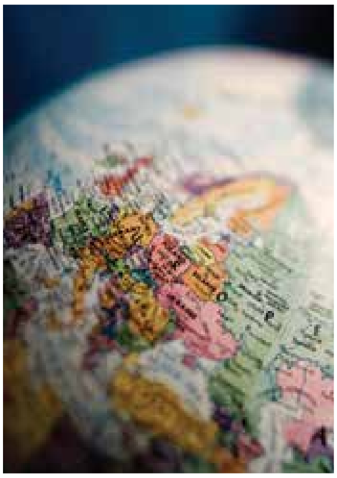
2014 EY European insurance outlook

Unlock new opportunities, simplify existing operations



Market summary

In 2014, growth potential for European insurers will rise as, and if, their economies recover from the recent economic crisis and recessions. Recovery is by no means assured. Third-quarter GDP growth was just 0.1% and potential relapse into another recession is not out of the question. The strength of recovery will continue to vary by country, reflecting macroeconomic factors within each subregion. Throughout Europe, this relatively slow economic growth and continued low interest rate environment is pressuring insurers as they seek paths to profitable growth, challenging existing business models, insurer investment strategies, product mix, business processes and operating structures.

Building a better working world

Market summary

Economic growth	Interest rates	Regulation	Customer needs	Technology
↔	↑ →	↗	↗	↗
Uneven economic recovery, recessionary threat remains	Low rates continue, affecting life more than non-life	Solvency II remains important, other regulations moving to forefront	New needs as regulation impacts distribution, digital empowers consumers	Digital and analytics key to future growth and profitability

A prolonged low interest rate environment poses a major threat to existing business models of life insurers by reducing investment income and squeezing product margins. This is encouraging European life insurers to continue to identify the potential for restructuring and simplification in order to drive out cost and streamline operations. As insurers watch investment returns dwindle from the impact of low interest rates, they will adjust portfolios and seek to increase yield without taking on significant added risk, most noticeably by seeking new diversification effects. The risk-return trade-off is, however, an important consideration, and as insurers gravitate to real estate, infrastructure and other alternative classes, they must risk to avert the errors of the recent past.

Offsetting lower investment returns are continued opportunities for growth stemming from the demographic realities of an aging Europe and improving middle class opportunities in some pockets. Improving economic conditions in some regions are likely to bring higher motor and home sales and stimulate more business formation. At the same time, the large loss potential stemming from the growing severity of natural catastrophe events in the region adds to consumer and business demand for financial protection. Despite the increased threat to businesses, the cyber liability market is still relatively immature in Europe and represents a meaningful opportunity for growth.

In 2014, European consumers will be increasingly digital, especially through their expanding use of mobile devices. However, EY's global survey, *Insurance in a digital world: the time is now*, published in 2013, found that an overwhelming majority — 84% of insurers — currently spend less than 10% of their IT development budget on digital. Leading companies will be increasing their investment to reach consumers through digital media.

The proliferation of data and analytics to draw meaningful insights from data is revolutionizing parts of the insurance sector, pushing some insurers to create a comprehensive platform to receive, store and exploit the insights from sound analysis of data. Virtually all functional areas of European insurers — from customer targeting to product design and pricing, to agency management, underwriting, claims and reporting — can be improved with architecture and analytic processes making efficient use of data.

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Regulations at the national, European and global levels continue to influence strategies, investments and capital requirements. EY's 2013 survey of global insurance executives, *Business Pulse: exploring dual perspectives on the top 10 risks and opportunities in 2013 and beyond*, makes clear that insurers need to adjust to stricter regulation on everything from capital requirements to commission rates and customer care. The successful conclusion of the Omnibus II Directive negotiations provides clarity over the long-awaited Solvency II implementation timeline delay until January 2016; as a result, other regulatory changes are moving to the forefront.

While these and many trends will be similar for European insurers in 2014, there are some issues that are more specific to the separate Eurozone and UK markets.

