

2013 European insurance outlook

Challenges and opportunities abound

Market summary

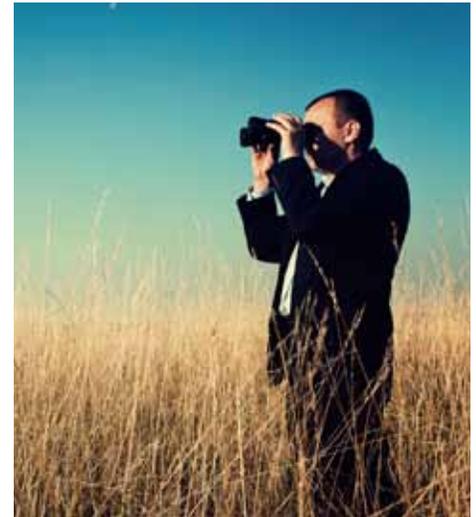
European insurers will continue to weather the challenging economic climate in 2013, at a time when they confront the development and implementation of European and national regulations affecting everything from capital and risk management to distribution and product design.

Against this backdrop, European insurers must focus on managing risks to capital and investments, identifying new opportunities for growth, and adapting systems and operations to address these critical challenges. Uncertainty over the timescale for implementation of the new European regime, together with the potential adoption of different aspects of proposed rules in different countries, will lead to differences in implementation across the region.

The macroeconomic environment in 2013 and beyond remains challenging in many European countries and a source of concern for the region's financial stability. Unease over government debt levels continues, as does political uncertainty influencing markets, despite relatively strong policy responses at the European government level. Overall, the political and economic climate continues to dampen growth prospects in Europe. Nevertheless, there are regional differences, with gross domestic product (GDP) returning to pre-crisis levels in some countries, and a return to recession a continuing threat in many others.

In these turbulent macroeconomic times, European insurers face key challenges such as the potential impact from sovereign debt defaults and recession-driven declines on the asset values supporting insurers' liabilities on the equity market. Additionally, a prolonged period of low interest rates will affect the financial resilience of life and non-life insurers, as they struggle to maintain pricing margins and limit the impact on capital and reserves. In this environment, some insurers may seek to increase product prices, which may affect consumer behavior in terms of the quantity and type of insurance products they purchase.

As insurers address these economic challenges in 2013, they will assess their systems and operations in response to a variety of new regulations. Affected areas range from solvency to financial reporting and distribution, and many insurers continue to both understand and prepare for the impact of these regulations.



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The impact of Hurricane Sandy on the European insurance industry has yet to be fully understood. While it may harden rates, it will also produce big losses for European insurers writing US business – direct or reinsurance. At present, the storm has caused US\$50 billion of losses, of which insurers are expected to pay out approximately US\$20 billion.

In this tumultuous environment, European insurers will need to:

- ▶ Focus on customer growth opportunities in a low-growth region
 - ▶ Focus on customers' needs
 - ▶ Appreciate the sharpened regulatory focus on consumers
- ▶ Protect and strengthen the investment portfolio
- ▶ Ensure capital adequacy
- ▶ Finalize the testing and integration of Solvency II systems
- ▶ Prepare and respond to developing regulation
- ▶ Consider tax changes that are ahead
- ▶ Anticipate upcoming non-bank recovery and resolution planning

Focus on customer growth opportunities in a low-growth region

In 2013, European insurers will increasingly focus on customers as they seek to improve premium retention and growth. Regulatory changes aimed at improving customer transparency about products and costs will sharpen this focus, guiding successful insurers to re-evaluate their business models and selling propositions. This re-evaluation will cause many insurers to alter distribution, products and services – for example, shifting away from offering investment-linked options and emphasizing protection and customer service. For some insurers, this will be a radical but necessary transformation to generate growth. At the same time, Solvency II will pressure insurers to develop and market more products that shift risk to the insured, rather than being retained by the insurer.

At first glance, the European Union (EU) appears to offer limited organic growth opportunities for life and non-life insurers. European life and non-life premium growth has been lower than in Africa, Asia and Latin America and mixed by comparison with North America. Europe nonetheless remains home to more than 550 million consumers, with a significant need for life insurance and non-life-insurance products. Even though some insurers are looking at “greener” pastures in developing markets, European insurers remain committed to their region. Successful insurers will improve premium growth by identifying and developing new products and services that deepen existing client relationships while attracting and retaining new clients.

