VISION

THE INSURANCE INDUSTRY

Facing the Future: Blueprint for Growth

Featuring data from the 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

55%
Reprice new business to adapt to market conditions

41%
Redesign products to be less sensitive to markets

37%
Large-scale investment in information technology

21%
Divest non-core business

PERCENTAGE OF INSURERS CONSIDERING STRATEGIC ACTIONS OVER THE NEXT 12 MONTHS

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About the Research

For this study, State Street commissioned the Economist Intelligence Unit to conduct a global survey of senior insurance industry executives. Of the 307 respondents, the largest proportion (53 percent) were from life insurance companies, with 19 percent from property and casualty firms, 12 percent from diversified insurers, and the rest from reinsurers and health insurers. The survey focused on senior executives, with 49 percent of respondents at the C-suite or above and most of the rest either senior managers or heads of business units. It was also global, with Western Europe and the Asia-Pacific region each providing 36 percent of those taking part, North America 26 percent, and the rest coming from Eastern Europe, Latin America, the Middle East and Africa.

In addition to the survey, Longitude Research conducted a range of in-depth interviews with corporate leaders from the industry and other experts, as detailed on page v. These interviews took place in April and May 2013. All direct quotes that appear in this report are drawn from these interviews.

Executive Summary

The insurance industry is experiencing a period of deep structural change as it responds to a wide range of market challenges. Flat sales and a difficult investment environment are encouraging companies to seek new sources of value. Demographic trends, new technologies and evolving customer expectations drive the needs for new products and a change in the way they are delivered to the market. Meanwhile, regulators are dramatically reshaping the playing field for insurers.

The issues outlined above are causing insurance firms to rethink many areas of the business, but they are optimistic about the future. For those organizations that can successfully navigate the winds of change, there are substantial opportunities for growth and innovation. This State Street study, based on a survey of more than 300 senior industry executives and a range of in-depth discussions with corporate leaders and other experts, identifies key areas where the industry is developing new approaches to help firms compete in a demanding and unpredictable environment.

Key Conclusions

Regulation is Changing the Game

Regulatory reform in the wake of the global financial crisis continues to transform the insurance industry. Fully 29 percent of survey respondents globally report that their companies have sold lines of business as a direct result of new capital requirements or risk management considerations, and this figure rises to 39 percent in Europe.

Meanwhile, half have thought about selling non-core businesses. Recent examples of restructurings include the sale by Hartford Financial Services of its individual life business to Prudential Financial and its retirement plans business to Massachusetts Mutual Life Insurance.[1] Regulatory compliance is also one of the main reasons why so many insurers (62 percent in the survey) are considering increased IT investment, either in the next 12 months or beyond.

These changes are costly and disruptive. There are ways, however, to turn compliance from a box-ticking exercise into a source of competitive advantage. First, leading insurance companies are using compliance programs to streamline their processes and to modernize their outdated IT systems. Second, at a more strategic level, regulation will prompt insurers to become more selective when it comes to choosing the markets in which they want to compete.

[1] Life Insurance Industry Restructuring Accelerating, Fitch Ratings, April 17, 2013.

Emerging Markets Offer Growth Potential, but the Price of Entry is Rising

Emerging markets are one of the primary growth areas for insurers and their potential remains great. For example, the value of insurance premiums held by each citizen in China and India was only $64 and $10 respectively in 2011, compared to slightly over $1,000 for Japan and Korea.[2] This indicates a huge opportunity for growth in the region.

Eighty-two percent of respondents, however, perceive challenges when expanding into new geographic markets. The large number of companies coming into the region is making the task harder, in part by rapidly driving up the cost of engaging in M&A. In 2012, over half of global insurance M&A by value took place in Asia, a trend that helped drive price-to-book ratios of firms in the region to nearly double that of insurers in developed markets.[3] Despite this, M&A remains an attractive option as it offers a way to buy into local talent and strong customer relationships within the region.

Demographic Trends and New Customer Segments Will Drive Product Innovation

Insurance companies have to adapt their products to meet the needs of a changing customer base. For example, the world's aging population provides substantial opportunities for those companies that can create new income products to support longer retirements. Products are also being developed for young tech-savvy audiences, such as mobile applications that can identify good drivers and reward them with lower premiums. Targeting the right product to the right customer segment is vital: prioritizing and enhancing product offerings is the most cited strategic priority globally (28 percent), and in the Americas that figure rises to 37 percent. (See Figure 1.) However, nine out of 10 executives say that bringing new, innovative products to market quickly is a challenge — making it the most widely cited major difficulty in the survey. The key is to be able to understand the new customer segments, and to target them quickly with the right value proposition.

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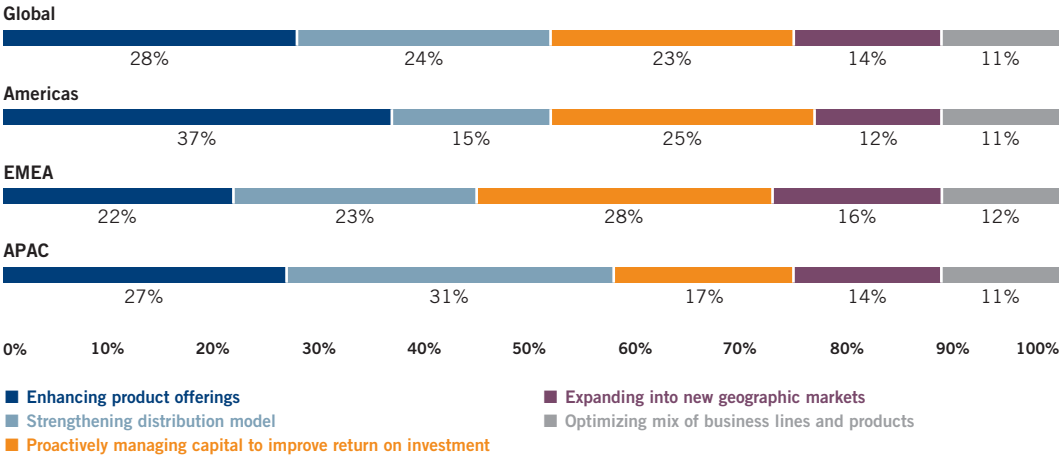
[2] Chaplin, Kent, "Market Presentation Asia Pacific," September 2012, www.lloyds.com/comparecountries.

[3] Reuters, Denny Thomas and Clare Baldwin, "Asian insurance M&A gets pricey as region's promise beckons," April 28, 2013; "Insurance M&A fell in 2012 to $54bn," January 4, 2013, *Reactions*, www.reactions.net.

Figure 1: What is the Top Strategic Priority for Your Business Today?



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

New Technology Has Made Revamping Distribution Models a Top Priority

Internet-based distribution models have already undermined the traditional intermediary model in many countries. Twenty-four percent of companies globally, and 31 percent in Asia, say that strengthening their distribution model is their top priority. Adapting distribution strategies to changing demographics and consumer needs is a challenge, according to 81 percent of respondents. Managing this transition is more than a matter of moving from traditional brokers to Web- and phone-based services. The leading players will be able to deliver seamless service and a consistent brand experience across all these channels.

