Market summary

Current economic and marketplace trends in the US suggest a continuation of modest gross national product (GDP) growth and a low rate of inflation in 2015. Despite this generally positive macroeconomic environment, increasing risk and economic uncertainty continue to prevail. Consequently, the US property-casualty market is confronted by contradictory signals of opportunity and challenge. For example, corporate revenue growth is strong and job growth is increasingly improving, but job wage growth has lagged. Similarly, core US inflation has remained within the Federal Reserve’s targeted range, but food and energy prices are volatile and medical inflation continues. Volatility in global economic conditions further complicates the macroeconomic environment. The anticipated interest rate recovery has stalled, and volatility in the financial markets may accelerate.
On the surface, the property-casualty industry appears well on its way to a second year in a row of strong performance. Combined ratios and return on equity (ROE) have reached levels not seen since before the financial crisis (see figure 1). This strong performance has helped strengthen balance sheets, increasing both surplus and invested assets. However, as of year-end 2014, ROEs were beginning to fall from a combination of capital accumulation, competitive pricing, weak investment returns and rising loss expense.

In this environment, pricing is constrained by capital accumulating faster than insurance exposures. The benign catastrophe results over the last two years have pressured reinsurance rates, which have correspondingly depressed pricing in primary lines. Additional pressures are anticipated if alternative capital providers, such as hedge funds, further their expansion into the casualty insurance business using predictive analytics. Several years of profitable property catastrophe reinsurance risk assumption have bolstered the alternative providers in their expansion plans.

As margin pressures mount in the industry, this increases the emphasis on expense management through technology upgrades and better integration of business units. To reduce costs, property-casualty insurers that grew over the past decade via acquisitions will need to increasingly focus on the post-merger integration of their physical plant, people, processes and data resources. Weak investment returns are another factor in companies’ declining profitability, since maturing investments are being reinvested at lower yields. This factor is compelling carriers to assume more credit and liquidity risk in their investment portfolios. To manage these strains on profitability, insurers need to continue to invest in technology solutions across the entire enterprise that respond more effectively to ongoing competitive pressures, increased risk and uncertainty.

Market leading performance in the property-casualty sector is being driven by investments in technology, distribution and risk management systems. As mission-critical information becomes more accessible, this is driving more assured data-driven business decisions in the C-suite. To segment and reach profitable customers, insurers also are using new technologies to develop and manage multiple distribution and communication channels. Nevertheless, new competitors leveraging more available and cost-effective solutions in analytics, communication and infrastructure may pressure the market’s technology leaders in 2015. In response, leading companies are migrating from stand-alone technology projects to an environment of continuous technological improvement.

The likelihood of increasing burdens and jurisdictional competition will continue to characterize the regulatory milieu in 2015. Regulatory bodies have proliferated at the international, federal and state levels. All will likely increase their demands for information, reporting and compliance,
External forces in 2015

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<th>Regulations</th>
<th>Catastrophes</th>
<th>Capital adequacy</th>
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<td>Pace of change accelerating</td>
<td>Increasing customer needs</td>
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with regard to accounting, solvency, fair practices, transparency, governance and marketplace equity. In the US, jurisdictional competition is evidenced by the potential overlapping oversight of the National Association of Insurance Commissioners (NAIC), state insurance regulators and the new Federal Insurance Office (FIO). Navigating possible conflicting rules and regulations may increase both human resource and financial capital costs.

These various factors indicate that 2015 may present a more challenging market environment for property-casualty insurers. Companies that proactively manage these evolving events will differentiate themselves from those that respond reactively. In this regard, insurers need to invest in new markets, products and approaches to existing customers. To grow the top line will require organizational realignment, a commitment to innovation and the implementation of advanced data analytics. The recruitment and retention of superior management talent is a key challenge, given that the role of underwriters, claims and service personnel is evolving. With organic growth uncertain, management must explore acquisition opportunities, particularly more targeted strategic expansion as opposed to large-scale consolidation. The ability to successfully plan and operate in this fast-changing environment is crucial, as the variable growth US economy will pressure insurance company management to assume greater risk, while determining which of these risks is economically sound.