Focus on customers needs

Ernst & Young's 2012 Global Insurance Customer Study (Voice of the customer) indicated that among European life consumers, the internet has furthered their ability to compare products and prices and obtain independent opinions before purchasing, even if they use an advisor to complete the purchase. At the same time, the survey found that consumers are willing, and indeed prefer, to buy products from companies they trust and make the purchasing process convenient. Nevertheless, they see the life insurance industry as lagging other sectors, with regard to service delivery and rewarding loyalty.

A strong message for insurers in 2013 is to provide consumers with simpler, more transparent products and the information they need to make informed decisions before purchasing. Insurers also must build trust by delivering a great customer experience while responding to their evolving needs throughout the life cycle. Finally, they need to reward customer loyalty, either when offering additional products or attempting to retain customers.

For non-life insurers, the survey revealed that European insurance consumers are driven by convenience and value. Convenience involves the ability to research and buy when they want. This, in turn, has driven the growth of provider direct and third-party online websites. Value is more than just offering the lowest price; consumers also are looking for a combination of product, service and price that meets their needs. The challenge facing non-life insurers is that convenience and value vary across markets and consumer segments.

As a result, non-life insurers in 2013 need to meet diverse customer needs by integrating online and offline communication channels to streamline both sales and back-office functions. New sales and renewal processes must be made simple and convenient for customers across whichever channel or medium they select. Finally, since dissatisfied consumers can easily and widely voice their complaints on the internet, possibly disrupting new sales potential and existing relationships, insurers must seek to develop, manage and protect their brands in the digital world.

Thanks to the internet, both life and non-life insurers are under increasing pressure to meet changing consumer demands on a 24/7/365 basis. The speed of information sharing among insurers, distributors and consumers places a strategic advantage on robust, integrated back-office systems that reduce or eliminate dataflow roadblocks and checkpoints.

Insurers will further benefit by improving their ability to organize and sift through increasing amounts of data to better understand and target customers. The increasing use of consumer analytics provides a competitive advantage by identifying the most profitable customer segments. The problem for insurers is that consumer data often resides in disparate product administration systems and formats. The challenge, then, is to efficiently organize and extract meaningful information from these systems.

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Emerging consumer regulations are sharpening the focus on value for money and suitability, challenging traditional pricing, incentives and distribution models.

Appreciate the sharpened regulatory focus on consumers

Emerging consumer regulations are sharpening the focus on value for money and suitability, challenging traditional pricing, incentives and distribution models. In response, insurers need to better understand the end customers' needs, simplify product offerings and offer true multichannel access – according to the ways in which customers want to interact.

Bancassurance as a distribution model may need to reinvent itself as regulations unbundling banking products and insurance products are implemented. Without a bundled sale, bancassurers need to be more focused on customer needs. A key aspect of this shift involves developing a deeper understanding of customer profitability when insurance sales are separated from banking transactions. Some bancassurers may re-evaluate their business model and consider separating their banking and insurance operations.

In 2013, insurers also will be adjusting to the European ban on gender-based pricing, which will increase the cost of insurance across life and non-life products. For motor insurers, a growing value-added service is increasing the use of telematics. While initially viewed as expensive technology, the ability to use telematics to price motor insurance on individual driving behavior may help avoid the significant increases in women drivers' premiums, which could result in the loss of business. During 2013, insurers considering the use of telematics need to understand how its adoption may be affected by sales via internet aggregators. Additionally, insurers considering implementing a telematics solution need to evaluate the demands it would place on IT, especially in the areas of data security and processing.