Nontraditional Asset Classes Could Boost Investment Returns, but Insurers Need to Develop the Tools and Expertise to Manage Them

Low returns on traditional investments, combined with a desire to diversify the investment portfolio, are leading companies to consider new asset classes. Globally, 23 percent say that increasing the return on investments is their top strategic priority, but that proportion rises to 28 percent in Europe, where especially low interest rates and the capital requirements of Solvency II make the issue particularly acute. In response to this trend, nearly half of the companies in the survey are thinking about increasing their allocation of alternative investments in the next year.

This represents a major shift in thinking, with 79 percent identifying the move into alternative assets as a challenge. Investing in expertise and specialized IT tools, as well as developing relationships with external asset managers and servicing partners, will be essential if companies are to balance properly risk and reward, while getting the most from this shift of investment focus.

Consolidating Data Systems Would Help Many Companies Improve Efficiency

In the current economic climate, insurance companies are still trying to reduce expenses. Many companies have disjointed IT systems that are legacies of their historical development, but have been reluctant to invest in integration. With the data demands of compliance, the needs to manage new types of assets, and the potential strategic gains of Big Data, it is inadvisable to delay the necessary investments in this area. For leading companies, a robust IT system that provides insights from data as well as required information will be a given.

As Markets and Regulations Evolve, Companies Should Selectively Outsource

Business models, in whole and in part, are shifting to deal with the changing environment for insurers. This means that the definition of what is a core activity many evolve as well. As part of this evolution, companies should review which areas of the business could benefit from outsourcing: 58 percent, for example, are evaluating the transfer of certain back- and middle-office functions for the investment portfolio to experienced third parties. Leading companies will retain core skills and competencies in-house, but outsource secondary activities — even when this breaks with tradition.

THE FUTURE DOES NOT BELONG TO THE SECTOR AS A WHOLE BUT TO THOSE COMPANIES THAT CAN CROSS THE BRIDGE TO THE NEW, AND DRAMATICALLY DIFFERENT, ENVIRONMENT OF THE POST-CRISIS WORLD.

Introduction: Impetus for Change

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The insurance industry has faced a challenging environment over the past few years. Insurers weathered the immediate storm of the global financial crisis relatively well, compared with other areas of financial services. Nevertheless, a number of trends have come together to drive sweeping changes across the sector.

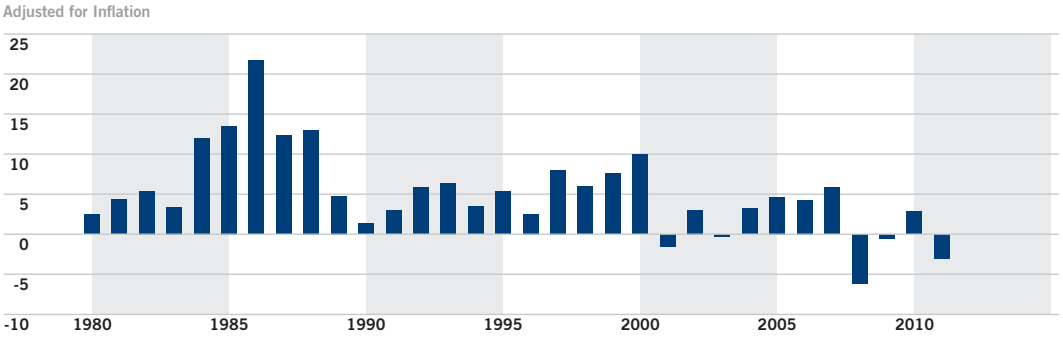
For one, the economic downturn has meant that traditional, lower-risk investments favored by insurers are now earning far less money. Long-term interest rates in the traditionally safe economies of northern Europe and North America typically sit under 2 percent.[4] Christophe Lepitre, deputy CEO of OFI Asset Management, puts the implications succinctly: "Companies have maybe 80 percent of assets in government bonds. Some are not comfortable positions to hold. Ireland, Portugal, Spain and Italy are volatile at the very least. For the rest — France, Germany and the UK — the rate is so low that it doesn't match their needs in terms of long-term liabilities." Although the tie between investment returns and liabilities may be more explicit in certain life products, low rates also weigh on the financial performance of property and casualty companies.

[4] OECD.Stat, "Key Short-Term Economic Indicators MetaData: Long-term interest rates."

THE ECONOMIC DOWNTURN HAS LEFT INVESTMENT RETURNS BELOW LEVELS NEEDED TO BREAK EVEN

Meanwhile, the current environment is also hurting sales. After two decades of steady if unspectacular growth, total real premiums fell in three of the four years between 2007 and 2011, for a cumulative drop of about 2 percent.[5] The biggest decline has been in life premiums, which have shrunk by 7 percent overall in that time period. The non-life market has had problems of its own. Between 2007 and 2011, non-life global total premium growth averaged a meager 0.96 percent. (See Figure 2.) Furthermore, 2011 saw the highest insured natural catastrophe losses ever ($120.3 billion) and 2012 the third highest ($71.3 billion).[6]

Figure 2: Real Life Premium Growth 1980–2011 (Worldwide)



Source: Swiss Re, Sigma World Insurance Database, accessed June 2013.

Another result of the financial crisis has been the ongoing wave of regulation affecting the entire financial services sector. The European Union's Solvency II Directive and the Solvency Modernization Initiative, along with Dodd-Frank driven reforms in the United States, have the highest profile. This is a global phenomenon, however. "In emerging markets like Latin America and parts of Asia the speed of change is ratcheting up," explains Shaun Crawford, global insurance leader at Ernst & Young. "They will be facing the same regulatory challenges as developed countries in two to three years."

In particular, the adoption of major new Insurance Core Principles by the International Association of Insurance Supervisors in 2011 has led to significant regulatory change across a wide number of developed and emerging markets. Among the latter, both India and China have substantially revised regulation and shifted toward the risk-based capital requirements that are increasingly common in the rest of the world.

[5] Swiss Re, Sigma World Insurance Database, accessed June 2013.

[6] Ibid.

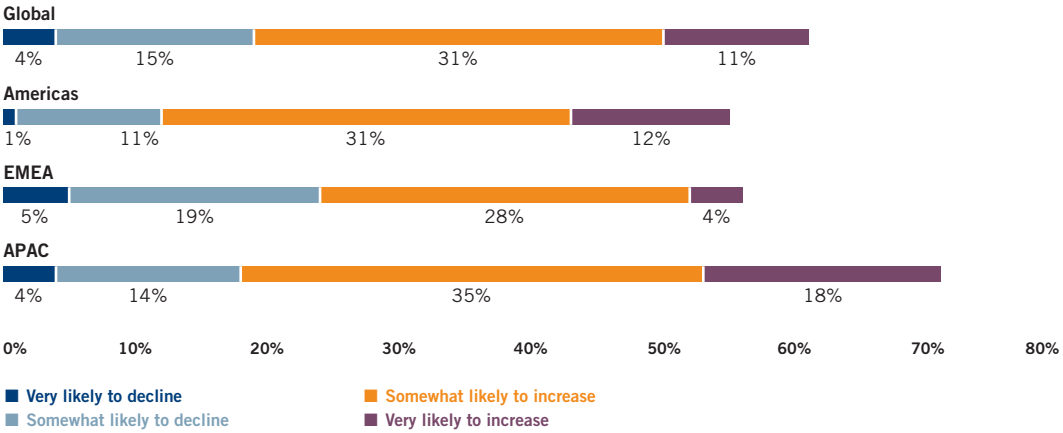
THE INDUSTRY IS SEEKING WAYS TO DRIVE LAGGING PREMIUM GROWTH

Finally, the industry is facing issues that predate the financial crisis. The most important is the ongoing shift in how consumers wish to interact with companies. Sachin Shah, a partner with Bain & Company, explains the shift. "The whole customer journey — everything from first researching and gathering information, through evaluating and making a decision, to buying the policy, as well as then administering and servicing it, having claims processed and giving feedback — that whole journey is enabled by the Internet. The majority purchase insurance online. And the most popular channel is the direct channel."

