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Executive summary

The repercussions of the global economic recession continue to reverberate across much of the world, creating significant impediments to the growth and prosperity of global life and non-life insurers.

Several consistent challenges remain in place for global insurance organizations in 2012. These include the protracted low-interest-rate environment, intensifying regulatory risk and capital pressures, eroding top lines and a dire need to streamline costs. At the same time, insurance-buying preferences are altering in many regions, a profound transformation driven in large part by the internet.

The general outlook for the global insurance industry is mixed, a consequence of persistently challenging economic, market and regulatory circumstances. Other than Asia Pacific, where continued growth is expected in 2012, the rest of the world is mired in economic instability. Europe, in particular, is saddled with ongoing political and macroeconomic uncertainty, affecting investors, consumers and insurer balance sheets. In the US and Canada, as well, low interest rates are pressuring investment yields, listless economic conditions are grinding down loss reserves and premium-rate adequacies, and expanding (though still inexact) regulations governing insurer risk and capital management practices are stymieing a quick strategic response to the malaise.

Nevertheless, in this climate of uncertainty, insurers can achieve meaningful results. The keys to success seem to be flexibility and innovation. Ernst & Young believes those insurers that make greater use of predictive modeling and other advanced analytics, prepare and plan in advance of anticipated regulatory changes, and resolutely reshape their products, services and distribution channels to conform to evolving customer preferences and needs will emerge stronger and more profitable in 2012.

Our global insurance outlook explores these and many other issues confronting global insurance organizations in 2012. In this report, we offer our perspective on the insurance markets in Asia Pacific, the Canada life and property/casualty insurance sectors, Europe, and the US life and property/casualty sectors.

The key challenges and opportunities by region are:
Asia Pacific

- Market concentration in mature markets is compelling growth in new and emerging markets.
- Rising wealth levels and changing population demographics are driving demand for life, retirement and non-life products.
- Insurers offering takaful and microinsurance products may develop untapped markets.
- Growth in online customers offers new distribution opportunities.
- Regulators continue to mull changes more in line with more sophisticated international standards, posing risk management, disclosure and other challenges.

Europe

- A sluggish economy and intensifying regulatory pressures are compelling new considerations about structure, business mix and business development.
- The need to produce more detailed information quickly is impeded by legacy systems and processes.
- Increased frequency in known severity risks requires more enhanced portfolio analyses and use of ERM techniques to identify risk correlations.
- Consumers want more control over the insurance purchasing decision, requiring products that are easier to understand and simpler to access.
- Distribution strategies must adapt to the growing use of the internet to remain competitive.

Canada life

- The prolonged low-interest-rate environment is increasing the risk of spread compression, requiring greater understanding of asset and liability cash flows under different scenarios.
- Given continued economic volatility, the need to streamline cost structures remains a priority, as does the modernization of legacy systems and processes.
- Preparing for the impact of diverse regulatory and accounting changes is necessary to maintain or enhance competitive standing.
- Greater use of predictive modeling techniques will help drive sales, as will investments in online sales platforms.

US life

- The continuing low-interest-rate environment is hampering sales and increasing risk of spread compression.
- Preparing for new regulations is vitally important, even though the landscape remains uncertain at this time.
- Improvements in analytical and predictive modeling techniques are required to increase sales and boost efficiency.
- Investments in internet sales methods will help reach prospective buyers who spend a significant portion of time transacting online.

Canada property/casualty

- Sustained low interest rates may further reduce company book yields, putting pressure on earnings and premium rates.
- Unstable investment markets and rising exposures require greater use of advanced analytics to bolster business intelligence and improve efficiencies.
- Upgrading aging legacy claims, policy administration, billing and other systems is a necessity to improve customer experience and cash flow.
- Despite uncertain regulatory regimes, insurers should not back off improvements to internal capital and risk management practices.
- The evolving demographic profile and needs of customers require multiple means of interaction, both online and offline.

US property/casualty

- The volatile economy and underwriting cycle insist on flexible strategic approaches and greater focus on market segments.
- The extent of federal oversight remains unclear, as do regulations governing solvency, capital and reporting, requiring ongoing assessment and preparation.
- Investments in core systems, information resources and skillful management processes will bolster growth and profitability.
- Insurers need to tailor products, services and distribution to changing buyer needs and behaviors.
- Greater use of business analytics will yield vital information guiding strategy, product development, marketing and claims management.
As challenges and uncertainties confront insurers in Asia Pacific, Ernst & Young believes that these five emerging issues will command management’s focus in 2012:

1. Meet diverse consumer needs for new insurance products
2. Develop and enhance distribution to meet consumer demand
3. Manage the human resource challenge
4. Address regulatory challenges
5. Invest in risk management and loss control
Market summary

Asia Pacific comprises many countries at various stages of economic development. A common factor across the region is the expectation of continued economic growth in 2012, in contrast to the European Union and the United States. More mature markets such as Japan will likely experience slower growth. However, concerns remain in many other Asian economies about the impact that global economic weakness, increasing domestic consumption, infrastructure investment and trade within Asia will have on supporting continued growth. Additionally, low levels of debt and large foreign reserves provide some buffer against further downside risks. There are also positive aspects from the sluggish economic conditions of Western economies, including falling commodity prices and potentially lower inflationary pressures in some countries. However, inflation remains a concern unless global economic activity falls sharply.

An expectation of continued economic growth in Asia Pacific, along with the increasing number of elderly and a growing middle class, creates significant opportunities for life insurers in the region to serve the financial needs of a wealthier, older customer base. At the same time, natural and man-made disasters have altered perceptions of risk, thereby enhancing the potential for non-life insurance products. Not surprisingly, life and non-life insurers in 2012 are expected to continue to enjoy strong premium growth, as they have over the past few years. This potential for growth presents both management challenges and risks for insurers, such as intensified competition from companies serving mature markets seeking expansion in less-developed markets. Furthermore, regulators in these markets are abetting these efforts by lowering some market-entry barriers.

Meet diverse consumer needs for new insurance products

Opportunities for growth

Market concentration in Australia, Japan and Korea is compelling several life and non-life insurers to seek growth in new and emerging markets. For instance, although there were 51 licensed non-life companies in Japan in late 2010, approximately 84% of non-life premiums in the previous fiscal year were controlled by three insurance groups, as a result of mergers. Similarly, in Australia, six general insurers control approximately 85% of the market. Obviously, this can act as a barrier for new or existing companies, either domestic or foreign, seeking market access to customers.

Emerging Asia Pacific countries, where growth rates are high, are preferred investment destinations for many insurers, for example:

- Sompo Japan acquiring Berjaya Sompo in Malaysia
- Mitsui Sumitomo acquiring PT Asuransi Jiwa Sinarmas in Indonesia
- IAG acquiring numerous targets in the region
- Zurich acquiring MAA in Malaysia
- Recently announced HSBC Insurance sale of its general insurance business in the region
- ING’s announcement regarding the sale of its Asia-Pacific insurance business

It is expected that these and other insurers in mature markets will continue to seek and evaluate expansion opportunities in higher-growth regions. Due diligence will continue to be a challenge. It will be necessary to move quickly, as some markets have a limited number of suitable local partners for the potential suitors.

Recent deals have experienced mixed success due to a combination of high entry prices, lack of scale and difficulty deploying global methodologies and toolkits. However, these potential drawbacks are not expected to dampen demand. Rather, they will guide an increased focus on operational aspects in coming years.

At the same time, Western insurers continue to establish operations in developing and emerging Asian markets. AXA, for instance, became the first foreign insurer to enter China’s variable annuity market. Liberty Mutual Group announced it was eyeing further expansion in the non-life markets of Thailand, Malaysia and Indonesia as part of its strategy for regional expansion.

Regulators in some emerging markets are encouraging this competition, for instance, in China, India and Vietnam, where regulatory barriers are perceived to be lowering for new market entrants. For existing insurers in these and other higher-growth areas, their market share is threatened by the expected increase in competition. Established, legacy companies may need to become more efficient to compete in the new and emerging landscape. New entrants, on the other hand, need to reach critical mass quickly and efficiently to compete over the long
Flexibility in uncertain times

Term. Some Western insurers pulled out of the market in China in part because they were unable to achieve strategic goals.

