Executive summary

Mexico's insurance industry continues to show strong growth driven by the country's economic stability in the past decade. In this context, an incessant increase in the penetration of financial services has led to a strong desire by local and foreign companies to significantly augment their market share.

This report highlights the economic conditions and trends in Mexico, the regulatory impact of Solvency II and the opportunities for growth for insurers through the embracement of digital opportunities, the effective use of data analytics and the creation of new customer experiences.

The future of the sector looks promising.
Mexican economic update

A rising manufacturing sector and efforts by the central government to privatize the energy industry, attract foreign investment and deregulate other sectors of the Mexican economy boosted the nation’s economic trajectory during the first half of this decade. In 2017, despite concerns that the Trump administration might impose tough trade sanctions or ramp up tensions on the Mexico-US border, employment growth and consumption have proved more resilient than we might have anticipated, and exports to the US continue to rise.

Oxford Economics forecasts that consumer spending will rise about 1.5% this year, compared with 2.8% in 2016. Overall, growth is forecast to rise 1.9% in 2017, compared with 2.1% in the gross domestic product (GDP) last year, constrained somewhat by rising inflation.

Among the challenges facing the Mexican domestic economy are:

- Consumer prices are rising, sparked in part by the sharp spike in fuel prices as the government has moved to deregulate the energy sector, and by a weaker peso, which effectively raises prices for imported goods. As the government moves to gradually deregulate prices across the country, the potential for higher inflation looms.

- Concerns about runaway inflation, in turn, have caused the Central Bank to raise interest rates. On 22 June, Banco de México’s governing board unanimously decided to increase the benchmark rate by 25 basis points to 7%, the highest level since March 2009. Annual inflation is running at its fastest pace in nearly eight years—well above the bank’s 3% target—as consumer prices rose 6.31% in the year through June.

- The volatile exchange rate creates additional uncertainty. The protectionist rhetoric coming from the Trump administration at first drove the peso lower, but the currency has rebounded since the inauguration, as President Trump has turned away from his promise to “rip up” the North American Free Trade Agreement (NAFTA).

- Cuts in government spending tend to dampen growth. Private investment in 2016 helped offset some federal government cuts, but private investment could decline this year, leading to a slight rise in unemployment. Tighter credit conditions will likely cause total investment to remain flat in 2017.

Despite these concerns, Mexican consumption and employment have held up quite well in the first half of 2017, which should continue to boost Mexican manufacturers. Manufacturing accounts for about 90% of Mexico’s merchandise exports, and much of it goes to the US. Moreover, the prospect for additional credit downgrades has diminished, as this year’s fiscal deficit will be much lower than expected, and the peso has recovered from earlier dips.

The US is Mexico’s single most important trading partner, accounting for 80% of exports and almost 50% of imports, which makes the country highly vulnerable to both the US economic cycle and changes in economic policy. Mexico’s current account deficit has widened in the last few years because of low oil prices, declining oil production and sluggish demand for manufacturing goods from the US.

However, demographic trends are also favorable. While Mexico’s population growth has slowed gradually over the past decade, it is still climbing at more than 1% per year—still a robust figure by developing-market standards.

In 2013, President Enrique Peña Nieto and his Institutional Revolutionary Party (PRI) signed a multiparty agreement (the Pact for Mexico) and ratified an ambitious constitutional reform agenda. This included overhauling the energy, communications, education and finance sectors; deregulating the labor market; and committing to responsible fiscal policy.