Repositioning for Growth

Despite these substantial challenges, insurers remain positive. In a global survey of 307 senior insurance executives conducted for this study, 42 percent expect the industry's profitability to increase over the next five years, more than twice the number expecting a decline (19 percent). (See Figure 3.)

Figure 3: How Will Profits Change in the Next Five Years?

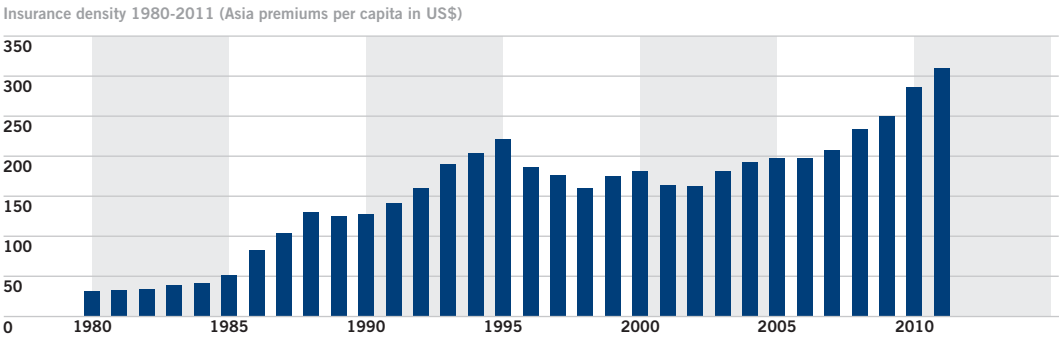


Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

MAJOR REGULATORY CHANGES ARE TRANSFORMING THE INDUSTRY LANDSCAPE

This optimism reflects some very real opportunities available to those insurance firms that effectively negotiate change and adapt to the new environment. Premium growth may be low globally, but in emerging markets it is rising fast. Insurance density — per capita premiums — in Asia, for example, rose by nearly 50 percent between 2007 and 2011. (See Figure 4.)

Figure 4: Insurance Density 1980–2011 (Asia)



Source: Sigma World Insurance Database, accessed June 2013.

Looking ahead, the opportunity to help meet the retirement needs of consumers in the region looks vast. (Not surprisingly, 52 percent of Asian respondents expect industry profitability to increase.) Similarly, changing consumer habits open up the possibility of finding new ways to reach potential customers. Even the growing regulatory burden may have a bright side by forcing companies to make long-avoided IT investments. The future, then, does not belong to the sector as a whole but to those companies that can cross the bridge to the new, and dramatically different, environment of the post-crisis world.

"Insurance is a really important product. You can't fly a plane, save for the future, or work in an office without some form of it. This will never go away. It is about the price people are willing to pay for it."

– Shaun Crawford, global insurance leader at Ernst & Young

An instinctively conservative industry like insurance may not find this easy. Says Laurent Clamagirand, chief investment officer of the AXA Group, “I would be mildly, but not overly, optimistic. There are many challenges in the future that are not insignificant.” Nevertheless, as Crawford notes, there will be winners. In looking at the immediate difficulties, he says, people often forget the basic truth: “Insurance is a really important product. You can’t fly a plane, save for the future, or work in an office without some form of it. This will never go away. It is about the price people are willing to pay for it.”

Opportunities therefore remain, waiting to be tapped. The challenge is the need for insurance companies to reinvent themselves in the face of substantial legacy issues. These legacy issues arose from M&A, siloed organizational structures and IT systems, as well as policy and pension liabilities that can last decades. This study will take a closer look at the key areas where tomorrow’s leading companies will need to initiate change today.

ONLINE DISTRIBUTION MODELS ARE OVERTURNING THE AGENT MODEL

Regulation: Facing the Immediate Challenge

Regulation: Facing the Immediate Challenge

Regulatory compliance is a hugely important issue for insurance companies, given that it secures them their license to operate in markets. Nearly one-third of survey respondents (32 percent) describe adapting to evolving insurance regulation as a major challenge, making it one of the biggest issues identified in the survey. Only 17 percent are so confident that they do not see this as a difficulty at all.

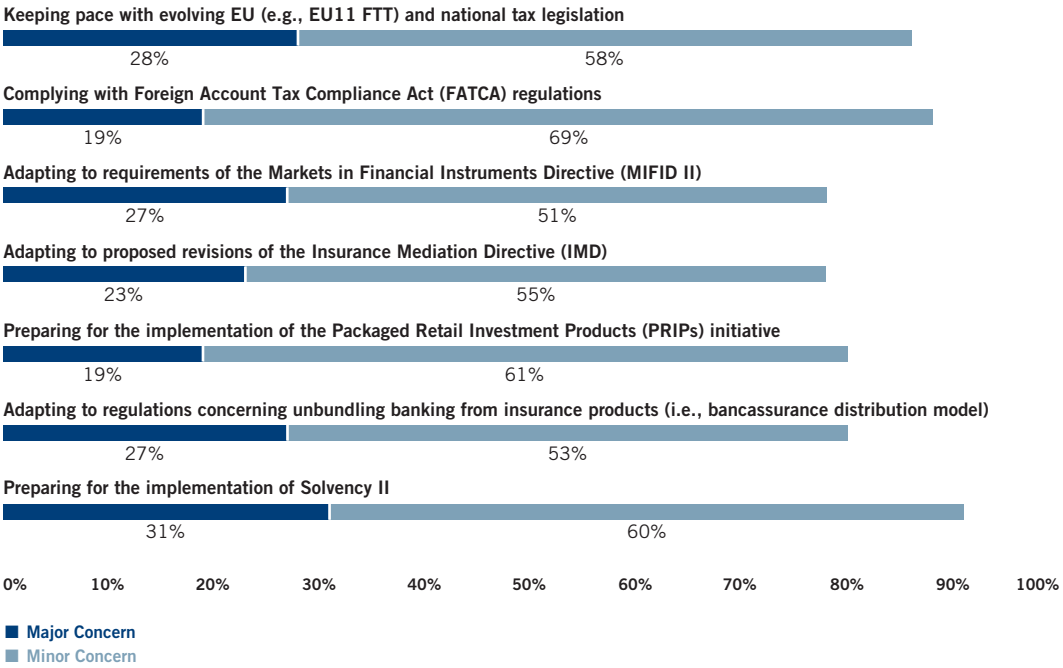
This issue is present in every region, although the focal points of concern inevitably vary. (See Figures 5 and 6.) Solvency II is a huge concern for those operating in Europe: 91 percent of respondents describe this as a challenge. More striking, however, is the sheer range of regulatory issues. These go from extraterritorial legislation by other powers — America's Foreign Account Tax Compliance Act (FATCA) is the second biggest challenge for EMEA respondents — to evolving European and national tax and financial regulation, to interactions with customers under proposed revisions to the Insurance Mediation Directive.

