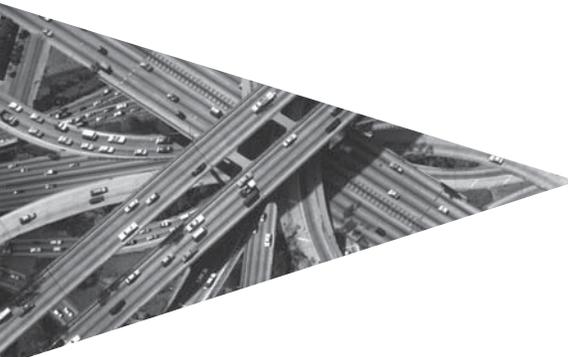


# 2012 outlook

Global Insurance Center



## European insurance outlook

### Insurers face difficult choices

#### 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 guided 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.



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

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 in 2012 to boost the bottom line 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 offer 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 among insurers engaged in domiciliary arbitrage in recent years, 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 preemptively 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, due to 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 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 in 2012 confront rising challenges 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 oft-fractionous nature of the risk management responsibility. The responsibility for risk control is often parsed out to 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,



Although the level of risk diffusion varies, all insurers in 2012 should elevate the importance of ERM for decision-making purposes and implement measures that streamline and centralize risk management.

two-thirds of insured global natural catastrophe losses were driven by non-US events, refuting the longstanding 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-aged 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 a decision 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, all insurers in 2012 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 both new and emerging regulatory actions. Life product offerings will continue to shift from investment-focused products towards 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 lifecycle, 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 towards 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 that have given 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, due to 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 towards 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 assuring 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 towards 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.

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