The reforms were expected to lift potential growth significantly. However, results have been disappointing so far, as the country faces external headwinds from low global growth and a stalling US manufacturing sector. The PRI administration also has looked to enact anti-corruption and police legislation and has set a liberal agenda on social issues such as legalizing medical marijuana and amending the constitution to permit same-sex marriage. Nevertheless, the June 2016 elections damaged the PRI’s prospects, as it lost 7 of the 12 contested governorships, while the center-right National Action Party (PAN) made large gains. Next year’s presidential elections are likely to be very competitive.
Overview of the Mexican insurance market

Potential for the Mexican insurance market is huge. The population is close to 130 million, yet the insurance penetration rate is only 2.3%1 – below 4.2% in Chile (the best in the region), 3.0% in Brazil, 2.5% in Argentina and Colombia, and 2.3% in Costa Rica. To maximize its full potential, the industry must resolve a number of key challenges:

- Advocating for a regulatory environment that provides mandatory civil liability coverage for automobile and services companies and mandatory home earthquake and flooding coverage
- Establishing obligatory insurance for vulnerable segments of the population that engage in high-risk activities (mineral extraction, the foundry industry, etc.)
- Fostering Mexico’s insurance culture with initiatives that include early age prevention and mandatory financial education
- Building trust and confidence in Mexico’s insurance market by offering flexible products that are well-adapted to the needs of customers and unbiased advice on coverage, terms, conditions and exclusions of insurance products

In Mexico the market with the highest potential is health insurance. Mexico’s health care spend is 5.8% of GDP, compared with a 9% average among member countries of the Organisation for Economic Co-operation and Development (OECD).2 Only 7% of Mexico’s population has health coverage, with 2.8% holding private health care.3 This contrasts with the 20.5 million Mexicans who currently lack access to health care.4 Finding a sustainable solution to this challenge will require a joint effort between the federal government and the private sector. Together, they will need to develop service arrangements between insurers and public health care agencies to broaden the portfolio of health services available to the public and reduce medical negligence rates.

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Digital transformation and its impact on distribution channels

Today, individual agents and brokers make up Mexico’s most significant distribution channel, generating more than 60% of insurance premiums. Over the past decade, however, these channels have shifted in three key areas:

1. Bancassurance has observed continued double-digit growth, and new companies are emerging. This has been driven by banking sector penetration where products are tied to loans and more brick-and-mortar banking outlets have been established.

2. The use of telemarketing and sponsors has created direct channels. A number of companies are distributing relatively straightforward products or products that cover specific sponsor needs. Although this channel has been successful for certain companies, it is not perceived as fundamental in revenue generation.

3. Digital solutions are being developed (primarily to distribute auto policies using simulators, purchase platforms and flexible products) to attract customers who prefer technological interactions. As an emerging distribution channel, digital is growing at a slower pace than in developed countries or those where agent channels are less prominent.

We foresee digital transformation and solutions playing a larger role in the country’s insurance market over the next 10 to 15 years. The average age of agents in Mexico is above 50, and younger generations are less interested in becoming insurance agents. Our estimate is that by 2027, most potential insurance customers will be digital natives, with insurance companies that have deep roots in the traditional channel (agents and brokers) in a position to develop digital capabilities or complement them through JV’s or buy-outs of InsurTech firms, to stay competitive and respond to customers’ needs.
Designing differentiators in customer experience is one of the biggest challenges that Mexican insurance companies face today. There is ongoing debate as to whether customers are defined as agents or policyholders. This uncertainty makes it difficult to prioritize and implement initiatives, since there are pros and cons to both perspectives.

In addition, the industry needs to continue building public trust in response to apparent skepticism about the value of buying insurance coverage and negative perceptions about industry service levels. In fact, price is seen as the determining factor when selecting an insurance policy and, for many, is significantly more important than service quality.

Enhancing the customer experience

Insurers seeking to provide meaningful customer experiences to their sales force and policyholders have sought to improve their processes by understanding the customer journey; designing streamlined processes; using data analytics; enhancing service and guarantees; and developing digital interactive tools, loyalty plans, and useful information such as prevention tips and health advice.
Insurance companies continue to face the challenge of adopting a comprehensive view of their customers. They are evolving from simply managing policies and lines of business to developing a “customer business map” that leverages their understanding of customers at different stages of their lives, the generational differences that define them (baby boomers, millennials, etc.), and how customers transition from an individual-based to a family-based approach that considers the needs of family members.