Demographic profiles create health and pension opportunities

As companies square off in Asia Pacific, opportunities abound. Changing population demographics and rising wealth levels in many countries are creating demand for conventional products like retirement and health insurance, in addition to non-life insurance. Insurers that recognize the opportunities presented by the region’s demographic and economic trends, and seize them with an array of products tailored to these trends, will achieve competitive advantage.

In 2011, for instance, the needs of the aging Japanese population guided insurers to introduce nursing care and private long-term insurance products. Opportunities for pension products are arising in Australia, which is further developing its pension system. This includes the introduction of a new, low-cost pension product to drive commoditization and improve affordability. A proposed increase in the mandatory contribution rate from 9% to 12% of earnings is expected to increase industry assets, and growing interest in post-retirement product reform, such as a compulsory form of annuity, may further fuel insurer interest.

While the financial promise of Asia Pacific pension markets is very attractive, their fragmentation requires careful consideration from a strategic-growth plan standpoint. Moreover, the market potential varies according to each country’s level of pension industry maturity:

• Among developing economies, China is broadening its pension system coverage to reach more of the population. Ambitious growth targets, and a strategic focus on social welfare issues documented in the Government’s recent five-year plan, will guide significant changes and opportunities.

• In emerging economies like Indonesia and Thailand, regulators are considering the implementation of more comprehensive pension systems. Although pension assets and market penetration may be low initially, double-digit growth rates are possible. Developing or enhancing existing distribution and delivery infrastructures may be crucial to achieve success in these regions.

Sources: Bank of Japan, Reserve Bank of Australia, New Zealand Treasury, Asian Development Bank, Swiss Re
The health care systems in Asia Pacific also vary in terms of quality, coverage and levels of maturity. Significant health care reform is underway in mainland China, Vietnam, Indonesia and Hong Kong, offering significant prospects for insurers that provide relevant products and services. The swelling affluent populations across Asia Pacific similarly present opportunities for wealth management products and services. Products designed for the wealthy and middle classes in Asia include insurance services similar to those provided by private banks. Regulators in China, for instance, are considering launching retirement savings accounts. Opportunities exist as well for non-life products, such as personal lines insurance.

Although these areas represent considerable opportunities, it will be necessary for insurers to complement their new product and pension offerings with sound product management, such as incisive pricing and cost-effective support systems.

The region’s cultural diversity and large population of consumers with more limited economic means opens the door to insurers offering takaful and microinsurance products to identify new and/or underserved market segments and strategies. The large Muslim populations of South and Southeast Asia, for instance, may present opportunities for takaful insurers.

Ernst & Young estimates that the global takaful market represented US$12 billion in premium in 2011, up from US$9.15 billion in 2010. Takaful has grown strongly in Southeast Asia, particularly in Malaysia (29%) and Indonesia (26%), even though these impressive growth rates are unadjusted for inflation, and new onshore licenses are rarely available in Malaysia.

Insurers continue to develop microinsurance strategies (sometimes also on a takaful basis) because of the opportunity for growth among Asia’s large rural and impoverished populations. In India, the number of new microinsurance policies sold rose from 13 million in 2008 to 20 million in 2010, with most sold by the state-owned Life Insurance Corporation, India’s largest life insurer. Elsewhere in the region, Allianz insures 440,000 customers in Indonesia with various microinsurance products, representing up to 25% of the company’s total number of insureds. Manulife has sold 100,000 policies in Vietnam. The absence of available supporting actuarial data, however, makes pricing microinsurance products a challenge for insurers entering this segment.

Develop and enhance distribution to meet consumer demand

The growing number of online consumers in Asia Pacific creates opportunities for insurers to develop new distribution channels. Proposed regulations that limit compensation or discourage some sales practices may hinder the development of agents and brokers, putting more emphasis on new channels. Additional opportunities can be gained by investing in improvements to traditional channels to complement internet distribution.

Develop mobile and online distribution channels to reach online consumers

Asia Pacific is a global leader in the use of mobile and internet technologies. According to Gartner, the estimated 62.8 million mobile payment users in Asia Pacific in 2010 represented approximately 58% of all global mobile payment users. In response to the growing number of mobile and online consumers in the region, insurers are developing a variety of mobile and online distribution channels. Since the internet increases transparency of product pricing, insurers may need to evaluate the impact of pricing decisions and adjust accordingly.

In developing and emerging markets, online distribution is growing. For example, India’s Aegon Religare sold 25,000 life insurance policies online in 2010, and other insurers have begun offering online distribution as well. Liberty Insurance (Vietnam) and BIDV Insurance launched online insurance services in the summer of 2011. Given these advances, insurers in all markets may need to develop or enhance their mobile and online distribution strategies in 2012.

As the use of smart phones and mobile applications spreads across the region, consumers will require assurances that their personal data is secure. The increased use of mobile and online insurance purchasing could overwhelm the ability of service providers and regulators to address consumer protection adequately. Moreover, increased “know your customer” requirements could complicate accepted approaches to customer acquisition in the mobile market. Consequently, insurers may want to increase capital and resource investments directed at assuring the security of consumer data in online transit.

Other marketing strategies also are proliferating. For instance, the number of Australian life insurance products sold through direct marketing increased from 109 in 2008 to 164 in 2011. Non-life insurance companies in Japan have begun working with cell phone companies to offer customers a new way to purchase insurance via mobile phones that have information.

2Ernst & Young’s World Takaful Report 2011, Transforming Operating Performance.
The availability of trained sales agents is also a hindrance to expansion and growth. As executives reach retirement age in Australia, Singapore and Japan, insurers are seeking to replace them, with mixed success. Across the region, the quality of distributors also is an issue, given increasing product complexity and the more demanding, sophisticated consumer base, as well as consequent increasing regulatory scrutiny.

Throughout much of Asia Pacific, insurers are contending with a supply of qualified insurance staff that is far below the demand. For instance, a study by the Southwestern University of Finance and Economics in Chengdu indicates that China will need approximately 58,000 new insurance management staff and 700 new actuaries by 2015. The shortage of qualified actuaries across the region is leading insurers to look for expertise in related fields, such as statistics and mathematics, to supply the quantitative, analytical skills supporting underwriting and rate-making functions. To the extent that companies develop their employees’ skills in-house, human resources and line management may need to invest in training to flatten the learning curve of new hires.

This imbalance between supply and demand for qualified insurance staff makes retention a high priority – a challenge for insurers that lack processes to identify high-performing employees and provide the appropriate incentives to elevate and maintain personnel motivation.

The broad mix of languages and cultures, combined with generational and individual personality differences, complicates the human resources challenges in Asia Pacific. Insurers operating in more than one country must be sensitive to varying employee motivations and aspirations. Insurers operating in the region should consider whether their variable salary and bonus schemes are appropriate incentives from a recruitment and retention standpoint.

Although fewer insurers seem to be deploying large-scale expatriate programs in the region, those that are need to be better attuned to the factors characterizing and affecting manager performance. Insurers will need to be highly resourceful and skilled to thrive in a fluid, relatively unstructured climate with rapidly changing rules.
Address regulatory challenges

Regulatory challenges are at the forefront of insurer concerns globally, from internal regulatory challenges within regions to those outside the region. Staying abreast of regulatory developments remains a complex, crucial task in 2012. Insurers that adjust their tactics in advance of impending rules or steer clear of punitive consequences gain a competitive advantage. All insurers must also understand the various regulations governing business practices prohibited in certain countries that are or may have been customarily permitted in their own regions. Regulatory frameworks within the region are at different stages of development, and are subject to rapid change.

Regulators in Asia Pacific are exploring the extent to which evolving international thinking on prudential requirements, as expressed in the standards of the International Association of Insurance Supervisors and exemplified in Europe’s Solvency II model, should drive change in their own standards. For instance, the Australian Prudential Regulatory Authority has engaged its insurance industry to consider new life and general insurance capital standards, to be effective 1 January 2013. In China, the CIRC is pushing for the adoption of ERM techniques, following the publication of its Guidelines on Implementation of Enterprise Risk Management for Life and Health Insurance Companies.

Thailand, Malaysia, Indonesia and India have taken steps to move their accounting closer to IFRS 4, a development that would increase transparency in their insurance accounting. The year 2013 is likely to see publication of a revised version of this standard, dealing with the measurement of liabilities, which will pose additional challenges.