Eurozone focus: a slower economic recovery and low interest rates

Economic growth in the Eurozone region in 2014 will help improve business results and increase nominal disposable income, but may not be strong enough to reduce unemployment. Nevertheless, Eurozone life and non-life insurance premium growth is forecast to increase modestly in 2014. Demand for retirement products will rise with increasing personal income and consumer wealth, with 20% of the Eurozone's population over 65 and an increasing number approaching retirement every year. Awareness of the exposure to financial damage caused by natural catastrophes will increase interest in protection products, after particularly severe floods and winter storms in 2013.

While increased premium growth will be welcome news, low interest rates will remain a particular challenge for Eurozone life companies as they try to reconcile investment guarantees with current asset yields. This issue is particularly acute in Germany, where the proportion of insurance sold with guarantees is higher than in many other European markets. Persistently low interest rates will also raise the cost of providing term products.

As in the Eurozone, the aging UK population offers insurers opportunities to provide a variety of products to help older consumers meet their financial challenges, and we anticipate continuing innovation in this space.

UK focus: stronger economic growth, low interest rates and adjustments to distribution

Turning to the UK specifically, business confidence will continue to improve in 2014 and firms will take advantage of low borrowing costs and strong liquidity. This will lead to stronger economic growth than in the Eurozone. UK unemployment is expected to decrease slightly, while nominal personal disposable income is expected to increase slightly.

As in the Eurozone, the aging UK population offers insurers opportunities to provide a variety of products to help older consumers meet their financial challenges, and we anticipate continuing innovation in this space. But reaching consumers to generate this premium increase will continue to be challenging in 2014.

In addition to EU-level regulations, UK insurers continue to face an evolving regulatory landscape. The Financial Conduct Authority's (FCA) thematic reviews (e.g., dual pricing and ancillary sales) may challenge many firms' current business models. The Prudential Regulation Authority (PRA) is focused on insurer risk management and solvency. The *Sergeant Review of Simple Financial Products* provided guidelines and recommendations that UK insurers and financial product providers should follow to introduce more consumer-friendly life insurance and savings products. Given the high proportion of non-life premium in the London market that originates from the US, the introduction of the Foreign Account Tax Compliance Act (FATCA) has created significant challenges.

In the post-Retail Distribution Review (RDR) environment, where commissions are banned on investment business and fees have to be paid for advice, the number of distributors will continue to shrink, as financial advisors and banks struggle to engage mass market customers profitably. In 2010, there were approximately 28,000 advisors in the UK; EY estimates that number will have fallen to 20,000 in 2014. However, online life distribution platforms will continue their comparatively strong growth into 2014, as consumers opt for self-service rather than fees.

In general insurance, the intense motor sector price competition from aggregators will continue and will limit insurers' ability to raise rates to levels appropriate for this margin-challenged line. The FCA is studying add-on pricing, competition and selling practices, raising the potential that add-ons to basic policies are likely to come under increasing regulatory and customer scrutiny during the year. Additional pressure for UK personal lines insurers will come from new caps on household flood insurance premiums for flood-prone areas, along with an industry levy, exacerbating falling home insurance rates.

Successful insurers in Europe in 2014 will:

1. Restructure and simplify the organization
2. Keep pace on the regulatory treadmill
3. Target key customer segments with innovative, profitable products
4. Retool their investment strategy
5. Develop digital platforms to reach connected consumers
6. Seize the potential of data and advanced analytics
7. Respond to regulatory changes in distribution and markets

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1. Restructure and simplify the organization

In 2014, European insurers will need to simplify, restructure and alter their business models. Successful insurers will be those that restructure and simplify their organizations to create more efficient operations that can take advantage of emerging growth opportunities.

A prolonged low interest rate environment poses a major threat to the existing business models of European life insurers, reducing their investment income and squeezing product margins. To survive in this environment, life insurers need to restructure their product portfolios. With balance sheets under extraordinary stress from guaranteed product obligations, the spread compression is driving insurers to focus on unit-linked products, whereby more risk is transferred to policyholders. A recent Linklaters survey of European life insurers[1] reveals that 62% had redesigned their products to reduce benefits to policyholders. If interest rate conditions persist, more insurers will follow suit, with 56% of insurer respondents stating they will be compelled to radically overhaul their business models. Almost half the respondents issued concerns that Europe may cease to be a viable life insurance market.