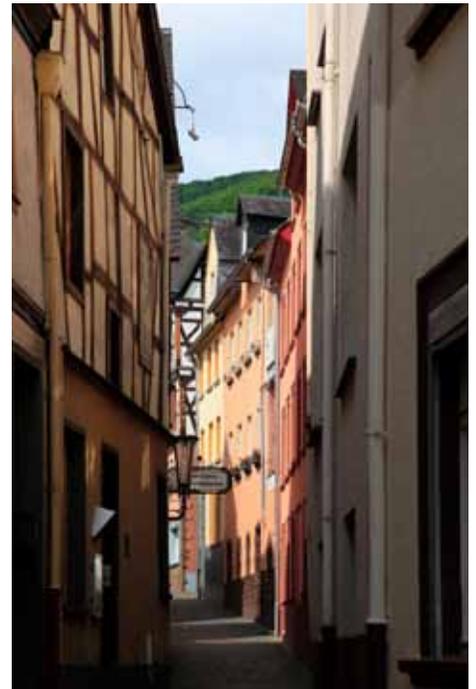


European regulations will continue to have an important strategic and operational impact on insurers. In the retail market, the Markets in Financial Instruments Directive (MIFID II), Packaged Retail Investment Products (PRIIPs) and Insurance Mediation Directive (IMD) will all be on the agenda of the European Parliament in 2013. European life insurers also need to prepare for the implementation of the PRIIPs initiative in 2014, although many details remain to be debated and finalized. PRIIPs will require insurers to provide a Key Information Document to consumers prior to their purchase of a policy. In 2013, insurers must analyze their product portfolios to identify the products affected by PRIIPs and prepare for the necessary operational changes this requires. The level of change will vary by country, depending on the level of existing local disclosure requirements.

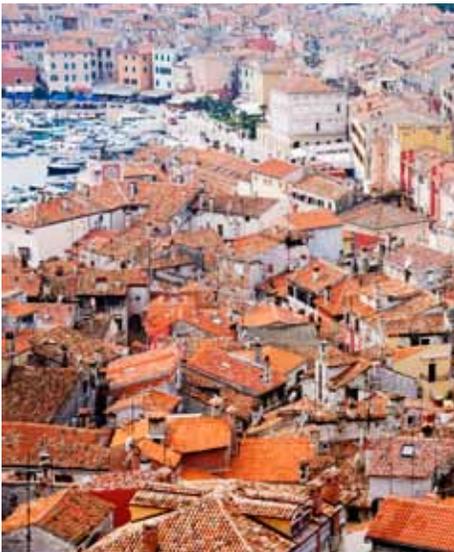
Similarly, proposed revisions to the IMD, which is not likely to be finalized and implemented until after 2015, may challenge existing distribution models while creating opportunities to develop new models. In this environment, fast-moving insurers that identify and respond to these challenges and opportunities are better positioned to profit in a more transparent and level distribution environment.

The European Commission (EC) has proposed revising the existing IMD, which regulates selling practices for all insurance products, from general insurance products like motor and household insurance to those containing investment elements. The revisions seek to improve transparency and establish a level playing field for insurance sales by intermediaries and insurance companies. Again, the level of change will vary by country, depending on existing regulations. The proposals will be debated during 2013, and a key area of interest will be discussions regarding commission disclosure, the degree to which this applies to insurers and - critically - how it will apply to insurance companies which do not pay commission, such as direct writers. The proposed ban on product tying also could have a significant strategic impact on the industry.

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Protect and strengthen the investment portfolio

In 2013, continued pressure on margins is anticipated, caused by the prolonged low-interest-rate environment and ongoing uncertainty surrounding sovereign debt. This will compel insurers to choose a combination of solutions to improve portfolio returns while further derisking their investment portfolios. Such combinations will involve sovereign debt holdings reductions, asset-to-liability duration matching improvements, hedging strategy refinements, and the seeking of higher returns in potentially riskier asset classes.

European insurers have taken steps to limit their exposure to sovereign debt of fiscally challenged countries. Domestic insurers are at greatest risk as they continue to retain substantial holdings of sovereign government debt. The retrenchment from holding the debt of Europe's fiscally challenged countries represents a change. The policy a few years ago was to diversify from home-country concentration to embrace a more diversified European portfolio. Several European insurers have trimmed their GIIPS (Greece, Ireland, Italy, Portugal, Spain) holdings in 2012 to favor lower-risk issues. Moving toward lower-risk assets, of course, means accepting lower returns on these assets. As a result, insurers will need to balance risk and return. This may lead some insurers to continue holding some GIIPS sovereign debt because of the higher returns it may produce.