Insurers face data issues stemming from adoption of more sophisticated regulatory requirements on solvency, risk management, governance, disclosure and IFRS standards. New reporting requirements, both internal and external, will require insurers to address data quality and reporting frequency issues to support the developing standards. Insurers must stay abreast not only of compliance needs, but also of the implications on their capital management from the forthcoming solvency and accounting regimes. Capital scarcity may be an
issue for some multinationals with finite resources to direct to their Asian operations.

More stringent anti-corruption laws also confront Asia Pacific insurers, especially multinational carriers that must exercise heightened diligence so as not to inadvertently violate extra-jurisdictional laws prohibiting bribery. The UK Bribery Act 2010 now exposes UK companies and their directors to liability for bribery committed anywhere by or for the company and for failure to have appropriate anti-bribery controls. This is a relevant consideration for multinational insurers operating in countries where it may have been considered customary to make facilitation payments to secure business. The new legislation applies even if no government officials are involved.

Another anti-financial crime law of note is the US Foreign Account Tax Compliance Act (FATCA), which becomes effective in 2013. Its purpose is to identify offshore tax avoidance in order to collect tax revenue, and it is aimed in part at banks and insurers operating outside the US.

Investing in risk management and loss control

Enhancements of regulations press insurers to improve their risk management frameworks and more stringently assess their own risk and solvency profiles. At the same time, risk management is more than ever a business imperative, as losses in 2011 demonstrate. The heightened frequency and severity of natural catastrophes, in addition to attritional losses in standard lines portfolios in Asia Pacific in 2011 and the continuing need for asset/liability management of life insurance products, require insurers to improve their risk management, loss control practices and pricing discipline.

Asia Pacific accounted for 80% of insured global natural catastrophes in 2011, an unprecedented proportion. Rising wealth and increasing urbanization in the region, combined with more frequent and severe weather catastrophes than other continents have experienced recently, point to higher loss potential in 2012 and beyond according to Munich Re’s NatCatSERVICE.

Moreover, competition in motor insurance in the developing markets of China and India has been stoked by increased ownership of automobiles, contributing to a deterioration of results in these portfolios. Even in the developed market of South Korea, the motor loss ratio failed to return to profitability in 2011, after the torrential rains of August and September inundated and damaged many thousands of cars.

Major natural catastrophes in Asia Pacific in 2011, including storms in Australia, earthquakes in New Zealand and Japan, and typhoons and flooding in Thailand, caused extreme insured losses in these regions, underscoring the importance of insurer risk management. Insurers should consider greater use of quantitative analytical tools that measure, model and manage natural disaster risks.

These events also may require insurers to re-evaluate their reinsurance partners. Some reinsurers, such as Toa Re, had limited their earthquake retentions and used retrocession to manage their capital exposure to the Great East Japan Earthquake. Others performed more poorly and have since reduced their exposure in the region, creating a capacity squeeze that could create opportunities for other players. Finally, higher prices and scarcer capacity for protection in peak risk zones are leading resourceful insurers and reinsurers to develop or take advantage of capital market alternatives to traditional reinsurance.

In China, the results from low-severity/high-frequency insurance lines, such as automobile, point to a need for prudent exposure-based pricing. The potential for China to allow foreign competitors into the compulsory automobile market requires motor insurers across the region to pursue leading-edge risk management and loss control processes in order to succeed.

Reinsurance capacity may not be as important a factor in managing risks in the developing and emerging markets. National reinsurers in Asia Pacific compete with international players to write the business originating within their domestic markets. There is a limit to how much domestic business local reinsurers can prudently underwrite. In response to higher claims, India’s state-owned General Insurance Corporation tightened underwriting conditions and reduced reinsurance capacity. Furthermore, a number of national reinsurers, including Korean Re, China Re and India’s GIC have recognized their concentration risks and are seeking global portfolio diversification and expansion. These efforts are expected to continue.

Conclusion

Local, regional and international insurers recognize that economic conditions and market penetration in Asia Pacific can contribute to their growth goals. However, reaching this potential requires overcoming obstacles and understanding the complexities. These include a rapidly changing regulatory framework, an increasingly volatile economic climate and the region’s inherent demographic and economic diversity. Insurers that overcome these barriers will be more knowledgeable and resourceful than their competitors.
Canada life

Uncertainty persists, but insurers can prosper

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
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 about 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 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) had 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 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 with their US counterparts. Present US generally accepted accounting principles (GAAP) 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 to prevent unreasonable risk-taking. However, many insurers perceive certain aspects of the framework as onerous, putting Canadian life insurers at a competitive disadvantage against their US counterparts. In recent years, OSFI has declared its intention to introduce revised regulatory requirements, with the current thinking that such a regime will be 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 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 and such) 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 now in the process of reviewing concerns voiced by insurers and investors over the volatility and capital impact of the proposed new standard, which is 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, in 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 over time, 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 as 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.
Given the economic, regulatory and uncertain growth prospects confronting the P&C market in Canada, Ernst & Young has identified five imperatives that are likely to command management’s focus in 2012:

1. Manage the company in the current low-interest-rate environment
2. Make better use of technology to increase business intelligence and improve efficiencies
3. Transform core insurance systems
4. Strengthen risk management infrastructure to respond to regulatory challenges
5. Adapt to the evolving risk profiles and needs of the customer
Market summary

The outlook for the property/casualty (P&C) insurance industry in Canada is mixed, given the persistence of challenging economic and market conditions. Concerns include volatile capital markets, the low-interest-rate environment and its impact on industry book yield and expanding regulations governing insurer risk and capital management practices.

Optimism is emerging; however, improvements in industry profitability may appear in the next two to three years. For instance, industry consolidation is expected to increase in 2012, as insurers awash in excess capital and capacity look to buy other insurers to achieve strategic growth plans. This, in turn, should keep the market value of insurers at current market prices or possibly even higher.

Additionally, actions are being taken in some provinces to reduce the cost of P&C insurance. Ontario’s Ministry of Finance, for example, announced in 2011 the establishment of a task force to determine the scope and nature of automobile insurance fraud and provide recommendations regarding ways to reduce it. Given the current loss picture, Ontario regulators also approved a 1.4% automobile insurance rate increase in the fourth quarter of 2011.

Nevertheless, in the current, protracted climate of global economic uncertainty, insurers cannot rely solely on well-developed and executed strategies to attain profitability. To achieve meaningful results, insurers will need to pursue innovation, leverage their superior information resources and manage their processes more closely to achieve a sustainable advantage. In this regard, greater use of advanced analytics and other technologies across the value chain presents opportunities to reach more customers more conveniently with lower-priced products they need and value.

Separating the victors from the also-rans in 2012 will be how well insurers respond to changes in buyer behavior, invest in and leverage new technologies and prepare for revisions in regulatory and risk evaluation methodologies.

Manage the company in the current low-interest-rate environment

After many discussions of a possible interest rate increase, the Bank of Canada in September 2011 made the decision to leave the interest rate unchanged. Although the ruling was a disappointment to the P&C industry, it did not come as a surprise – a month earlier, the US Federal Open Market Committee had made the unprecedented decision to lock in a low-interest-rate environment until 2013.

Many P&C insurers in Canada had planned that interest rates would increase significantly and gradually return to more normalized levels, particularly after the recession was declared officially over in 2010. While interest rates did, in fact, inch up in 2011, the actual increase was smaller than had been hoped. Shortly thereafter, the US Federal Reserve announced the development of a stimulus plan, called “Operation Twist,” to lower long-term interest rates further – to the industry’s dismay.

The consequences of a sustained low-interest-rate environment are of great concern to P&C insurers. If current conditions prevail through the next three years, companies’ book yields may decline by approximately 30 basis points, putting pressure on their earnings and premium rates.

Although the impact of the projected decline in yield is less than the expected effect on the Canadian life insurers (due to the relatively shorter liability durations for P&C companies), it is significant enough to affect product pricing and profitability. Possibly offsetting this scenario, however, is the prospect for lower assumed inflation rates, which may reduce the costs of products being sold.

Asset liability management (ALM) — managing the matching of assets and liabilities — is more challenging in a declining-yield environment. P&C insurers thus need to develop more sophisticated ALM approaches, which can reduce variability in their surplus positions; for example, increasing the asset duration by investing in longer-term assets offers the potential for additional yield, as well as more proper asset/liability matching as the liability durations extend. Conversely, duration mismatching over extended periods will increase risk, given that long-term interest rates are at historic lows.

