

# 2010 outlook

Global Insurance Center



## US property-casualty insurance industry outlook

### Executive summary

The US economy will recover slowly from the extended recession through most of 2010. Lagging employment with falling aggregate wages, a weakened residential and commercial real estate market, tight credit and a behavioral shift on the part of consumers from consumption to savings are factors contributing to a delayed recovery. Inflationary pressures may build as a result of the stimulus and growing deficit, although their effects may not begin to emerge for a year or two.

The US property/casualty (P/C) insurance industry, despite being relatively unscathed by the financial crisis, will face challenges from an extended soft underwriting cycle. Capital remains at relatively strong levels, with the negative impact of 2008 capital market losses substantially concentrated among very few players. With the exception of financial/mortgage guaranty companies, incurred losses have moderated through the recession due to flat or declining exposures and modest catastrophe activity. For the most part, there have been no significant pressures from stock markets, rating agency downgrades or M&A activity to stimulate any meaningful industry-wide changes.

However, the industry continues to be challenged by regulatory uncertainty at both federal and state levels, as well as by prospects for massive health care restructuring. The importance of expense control and organizational effectiveness cannot be underestimated in a soft and gradually deteriorating underwriting environment. As economic recovery and a return to more normal conditions unfold, the gap between strong and weak performers is likely to widen. Better prepared companies will have opportunities to expand and acquire, while the unprepared will struggle to compete and be forced to withdraw from less profitable and non-core sectors.

Ernst & Young has identified five issues that will influence P/C insurance industry in 2010:

1. Living with pricing malaise
2. Operating successfully in a continually changing regulatory environment
3. Focusing on core businesses and readdressing product and distribution strategies
4. Building more risk management capacity with stronger governance and transparency
5. Improving the effectiveness of company infrastructure

## Living with pricing malaise

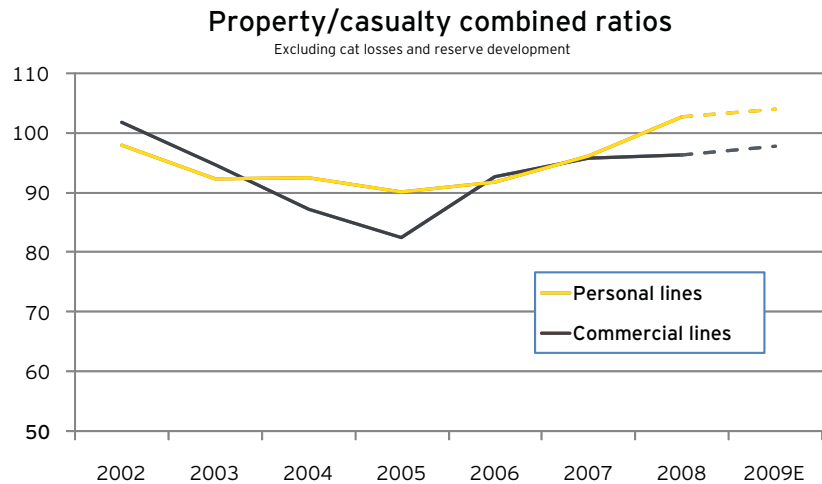
The recession has placed continued pressure on pricing, with reduced insured exposures due to a weak economy and insureds' increasing retentions. This has forestalled any anticipated hardening of the market. After a 2008 calendar year which experienced higher catastrophe claims and significant investment losses, underwriting capacity, as measured by statutory surplus, remains relatively strong for the industry. A rebound in asset values and a very benign hurricane season in 2009 have resulted in premium to surplus leverage ratios well below 10-year averages.

On the commercial side, exposure-based premiums continue to fall due to the weak recovery depressing sales, wages and property values. While the rate of pricing deterioration has slowed in most commercial lines (and decreases are less severe than they were in the past two years), brokers and buyers are pushing for pricing reductions in a broad effort to control expenses. However, there appears to be thinner margins in the prices. Figure 1 shows that combined ratios for most commercial lines (excluding prior year reserve development and catastrophes) have been increasing since 2005 and rose above 100% in 2008. Based on overall industry results through nine months, accident year ex-catastrophe combined ratios are likely to be at least one point higher in 2009. Second and third quarter commercial segment pricing surveys showed slight increases for property and slight decreases for casualty risks.