Similarly, the vast majority of American respondents cite adaptation to evolving National Association of Insurance Commissioners standards around capital requirements — such as the Own Risk and Solvency Assessment (ORSA) — as a concern (85 percent). Eighty-one percent

SIGNIFICANT REGULATORY CHANGE IS A GLOBAL ISSUE

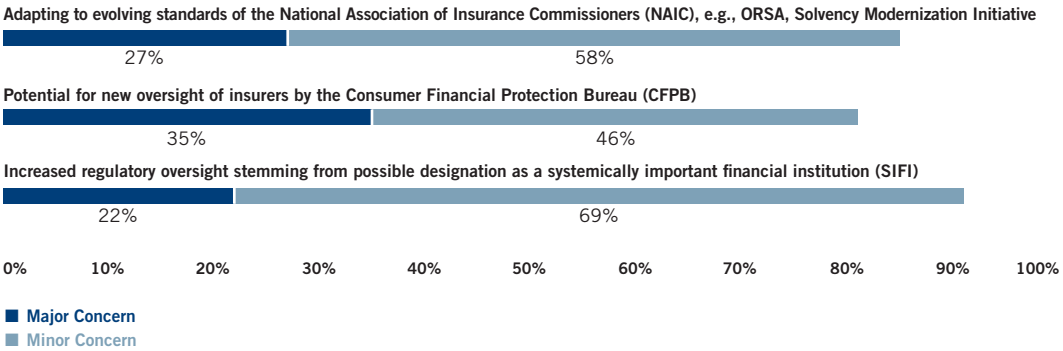
say the same of the potential for new insurance oversight by the Consumer Financial Protection Bureau. In fact, the variety of regulation is a global issue. In Asia, not only are insurers adjusting to tighter capital regulation, but diverse regimes covering consumer interaction mean that distinct approaches are needed in different countries.

Figure 5: Compliance Concerns of Companies Operating in Europe



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

Figure 6: Compliance Concerns of Companies Operating in North America



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

SUBSTANTIAL UNCERTAINTY REMAINS REGARDING WHAT SHAPE NEW REGULATORY STRUCTURES WILL TAKE

Cost and Confusion

The costs of regulation are by no means trivial. The European Commission estimates that Solvency II alone will cost the industry €2 billion-€3 billion to implement over five years. This cost will hit an industry already struggling with low premium growth and interest rates. Only 30 percent of survey respondents think it likely that they will be able to pass on these costs to customers.

Adding to the industry's difficulties is the remaining uncertainty around major pieces of regulation. As Clamagirand points out, even before implementation of Solvency II, "we are already living in a world where each time we invest we need to consider the capital charge." Nevertheless, the capital requirements associated with some potentially important assets, such as infrastructure bonds, remain undecided.

In the US, Professor Scott Harrington, academic director of the Wharton/Penn Risk and Insurance Program, notes that there is "tremendous uncertainty on which institutions will be designated as systemically important financial institutions (SIFIs)." It is likely that only one or two major US life insurers in particular might receive this designation and attract bank-like regulation. Nevertheless, fully 22 percent of respondents operating in North America describe SIFI as a major concern.

Looking beyond the national perspective, Harrington points out that "great disagreement between EU and US regulators" exists over the best way to calculate capital requirements. This, in turn, makes the future shape of international regulatory architecture opaque. Our survey reflects this lack of clarity: the same number (39 percent) expects global regulatory convergence as foresees the continued existence of national standards.

Such uncertainty has important business implications. Until insurance companies know the full outcome of Solvency II, they may be unwilling to invest in developing the products that an aging population will need. Robin Matthias, of McKinsey & Company's European Insurance and Asset Management Practice notes that across the financial services industry, "the willingness to take bold moves, given quite a bit of uncertainty around what will happen, has probably come down. Many players seem to have adopted more of a wait-and-see attitude toward regulation."

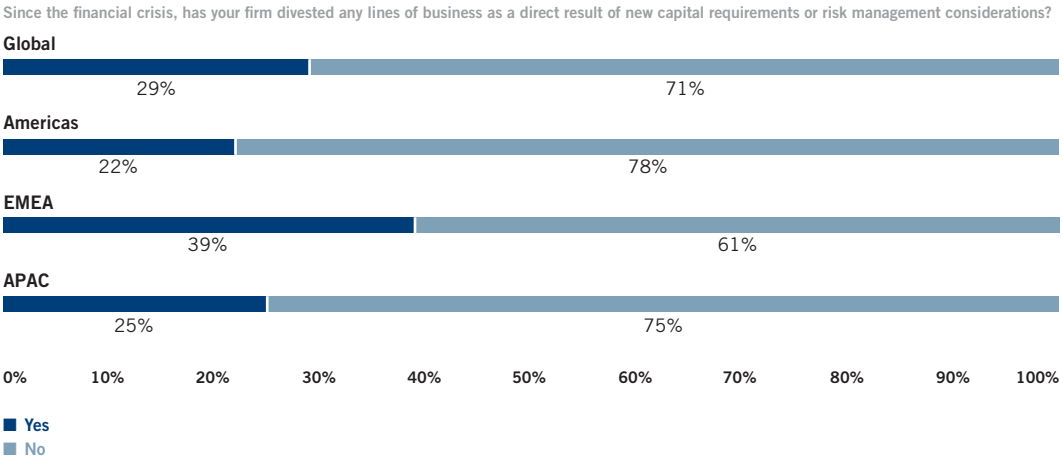
All this uncertainty creates a fear that regulators may make choices that significantly damage the industry. Jim McCaughan, president of Principal Global Investors, explains: "What most worries me about how things are changing right now is that we are going from a situation where the system was insufficiently safe to one where it is so oriented to safety that it precludes returns. That would mean that capital would not be available."

SOME COMPANIES ARE SHEDDING NON-CORE LINES OF BUSINESS OR GEOGRAPHIC MARKETS

Beyond Compliance

So how are companies addressing the current regulatory challenges? One response for many is to refocus to avoid unnecessarily attracting regulation or its costs. Twenty-nine percent of executives surveyed say that their firms have, since the financial crisis, divested themselves of lines of business as a direct result of new capital requirements or risk management considerations. This figure rises to 39 percent in Europe. Moreover, globally half have been evaluating the possibility of divesting non-core businesses. (See Figure 7.)