European insurers will continue to refine their asset liability management (ALM) in 2013, as many still have asset durations several years short of accompanying liabilities. Improving asset liability matching will require insurers to lengthen the duration of some fixed-income securities. Lengthening the durations may increase credit risk, however. Additionally, the availability of quality long-duration assets may be limited. Insurers thus need to balance improvements in ALM against the challenges. Insurers not wishing to lengthen the asset duration may use derivatives as an alternative, although this option can create counterparty exposures and liquidity requirements that must be managed. Finally, since cutting exposure and hedging against adverse developments do not tend to boost returns, some insurers may take on more investment risk.

Effectively increasing investment returns requires expenditures in investment risk management, access to a variety of asset classes and markets, and an understanding how the risks in these asset classes and markets affect the overall level of risk borne by the company. A key influence on an insurer's risk appetite will be the treatment of various asset classes like real estate investments under the existing Solvency I and the proposed Solvency II, as well as an insurer's own view on the inherent riskiness of particular assets. Larger insurers may gain a strategic advantage over smaller competitors, both in terms of access to certain classes of asset and in investment risk management systems.

The European Insurance and Occupational Pension Authority reported in its mid-2012 report on European insurance that while life insurers are examining how to reduce the capital strains caused by guaranteed products, the prolonged low-interest-rate environment will depress the yields available for new business. If price rises are deemed unattractive to customers, an increasing focus on marketing unit-linked and reduced-guarantee products is anticipated.

Ensure capital adequacy

In 2013, European insurers must continue to review and refine their capital management strategies to be Solvency II-ready, as well as to optimize their balance sheets and appropriately redeploy capital. Sound capital management strategies can bolster the appeal of the insurance sector to investors who wrongly view insurers and banks through the same lens, often failing to appreciate insurers' stronger operating fundamentals and much lower liquidity risk.

Full implementation of Solvency II by 1 January 2014 appears completely unrealistic to regulators and the industry alike. To resolve the remaining key technical issue, many insurers will be required to participate in the Long Term Guarantees Impact Assessment during Q1 2013. In some European countries, insurers also must respond to further information requests during the year, providing their Solvency II capital positions to regulators and accelerating the need to manage these results alongside existing Solvency I capital.

The transition to a more risk-sensitive regulatory regime will foster potentially higher capital requirements for some forms of guaranteed benefits, as well as increased capital costs for certain risk exposures. These unfolding requirements, combined with the strains from Eurozone sovereign debt, low interest rates and low investment yields, are driving insurers to take bold moves to improve capital management. These include enhancing asset liability management, using reinsurance as a capital management tool, spinning off entire entities or shedding underperforming units, and evaluating whether alternative domiciles might offer better capital treatment with respect to non-European business.

As insurers evaluate the ways in which reinsurance can be a tool for effective capital management in 2013, they must also be aware of the changing nature of reinsurance, both in terms of the available products and Solvency II requirements to fully assess and reflect a cedent's counterparty risk exposure to the reinsurer. In addition to traditional quota share and excess of loss arrangements, new capital market alternatives to traditional reinsurance are available. These include collateralized reinsurance and burgeoning products in the insurance-linked securities market, which are especially valuable for cedents seeking to reduce their exposure to capital-consuming low-frequency/high-severity property or liability loss events.

In 2013, insurers must take actions to allocate capital optimally and to support the product mix and their geographical footprint. Capital diverted from lagging operations will need to be deployed in regions and products with brighter prospects. Numerous European insurers have looked to Asia and other high-growth emerging regions, such as Latin America, for future premium growth. Within Europe, life insurers will need to consider how much capital to allocate to the products likely to grow in demand in an aging population, such as savings, longevity and long-term-care products.



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Finalize the testing and integration of Solvency II systems

While the EC continues to determine the implementation date for Solvency II, insurers in 2013 must focus on finalizing the necessary capabilities to comply with Solvency II's requirements, among them Pillar 3. The consequences of errors or omissions in Pillar 3 reports may result in more reworking of data gathering and calculations or, in extreme cases, result in capital add-ons to solvency capital requirements regardless of the status of other pillars. Successfully demonstrating the embedding of reporting requirements into a business-as-usual environment and implementing Pillar II under the existing timelines will remain a significant challenge. Insurers need to be adaptable and ready to deliver the key reporting solution that Pillar 3 presents to their organizations.