In personal lines, the industry is also contending with a net reduction in insured exposures from falling real estate values and rising foreclosures, more uninsured drivers, higher deductibles and cheaper coverage options. Combined ratios remain below 100%, but these have been rising since 2005. Pricing appears to be sufficient to offset decreases in exposure, but probably not enough to offset increased claim severities. Personal lines insurers will be looking for price increases as well. However, greater regulatory resistance to rate increases and continued aggressive advertising based on price, indicate moderate pricing policies into 2010.

Financial performance for the last two years has benefited significantly from substantial industry-wide releases of reserve redundancies built up in prior years. However, it is hard to imagine the

Figure 1



Sources: Conning & Co. P/C forecast and analysis by line of insurance, company statutory filings; property claim services; EY estimates

same level of redundancies remaining within current reserve estimates. The overall industry calendar year loss ratio is expected to deteriorate by about two percentage points in 2010; but this will vary substantially among markets and business segments. Nevertheless, anticipated low investment returns and weakening underwriting results are starting to pressure insurers to shore up premium rate adequacy with price increases. The timing and magnitude of economic factors and underwriting responses will also likely increase loss ratio variation among business segments.

In an environment where investment returns will be unable to offset weak underwriting results, a critical success factor is the ability to deploy capacity in more profitable underwriting markets and control risks carefully in less profitable ones. Insurers can get ahead of the pricing curve by maintaining strong underwriting and controlling coverage terms and conditions.

## Operating successfully in a continually changing regulatory environment

In response to political pressures, insurers should anticipate enhanced regulatory oversight in 2010. While the focus is on the regulation of banks and complex investment instruments, there are also demands for new regulation and oversight of

insurers. As a result, insurers need to evaluate the combined impact of a more intense regulatory environment on their business models, capital requirements and governance structures.

Washington, D.C. is centered on stimulating economic recovery, while maintaining broad concerns about systemic risk and consumer protection. At the same time, the pace of regulatory change in insurance is compounded by debate and disagreement over the relative roles of state versus federal oversight of solvency, insurance products and processes. State regulators will be pressured to develop greater consistency in the regulation of insurance in areas such as consumer protection, product complexity and corporate governance. The taxation of insurance companies and their products continue to be part of these regulatory change discussions as federal and state governments seek additional sources of revenue. One additional complication may arise if, due to the debate over healthcare, Congress decides to repeal the McCarran-Ferguson Act, thus subjecting all insurers to full anti-trust requirements.

Efforts at improving consumer protection will continue, particularly as complex insurance products converge with changing consumer behavior and demographic shifts. These trends affect how insurers design and market products and may accelerate the development of simpler products.

# A key consideration for insurers is the need to focus on understanding the links between risk management and capital management.

Until US GAAP and International Financial Reporting Standards (IFRS) truly converge, US insurers will face two significant challenges. First, multinational insurers operating in the US will incur higher costs from maintaining and producing two sets of accounting statements. The second challenge is that the major world capital markets, except for New York, use IFRS as their financial reporting standard. This makes it more difficult for US insurers seeking to raise or rebuild capital from other markets. Looking forward, insurers need to understand the implications of IFRS and US GAAP convergence on their business.

Solvency II is gaining ground in Europe with the passage of the framework directive in May 2009. As insurers rebuild capital levels, they are concerned about the additional impact of Solvency II on their fragile capital positions, and the significant cost of implementing this new regulation. Solvency II's global standards, solid governance and supervisory principles will influence how European companies manage their business in the future. The impact in the US remains to be seen.