Figure 7: Divesting Business Lines



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

Similarly, some companies are consolidating geographically. Crawford notes, "We've seen quite a bit of rationalization and are starting to see some consolidation." He adds that some of the push into emerging markets arises because some companies are seeing that they "can make good money without the level of regulation in mature markets."

Although it can be reduced, ultimately regulation cannot be avoided. Insurers are therefore making substantial compliance investments. The largest element of this is in IT, a trend that is likely to continue. Sixty-two percent of respondents report that their companies are evaluating substantial IT investments, an investment which is almost certain driven in part by regulatory compliance.

Christopher Morgan, a leading technology expert at Deloitte, points out that companies should see this investment as an opportunity to go further than just compliance. "Some companies

take a tactical view — to just get in and resolve the requirement. Firms that are very strategically focused understand that if they make this kind of spend they should do it broadly." Such an approach, he says, requires a cultural shift for many insurance businesses but the rewards can be substantial. Improved IT is a key aspect of the better risk management, lower costs, and greater understanding of customers and investments that are central to the changes insurance companies will need to make to address the diverse challenges they face.

Regulatory compliance is causing many companies to review the extent of their operations and forcing them to invest heavily in IT. In both cases, these activities can merely involve risk reduction and check-box compliance. Tomorrow's leading companies, however, will take the opportunity to make these changes in a way that help them address the broader range of challenges they face.

"We are going from a situation where the system was insufficiently safe to one where it is so oriented to safety that it precludes returns. That would mean that capital would not be available."

– Jim McCaughan, president, Principal Global Investors

COMPANIES NEED TO TRANSLATE COMPLIANCE INVESTMENTS INTO LONGER-TERM VALUE

New Sources of Value

"Companies that succeed are those that can figure out innovative ways to provide products for the growing middle class. These firms can quickly get local talent who understand local conditions and can communicate with potential customers."

Professor Scott Harrington
Academic Director, Wharton/Penn Risk and Insurance Program

New Sources of Value

Compliance, however necessary, does not drive growth. Insurers are therefore looking at a variety of strategies to increase premium income.

In doing so they are responding to three simultaneous shifts that are changing the sales environment:

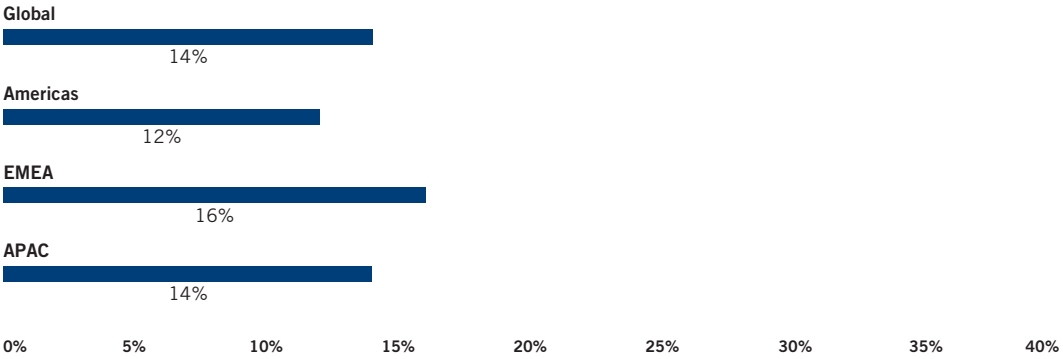
- The shift in focus from existing markets to high-growth emerging markets
- The new product requirements that arise from an aging population
- The development of online distribution models and how this is changing consumer expectations around interaction with companies

EMERGING MARKETS ARE SEEING PROMISING GROWTH, BUT ALSO SUBSTANTIAL INCREASES IN M&A ACTIVITY

Trend I: New Markets and Global Expansion

Many leading insurers based in developed countries are moving into emerging economies, especially in Asia: 14 percent of survey respondents say that expansion into new geographic markets is their single leading strategic priority. (See Figure 8.)

Figure 8: Top Strategic Priority: Expanding into New Geographic Markets



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

The attractions of emerging markets are clear. From 2010 to 2012, while non-life real premium growth in developed countries stayed near or below 2 percent, it has been far higher in the major emerging markets. Life premiums tell a similar story except that regulatory change in China and India led to declines in the past two years, which are expected to be temporary.[7]

Looking ahead, the future appears even brighter. Insurance penetration for non-life insurance as measured in premium per capita in the two largest emerging markets, China and India, was only $64 and $10 respectively — compared with slightly over $1,000 for Japan and Korea.[8] On the life insurance side, many developing countries will need to fill an annuity gap as populations age because governments do not yet have the resources to provide an extensive social safety net. According to the Asia Development Bank, private pension assets in China and India, for example, grew on average by 35 percent per year between 2002 and 2010.[9] They nevertheless still represented less than 1 percent of national GDP, comparatively a very low figure. Such

[7] Swiss Re, "Global Insurance Review 2012 and Outlook 2013/14," December 2012.

[8] Chaplin, Kent, "Market Presentation Asia Pacific," September 2012, www.lloyds.com/comparecountries.

[9] Yuwei Hu, "Growth of Asian Pension Assets: Implications for Financial and Capital Markets," Asian Development Bank Institute Working Paper Series No. 360, May 2012 (especially tables 1b and 1c).

data help explain why 44 percent of respondents to the 2013 State Street Insurance Survey from companies operating in Asia-Pacific countries cited demographic trends as providing the region's greatest opportunity.

Seizing these opportunities, however, is not easy: 82 percent see some degree of challenge in expansion into global markets and 89 percent say the same about developing a global fund platform. This is partly because so many companies are now competing for the chance to tap in to these markets. Insurance mergers and acquisitions (M&A) in Asia reached a record $30.5 billion in value in 2012, over half the global total for that year.[10] Clamagirand notes, "Many players have the same dream. They expect emerging markets to take off and allow this industry to go back to growth." This expectation is making acquisitions expensive: Reuters reports that Asian insurers already trade at twice the price-to-book ratio of those in developed countries and the figure is increasing.[11] The large number of local and regional players, however, makes buying into the market in many ways easier than organic growth, as these companies tend to know their local customers very well.

By contrast, another big challenge — the rapidly changing regulatory environment — creates a favorable opening for multinational companies. Domestic insurers are having to adapt to tighter regulation, an area in which the developed-market insurers have more experience.

Ultimately, however, there is no easy route to success. "The fundamental challenge in most emerging markets involves getting feet on the ground," says Harrington. "Companies that succeed are those that can figure out innovative ways to provide products for the growing middle class. These firms can relatively quickly get local talent who understand local conditions and can communicate with potential customers." If that local talent can be matched with world-class practices in product design, excellence in service and/or state-of-the-art technology, companies have a strong opportunity to distinguish themselves in these markets.

