivers hint at a pending cycle turn, it is likely to be in particular segments and markets, rather than industry-wide. The most recent soft underwriting cycle exhibited gradually deteriorating margins over several years, and insurers are likely to experience a similar gradual ascent to increased margins as markets harden.

Insurers that employ flexible strategic responses to this potential cyclical shift, in terms of capital and resources, are best positioned to maximize the market conditions. To realize superior returns in either a soft or mixed cycle requires a close focus on market segments and competitive interaction. Diligent monitoring of changes in loss exposures and loss development drivers will guide flexible adjustments to risk management and risk pricing.

To execute fluid strategies in an environment of multiple uncertainties, an insurer's operational capabilities, infrastructure and corporate culture must support flexible, rapid and well-governed decision-making, thereby assuring agile performance with accountability.

Anticipate, understand and address the impact of prospective regulations

The extent of federal regulatory oversight of insurance in the US remains uncertain, despite passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act nearly two years ago. The legislation required the establishment of the Federal Insurance Office (FIO), which is responsible for determining and managing systemic risk. It is not clear at this juncture how the FIO will handle these responsibilities. For instance, will it develop into a federal supervisor of insurance, and if so, will this then meet the "equivalency" requirements under Solvency II? If the US does not achieve equivalency when Solvency II goes into effect, it may trigger new capital requirements, hinder the ability to operate in the Euro zone and result in trade retaliations.

State insurance commissioners and legislators continue to explore revisions to insurer solvency requirements. The National Association of Insurance Commissioners' Solvency Modernization Initiative Task Force proposes to develop all major insurance regulatory policy decisions by the end of 2012. This revised framework will include a consideration of international insurance supervision, and the development of accounting standards. While indications are that risk-based capital measurements will continue to provide a floor for required capital, formulas will be updated to reflect the emerging consensus on risk-based measures, such as principles-based reserving.

More substantial revisions to capital assessments may include requirements for the boards of directors and/or senior management of insurance companies to conduct an annual Own Risk and Solvency Assessment (ORSA), and report these results to the relevant state regulator. Under the ORSA proposal, insurers would document an assessment of their prospective solvency using both qualitative elements of risk management policy and quantitative measures of risk exposures.

Final standards for insurance reporting revisions from the Financial Accounting Standards Board and International Accounting Standards Board are expected in 2012, with conversion to occur either in 2014 or 2015. Serious financial reporting and business consequences would follow. For instance, a proposed contract standard includes recognizing a probability-weighted estimate of cash flows through to the fulfillment of the contract. A discount rate updated annually also would be required for all contracts, unless the discounting is immaterial. At a minimum, these changes will necessitate significant systems' updates. Given substantial increases in reported earnings volatility, insurers' integrated risk and capital management strategies also may need revision.

These profound regulatory and accounting changes are likely to develop over the next three years, and may continue to evolve beyond their implementation. They require insurers to assess their impact prior to implementation, and be well prepared for when the changes occur. In this regard, companies should consider

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enhancing the sophistication, articulation and deployment of their risk management standards and related systems support, as compared to their current regulatory and reporting environments.

For insurers that are technically proficient at risk management, and have made significant investments in this area, a more sophisticated environment could lower their relative cost of capital, and improve their competitive standing. For insurers that fail to appreciate the impact of the regulations, a potentially higher cost of capital may derail their competitive strength.

Comprehend and act upon changing insurance buying behaviors

Marketing success is built on a clear understanding of the customer. In terms of tomorrow's customers, their characteristics, buying behaviors and risk profiles will likely bear little resemblance to those today. Consequently, identifying, assessing and capitalizing on the characteristics of tomorrow's customers present the ability to tailor products, services and distribution channels to their specialized needs.

Insurance company marketing is altering from the days when contact with the customer was infrequent, and dedicated to outbound messaging. With the rise of social media applications and mobile technologies, it is possible now for insurance companies to be in relatively constant contact with the customer base, with much of this contact initiated by the client.

Baby boomers will likely need to work longer than previous generations. And, it is expected that they will be driving with greater frequency than today's seniors, and will demand a communication method that suits them.

The young will need another form of communication because they are more adept at using new information and communication technologies. Their employment is more transitory, and their income streams are more turbulent. The young also share different views to some extent over the ownership of property, which partly explains why home ownership has declined dramatically in the past decade. Some of this is driven by high unemployment

and depleted assets, but it is also a reflection of changing attitudes: for many younger people, the bursting of the housing bubble and the personal financial turmoil it caused has altered the cost/benefit equation of home ownership. A similar attitudinal shift is apparent in automobile ownership, evidenced by the growing popularity of the Zipcar among younger drivers.