The magnitude and implications of low interest rates highlight the need to improve risk management and capital programs, and better prepare for the impact of extreme events. A sound risk management program is one in which the risk appetite is defined, the appropriate risk tolerances are established and relevant stress tests are identified to measure financial exposures. Retaining sufficient capital consistent with the identified risk exposures and having contingency plans in place are both essential to absorb the impact of adverse scenarios.

Companies that possess well-established risk and capital programs are best equipped to manage these challenges. Nevertheless, there is no simple solution. Each company will need to evaluate its options in light of its own capital position and business strategy, balancing the competing interests against the constraints.
Make better use of technology to increase business intelligence and improve efficiencies

Unstable investment markets and the increasing exposure base require P&C insurers to make greater use of technology that expands their analytical capabilities and improves operational efficiencies. Even companies that have already reaped benefits through the use of predictive modeling must continue to enhance their capabilities. Clearly, insurers that have yet to implement tools to predict future buying behavior should consider their timely introduction.

In an investment environment characterized by record-low yields on the fixed-income portfolio and extreme volatility in equities, insurers must find new ways to do more with less. Although companies tend to sharpen their focus on non-investment areas of the business – like underwriting and claims management – they also should consider tightening their operational efficiencies and improving cash flow across the enterprise, given the reduced income from investable assets. In this regard, P&C insurers should use advanced analytics more strategically, challenging the key decision points across the value chain.

Advanced analytics enhance information on customer markets, underwriting segment profitability and claims management, efficiently responding to the need to do more with less. Insurers have access to an enormous volume and array of data, including customer information from public, proprietary and purchased sources, and new types of information available from social networks. Companies have the opportunity to heighten their data analysis capabilities by investing further in these tools to unearth much deeper information for decision-making purposes.

One area offering largely untapped promise is claims management. Many insurer claims departments are not as advanced in the use of analytical tools as their underwriting counterparts, owing in part to the unstructured nature of much of the data generated within the claims function. Business analytics applied to the claims function can help insurers settle similar claims according to proven best practices, leading to more accurate reserves, reduced leakage and fairer and more appropriate settlements. The tools give decision-makers across the enterprise a real-time view of claims and the 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 offer another rich source of deep customer insight and enhanced marketing capabilities. As the pace of change in information technology accelerates, insurers’ own information management capabilities must be in tune with these changes. Information needs have evolved from “more data” to “more access” to “real time.” Social media outlets provide a continuous look at the customer, broadening real-time information capabilities. The technology further provides a platform for insurers to communicate their message and engage the market in very specific ways.

Yet another new frontier promising greater efficiency is cloud computing. Fundamentally, cloud computing pushes down the price of computing and expands its availability, thereby reducing and, in some cases, eliminating capacity constraints. Leveraging cloud-based solutions may heighten P&C insurers’ analytical aptitude while providing greater processing power. Tasks formerly limited by processing power or data-storage capacity are now possible, while operational flexibility is enhanced. However, these benefits must be balanced against the security and performance risks of depending on an external source for computing infrastructure, application software and services.

Transform core insurance systems

The need to transform core insurance systems, such as claims, policy administration, underwriting and billing, is escalating, driven by rising customer expectations, changing regulatory demands and intensifying competitive pressures.

Insurers confront a variety of new competitors, unencumbered by legacy IT systems, that are eager to carve out attractive market niches. This creates an urgency to upgrade established insurers’ IT systems, which are aging at the same time, while there are fewer resources available to maintain them. Talent is another factor urging change – incoming claims and systems professionals are looking for opportunities to employ their skills, rather than learn antiquated technologies and programming languages to service a system on its way out. Most compellingly, customers want and increasingly insist upon the instant service they receive from other industries from their P&C insurers.

The claims system may be the key driver for this needed transformation. Claims payments and loss adjustment expenses account for approximately 65% to 70% of an average
P&C insurer’s premium dollars. This loss expense deserves a fair share of management attention and should be a primary focus of innovation and investment. Client service expectations are particularly high for claims and, for many customers, this represents the only meaningful user experience with the insurance product.

The growth by acquisition strategy of many P&C insurers has resulted in multiple legacy systems and processes affecting their claims management. In addition, due to data migration problems, some insurers have maintained older data in their legacy systems. This poses an array of problems for claims units, including the following:

- Legacy systems tend to be poorly documented and often lack vendor support.
- Siloing of data limits sharing across business units and the realization of potential economies of scale.
- Working around legacy system issues has created disjointed processes, compelling business users to act as the integration point.
- Companies seeking to develop analytical capabilities need years of policy and claims data, requiring conversion of data from legacy systems.

The persistence of these problems, combined with the growing importance of the claims operation to the success of the business, indicates a continuing need in the marketplace for improvement. An upgraded claims system will improve communication with customers and provide greater interaction with distribution channels, helping to ensure that high customer expectations are met.

Underwriting and policy administration systems are additional focal points for investment. Policy administration is one of the more challenging areas to transform, compelling many insurers to put off system replacements and patch up older systems instead, thereby creating customer service and employee satisfaction issues.

The weak investment environment also obliges a renewed focus on underwriting profitability. Insurers should use technology to improve underwriting productivity and enforce underwriting discipline and guidelines.

One last area of consideration is billing systems, which tend to have the same legacy limitations as claims and policy administration systems. Customers today expect up-to-date, online access to account information, as well as flexible payment options. Transformation of the billing system can improve both the customer experience and cash flow.

Strengthen risk management infrastructure to respond to regulatory challenges

Leading insurers are moving toward internal capital models for internal risk management, capital management, regulatory reporting requirements and rating agency assessments.

The Office of the Superintendent of Financial Institutions Canada recently published the final version of its MCT Advisory Committee’s paper, Canadian Vision for Property and Casualty Insurer Solvency Assessment. The paper calls for regulatory asset requirements to be calculated on two bases – target asset requirement (TAR) and, at a minimum level, minimum asset requirement (MAR).

All insurers will be required to use the standard approach to calculate MAR. The most sophisticated method of calculating TAR would be the internal model approach, in which the models are integrated with the insurer’s risk management system. The internal model approach will be made available only to those insurers that can demonstrate that they have robust controls in place and have met minimum regulatory standards.

Although a definitive timetable has yet to be approved, the internal model approach should be implemented gradually, beginning with the measure of insurance risk for regulatory capital purposes, which is expected no sooner than 2015.

Currently, the MCT Advisory Committee is concentrating its efforts on criteria and best practices – for example, whether a value at risk (VaR) or a tail value at risk (TVaR) should be used to measure the insurance risk. It also is studying if a one-year or a lifetime horizon should be used for regulatory capital requirement purposes. Moreover, the committee is assisting in the development of models of P&C insurance risk, as well as the criteria and standards that P&C insurers will have to address to use the internal models for regulatory capital purposes.

Insurers should assess the impact of these changes prior to implementing the internal model approach; this way, they are well prepared if and when the changes occur. Companies also will need to have sufficient skilled and competent resources in place dedicated to the modeling function. To achieve this, insurers should consider enhancing their risk management standards and related systems support beyond what is required under current regulatory and reporting regimes.

Management not only will have to develop the internal models embedded in risk management, but will also have to independently check them to ensure the results are
verifiable, auditable and understandable. We believe that sound governance and market conduct, supported by effective reporting and disclosure, are key elements of an effective solvency framework.

Even insurers that are currently proficient at risk management, or have made significant investments in this area, could benefit from a more sophisticated approach. This, in turn, could help to lead to a decrease in these insurers’ relative capital costs, while boosting their competitive standing.

Insurers that fail to appreciate the impact of the new regulations are at risk and could encounter a potentially higher cost of capital, significantly reducing their competitive strength.

Adapt to the evolving risk profiles and needs of the customer

To successfully market their products, insurers need to understand and appreciate the changing profile of their customers. Not only will buying behaviors likely alter, but risk profiles will undoubtedly bear scant resemblance to current views. Evolving demographic segments will be different from historical antecedents and shaped by future events. Reaching tomorrow’s customers thus requires a fresh look at the changing face and voice of the market, and the timely development of new products, distribution channels and service offerings that address these altered needs.

Marketing leadership at many insurance organizations came of age when contact with the customer was infrequent and initiated, for the most part, by the insurer via outbound messaging. The world has changed, however. The rise of social media and mobile technologies makes it possible (and feasible) for insurance companies to remain in relatively constant contact with the customer base, with much of this contact initiated by the client.