It will be several years before many of the structural implications of health reform go into effect. However, workers' compensation will be impacted regardless of what form the legislation takes. For example, provider fee schedules are based on Medicare rates; any changes in Medicare reimbursement will affect workers' compensation payments over time. According to the National Council on Compensation Insurance, the percentage of workers' compensation losses attributable to medical costs increased from 46% in 1988 to 58% in 2008. If legislation yields meaningful reduction in the growth of medical expenses, there could also be significant benefits in loss cost containment. Another likely element of the reform package will be increased pressure on reimbursement rates and payments to physicians and hospitals, following the lead of Medicare to limit payments.

As progress moves forward on all these developments in 2010, insurers find themselves operating in a continually changing regulatory environment. They will need to evaluate the impact of regulatory changes on all financial and operational aspects of their business, as well as the future growth potential. While this set of initiatives

is certainly challenging, the effects of regulatory changes frequently afford opportunities.

## Focusing on core businesses and readdressing product and distribution strategies

As the economy continues to stabilize, insurers need to evaluate and implement tactical and strategic decisions about non-core businesses, products and distribution channels. These decisions are crucial in helping insurers rebuild capital, as well as positioning themselves for future growth.

Insurers will continue withdrawing from non-core businesses in 2010, as they conserve capital and reallocate it among those businesses with the best chance of future success. This withdrawal creates opportunities for better-capitalized companies to increase market share as weaker competitors close or sell operations that add marginal value. At the same time, better-capitalized companies also will remain focused on what they see as their core businesses, which will contribute to industry consolidation. Insurers must prepare for the new competitive landscape.

The P/C industry recognizes the importance of all channels to meet evolving customer needs. Based on this evolution, the market is segmenting into three distribution types: self-service, full-service and a mixed model. Segmentation is based on the level of service customers need and the prices they are willing to pay. Currently, the mixed model comprises the largest part of the market.

## Building more risk management capacity with stronger governance and transparency

Insurers often do not have leading practices in place to identify and monitor the wide variety of risks they are facing. Risk monitoring should start in business units and should be coordinated from the corporate center. Business units and chief risk officers (CROs) should work closely together to maintain processes to identify and escalate emerging risks to executive management and the board. Individuals at every level in the process will need to take an active role in setting and maintaining a reporting paradigm that allows key stakeholders to understand the results and

their implications across an expanded range of adverse scenarios. These challenging times provide an opportunity to employ effective enterprise risk management programs to further increase management transparency and encourage consistency in aligning risk tolerance with risk appetite.

At the enterprise level, governance needs to focus first on confirming the organization's risk appetite and risk-taking limits. In addition to establishing procedures to monitor capacity, the CRO must drive the risk budgets for business units, set clear lines of authority and procedures for approving the assumption of risk and execute approved responses when risk limits are exceeded. Real-time monitoring of risk-taking is needed to ensure that risk limits are enforced before any additional risk is booked.

The CRO will also face increasing demands from regulators and rating agencies on risks assumed and capacity. In fact, as external stakeholders, rating agencies and potential new regulators set guidelines for enterprise reporting, the demands will undoubtedly increase for business units as well. In addition to collaborating on setting enterprise risk levels, local business units will increase their monitoring of risk levels, their range of scenarios used for modeling risk and their scrutiny of regulatory capital and liquidity with respect to both new and in-force business. The range of modeling tasks will continue to expand in 2010 as dynamic capital forecasting, asset liability management, portfolio optimization, hedging and stress testing all vie for attention. Stress testing and forecasting models will be built to incorporate extreme events.

A key consideration for insurers is the need to focus on understanding the links between risk management and capital management. Often, decisions to allocate capital do not take risk into consideration in a disciplined, consistent and comprehensive manner. Without management and board support for risk management initiatives, CROs will not have the resources and power to improve the decision-making process.