Census results released in 2011 confirm a more diverse ethnic mix across the country. The Asian-American and Hispanic populations are rapidly growing, each with characteristics of value to insurance marketing departments. Armed with insights on their customers' changing demographic profiles, savvy insurers are dedicating substantial resources to creatively approach these segments with tailored messaging. Many insurers are recognizing the need to overcome language and cultural barriers to tailor the value proposition to this evolving customer base, which will yield competitive advantage.

Insurers should consider a multi-channel strategy that suits customer expectations, providing clear product information to new buyers and a simplified renewal process for returning customers. Although online will be the dominant channel for personal lines insurance buyers, insurers need to integrate both online and offline channels to address evolving customer needs over the product life cycle, taking into account the mix of customer types, age and their differing information, and risk needs.

Increase investments in core systems to bolster growth and profitability

Pressures are mounting to transform core insurance systems such as claims, policy administration, underwriting and billing. The push for improvement comes from competitors, heightened customer expectations and, above all, increasing costs to maintain and upgrade systems.

New competitors are on the scene today, carving out attractive market niches without the burdens of an expensive legacy system. The age of many insurers' systems creates an urgent need for change, given fewer capital and other resources available to maintain these

older systems. Moreover, incoming claims and systems professionals are looking for opportunities to employ their skills, not learn antiquated technologies and languages to service a system with a short shelf life. Finally, as customers expect the instant service they have received from other industries, they are holding insurers to a higher standard.

Many insurers are encumbered by multiple legacy systems, due in large part to numerous acquisitions executed over the years. In addition, some insurers have kept older data in their legacy systems because of data migration costs. This poses an array of problems for claims units, such as:

- ▶ Siloed data limits, both sharing across business units and realization of potential scale economies.
- ▶ Workarounds to legacy system issues have created disjointed processes. Companies have created workarounds in Excel and Access – with the business users acting as the integration point.
- ▶ Legacy systems tend to be poorly documented, and often lack vendor support.
- ▶ Companies hoping to develop or extend their analytic capabilities need years of policy and claims data to do so, requiring conversion of data from legacy systems.

The persistence of these problems, combined with the growing importance of the claim operation to the success of the business, indicates a continuing need in the marketplace for improvement in this area.

Faced with limited investment alternatives yielding an attractive return, insurers are investing in themselves to position their operations for growth and improved profitability. The claims system is becoming a focal point for this transformation. Claims payments and loss adjustment expenses account for 70% to 75% of premium dollars at the average property-casualty insurance company. Consequently, these subjects deserve a fair share of management attention, and should be a primary focus of innovation and investment. Service expectations are particularly high for claims, because – for many customers – it is the only meaningful user experience with the insurance product.

Underwriting and policy administration systems are additional focal points for investment. The weakened investment environment sharpens the focus on underwriting profitability. Technology can be leveraged to improve underwriting productivity, and enforce underwriting discipline and guidelines.

Policy administration, on the other hand, is one of the more challenging areas of an insurer's operations to transform. The difficulty compels many insurers to put off replacing the system and patch the old one instead, which fosters negative repercussions for customer service and employee satisfaction.

Billing systems tend to suffer from the same legacy system limitations as claims and policy administration systems. Transformation of the billing system can improve the customer experience and the insurer's cash flow. Customers have come to expect online, up-to-date access to account information, as well as flexible payment options.

Apply business analytics to address difficult top-line growth conditions

In this uncertain economic environment, insurers that apply business analytics across the value chain can develop deeper information on customer markets, underwriting segment profitability and claims management. These insights can then guide both strategy development and execution.

The use of predictive and descriptive analytics turns raw historical and transactional data into vital information for decision-making purposes. Unique relationships between customers and products across the value chain can be discerned, and a rich fact-based environment can be attained. More refined business analytic tools are now available to insurers. At the same time, processing power has increased, and there are more external data sources to feed into the models, promising much deeper analysis for decision-making purposes. While many large insurance organizations routinely leverage analytic tools, Ernst & Young believes that upgrading these capabilities will yield competitive advantage.

Strategic customer retention and policy renewal are critical in the current economic climate, in part because account retention expenses are typically less than account acquisition expenses. In this regard, insurers can apply analytics to identify customers that are likely to shop their

policies, and those offering more long-term profit opportunity. Information in hand, insurers can then develop proactive customer retention strategies.

Other opportunities across the value chain include the use of predictive analytics by an insurer's claims department to settle similar claims according to proven best practices, thereby guiding more accurate reserves, reducing leakage and assuring fair and appropriate claim settlements. Claims analytics can provide decision-makers across the enterprise with real-time visibility into a claim, as well as the overall performance of the claims operation. Evolving applications combine both internal and external data to achieve straight-through claims processing and fast tracking, in addition to information on claims triage, routing, fraud and severity.

Social networks also should be explored to obtain deeper customer insight for marketing purposes. Social media not only can push out an insurer's message, it provides the means to "listen" to the market in real time.

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