To remain industry leaders, successful property-casualty insurance companies will need to react to these macro and industry challenges in 2015 in the following ways:

1. Respond to increasing competition with strategic cost management and laser-focused pricing
2. Engineer an enterprise data excellence strategy
3. Improve customer connectivity by expanding distribution and customer service
4. Retool operations for new and evolving risks
5. Proactively address multiple regulatory requirements and potential tax considerations
6. Address investment performance and capital management

Respond to increasing competition with strategic cost management and focused pricing

In 2015, insurers are entering an uncertain operating environment marked by slower premium growth and increasing competition. Personal lines exposures remain below historical levels (see figure 2), further pressuring top-line growth. Maintaining good profit margins requires insurers to focus on cost, efficiency and more refined segmentation and pricing.
For the past three years, insurers have been able to maintain stable expense ratios due in large part to premium growth. However, if rates ease in 2015, premium growth may not be able to keep up with expense growth.

The continued expansion of aggregator and direct-to-consumer business models is enhancing insurance product cost transparency, while the need to operate multiple distribution and communication channels is increasing carrier expenses. Additionally, many insurers are just beginning to rationalize previously acquired operations and legacy systems. To improve efficiencies and be more competitive, insurers must attend to redundant operations, processes and data resources. Cost reduction is no longer just an operational issue; it is now a competitive necessity. More forward-thinking companies will aggressively tackle their costs.

Technology solutions are critical to achieving strategic cost management and customized pricing and segmentation goals. Sustainable competitive advantages flow from precise, segmentation and optimized customer pricing using internal and third party data. Micro-segmentation of customer risk attributes is equally important. Leading insurers also are improving their profitability through integrated cloud computing solutions that cost less than on-premise technology. They are further trimming expenses by implementing straight-through processing to reduce duplicate data entry across functions.

Several approaches are available to insurers to improve cost effectiveness, such as selective offshoring, shared service centers, process optimization and third-party spending controls. Some insurers also have established onshore captive service centers in lower-cost geographies with educated workforces to replace their existing, higher-cost infrastructure.

In the effort to reduce expenses, insurers must not limit their ability to build new capabilities in today’s competitive environment. Strategically, they must weigh prospective expense reductions against their respective goals and competitive differentiators. In turn, this should guide better decisions to reduce costs and improve business performance. Identifying the most effective long-term cost reduction opportunities is important in these deliberations.

Engineer an enterprise data excellence strategy

Property-casualty insurers in 2015 must embrace an enterprise data excellence strategy that addresses all aspects of
Improve customer connectivity by expanding distribution and customer service

Reaching the insurance customer in a variety of formats is increasingly becoming a competitive necessity, given the expansion of channel choices available to consumers from other industries today. Adding channels and offering alternative modes of communication improves client access, enhancing competition for the most profitable customers. To address competitive distribution challenges, insurers first need to expand their methods and modes of customer interaction.

Competitive pressures have created the need for insurers to evaluate the effectiveness of their traditional customer connection points. In personal lines, some companies have strategically developed a suite of capabilities that meets the full spectrum of customer distribution and service needs. Other carriers are adding their operating model. Data collection and analysis are necessary decision-making tools, particularly as more insurers compete on their respective levels of data superiority and/or develop new business models enabled by these capabilities.

For example, customer acquisition and retention will improve through sharpened data acquisition and predictive modeling. Led by chief data officers, enhanced data analytics is sure to improve competitive positioning, as well as attract management at all levels capable of adopting the expanding uses of data analytics.

Improved data acquisition and predictive modeling capabilities will provide a more detailed understanding of customer risk profiles, generating more customized insurance coverage, better pricing and cross-sell opportunities suited to each buyer’s needs. Customer loss analyses will speed claims adjudication processes, further improving customer retention and brand loyalty. The micro-segmentation of a customer’s risk profile also presents the opportunity for an integrated customer solution, rather than the more discrete responses offered by less technologically astute competitors.

To effectively segment customer prospects for acquisition purposes requires leveraging both third-party data and internal data. Armed with this information and using sophisticated data analytics, insurers can predict which customer segments are most likely to respond favorably to specific insurance product solicitations. They are also able to better understand the different distribution channels best equipped to provide the solicitations, which can be tailored to consumers based on whether they are price-sensitive or more interested in customer services or security.