The limited organic growth opportunities and diminishing investment returns also oblige European insurers to correct management structures and simplify decision-making processes. Another strategic priority in 2014 is cost reductions to improve margins and operating results, although, paradoxically, insurers may need to invest further in system overhauls and upgrades. In this regard, insurers need to examine the prudence of developing entirely new systems versus laying new applications on top of legacy systems. The need for new systems is particularly acute in the claims area, where multiple systems for claims are incapable of receiving the increasing volume and variety of data — the so-called big data phenomenon.

[1] *Life changing: the outlook for life insurance companies in Europe*, Linklaters, 2013.

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In the quest for additional sources of value creation, many European insurers are restructuring their reinsurance buying strategies to achieve cost savings through the purchase of fewer, more consolidated treaties. Competitive pressures from burgeoning capital market alternatives have compelled leading reinsurers to offer more generous terms to cedents, including expanded coverages, multiyear contracts and the removal of specific exclusions and loss ratio caps.

Restructuring also is evident, with some Continental European insurers putting their life insurance books of business into runoff to release trapped capital. These reactions are a response to Solvency II dictates. In the UK, Celent identified that 39.6% of premiums for life, annuities and pensions were from non-strategic or closed books. The move to allocate capital away from both legacy life and non-life books of business is boosting the European runoff market, which grew by 5% in 2013 to €235b (US$318b). Some European insurers are reallocating this capital toward higher growth market opportunities in Asia and Latin America.

2. Keep pace on the regulatory treadmill

EY's 2013 *Business Pulse* survey makes clear that insurers need to adjust to stricter regulations on everything from capital requirements to commission rates and customer care.

The long-awaited agreement on Omnibus II, and certainty regarding its implementation date (1 January 2016), returns Solvency II to the forefront of the regulatory agenda. With agreement on Omnibus II, there is now a clear deadline for achieving Solvency II compliance in 2016. As other global and European regulatory requirements beckon, European insurers must maintain pace with this regulatory treadmill, or risk falling behind and having to spend extra effort and expense to catch up in the future.

As insurers keep pace, 2014 will be a big year for them to complete their model development, documentation and validation to support their applications for internal model approval. The short timelines added to the regulatory complexity will strain insurer resources. Companies should consider taking a holistic approach to these changes, rather than a piecemeal approach, permitting more comprehensive responses that reduce costs and duplication.

Insurers also must ensure their processes and systems are ready for Solvency II's transitional reporting period (2014–15) and final implementation in 2016. Methods to report interim quantitative reporting templates (QRTs) prove the existence of an effective risk management system and verify that the forward-looking assessment of "own" risks are needed. The challenge is determining if more permanent solutions rather than shorter-term and manual solutions are best to meet the rapidly approaching transitional requirements and full implementation by 2016.

Other regulations coming to the forefront include the global systemically important insurer (GSII) designation, which touched only a few European insurers in 2013. Nevertheless, insurers need to bolster their awareness of the efforts by local regulators to place insurers of national importance under closer scrutiny. At the same time, insurers face numerous other regulations from the EU, such as MiFID II (Markets in Financial Instruments Directive II), PRIPs (packaged retail investment products) and IMD 2 (Insurance Mediation Directive 2), affecting everything from distribution to product disclosure and investments. Insurers across the EU will need to evaluate the framework and functions of their existing compliance models to ensure they remain fit for purpose.

Although the EU Draft Directive on Financial Transaction Tax is also set for implementation in 2014, not all governmental bodies are in agreement as to the shape and scope of the tax, requiring continuing insurer interactions with Brussels and national governments to stay on top of the issue. In the interim, insurers need to evaluate how these tax changes may affect business operations and plan accordingly. While the full impact remains uncertain, insurers are expected to develop systems for the identification, collection, reporting, registration and accounting of the tax.

The EU is not the only source of regulatory concern. Regulations in the US, such as the Dodd-Frank legislation and FATCA, in addition to solvency and compliance regulations in Asia-Pacific, require the attention of European insurers operating beyond local borders. Insurers need to consider how best to incorporate these external regulations in their comprehensive response to regulatory change.