In terms of preparation, some insurers are more advanced than others. Ernst & Young's Solvency II 2012 survey found that for those insurers that had completed an initial Pillar 3 gap analysis, 2013 will be a year of testing systems and gaining confidence in the successful integration and embedding of these regulations into regular operational processes.

For insurers kicking off their Pillar 3 analysis, 2013 will be a year of catching up. This may affect their overall profitability as project expenditures increase to bridge the gap and money is spent to secure the best available talent and resources. The issues described above provide some indication of the breadth and depth of the challenges late-starting insurers may face. Meeting these challenges will likely be costly to financial, human and system-related resources.

For all insurers, the costs associated with these regulatory changes will affect their corporate income statements and disclosures. As a result, insurers must be prepared to answer detailed stakeholder questions about their preparations for the regulatory changes and the rising costs associated with them.



Prepare and respond to developing regulation

With European sovereign debt issues continuing to dominate the macroeconomic agenda and the implementation date for Solvency II being postponed once again, insurers nonetheless cannot afford to reduce their focus on the implementation activities related to future regulatory and financial reporting changes.

Despite the postponement, a convergence is likely between the implementation dates for Solvency II reporting and the financial reporting changes represented by International Financial Reporting Standards (IFRS) 4 Phase II increases. For insurers grappling with the major challenges these initiatives convey, the delay presents a perfect opportunity to step back, think strategically and carve a competitive edge. For example, companies may transform the way they produce and use data or assist Finance to add greater value.

Both IFRS 4 Phase II and Solvency II involve fundamental changes and significant delivery challenges for insurers. With regard to the latest implementation date for Solvency II, it appears most likely at present to become effective in 2016. In parallel, insurers are preparing for changes to both asset accounting under IFRS 9 and liability accounting under IFRS 4 Phase II. IFRS 9 is expected to be implemented by 1 January 2015, while IFRS 4 Phase II is likely to have an effective date between 2017 and 2018.

Until now, the data required for implementing Solvency II, and for reporting under Pillar 3, seemed likely to be required well before the implementation of IFRS 4 Phase II. As such, it has made sense for organizations to prioritize Solvency II, thereby deferring any significant work on IFRS 4 Phase II until more clarity is provided on the implementation date.

As the expected implementation timing of the two measures becomes increasingly aligned, insurers have a real opportunity to take stock and look closely at how they are addressing their implementation, especially with regard to data, systems and processes, i.e., to address system and data matters in one initiative.



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The current economic environment across the Eurozone, the EU and other parts of the world appears to have increased the volume of tax law change globally.



Consider tax changes that are ahead

Tax legislation is a moving target, with governments drafting and redrafting tax laws. These aim to raise new revenue streams, erase a perceived abuse or make one territory more attractive for taxpayers than another. The current economic environment across the Eurozone, EU and other parts of the world appears to have increased the volume of tax law change globally. Consequently, insurers must keep abreast of evolving developments and adjust their business models accordingly.

Tax change affects every aspect of an insurer's business. The taxation of a company's profit is usually the main area of focus, but personal tax changes in some countries could affect the nature of the policies written. Customers demand different attributes in their insurance and investment products, and the increasingly changing nature of these products may affect an already-stressed investment return.

Insurers' top-line results are likely to feel the impact of changing tax regulation, such as financial transaction taxes in France and Spain, withholding tax rates in Portugal, and the emergence of global reporting and withholding obligations imposed by some countries on their citizens located abroad, e.g., the Foreign Account Tax Compliance Act (FATCA) in the United States.

With regard to possible exposure to FATCA, European life insurers will need to review their customer and investment accounts in 2013. FATCA regulation is designed to counter offshore tax avoidance by US citizens who have invested outside the country in cash-value life insurance contracts, equity or debt securities, or any depository or custodial accounts. European insurers should accelerate their impact assessment activities. This includes developing an implementation plan to perform account due diligence on pre-existing accounts, revising account holder identification and onboarding processes, and designing new information reporting and withholding procedures. Each of these activities will require meaningful changes in business processes, as well as technology support.