Baby boomers were not shaped by a Great Depression and World War, but by an age of relative abundance. Marketing plans built on assumptions that this group would behave like today’s seniors are bound to fail. The baby boom generation lacks the defined benefit pension plans of their predecessors, and the great recession has reduced the value of their defined contribution plans. Consequently, boomers will likely be more active at advanced ages and will need to work longer than their forebears worked, leading them to drive more frequently than today’s seniors, with obvious insurance implications.

Such differences also are evident with regard to baby boomers and the younger segments of the population. Younger individuals are comfortable with new information and communication technologies, their employment is more transitory and their income streams more volatile. Many have a different perspective regarding the perceived benefits of automobile and property ownership than did previous generations.

This diversity in technological aptitude and service expectations creates pressure for insurers to offer multiple means of interactions with customers. With regard to personal lines of insurance, online will be the dominant channel. Smart companies may seek to integrate both online and offline approaches to satisfy evolving customer needs and expectations, considering the diverse risk transfer needs of this demographically diverse segment. Above all, routinely checking the pulse of the evolving marketplace makes good common sense.
Europe

Insurers face difficult choices

Ernst & Young believes that five broad needs are emerging to command management’s attention in 2012:

1. Retool the organization to quickly respond to challenges
2. Transform financial operations and systems
3. Integrate risk management to identify emerging and diffused risk
4. Rationalize product portfolios to reflect a changing consumer market
5. Adapt distribution channels to remain competitive
Market summary

European life and non-life insurers face important strategic decisions in 2012. Volatility and deterioration in macroeconomic and political factors are disrupting balance sheets, consumers and investors. Unfolding regulatory initiatives will have a pervasive influence on insurer operations. A mature insurance market across much of the landscape continues to make growth difficult to achieve. And consumer needs and expectations are rapidly changing. These forces are combining to create considerable challenges for insurers seeking to improve both top- and bottom-line performance. Those companies that have a deep understanding of these challenges, and respond with strategic solutions, will outperform their peers.

Economic developments in Europe create significant risks to insurer balance sheets and may result in a prolonged and stagnant organic growth environment. Fiscal imbalances that led to the downgrade of sovereign debt in weaker European countries have adversely affected the balance sheets of numerous European insurers and reinsurers. Possible sovereign defaults, which may spread to other countries and sectors, could further reduce asset portfolios. A sudden spike in interest rates would further destabilize insurer portfolios and loss reserves, challenging the ability of insurers to remain competitive in the marketplace. Finally, wider recessionary conditions could reduce consumer and business demand for insurance products and services, adding to the restrictions in top-line growth potential.

Proposed regulatory changes transforming solvency and accounting standards will affect insurers from both a capital management and operational standpoint. For instance, insurers will be compelled to rethink their business and product mix in light of the anticipated capital requirements. These looming regulatory challenges will require insurers to support new reporting requirements with improved data quality and possibly with overhauled financial systems. Adding another dimension to these regulatory pressures are customer protection concerns from the country level, which may further induce insurers to alter their products and distribution.

Insurance market conditions in Europe are playing out on different fields. The region is increasingly differentiated from an economic performance standpoint, as indicated by the more economically challenged southern region and its impact on polarization. By contrast, more concentrated and mature markets characterize the northern countries. Still, the low market penetration in parts of eastern and southern Europe presents opportunities for organic market growth. The diversity in economic health and insurance penetration across these regions underscores the importance of a differentiated strategy. Consumers in these areas also are moving away from investment-linked products toward those that are easier to understand and offer more guarantees and lower costs.

Insurers operating in Europe in 2012 will need to make smart decisions to prosper amid the aforementioned adverse economic developments, significant imminent regulatory changes and a more demanding and changing consumer base.

Retool the organization to quickly respond to challenges

The severity and rapidity of change in the strategic environment in Europe has shortened the margin for error and increased pressure for quick responses from managers. Insurers that effectively identify and act on their strategic choices are best positioned to minimize the downside impact from adverse conditions and seize available opportunities on the upside.

Rapid changes in the economic picture for Europe, combined with continued sluggish growth prospects and increasing regulatory pressures, will compel leading insurers to reconsider their corporate structures, business mix and business development programs in 2012. A particular structural change that insurers may consider to boost the bottom line in 2012 is intra-region mergers and acquisitions (M&A). Other tactics to improve bottom-line performance may include the consolidation of back-office operations and the outsourcing of service and support functions, such as customer call centers. Insurers also may weigh domiciliary decisions regarding their legal structures and operating units, based on a review of rapidly changing fiscal, regulatory and insurance market considerations. Finally, some insurers may be positioned to further develop operations in higher-growth territories.

Given the challenges impeding robust top-line growth in 2012, insurers operating within Europe need to review their current business mix. Some may reconsider their geographic locations and/or lines of business. Pressures from analysts and stakeholders to improve performance in the difficult European insurance environment will likely guide more consolidation of the industry through enhanced M&A activity. With more than 5,000 insurers, the European insurance market has long been considered ripe for consolidation. Although European M&A activity was restrained in 2011 because of the depressed valuations of companies and a “wait-and-see” attitude concerning Solvency II, the growth-starved conditions create pressure for M&A activity to revive in 2012.
In this low-growth environment, expense reduction remains critical for European insurers. To pare costs, insurers will possibly offshore select functions and consolidate service operations into centralized locations. Many insurers have decentralized areas that require higher customer touch while centralizing the support/service activities, a model that others may follow. Consolidation of companies that enjoy a harmonious alignment from a strategic standpoint also offers potential cost savings by combining their support functions. These strategic expense reduction decisions are perceived as winning propositions for 2012.

Pressures are building on European insurers and reinsurers to increase the business diversification benefits of Solvency II. This may lead some insurers to acquire the books of business and “lift-outs” of underwriting teams. Others may decide to improve their financial strength by divesting capital-intensive lines of business. Consequently, increased activity may occur with regard to renewal rights transactions, runoffs and solvent schemes of arrangement, such as Part VII transfers in the UK.

Insurers operating in Europe must continue to review the fiscal and regulatory implications of the location of their operating and corporate structures. Continental Europe and the United Kingdom have attracted interest in recent years among insurers engaged in domiciliary arbitrage, seeking favorable insurance tax regimes and greater access to the European market. In addition to altering their operational and headquarters locations, many European insurers with group structures have pre-emptively shifted their operating units from subsidiary to branch status, thereby lightening the capital, regulatory and expense load associated with multiple subsidiaries and platforms. Such transformative decisions in 2012 to optimize corporate organization and simplify legal structures will widen the performance gap among European insurers.

While the focus among European insurers in 2012 will remain on Europe, some have announced their intention to continue to develop markets outside the region. The higher-growth markets of Asia and other emerging regions present economic growth opportunities surpassing the 1% growth forecast for Europe in 2012. This activity may occur through M&A, joint ventures with local insurers or building new operations.

Transform financial operations and systems

Given the critical importance of financial operations and systems, insurers need to consider transforming the processes that support them to achieve their strategic and operational objectives. Additionally, the intensifying pressures of the changing regulatory and accounting regimes require insurers to produce more detailed information in a timelier manner. Impeding this goal are insurers’ legacy systems and processes, not to mention concerns over the quality of data. As befits a diverse region, not all European insurers are starting from the same place in terms of financial and systems technology enhancements.

When it comes to supporting the development of new products and the integration of newly acquired businesses, some insurers are finding that wholesale replacement of their front-end policy systems is not feasible because of the exorbitant cost and time required and the need to correct data quality issues. Consequently, insurers may initially focus their attention on the interfaces between large policy administration and finance systems to minimize the cost and delivery risk.

Many global insurers, and those operating in multiple countries within Europe, are recognizing the capital and operational advantages of centralizing their capital and risk management within the head office. Challenging centralization are legacy systems and local financial operations. In addition, the federated structure of many global insurers may create operational barriers thwarting the effective exchange of financial and risk information between the head office and local operations. Insurers pursuing centralization may want to factor in the organizational changes that are needed to overcome these barriers.

Insurers are treating actuarial modeling as distinct from other parts of the Solvency II program. Nevertheless, the 2011 QIS 5 exercise found that, in many cases, the data was insufficient to perform full, “look-through” solvency capital requirement calculations. Catastrophe modeling data for many non-life insurers is a particular concern, given issues around the availability and granularity of key non-financial information. For life insurers, there is increasing pressure to achieve greater transparency of asset and investment-risk data, with counterparty exposure, corporate debt and asset liquidity especially under the microscope.