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With the comment period on the revised Exposure Draft of International Financial Reporting Standards (IFRS) 4 Phase II now closed, the industry in 2014 must pay close attention to whether or not the International Accounting Standards Board (IASB) will issue the final standard in early 2015, as planned. Combined with IFRS 9, the operational and practical implications of IFRS 4 Phase II are significant. In 2014, insurers will need to assess these accounting and reporting changes to ensure they understand the synergies that can be leveraged from Solvency II reporting and additional reporting requirements in the future.

In the UK, insurers have the added challenge of implementing Financial Reporting Standard 102, which effectively replaces current UK generally accepted accounting principles (GAAP) in 2015. UK insurers continue to face an evolving regulatory landscape. The FCA's thematic reviews (e.g., dual pricing and ancillary sales) also challenge many firms' current business models, while the PRA is focused on insurer risk management and solvency. Other pressures include the *Sergeant Review of Simple Financial Products*, which provides guidelines on the introduction of consumer-friendly life insurance and savings products.

As the Eurozone and UK continue to recover from the recent economic turmoil, European insurers have an opportunity in 2014 to increase sales by targeting two customer segments — the region's aging population and the personal and commercial non-life markets.

3. Target key customer segments with innovative, profitable products

As the Eurozone and UK continue to recover from the recent economic turmoil, European insurers have an opportunity in 2014 to increase sales by targeting two customer segments — the region's aging population and the personal and commercial non-life markets. Insurers still must maintain focus on profitability to fully realize the benefit of higher sales.

A 4% increase in the number of individuals aged 65 years or older in the EU is forecast for 2014, at a time when austerity efforts continue to contract the social safety net. The lower level of social support increases the need for retirement income, health and long-term care products and advice. Some older individuals with the financial means are more likely to travel, increasing potential sales of travel insurance. These opportunities vary based on local demographic and regulatory conditions, requiring insurers to evaluate which areas offer the greatest opportunity for growth.

As consumer wealth improves, so does the demand for cars and other goods. Sales of cars in Germany have stabilized and are expected to increase in 2014, according to the German Automobile Federation. Spain, Portugal and Greece recorded double-digit increases in new vehicle registrations, translating into higher sales of motor and other non-life coverages. Meanwhile, £300m (US$494m) in storm losses in 2013 in the UK, and €3b (US$4b) to €6b (US$8b) from the central Europe flood damage caused in 2013, have increased consumer and business awareness of the need for property and business interruption insurance. Similarly, news of data breaches and identity theft events has raised concerns about commercial and personal cyber risks, creating a growing market for these products.

As growth conditions improve, successful insurers will be disciplined about their bottom-line profitability and capital allocations. As Europe's consumers become more confident about their personal financial situations, and are able to purchase more insurance due to the improving economic conditions, insurers may eventually engage in pricing wars to spur top-line sales growth. Evidence of lower prices and other efforts to gain market share is apparent in the motor insurance markets in some countries. For non-life insurers, the growing use of aggregator sites adds further pressure on pricing. Low interest rates also pressure insurer investment spreads, affecting the profitability of some life products. As a result, insurers face another year when profitability may prove difficult to achieve.

4. Retool their investment strategy

Recognition that the low interest environment may persist in 2014 increases the imperative for all insurers to take actions to reshape their investment allocation strategy. In this effort, insurers must pursue strategies to increase investment yields, and be clear that they are being compensated for any increase in risk that is added to the portfolio. They also must take into account the risk correlations that may emerge among different asset classes, as well as the correlations that may exist between asset and liability exposures in changing economic environments.

Successful insurers in 2014 will pursue multi-asset strategies that include higher-yielding alternatives, hedging and stress testing these strategies to minimize risk from adverse scenarios. Macro hedging can reduce currency and other forms of volatility, as well as manage strategic positions at both the group and operating company levels. Stress testing can reveal key vulnerabilities in the investment portfolio from severe event and risk factors weakening solvency positions. Although most stress tests evaluate single factor shocks, such as sovereign risk, liquidity risk and interest rate changes, comprehensive stress testing contemplates concurrent stressor and contagion effects.