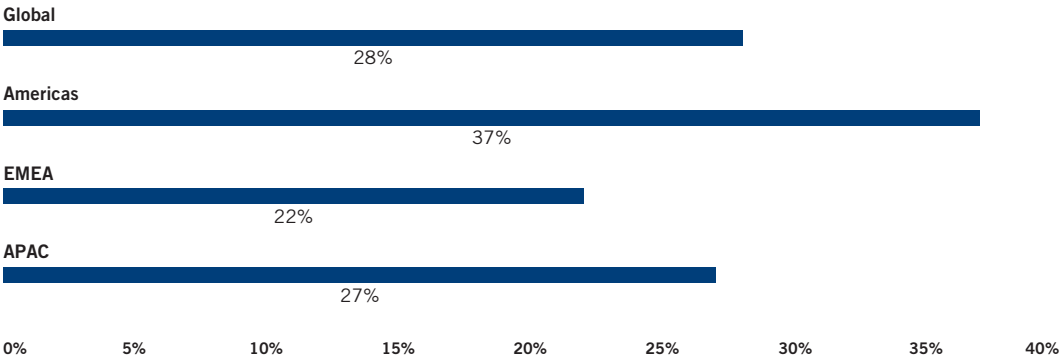
AGING POPULATIONS IN EMERGING AND EXISTING MARKETS REPRESENT SUBSTANTIAL OPPORTUNITIES FOR PENSION AND INCOME PRODUCTS

[10] Reuters, Denny Thomas and Clare Baldwin, "Asian insurance M&A gets pricey as region's promise beckons," April 28, 2013; "Insurance M&A fell in 2012 to $54bn," January 4, 2013, *Reactions*, www.reactions.net.

[11] Reuters, Denny Thomas and Clare Baldwin, "Asian insurance M&A gets pricey as region's promise beckons," April 28, 2013.

Trend II: New Products for Aging Populations

Figure 9: Top Strategic Priority: Enhancing Product Offerings



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

In most developed countries, and many developing ones, the average age is rising. According to data from the United Nations, the average life expectancy will rise at a little under two years per decade for the next three decades.[12] Population aging can have a significant impact on the property and casualty insurance market but its most obvious impact is on the life side. Unless the typical retirement age of 65 increases in line with life expectancy, each decade will see the average time people survive after retirement growing by more than 10 percent. Harrington sees "a lot of uncertainty about what you can do to meet the needs of an aging population, especially in the current low-interest climate. It creates a fundamental challenge as you go from asset accumulation to asset use."

Survey respondents certainly report that they are focused on new products, including those to address longevity: 55 percent are considering pricing new business to adapt to market conditions in the next 12 months. They are also looking to fill gaps in their propositions. Prioritizing and enhancing product offerings is the most cited top strategic priority globally (28 percent) and in the Americas (37 percent). (See Figure 9.)

Unfortunately, those surveyed admit that they find innovation particularly difficult. Ninety-three percent say that bringing new, innovative products to market quickly is a challenge and 44 percent say it is a major one — making it the most widely cited major difficulty in the

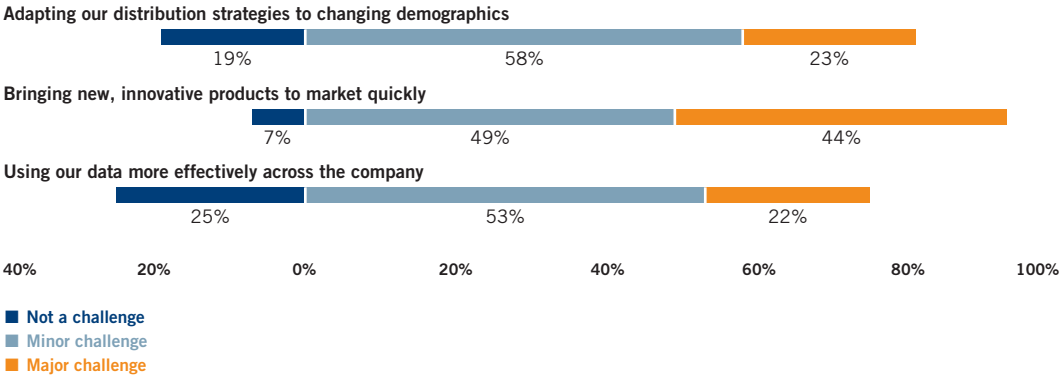
[12] United Nations Department of Economic and Social Affairs, Population Division, Population Estimates and Projections Section, World Population Prospects, 2012 revision.

NEW TECHNOLOGY IS REQUIRING INSURERS TO RETHINK HOW THEY INTERACT WITH CONSUMERS

survey. The current low returns on traditional investments make this all the harder. McCaughan believes that while demand for income products with guarantees will increase, consumers are not necessarily willing to pay heavily for such security.

New products that find a way to square this circle, though, will be worth the effort. McCaughan concludes that there is a huge opportunity in solving the issue of how to create products that can support customers through a longer retirement. "When someone shows up with a million dollars, how do you turn that into sixty thousand a year [over the rest of their lifetime]?" he asks. "That is tough when he or she might live another 30 years or more. I don't think anyone has really done it yet, but those who do it best will have very large businesses going forward."

Figure 10: Challenges in Product Innovation and Distribution

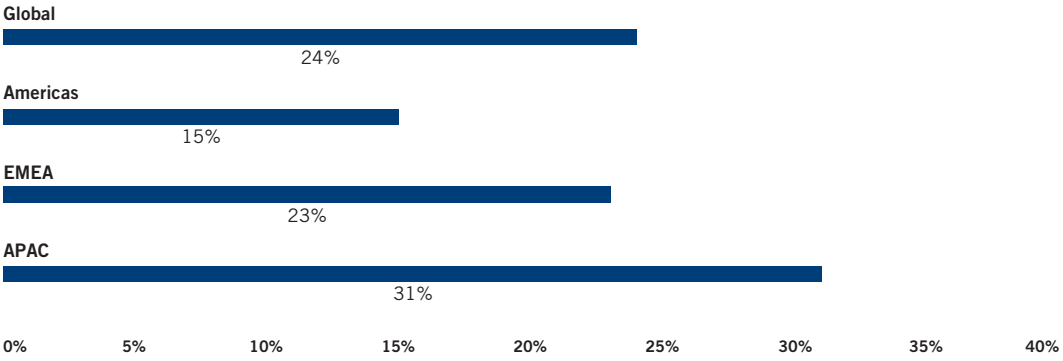


Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

Trend III: New Distribution Channels

Consumer adoption of increasingly powerful information and communication technology is continuing to reshape customer expectations about how they should be able to interact with businesses. Unlike aging, the impact of technology on distribution channels cuts across all types of insurance. It helps explain why improving the distribution model is the leading priority at 24 percent of companies, including 31 percent in Asia. Again, companies are not finding it easy: adapting distribution strategies to changing demographics and consumer needs is a challenge, according to 81 percent of respondents. (See Figure 10.)

Figure 11: Top Strategic Priority: Strengthening the Distribution Model



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

This trend is also related to demographic change in one important respect. Insurance companies are finding that older customers often continue to feel comfortable with traditional sales channels, in particular brokers and other intermediaries. Younger customers have long ago migrated to the Internet, now often accessed through mobile devices.

Demographic trends are leading to a "refinement in segmentation of customers and customer needs," says Scott Anderson, director of performance and risk at American Family Insurance. This has left the industry caught between diversifying the business on both the distribution and product levels, or focusing on excelling in one of these areas. Survey respondents certainly see this dilemma: 81 percent say that adapting distribution strategies to changing demographics is a challenge, with 23 percent calling it a major one.