This shift in approach will allow insurance companies to compete directly with the bancassurance sector and establish direct marketing contacts with their customers while providing significant direct assistance to agents and their associated distribution networks. These changes will require insurers to compile customer-level information from traditional insurance operating platforms and to develop customer and insurance marketing intelligence based on this information.

In Mexico, approximately 65.5 million people have access to the internet and 81 million use cell phones. Three-quarters (76%) of cell phone users have a smartphone and 89% – or 55 million people – have internet access on their phones. This technological penetration presents a huge opportunity for local and global insurers to use digital applications to distinguish their value propositions and bring added value at critical times for customers. It also fosters an insurance culture through new designs and approaches that enable better communication and greater appreciation of insurance coverage and benefits.

To reach this digital market, companies are launching mobile apps that provide insurance quotes, policy purchases, incident reports and geolocation maps of product offerings, and even track the arrival time of claims adjusters. It is becoming more critical for insurance companies to develop analytical capabilities and design tailored customer experiences to achieve maximum relevance. Frequent use of digital solutions will maximize value for customers, agents and the insurance ecosystem in general.

Mexico is also accessing low-cost technologies and human talent to leverage big data, which is leading to exciting opportunities to reduce operating risks, minimize costs and improve efficiency. Customer authentication through mobile devices and centralized certification centers is helping reduce fraud, among other benefits. To achieve success, insurance companies must adopt a data governance approach that allows them not only to meet their regulatory requirements, but also to provide a high level of quality and consistency in the data analytics.

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5 INEGI, “Statistics Given the International Internet Day,” May 2017 - 65.5 million people from six years of age onward have access to the internet.
On 4 April 2015, the Mexican Insurance Law, which includes a Solvency II-like regulatory regime, became mandatory for all insurance companies that do business in Mexico. Mexico's new insurance regulatory framework includes a three-pillar risk management approach: Pillar 1 is a new technical reserve and capital requirement regime, Pillar 2 covers governance guidelines and Pillar 3 outlines new disclosure requirements.

After conducting a series of five quantitative impact studies, most insurance companies have been able to obtain their solvency capital requirement (SCR), leading to more stable results. During 2015 and 2016 several changes to the model and regulations existed. Insurers should have implemented more mature models and systems to assist them in calculating their technical provisions.

For Pillar 2, Mexican insurance companies are currently building their governance system, and most now have policies and manuals in place. Nevertheless, in the coming months, insurance companies will need to demonstrate that they have implemented these requirements. The first formal full ORSA report was due to the regulator by July 2017, but the required stress testing activities continue to be difficult because the SCR projection is hindered by the technical restrictions of today's standard model software. Moreover, insurance companies are working on compliance with their internal control requirements as they develop internal audit work plans that include different levels of specializations including risk management, actuarial activities and anti-money laundering.

For Pillar 3, Mexico's insurance regulator requires insurance companies to file nine regulatory reports. So far, insurers have invested significant resources in improving the quality of their information, data governance and reporting automation systems.

Mexican insurance rules also require statutory accounting principles for insurance companies. These present two key challenges: managing the principle of annualized life insurance premiums and managing early revenue recognition under the technical reserves regime, since the regulator believes that insurance companies should adopt the principle of preparing economic balance sheets.

It is important to mention the SCR results obtained in 2016. In some cases, these reflected past errors in risk management – particularly relating to asset or liability matching and reinsurance structures. In other cases, insurance companies have not performed a risk analysis profile because the new capital requirement is either similar to or less than that under the old regulatory regime. Insurers need to improve the efficiency of their information extraction, capital requirement and technical reserve reporting processes.