European insurers have already borne a tremendous cost in time and expense in preparing for Solvency II. The CEA – the European insurance and reinsurance federation – estimates that the overall cost eventually will exceed €4.5 billion. Key insurance company staff has been diverted from their normal functions to attend to the evolving and voluminous analyses required to be in compliance with Solvency II, causing opportunity costs for their companies. Solvency II demands also are straining actuarial resources that otherwise might have been engaged in critical pricing or reserving activities, or in

Flexibility in uncertain times

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developing simulation tools to model the impact of regulatory change. The impending introduction of International Financial Reporting Standards (IFRS Phase II) will require insurers and reinsurers to continue to invest heavily in information technology and other systems through 2012, so as to meet the start date with minimal disruption. In this regard, insurers need to evaluate the ongoing impact of financial system development on their business operations to support both Solvency II and IFRS.

**Integrate risk management to identify emerging and diffused risk**

European non-life insurers and reinsurers confront rising challenges in 2012 from the increased frequency of known severity risks, in addition to emerging insurance risks, in their portfolios. These issues require insurers to apply more rigorous analytical discipline to existing portfolios. It further compels higher-level enterprise risk management (ERM) techniques to identify and manage potential risk correlations across insurance portfolios and with other risk categories.

Hindering the development of higher-level ERM techniques in organizations is the often fractious nature of the risk management responsibility. The responsibility for risk control is often distributed among several departments and functions, which may be only loosely aligned, connected via informal channels and utilizing different risk models, risk catalogues and rating scales. Such diverse internal risk-control structures may hamper insurers in their ability to rapidly identify and mitigate emerging risks in 2012. Successful insurers will evaluate the best methods to overcome this problem.

Given the lack of significant investment returns to bolster results, insurers must address the impact of high-frequency attritional losses in traditional non-life insurance products. Poor results in some European product lines, like German and UK motor portfolios, underscore the importance of addressing portfolio loss trends.

European insurers with global scope also must properly manage tail risk, given the impact on insurers and reinsurers of high-frequency/high-severity global natural catastrophes in 2011. Although the brunt of natural catastrophe losses was in Australasia, the insurance ramifications were global. Interestingly, two-thirds of insured global natural catastrophe losses were driven by non-US events, refuting the long-standing assumption that US catastrophe losses dominate the market. This also introduces a new level of correlated credit risk into the reinsurance market. European insurers may need to consider broader use of capital market solutions or other alternatives to traditional reinsurance to supplement coverage of their non-life tail-risk exposures.

Capital market alternatives also should be considered as a way to address European life insurance exposures, given demographic trends of greater longevity. Europe is home to more than half the world’s countries, which enjoy the highest average life expectancies. As the European population ages, European life insurers face increasing liabilities from the assumption of longevity risk in annuities. Insurers seeking growth by providing protection and retirement services to older consumers and capturing their pension liability business will need to evaluate the use of predictive modeling tools to evaluate longevity risk and capital market solutions like longevity swaps. In addition, they must determine how to incorporate these techniques into current risk management processes.

European insurers and reinsurers must continue to pursue ERM, treating it as an opportunity to further protect their businesses rather than as a compliance exercise. In the post-Solvency II world, ERM will be instrumental in decisions to launch new products and/or select new distributors. Although ERM is de rigueur at insurers, due to financial rating agency and regulatory body requirements, it should be wielded as a business discipline for identifying and assessing risk as opposed to a reporting exercise. The process of measuring and mitigating risk in an insurance portfolio, or comparing it across the portfolio with another area of the company’s operations, should become an embedded corporate policy.

In this regard, insurers must overcome the aforementioned fractious nature of risk management responsibility. Perhaps most troubling, given emerging regulations that increase the involvement of the board of directors and executives in risk management, is the threat of risk fatigue disabling the ability to assess the company’s risk from a holistic perspective. Although the level of risk diffusion varies, in 2012 all insurers should elevate the importance of ERM for decision-making purposes and implement measures that streamline and centralize risk management.

**Rationalize product portfolios to reflect a changing consumer market**

In response to changing consumer preferences, regulatory pressures and financial losses, European insurers will continue to rationalize their product portfolios. Pricing may need to
be adjusted to reflect rising loss ratios, the volatile economic environment and new and emerging regulatory actions. Life-product offerings will continue to shift from investment-focused products toward protection products that present wider profit margins. Higher hedging program costs due to regulatory changes also will need to be managed.

The challenge for European life insurers is to balance the need to charge more in premium with evolving consumer preferences. Several consumer trends are emerging in Europe. They include a desire to buy insurance products that are both simple to understand and convenient to access, thereby building confidence in the purchase. Additionally, many consumers are expressing an interest in an expanded ability to access products and information throughout the product life cycle, preferably online. They also want a customer buying experience that responds to their changing needs over time and helps to build trust with the provider. Finally, they seek features that reward their loyalty, particularly when buying additional products.

With this as a backdrop, a recent CEA report indicates that nearly 75% of all life insurance products bought by Europeans included a savings feature offering a minimum return or capital guarantee. This preference has led insurers to shift products away from unit-linked products toward savings and non-financial guarantee products that focus on mortality, longevity and protection components. The protection feature enables insurers to generate higher margins, but the guarantees in these products represent the assumption of higher levels of risk by the insurer.

Several trends are emerging:

- Customers going back to banks for pure investment/savings products that have fewer constraints
- Customers giving up on unit-linked products that have no guarantees and are very capital-intensive because of market risk
- Insurers reducing their pure savings products and increasing those that have a protection component, offer better margins and are less capital intense
- Insurers emphasizing greater convenience, simplicity and value in their insurance offerings

A possible interest rate spike in 2012 may invite the scenario of consumers switching from guaranteed products to higher-yielding bank savings products. If insurers respond by offering products with minimum returns or capital guarantees, making good on the guarantees could adversely affect their profitability. In combination with potentially higher capital charges resulting from investment losses, insurers may decide to divest lines of business.

Life insurers, especially unit-linked insurers offering guaranteed benefits, use hedging to mitigate equity market volatility and interest rate risk. However, hedging costs are expected to rise, due to increased financial market volatility and/or regulations, such as Markets in Financial Instruments Directive II. This could further reduce the already narrow margins on investment products. As a result, life insurers will likely continue to shift from investment to protection products. Nevertheless, they still face the need to manage the accumulated risks from in-force investment products.

Non-life insurers have experienced weak technical results from increased winter storms and bodily injury claims, compelling many to de-risk products by raising prices. Price increases were not uniform across markets; some markets, like Ireland and the UK, experienced significant premium-rate increases, while others, like the German motor sector, remained soft, despite meaningful levels of claims inflation.

Regulatory efforts to improve consumer protection by reducing the use of commissions, such as the UK’s Retail Distribution Review, also will affect product pricing. Under IFRS 4 Phase II, incremental acquisition costs like commissions are included in the fulfillment cash flows in the insurance contract’s liability valuation. With no commissions paid by the insurer, cash flows are reduced and the amount of liabilities is changed. As a result, a risk analysis of the effect of the ruling on premium and liability flows will need to be undertaken in 2012, to assure capital charges are properly adjusted. Additionally, the shift away from commission to fee-based compensation may guide decisions to reduce the number of distributors and determine new ways of compensating distributors.

Life and non-life insurers also must review pricing and risk considerations as a result of the abolition of gender-based pricing by the European Court of Justice. Non-life insurers, for example, can price their products using different risk factors such as driving behaviors. Many may consider investments in technologies like telematics and pricing analysis, balancing these investments against the cost-reduction efforts to keep prices low. The ruling takes effect at the end of 2012; consequently, annuity insurers may find an increased number of male applicants seeking to lock in the higher rates. Insurers also need to improve the design and marketing of products to women as they will receive higher payouts once the ruling becomes law. Economic and regulatory capital implications also need to be addressed, given the risk considerations of the changing underlying pricing and exposure mix.
The challenge for European life insurers is to balance the need to charge for higher risks with the consumer’s preference for lower-cost, more transparent and easier to understand products. Many insurers still have not fully grasped the competitive value of making their products more accessible in recognition of the evolutionary changes in consumer motivation, attitudes and behavior. These changes are largely a consequence of the growing influence of the internet as a sales and information channel.