Creating a truly integrated multichannel distribution system is much more complex than migrating from one means of communication to another. Michel Bois, director of information systems at CNP Assurances, feels that it is vital to keep all the sales and service channels open: "If we cut the old ones, our present customers will be disappointed. Furthermore, opening the new channel is an opportunity to get new customers."

He adds that the marketplace also requires more than a choice of a single channel for each customer. Ideally, the client should be able to initiate contact through any given medium and then continue it seamlessly via another. For example, data from an application partially filled out and saved online should be available to a sales agent if the customer phones for help in completing it. Bois says that this change is "absolutely at the top of CNP Assurances' priorities" given its importance in accessing the customers of the future.

In addition to saving money and improving service, the new digital channels enable insurance companies to access a wealth of data on their customers. Leading players are now looking at ways to harvest that data to create personalized marketing, as well as to price products based on a deeper understanding of the customer. "Insurance companies used to give you a price based on a broad demographic cohort," comments Shah. "Now they have a lot more information about you as an individual, and some are even augmenting this with tools that can scrape information from social media channels."

Although online channels have been used by the insurance industry for about 10 years now — often in quite a rudimentary way — these trends show some of the ways in which leading players are beginning to use IT as a source of differentiation and competitive advantage.

"If we cut the old channels, our present customers will be disappointed. Furthermore, opening the new channel is an opportunity to get new customers."

– Michel Bois, director of information systems at CNP Assurances

OBAMACARE TRANSFORMS CUSTOMER INTERACTION FOR HCSC

Although this study focuses largely on challenges that have broad relevance across most types of insurance and geographic markets, substantial specific issues exist for particular countries and sub-sectors. In the United States, for example, the implementation of the Affordable Care Act, colloquially known as "Obamacare," will dominate the agenda of health insurers for a number of years.

Health Care Service Corporation (HCSC), the largest customer-owned health insurance company in America, operates as Blue Cross/Blue Shield in Illinois, Texas, Oklahoma and New Mexico. The company has major plans under way to enter into the health care exchanges that are currently being set up under the legislation.

HCSC expects this to affect dramatically its customer base and the way it interacts with it. Historically, most of its business has been conducted through group plans, but the health care exchanges will involve high-volume interactions with individuals. The company already has more personal subscribers than most American health insurers — about 1.5 million, a number that has steadily grown in recent years. The rapid enrollment of potentially several million more, however, will require an almost overnight shift that would otherwise probably have taken decades to occur.

"It's a tremendous change," says Kenneth Avner, CFO at HCSC. "The sales process for most of our members is the group model where a small number of sophisticated buyers, the company's HR department and the CFO, make the benefit design decisions." With retail, however, the company will now interact with millions who have far less detailed knowledge of the market or of specific products. And the interaction will be concentrated during the annual enrollment period. "We know how to deliver excellent service to the retail market, but we cannot afford to use the traditional human-based service model when most of the enrollment is heaped in a couple of months each year."

Improved online channels are an important part of the solution when serving these huge numbers of retail customers. Avner points out, however, that the process of purchasing health insurance is highly complex, and that the subsidies and other aspects of Obamacare will make it more so. Because of this, in most cases the actual purchase decision will require confirmation through human contact. Even if a relatively small percentage of interactions falls out of electronic enrollment, the company will still need to handle a huge number of calls.

Deploying sufficient staff to field those inquiries brings its own complications. Staff need to be thoroughly trained, as there will be "little experience among consumers." Ultimately, some guesswork is necessary.

The company believes it is prepared. How well it copes in the end, however, will depend on its ability to transform its customer relationships and communication channels.

"We know how to deliver excellent service to the retail market, but we cannot afford to use the traditional human-based service model when most of the enrollment is heaped in a couple of months each year."

– Kenneth Avner, chief financial officer, Health Care Service Corporation

The Search for Better Investment Returns

"When yields were big enough, we had a large enough source of assets not to bother. Now we need to diversify big time."

Laurent Clamagirand
Chief Investment Officer, AXA Group

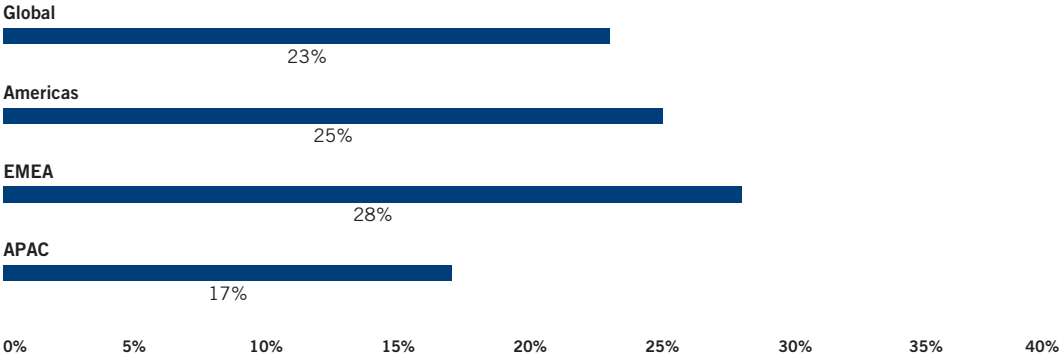
The Search for Better Investment Returns

Just as they are seeking ways to improve lagging premium income, insurers are responding to the economic conditions that have constrained investment income. Fully 23 percent of respondents to the 2013 State Street Insurance survey say that this is their company's top strategic priority today.

In Europe, especially low interest rates and the coming capital requirements of Solvency II make the issue acute. There, this is the most commonly cited top priority (28 percent). (See Figure 12.)

LOW YIELDS ON TRADITIONAL INVESTMENTS ARE LEADING INSURERS TO MOVE INTO NEW AREAS OF INVESTMENT

Figure 12: Top Strategic Priority: Managing Capital to Improve Return on Investment



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

Low interest rates are encouraging more insurance companies to consider alternative assets to drive yield, as well as to diversify their portfolios and help manage risk. Accordingly, the businesses of 80 percent of respondents are actively considering increasing their allocation to alternative investment classes. Nearly half (49 percent) expect to do so within the next year.

Insurers are not, however, finding diversification straightforward. Fully 79 percent of respondents report that investing in more complex asset classes is a challenge for their firms. Almost nine out of 10 executives say the same about executing effective strategies to balance assets and liabilities. Part of the problem is that innovation on the investment side is a relatively new area for insurance companies. McKinsey's Matthias explains, "Many insurers before the crisis did not focus as much on the investment function because it was contributing a significant share of profits. Now the attention is there, but many people don't know where or how best to start."