Finally, companies also need to strengthen their underwriting risk evaluation and monitoring and asset or liability matching activities to enjoy the benefits of these regulations and improve the overall efficiency of their capital requirement and risk management processes. Moreover, insurance companies should consider linking risk and business strategies to enhance processes for setting premium limits and tolerance levels and to perform effective stress tests.
IFRS 17 implications for European insurers

On 18 May 2017, the International Accounting Standard Board (IASB) issued the new insurance accounting standard, IFRS 17 Insurance Contracts. This standard will impact European insurers in Mexico, as it represents the most significant change to European accounting in 20 years, requiring insurers to entirely overhaul their financial statements. Given the scale of this change, investors and other stakeholders will want to understand the likely impact as early as possible.

The Standard uses three measurement approaches:
1. General model or building block approach (BBA) – for most long-term contracts
2. Premium allocation approach (PAA) – for most short-term contracts (optional)
3. Variable fee approach (VFA) – for contracts with direct participation features

The principles underlying these measurement approaches result in a fundamental change to current practice, particularly for long-duration contracts.

Given that IFRS 17 will result in a profound change to the accounting in IFRS financial statements of insurance companies, it will have a significant impact on data, systems and processes used to produce financial reporting as well as on the staff implementing it.

We anticipate that to effectively tackle these changes companies will be required to:

- Perform gaps analysis comparing existing (and post Solvency II) system, process, people and data functionality with that required after the introduction of the new IFRS standards.
- Produce impact assessment studies to plan implementation steps, identify the effort required to achieve compliance and understand and explain the financial impact.
- (Re)design data, models, systems and processes to enable smarter reporting and achieve synergies and efficiencies through standardization, integration and transformation.
- Develop group-wide accounting policies and guidelines to support business and financial management.
- Support IFRS program implementation with cost-effective and timely project management.
- Provide customized training for IFRS changes to fill competency gaps.

The effective date of the standard is 1 January 2021; however, the complexity of IFRS 17 is such that achieving compliance will require an early start to the transformation of the accounting standards and systems as well as redefining actuarial processes.
Conclusion

The Mexican insurance market presents a significant opportunity for growth – well above rates seen in developed countries. However, the potential to bring the market into a position of leadership in the Latin America region has yet to be achieved. We believe that the sector must continue to focus on developing an agenda related to the introduction of mandatory insurance rules intended to provide coverage to high-risk populations and events, such as vehicle civil liability insurance and home hurricane coverage.

The industry also needs to implement long-term initiatives to integrate financial education (including insurance) into the curricula of schools at all academic levels – from elementary school to post-graduate programs – and have teachers play a role in promoting financial education.

An important challenge for the sector is to adopt a customer-based approach to communicate directly with all customers. Most companies currently invest in their largest-traditional distribution channels. However, we see that those that focus on winning customers based on the principle of “in the right place at the right time” and that shift from consumer preferences to self-service models – which have been growing exponentially in the past two years – will be the best positioned to lead the market in the future.

The main driver behind this is a cultural shift to meet customers’ needs by providing effective solutions at all levels in the organization. Transforming the business, changes in customer behaviors, significant regulatory changes and the need to strengthen risk management and controls are key forces shaping the Mexican insurance industry. Insurers need to design viable plans and build effective teams to be the best at tackling these challenges.

EY is well-versed on these significant challenges and has built a solid insurance service that includes multidisciplinary industry professionals who collaborate and provide end-to-end approaches for insurance companies.

How insurers can compete in today’s Mexican insurance market:
- Identify the behavior of customers: know their preferences, where to find them and the value that the insurance company can provide.
- Focus on designing comprehensive solutions and memorable customer experiences while expanding their vision on product design.
- Interact with customers: understand their expectations, while refraining from involving them in the company’s processes, products or sales activities.
- Embrace change and innovation. The Mexican insurance market is perceived as being overly cautious and conservative. In many markets, the current top insurers are those that innovate successfully and believe that their most important asset is creating and introducing new ideas.
- Be efficient and relevant to the customer. Meet customers’ needs, and offer a “distinctive experience” that can be described as the best in terms of cost or benefit for the customer and the insurance company.

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