The search for higher yield suggests that European insurers will continue to shed their exposure to sovereign debt and other classes perceived as bearing higher risk, such as bank debt. They are also likely to reduce their holdings of high-grade fixed income debt, shifting assets to classes deemed higher yield at no additional risk. In the UK, insurers are reducing their positions in such safe havens as bond and money market funds.

European insurers also seek ways to generate incremental returns through strategic diversification, which should yield benefits under Solvency II. For example, if an insurer were to replace some fixed income investments (at a 20% capital charge) with real estate investments (at a 25% capital charge), the diversification credit would reduce the overall capital requirement, even though the insurer has moved into a class requiring a higher capital charge.

Insurers will increasingly apply robust economic scenario tests of the interaction between asset classes and liabilities, including considerations of policyholder behaviors and competitive environments. By changing their investment portfolio positions, this may either mitigate or exacerbate insurers' enterprise risk and returns, in directions that may differ from the pure economics of the investment class.

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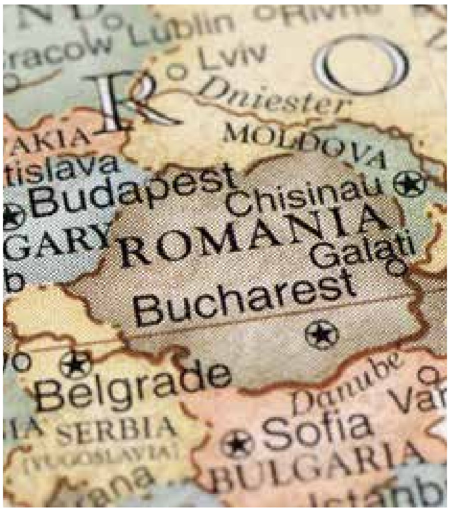

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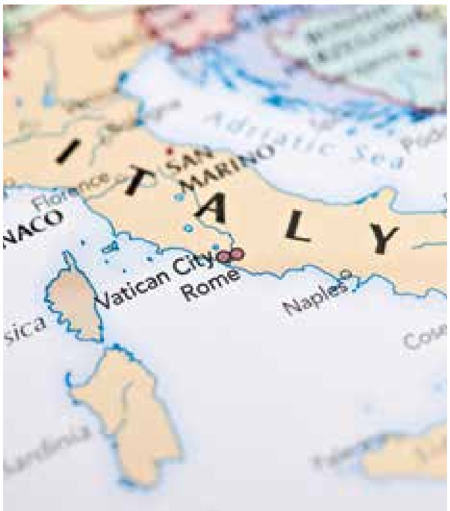

5. Develop digital platforms to reach connected consumers

As the European economy improves, insurers are expected to develop a stronger digital presence to reach connected consumers. Investments in digital channels will address the increasing service expectations of consumers purchasing insurance on the internet. Social media, for instance, empowers consumers to share their service experiences to friends and acquaintances. A recent EY survey, *Protecting and strengthening your brand: social media governance and strategy*, conducted in the UK, reveals that 80% of social media users connect with friends and family in rating products and services.

The development of digital platforms is an essential success factor in 2014. At present, the overwhelming majority of insurers (84%) spend less than 10% of their IT development budget on digital initiatives, according to EY's global survey, *Insurance in a digital world: the time is now*. On the bright side, the survey indicates that 37% of the European insurer respondents expect a more than 50% increase in their spending on digital development in the next five years, much higher than the 24% increase in these plans globally over the same period.

With fewer distributors due to regulatory changes, a digital platform can satisfy the technological needs of the distributors that remain. The enactment of stringent commission and distribution model changes in the UK and the Netherlands, and implementation of PRIPS and similar regulations in the Eurozone, focus distributors more on servicing higher-net worth insurance customers than middle-market consumers. As a result, insurers have the opportunity to reach these "abandoned" customers by developing digital platforms providing financial advice and online purchasing. Nearly 50% of European respondents to the EY survey said that "regaining more direct control of the customer relationship" was the key driver in their digital strategy.