## Improving the effectiveness of company infrastructure

Premium and expense growth is another key issue for the P/C industry. Expense ratios have been increasing since 2004, as noted in Figure 2. A

combination of decreasing premium exposures and rates for commercial insurance products has exacerbated this condition in the past two years. With the negative near-term outlook for commercial premium growth, the industry faces another year of eroding margins that will challenge many insurers with uncompetitive operating cost structures. Short-term expense reduction initiatives may relieve current pressures, but they also can increase risks if cost cutting impairs operating effectiveness. Efficient organizational structures and more effective use of technology are key strategies to follow.

The relative importance of efficiency as a business priority often re-emerges during recessions and other conditions where margins are compressed. While the concept can be simplistic, the application and its effective measurement can be complex. Two key considerations frame successful cost reduction programs. First, addressing the effectiveness of long-term objectives will result in a program that is more responsive in evolving environments than one that simply focuses on cost containment. Second, the objectives of sustainable programs recognize that multiple leanness initiatives have diminishing marginal returns. Leading companies have adopted sustainable cost reduction by nurturing a culture of cost management that emphasizes delivery of value in all aspects of the business.

Historically, insurers have considered process re-engineering and head count reduction as a way to reduce costs, but in the current environment, insurers will need to move beyond that to address cost reduction through transformation. This creates a path for greater sustainable value creation by examining the overall operating model.

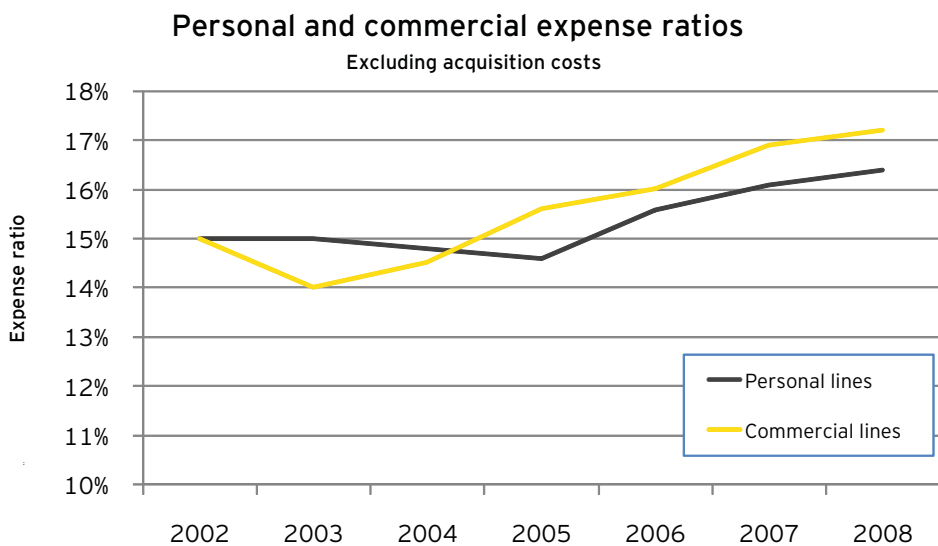
Insurers' transformation agenda should address: (1) simplifying, streamlining and consolidating

organizational structures to reduce organizational complexity; (2) driving greater automation into the operating environment by eliminating manual business processes (from new business to claims) across the value chain as this contributes to higher costs; (3) simplifying the technology environment by consolidating redundant legacy systems across finance and operations; and (4) consolidating third party vendor relationships to drive greater cost savings and overall quality.

New technologies have been transformational for the industry, as well as for individual insurers. Robust connectivity and rapid real-time transactions among customers, insurers, distributors, and third-party data and service providers continue to increase reliability, reduce turnaround time and improve data quality. This is achieved in the context of the soaring volume of automated and semi-automated transactions. The standard of expected connectivity is constantly increasing, along with the breadth of expected transaction support. This now includes billing, claims applications, policy view, endorsement, quotes and issuance.

Insurers will need to move towards a more comprehensive view of cost reduction than they have in the past. This will enable them to achieve overall operating efficiency, improve business performance and enhance their ability to be more competitive.

Figure 2



Source: Conning & Co; note: expenses exclude commissions

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