In some areas, European insurers are not delivering what customers want and expect – greater product simplicity, accessibility and convenience to permit more informed decisions when buying insurance, in contrast to relying exclusively on intermediaries to direct what is right for them. While advice from an agent is still considered a valuable source of information, it is only one of a wide range of sources consulted by buyers, particularly younger ones. In summary, consumers want more control when buying life and pension products.

The internet offers a vast trove of information to allow a wider comparison of products, prices and independent opinions. Consumers have become accustomed to utilizing online channels to buy products and services from other industries that have more fully responded to their changing needs. They now expect the same purchasing opportunities from insurers, even though they may ultimately reach out to an agent or other intermediary to complete the transaction.

**Adapt distribution channels to remain competitive**

The growing use of the internet as a distribution channel will continue to challenge existing life and non-life distribution models and marketing plans. Insurers need to adapt their distribution channels to be successful in the new competitive environment. At the same time, regulatory changes will affect the significant bancassurance model in some countries, altering the competitive landscape and creating opportunities to forge new distributor relationships.

Direct sales of insurance policies via the internet are growing rapidly, albeit unevenly, among various European countries. According to the CEA, direct sales of life insurance accounted for more than 20% of total new premiums in five countries in 2009, including Poland and Ireland. The same year, the direct sale of non-life insurance policies accounted for more than 20% of new premiums in 10 countries, including France and the UK.

As more business is conducted online, significant challenges are emerging for insurers. Data security is crucial, not only to protect financial transactions, but also to protect customers against identity theft. This will lead insurers to invest further in more robust data protection. Additionally, the increasing development of internet applications and approval systems increases underwriting risk because insurers must rely upon information supplied by the customer, as opposed to this data being vetted and submitted by an agent or broker. The potential for mis-underwriting, let alone outright fraud, will lead insurers to improve the verification and confirmation of customer-submitted data.

Finally, regulatory concerns about consumer protection can be expected to increase as companies move toward online sales and distribution. For insurers that utilize their own sites for distribution purposes, compliance with new consumer regulations may be easier than for those who distribute through third-party marketers. Such insurers thus may have a greater challenge ensuring compliance.

In the non-life market, insurers need to manage the pricing challenges arising from the growth of aggregators. By increasing the ability of consumers to comparison-shop the price of insurance products, aggregators exert downward pressure on prices. In addition, the ability to compare prices has a secondary effect on customer loyalty by enabling current customers to more easily find similar products with lower prices. What began as a UK concept is now beginning to enter continental Europe (Courtanet in France and Compricer in Sweden exemplify this expansion). Still, aggregator success depends on a number of local dynamics, including the legislative environment, its infrastructure and its online buying culture.

Not surprisingly, insurers are now beginning to take advantage of the aggregator channel through direct ownership of aggregators. In addition, they are working to evolve the traditional distribution model from a single channel to distribute a particular product to one type of client toward creating a single touch point between the client and all the insurer’s products. This transition will require that an insurer and its distributor networks share client information and provide necessary training to make cross-selling a reality.

Insurers will continue to develop their bancassurance relationships in markets where this remains a significant distribution channel. For instance, bancassurance accounted for more than 50% of gross written premiums in Austria, France, Italy, Portugal and Spain at the end of 2009. Given the dominance of this channel in these markets, several insurers announced in 2011 that they had strengthened their relationships with banks, increasing the variety of products offered through the bank and/or creating new brands via the integration of the insurer and bank names.
Nevertheless, stricter regulations and higher capital charges under CRD IV, the European Union’s version of Basel III, will affect the bancassurance model in 2012. Banks with insurance subsidiaries will be under pressure to look for ways to maximize the value of these operations. These bancassurers may choose to switch from a manufacturing and distribution model to less capital-intensive distribution-only models. This creates new distribution opportunities for insurers to exploit in 2012, acquiring divested businesses from bancassurers and establishing new distribution relationships.
Given these political, economic and regulatory qualms confronting the market, five broad themes are emerging to command management’s focus in 2012:

1. Manage the company for the current low-interest-rate environment
2. Prepare for the impact of accounting and regulatory convergence
3. Invest in customer analytic tools to drive efficiency and improve risk management
4. Monitor developments in life insurance taxation
5. Embrace the internet
Market summary

Life insurers in the United States face a conundrum as they head into 2012 — managing both capital and risk in an economically and politically uncertain year while continuing to lay the groundwork for future growth. The uncertain economic climate, compounded by ongoing concerns over US debt, continues to put pressure on life insurer ratings and capital levels.

Factors intensifying this pressure include:

- Low interest rates raising concerns over spread compression
- Volatile equity markets increasing hedging costs and reserve requirements
- Impacts of the unfolding Eurozone financial crisis — particularly for multinationals
- Insistent investors wanting higher returns
- The changing regulatory environment

With these factors as a backdrop, management will need to maintain current credit ratings and capital levels in 2012 while simultaneously trying to improve earnings. However, the latter may prove potentially difficult through organic growth strategies. Continued unemployment creates competition for consumers’ dwindling financial resources, which may affect new life insurance sales. Additionally, retirement account assets are still recovering from losses suffered in 2008, delaying further development of the retirement income market.

Although variable annuity sales increased in the first half of 2011, the return of volatility in the second half has darkened the outlook for 2012. Potential regulatory changes also may challenge some insurers if capital requirements and distribution models are disrupted, as expected.

Consequently, US life insurers may need to improve earnings through such non-organic means as an opportunistic acquisition, while building the foundation for organic growth after 2012. Nevertheless, larger and well-capitalized insurers may explore options outside the US for both organic growth and strategic acquisitions, although some foreign markets are becoming less attractive due to increased competition and their own changing economic circumstances. Multinationals with operations in the US may continue to feel ongoing impacts from the Eurozone crisis, and there could be secondary effects for US-based insurers as well.

With a presidential election looming in November 2012, insurers will confront a potentially deadlocked political climate during the year, possibly slowing down key regulatory changes. At the same time, efforts toward the convergence of accounting regulations and technical standards may decelerate, due to their complexity and impact on insurers and the need for further analysis in the uncertain economy. Looking ahead, life insurers may be challenged by efforts in Congress to reform the federal tax code, with implications for both corporate-level industry taxes and policyholder taxes.

Manage the company for the current low-interest-rate environment

In August 2011, the Federal Open Market Committee (FOMC) made an unprecedented announcement, locking in a low-interest-rate environment until 2013. It has been a challenge for life insurers to manage through nearly two years of guaranteed low-interest rates at the short end of the yield curve. After the official end to the recession was announced, many insurers had hoped for a return to normalcy for rates. Adding to their dismay was the Federal Reserve’s announcement in September 2011 of "Operation Twist," a stimulus plan aimed at lowering long-term interest rates further.

The relatively low-interest-rate environment increases the risk of spread compression for existing products. At the same time, efforts to increase the sales of fixed annuities and universal life insurance are hampered by low credit rates. This led some insurers earlier in the decade to chase yield at the cost of assuming greater risk, resulting in both realized and unrealized losses during the credit crisis of 2008. They may shy away now from taking on more risk, wishing to avoid replaying the events of that tumultuous time. Yet, simpler approaches to improving results, such as increasing the asset-portfolio duration of the General Account, may achieve the desired intent, softening the FOMC’s proposed actions.

A more sophisticated approach to interest rate and market risks, to possibly protect an insurer’s surplus position and simultaneously promote growth, is to improve the asset and 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 through 2013, they could climb rapidly after the current actions of the Federal Reserve come to an end. In such a situation, disintermediation risk can be a concern, as policyholders may lapse existing policies in favor of investing in new policies with higher credited rates. Understanding the interaction of the asset and liability cash flows under a variety of scenarios will help prepare insurers to weather these uncertain financial times.
New asset classes and more complex financial instruments also may assist in improving financial results. To avoid the dangers seen in the recent financial crisis, insurers need to more fully comprehend the structure and safeguards among these assets. Utilizing a variety of stress scenarios to understand counterparty risks, correlations in credit risk, capital requirements and cash flows can help insurers better evaluate investment opportunities. Looking through the lens of risk-adjusted returns can give confidence as to whether or not the insurer is receiving a sufficient return for the asset risks being absorbed.