Insurers face the prospect of competition from non-traditional sources with sophisticated data analytics capabilities. For example, technology firms have become more comfortable with risk identification and selection because of the wide availability of significant third-party data sources. A case in point is mobile apps that allow ride-sharing businesses to provide commercial automobile insurance coverage to drivers for the period in which they are transporting passengers, instead of continuous coverage. Technology also has enabled some entities to provide small business coverage electronically without any agent or even carrier involvement. An industry that had been relatively protected may well be a target for disintermediation.

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new channels, driven by their similar assumptions regarding the market’s direction.

At the same time, customer expectations are rising with regard to price transparency, real-time customer service and support and instant delivery (see figure 3). These expectations also are influenced by customer interactions with retailers, where they seamlessly progress from information gathering to shopping, purchase and service. In this environment, insurers must improve the customer experience by providing additional distribution outlets and customer contact points.

To further sharpen their competitive edge, successful insurers will optimize the channel mix and provide channel partners with data analytics tools. Agents and brokers will find it easier to collaborate with an insurer that leverages data analytics. This will enable them to identify potential high-value lifetime clients and guide them to these prospects. Improved data and implementation technology also provides deeper insights into customer preferences, identifying the most profitable customers. Products and pricing can then be customized and/or bundled to address individual customer needs.

Effective integration of technology solutions will enhance an insurer’s ability to track financial performance, customer satisfaction and the operational efficiencies of multiple distribution channels. New customer contact channels continue to emerge, including car dealerships, mobile phones, kiosks and social media. Integrating these channels to provide a seamless customer experience across an insurer’s sales and service activities is the next competitive differentiator.

Retool operations for new and evolving risks

As insurers pursue top-line revenue growth in new products, the effective identification, analysis and mitigation of new and emerging risks is increasingly important. Throughout the global economy, new business models are replacing traditional services while altering customary risk patterns. In this new sharing economy, services provided by individuals inexperienced in risk mitigation...
and delivery issues are on the upswing. Consequently, the risk characteristics for these services will be different from the risks inherent in more traditional models, insofar as frequency and severity.

To address these challenges, insurers need to re-engineer their traditional business processes. Overhauling outdated underwriting processes will be critical, as new product time-to-market accelerates in response to shortened product life cycles. More modular and granular product development will assist management in responding to real-time customer feedback and fast-changing customer preferences.

Insurance coverage in the future will need to address new ways of activating and terminating the risk transfer, given the marketing of insurance products in short, distinct time frames in today’s sharing economy. As consumer demand increases for shared services, insurers that best capture unique risk profiles to offer more customized products will be in a prime position to seize these new market opportunities.

Other new risks offer additional opportunities for growth. A case in point is the networked connectivity of machinery and appliances, known as the “internet of things.” While this provides greater risk transparency, it also introduces increasing data collection challenges. Networked products, such as appliances that transmit failure reports, will help insurers to more precisely predict future appliance breakdowns. As massive amounts of information are gathered, evaluated and stored, insurer underwriting, claims and distribution processes will struggle to maintain pace.

Cyber-crime coverage is another area of opportunity, given the recent spate of highly publicized attacks at large and smaller companies. Networked products are sure to increase the risk of criminal intrusions, which will correspondingly fuel demand for cyber coverage. Bundling insurance products such as warranty coverage and cyber insurance could facilitate new cross-sell opportunities.

Figure 4: Worldwide “internet of things”

<table>
<thead>
<tr>
<th>Year</th>
<th>Billions of units</th>
</tr>
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<tbody>
<tr>
<td>2014</td>
<td>11.4</td>
</tr>
<tr>
<td>2015</td>
<td>13.7</td>
</tr>
<tr>
<td>2016</td>
<td>16.3</td>
</tr>
<tr>
<td>2017</td>
<td>19.2</td>
</tr>
<tr>
<td>2018</td>
<td>22.2</td>
</tr>
<tr>
<td>2019</td>
<td>25.2</td>
</tr>
<tr>
<td>2020</td>
<td>28.1</td>
</tr>
</tbody>
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*Excludes stand-alone sensors, smartphones, tablets, PCs and wearable devices.