In February 2012, a joint statement was issued by the US, France, Germany, Italy, Spain and the UK. It described a possible framework whereby foreign financial institutions would report required FATCA information to their local tax authorities. This, in turn, would be provided to the US under exchange provisions, tax treaties or other information exchange agreements. In September 2012, the UK and US became the first parties to conclude an intergovernmental agreement. It is understood that US authorities are concluding similar agreements with up to 50 other partner countries. Thus, it is highly probable that multinational groups operating throughout the world will need to comply with FATCA in different ways, depending on the various jurisdictions in which they operate. This may increase compliance costs and better coordinate reporting.

The manner in which companies arrange their tax affairs across their global group is under a great deal of scrutiny in certain countries. Much of the focus has been around the organization of their supply chain within the group – where functions are carried out or

where services originate. Most countries have transfer pricing rules as part of their tax regime. The principle behind transfer pricing is that transactions between connected parties must be concluded at an arm's length rate, i.e., what a third party would charge for the same service or product.

When elements of a group's supply chain are in different countries, this may lead to an allocation of business profits across the world. Where parts of the profits arise in countries with lower tax rates, groups are being challenged through public opinion or fairness. Any company could face enhanced scrutiny as a result of its transfer pricing policy and global operating model. Therefore, the senior executives trading or organized globally should be aware of this additional level of focus. They should also be prepared, if needed, to support their position and justify the manner in which they organize the company's affairs. Robust transfer pricing policies and documentation are an absolute must, but a plan of response may also be a good idea.

Clearly, complying with global taxes is becoming more complex. Given the significant cost of tax to business, implementing measures that drive tax efficiency will increase in importance.

Anticipate upcoming non-bank recovery and resolution planning

After a pronounced scrutiny of banks, regulators are beginning to turn their attention to insurers with regard to their recovery and resolution plans in cases of severe distress, thereby enabling an orderly liquidation of the institution with limited impact on retail customers or the global financial system.

At a global level, The International Association of Insurance Supervisors (IAIS), under the tight reins of the Financial Stability Board (FSB) and the watchful gaze of the G20, is assessing 48 insurers for systemic risk across five key factors: – size, global activity, interconnectedness with the financial markets, ease of substitutability of cover, and non-traditional and non-insurance activity.

In less than three months, the IAIS will deliver a list of global, systemically important insurers (G-SIIs) to the FSB, and in April 2013, this list will be published. The G-SIIs will be required to submit detailed recovery and resolution plans and systemic risk reduction plans.

To date, reactions from insurers have been mixed. While a few insurers oppose the prospect of more regulatory pressures, others recognize that their global size, reach and diversification have contributed to the tighter regulatory approaches. For some insurers, there are obvious strategic opportunities to position their products as recovery solutions for other insurers. Despite these differences in view, those insurers that believe they will be designated a G-SII, or think they are on the cusp of this designation, are gearing up and forming programs now, ahead of the first cohort of G-SII designations expected by April 2013.



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Once the April 2013 designation is announced, insurers will have 18 months to complete a recovery plan, a resolution plan and a systemic risk reduction plan. These will be challenging for most insurers under the current proposals. Implementation of the systemic risk reduction plan may include restructuring, and improving of liquidity planning and governance. Insurers expecting to be designated as G-SIIs must plan now for the necessary actions.

The EC is currently considering its approach to systemic risk in non-banking financial institutions, such as insurance. National policymakers also are paying greater attention to this area. Even if an insurer is not designated G-SII, regional or national supervision still means it must contemplate its potential failure. Regulators are likely to require evidence of credible planning covering core business units and jurisdictions. Developing a consolidated approach that addresses global, regional and national systemic risks indicates the impact on insurers will be substantial. Insurers must look at the contingency plans they have in place and make them more robust, identifying the risks and dependencies to which they are subject, the available options and necessary decisions.

While all the work already completed with respect to programs such as Solvency II preparation and enterprise risk management (ERM) provides many groups with a good foundation for recovery and resolution planning, the exercise is far from trivial, not least given the complexity of insurance regimes in many countries and the degree of connectivity in some insurance groups. Banks have found that addressing these areas requires the involvement of many specialist skills and needs sponsorship from the top. This is hard to achieve when many countries are evolving their insurance regulation. However, the greater risk to insurers in the next few months is not engaging with the process on a timely basis and at a sufficiently high level.

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