**Prepare for the impact of accounting and regulatory convergence**

Regulatory uncertainty more than likely will persist through 2012, given the present contentious reform efforts and attempts by competing interests to converge systems in divergent directions. Changes are being implemented at all regulatory levels, and navigating these changes will yield challenges as well as opportunities for insurers.

Although the Dodd-Frank legislation has passed its first anniversary, many key rules have yet to be formalized, several of which are expected to have an impact on insurers. Already, the Federal Insurance Office (FIO) has been established, and its mandate covers a wide variety of topics, from expanding access to insurance coverage for under-served populations to considering how (or if) insurers contribute to systemic risk. Challenging the traditional sphere of the National Association of Insurance Commissioners (NAIC) and its respective state departments of insurance, the FIO may create a federal supervisor of insurance on top of existing state-based regulation of the industry.

One area where the FIO may come into contention with the NAIC involves Solvency II, which is slated to become effective in January 2014. The issue is over “equivalency” for US insurance regulation. In its Solvency Modernization Initiative, the NAIC has endeavored to establish a standard that conforms to Solvency II principles, albeit with one possible exception – national-level insurance supervision. The NAIC itself does not have supervisory power, and Solvency II equivalence is based on the existence of a national supervisory body.

Should the US not have a regulatory system that is recognized as equivalent when Solvency II goes into effect, a variety of issues will arise for both US subsidiaries of European insurers and US insurers with business in Europe. For instance, insurers may need to restructure operations. Merger and acquisition opportunities may arise if European insurers decide the capital requirements for US operations are too high, assuming they have to hold the amounts required by Solvency II. With regard to equivalency status for the US, potentially affected companies may want to prepare strategies for either possibility.

Leaving equivalency aside for the moment, both the NAIC Solvency Modernization Initiative and the EU’s Solvency II require companies to develop a full understanding of their material risk profile. Under this principle, management must understand the models used for calculating required risk capital and use these models in their decision-making. This will require a robust vetting of the models, as well as more thorough communication of the risks to stakeholders. Insurers should leverage these regulatory changes to improve their business decisions, acquiring a better understanding of their risk profiles while optimizing performance against assumed risks.

In addition to global regulatory developments on a macroeconomic scale, insurers may also want to consider specific regulatory changes at the microeconomic level, which may be leveraged to optimize performance. Specific developments in valuation changes may pose an impact for certain product types, among them universal life with secondary guarantees and indexed annuities with guaranteed living benefits. In principles-based approaches to capital and reserving, some products and product features may have smaller requirements in capital and reserves while others may have greater requirements. Insurers will need to adapt their product features and pricing to these new approaches, repositioning certain products to take advantage of this new environment.

At the micro level, expectations are for increased competition among some US states deriving from their respective regulatory environments. Some states, for instance, have actively attracted insurers to form captive reinsurers within their borders. Consequently, insurers may want to consider both international and national regulatory differences insofar as adjusting their corporate structure and capital allocation priorities to capture regulatory arbitrage opportunities.

While insurance accounting standards may eventually converge globally, we anticipate deliberation and slow movement with the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB). It is quite likely that we will see a FASB Exposure Draft in the summer of 2012 and industry debate thereafter. However, understanding the effects of the proposals remains critical to insurers if they want to shape the discussions and eventually gain competitive advantage.
Invest in customer analytic tools to drive efficiency and improve risk management

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

Life insurers are looking to use predictive modeling to improve their underwriting speed and accuracy. Traditional life underwriting requires a broad array of medical tests and is both time-consuming and expensive. The delay between application and acceptance reduces the number of policies that ultimately are issued. Automated underwriting and straight-through processing are partial solutions to this delay, eliminating many manual and duplicative processes. Predictive modeling goes further, automating underwriting by applying business rules and tapping additional external information to effect underwriting decisions more quickly.

Predictive modeling has benefits beyond underwriting, as well. The information it produces on policyholder behavior can be used to target a marketing message to the individuals who are most likely to purchase the product. There is some history to this: banks have long aimed their products at people who have recently purchased a home, and producers of baby products are especially adept at putting advertising material in the hands of new parents. Insurers can learn from these experiences, targeting their life insurance information at a more precise and opportunistic time, when a person's life events create a need for a particular insurance solution. Combined with social media and other internet strategies, predictive modeling can help reach out to new customers, such as the young and middle-market consumer.

An insurer also can improve its back office through the use of predictive modeling. Given the extensive modeling of multiple scenarios required by the developing principles-based regulations, an insurer can improve its risk management processes by gaining insight into the range of outcomes that can occur in the current volatile environment. This information can then be used to prepare accordingly for the more likely outcomes while developing contingency plans for the less likely outcomes. The proposed principles-based regulations require extensive data collection and modeling capabilities before a company can tap its own experience for regulatory purposes. Companies leveraging their own experience, nonetheless, can set reserves and capital levels that appropriately reflect their products, underwriting skill, mix of business and customer base.

Monitor developments in life insurance taxation

As we peer into the future, insurers may be challenged by efforts in Congress to reform the federal tax code. Possible implications exist for both corporate-level industry tax and policyholder tax issues. Budget deficits and taxation are serious concerns, yet they will be in flux because of the economic and political changes underway. The presidential and congressional elections in 2012, with the health of the economy as a central political issue, could set the stage for changes in the tax code, with significant repercussions for the life insurance industry.

As Congress grapples with budget deficits and how to make the tax code more pro-growth and competitive on the international stage, both political parties are focusing on “tax expenditures” as a way to finance deficit reduction and tax reform. Under the current tax system, the buildup of value in an annuity or a life insurance policy is not taxed until the policy is surrendered. Life insurance death benefits also are not taxable to the beneficiary. This inside buildup in life insurance and annuities, retirement savings, small life insurance company deductions and the tax treatment of life insurance company reserves are among the many items that are included in the tax expenditures under consideration. The Obama Administration’s Deficit Reduction Package recommended to the Super Committee of a dozen lawmakers working out a compromise on deficit reduction, calls for US$1.5 trillion in increased revenue. In the package are the Administration’s FY 2012 budget proposals (also proposed in previous budgets) and various propositions, such as modifying the dividends-received deduction for life insurance company separate accounts. The package also calls for eliminating corporate-owned life insurance (COLI), by expanding the pro rata unrelated interest disallowance for COLI. These politically charged issues will heat up in the months ahead.

Embrace the internet

Some sectors readily lend themselves to transacting on the internet. Brick and mortar stores like Best Buy, for instance, can capture additional sales online, while still driving in-store sales from customers who want a more personal interaction. Companies whose services are in high demand, such as television, radio and newspaper, also report high-transaction volume on the internet. Then, of course, there are retailers like Amazon that only sell online.

Insurance companies, on the other hand, have historically operated via a very traditional sales model. An agent typically solicits information about a family’s needs and presents both
advice and products addressing these needs. An application is written at the home or office and the paperwork is sent to the insurance company, which then issues a policy. While other sectors have been nimble in adapting to the internet and leveraging its opportunities, life insurance companies have lagged behind. Perhaps this is due to the nature of the sector’s products and services and the complexities and subjectivity of underwriting.

At present, the extent of life insurer presence on the internet largely consists of financial calculators of insurance needs, sales lead-generating activity like educational materials and product information and proprietary internet applications that support the sales force through online insurance application forms and illustrations.

The newest generation of insurance buyers is young, internet-savvy and transactionally self-sufficient. Such consumers have grown up in a “do it yourself” culture and spend a significant portion of their time transacting online. While insurance in its current form does not lend itself well to internet sales, life insurers can leverage the internet to develop stronger ties to customers and build a better brand.

In the future, it will be possible for a consumer to submit applications to several insurers, receive competitive quotes, and, educated by web-based information on the insurers, decide which insurer best suits his or her needs and wallet. Creating incentives for consumers to transact online, much in the way many airlines do, could guide lower premium options, versus purchasing insurance solely through an agent.

Social media also continues to play an ever-increasing role in our personal and professional lives and in our personal and business decisions. Most companies can now be followed on LinkedIn, Facebook and Twitter. We predict these and other similar sites present the next major opportunity for insurance company sales.
Ernst & Young believes that five broad needs are emerging to command management’s attention:

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

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)

Natural catastrophe losses between 2008 and 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 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 Eurozone 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 FASB and IASB 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 to be well prepared when the changes occur. In this regard, companies should consider 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 growing rapidly, 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 approaching 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 claims 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 also provides the means to “listen” to the market in real time.
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