Proactively address multiple regulatory requirements and potential tax considerations

The growing volume and complexity of insurance regulations, in addition to the various overseers of these rules such as the NAIC and FIO, compel insurers to invest in more flexible technology, data analytics and skilled management. While more stringent regulations may impede growth, increase expenses and divert valuable human resources, the impact will be less for insurers that select appropriate technology and data solutions to address their broader risk management and reporting demands.
Insurers need to expand their management pools with management talent that is well-versed in regulatory and reporting matters. Demands from multiple and potentially conflicting jurisdictions require solutions with enterprise-wide application. Investing in the efficient use of data to satisfy current and future regulatory demands will be more cost-effective if accompanied by judicious staff additions to respond to increasing regulatory information requests.

In 2015, insurers with more than $500 million in direct premium ($1 billion for insurance groups) are required to comply with the NAIC’s requirement to submit annual reports of their Own Risk and Solvency Assessment (ORSA). The scope and detail of the data to be provided vary according to the nature and the complexity of the insurer. Nevertheless, insurers must provide the quantitative methods they used to assess risks and the impact of these risks on their balance sheets. They must also submit a description of the company’s processes for model validation. Although ORSA requirements are an annual process, they may be iterative – should an insurance commissioner request additional detail, the insurer must be in a position to provide robust data, as well as a detailed understanding of risks, their interrelationship and how these risks can be mitigated. In addition, ORSA is likely to evolve to entail additional reporting challenges.

Insurers also need to be ready to respond to increased data requests from the FIO, which has indicated interest in developing standards for personal lines insurance, specifically governing pricing and rate regulation practices. The FIO’s potential involvement in consumer protection initiatives, such as the affordability of personal lines insurance in underserved communities, would increase data demands in the future. At present, it is unclear if the information requests from new regulators will conform to standard statutory information or accounting conventions, increasing their potential impact on insurers.

Finally, insurers should monitor the proposed tax law changes currently in discussion in Congress, such as the Camp proposal. In the proposal’s current draft are changes to how property-casualty insurer loss reserves would be treated for tax purposes.
Address investment performance and capital management

After a brief initial rise in interest rates in mid-2013, rates have since retreated. The concerns over a rapidly rising interest rate environment appear to have given way to anxiety over continued low rates. Although the property-casualty industry’s investment income is improving modestly, this is primarily due to new cash flows and invested asset growth, as reinvestment yields continue to languish. While the industry’s embedded yield appears to have bottomed out in 2014, it is not expected to rise appreciably in 2015.

As a result, insurers continue to seek enhanced yield and investment income through changes in credit quality, liquidity and maturity. However, the prolonged investment market challenges leave insurers with few ways to achieve these aims. One of the more significant shifts in bond allocations has been the migration toward lower-rated NAIC-2 category assets (BBB rated credits). Insurers also have taken on more liquidity risk by investing a greater portion of their bond portfolios into private placement securities. While these actions have enhanced overall yields at the margin, they have not mitigated insurers’ credit exposures and concentration risks.

Given an abundance of capital, most insurers are re-evaluating their investment allocations to enhance performance and improve diversification. Among the asset classes that insurers are considering are common stocks, loan products, master limited partnerships and hedge funds. While these alternatives can improve an insurer’s investment risk profile and provide added diversification, they require greater sophistication in risk modeling and monitoring, in addition to both internal and external reporting.

In today’s increasingly demanding regulatory environment, these new investment allocations need to be modeled and better understood. To do this, insurers increasingly need global enterprise risk management capabilities, improved risk analyses and technology solutions that measure investment risk across multiple asset classes and economic scenarios.

To optimize capital deployment, insurers will continue to pursue capital management strategies such as share repurchases, extraordinary dividends and even merger and acquisition transactions. Management will rely on both internal and external capital models to balance their return objectives with regulatory, solvency and rating agency capital margin requirements. Expectations are for global political and economic volatility and uncertainty to continue to influence the capital markets in 2015, requiring insurers to take a more proactive approach toward managing their investment and capital management strategies.

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