As insurers develop digital platforms, they face several challenges, chief among them the cost and complexity of integrating new customer-centric systems with multiple legacy systems. Identifying an appropriate return on the investment in digital will be a key factor in moving forward with such plans in 2014. Finally, as insurers streamline operations to increase customer transparency, they must heighten their data security, given the potential for reputational damage from a data breach involving customers' personally identifiable information.

6. Seize the potential of data and advanced analytics

European insurers that adopt a comprehensive, cross-functional enterprise data analytics strategy in 2014 are likely to outperform those carriers with more fragmented approaches. Virtually all functional areas, including customer targeting, product design, pricing, agency management, underwriting, claims and reporting, can be improved by more efficient use of data. Advances in predictive modeling, for instance, make possible significant improvement in underwriting and claims processes.

Building an enterprise data platform requires sound data architecture and controls to assure data quality and completeness. In 2014, European insurers need to improve their management of data at all phases of the product delivery spectrum, from front end to back end. As EY's recent Solvency II benchmark survey indicates, a principal reason why many European insurers are not ready to be Solvency II-compliant is because of data quality management problems.

Since many insurers' data resides in disparate systems, it must be consolidated into enterprise data to reduce duplicate data entry and access activities. Once this data architecture foundation is built, information can be processed via analytics to yield high-level insights — patterns, anomalies and relationships that guide informed decisions on agency management, business development, underwriting and claims.

Advances in claims-predictive modeling may generate significant margin improvement for insurers, particularly for those first to implement these tools. For instance, data analytics can enhance the discernment of fraudulent claims. An estimate from Accenture[2] indicates that European insurers lose approximately €10b (US$14b) annually to fraudulent claims. Claims executives report a rising incidence of fraudulent claims, and weaknesses in their ability to adequately detect fraud. Other claims activities such as settlement management, subrogation optimization and claims benchmarking also can be improved through advanced data analytics.

As predictive analytics are applied to small commercial and larger businesses, the increasing volume of available data can be applied to complex business lines and specialty classes. The rich data on customer behaviors provided by such innovative technologies as telematics also invite opportunities to redefine how products are priced. Down the line, predictive modeling will move the dial closer to the "science" end of the "art versus science" underwriting challenge.

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[2] "Fraudulent P&C insurance claims on the rise in Europe, Accenture survey finds," Accenture, June 2013.

7. Respond to regulatory changes in distribution and markets

In 2014, European insurers will need to address the disruption of their distribution strategies caused by regulations such as PRIPS, MiFID II, IMD 2 and RDR. RDR has already impacted the UK and Dutch markets with a decrease in the number of investment advisors in the UK, affecting revenue and expenses, and causing many insurers to focus on a higher-net wealth clientele. Local regulatory initiatives also affect insurer distribution networks.

Some UK insurers are responding with alternative methods of providing financial advice to middle-market consumers, such as building platforms that facilitate online transactions. Other insurers are focusing on digital distribution to accomplish the same goal. Insurers can effectively combine traditional and digital distribution methods.

Insurers are adjusting to the growing use of online aggregators and comparison sites, the fastest-growing insurance distribution channel. A Finaccord study[3] indicates that 42.3% of Europeans purchasing car or home insurance for the first time, or switching from their current carrier to a new insurer, undertook these actions online in 2012, up from 35.4% in 2008. Some insurers have adjusted to this reality by purchasing an aggregator (14 out of 43 aggregators are currently owned by an insurance company or broker, according to CP Consulting). The largest aggregator, BGL, in France, Spain and the Netherlands, for instance, is now owned by an insurer.

As insurers make these adjustments, regulatory scrutiny of aggregators is increasing. The European Insurance and Occupational Pensions Authority (EIOPA), in particular, is looking to exert its influence and provide leading practice guidance to comparison websites in the first quarter of 2014. EIOPA has issued concerns about customer overreliance on the price of products rather than the terms and conditions, conflicts of interest due to the close commercial links between insurers and comparison sites, and the suitability of websites for certain types of products.

[3] *Aggregation metrics: consumer approaches to online insurance comparison sites in Europe*, Finaccord, January 2013.

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