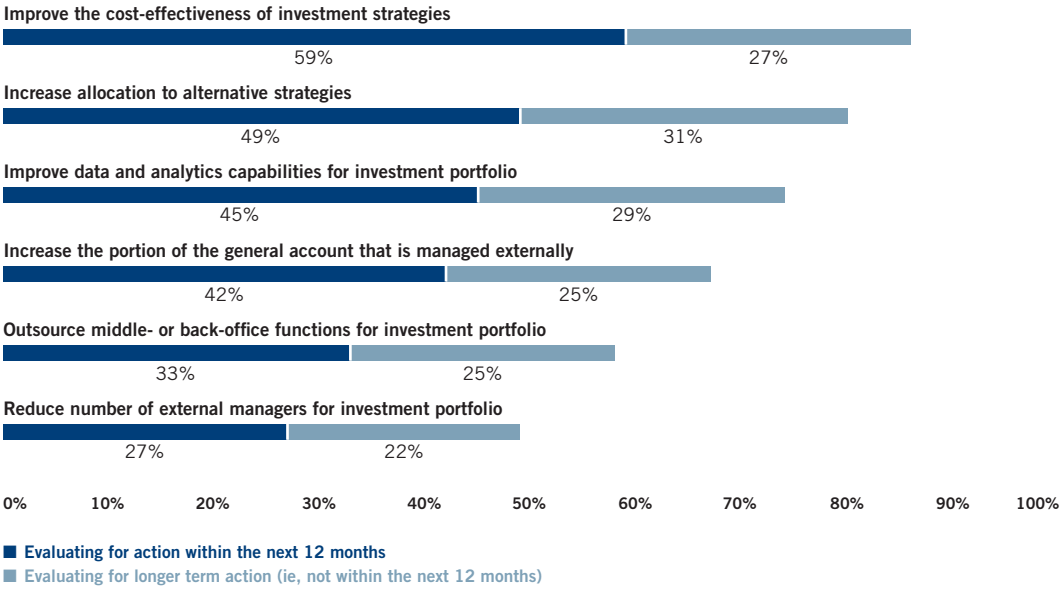
American Family Insurance in one of the companies that has significantly changed its strategy on the investment side. The company has increased diversification of the investment portfolio, and the focus has shifted from security selection to a more explicit linking of liabilities and assets with portfolio management. Investment management has been partially outsourced. "We spend a lot more time looking at risks in the portfolio," Anderson says, "and manage them in a more diligent way."

Ernst and Young's Crawford reports that other firms have experienced an even deeper transformation: "A number of insurance companies are reinventing themselves as asset gatherers and focusing on the investment market," he says. "You are seeing them taking market share away from private banks."

For those companies that take on new asset classes, it is vital to build the capability to understand and manage them. This may seem obvious, but it is a significant challenge for the industry. Respondents point to difficulties in sourcing talent: one in four say their business has trouble hiring knowledgeable, qualified staff in the field of asset allocation.

Outsourcing can be useful, although it is not a complete answer. Matthias warns: "You should build a dedicated team of investment professionals if you want to invest in corporate loans. Even if you partner with an asset manager, you probably still want to have sufficient expertise in-house, especially with regard to assessing and understanding the associated credit risks."

Figure 13: Six Actions Insurers are Considering for Their Investment Portfolios



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

SOME INSURERS ARE EXPERIMENTING BY OUTSOURCING MANAGEMENT OF THESE ASSETS

Investment Portfolios and the Power of Data

Although managing new asset classes brings a number of further issues (see AXA case study on page 32), one area where many companies particularly need to focus is developing specialized IT tools that help to manage diversified investment portfolios. While 84 percent of respondents say that their company's portfolio investment data is accurate, only two-thirds believe it allows them to understand their total risk exposure. Outside observers paint an even more worrying picture. OFI's Lepitre says that at most small or medium insurers, asset managers do not have the right IT systems to deal with the difficulties in assessing the risks of complicated investment products. Even when an external asset manager provides the necessary information, these flawed systems can restrict companies' ability to extract reliable insights from the data.

The industry is focused on catching up. Forty-five percent of respondents say that their companies are actively evaluating improvements to their investment portfolio data and analytics capabilities in the next year, and a further 29 percent consider this to be a longer-term priority. (See Figure 13.) CNP Assurances' Bois explains that improved analysis capabilities are becoming essential. "We need to have a daily view of all our assets with a good valuation," he says. "We also need to be able to simulate what happens if we do this or if interest rates do that. We definitely need a very powerful asset management IT platform." Although CNP Assurances' size makes this all the more important, all insurance companies can benefit from having improved abilities in this area.

Collectively, these trends create the need for real innovation on the investment side of insurance businesses. These challenges are relatively novel for insurance companies, and it is an area where we can expect to see considerable experimentation over the coming years.

ENHANCED ABILITIES ARE REQUIRED TO UNDERSTAND AND MANAGE NEW RISKS ARISING FROM MORE COMPLEX ASSET CLASSES

New Assets Require New Ways of Doing Business: AXA Group

The experience of the AXA Group reveals some of the key challenges insurance companies face as they move into alternative investments.

Laurent Clamagirand, the company's chief investment officer, explains why a new approach is necessary: "With policy orders on the life side for which the yield is above 3 percent, and when 10-year bonds are below 2 percent, it is very difficult. When yields were big enough, we had a large enough source of assets not to bother. Now we need to diversify big time."

The new strategy entails a substantial shift. Clamagirand estimates that between 20 percent and 25 percent of AXA's new investments will go into nontraditional assets this year.

Choosing appropriate investments, however, is far from straightforward. First, options are constrained. Solvency II has burdened certain classes with onerous capital requirements. Accordingly, AXA has already reduced its previously low equity holdings and these are unlikely to grow. At the same time, some traditional investments also have new risks attached. Clamagirand notes that buying government bonds from struggling southern European economies, whatever the inherent risk, is now largely taboo.

AXA also needs to find assets with characteristics that match its liabilities. This opens up various possibilities, potentially including infrastructure loans because of their long, predictable cash flows. Another choice might be trade financing on the finance side. The biggest new asset classes for AXA have been corporate loans and real estate.

The shift is not merely one of investment class. It brings other necessary changes. Better data is needed to understand the risk involved in particular investments. However, the IT efforts surrounding AXA's preparations for the implementation of Solvency II are helping the company meet this challenge.

Just as important as technology is developing appropriate investment expertise within the company. For AXA, this was not as difficult as it might have been because it already had internal experts in corporate credit before the financial crisis. It also has the resources to develop or hire more. Nevertheless, Clamagirand notes that this is "not something common for small and medium players. Some companies can do it; some can't." The new strategy also requires asset managers to work much harder than was necessary with their traditional investment portfolios. "It is a big change," he concludes.

ROUNDTABLE DEBATE

Insights on Risk: New Frontiers in the Insurance Industry

"We place more emphasis on using the massive data sets that insurance companies collect as well as all the tools and processes to reach down to more granular levels within product lines and business units. This integration and granular drilling down to where greater opportunities can be found is imperative."

Celia Kapsomera
Vice President, Risk and Investment Management,
GLOBAL Reinsurance Corporation of America

ROUNDTABLE DEBATE

Insights on Risk: New Frontiers in the Insurance Industry

Moderator

Gareth Lofthouse
Managing Director,
Longitude Research

Panelists

Jostein Amdal
Chief Risk Officer,
Gjensidige Forsikring

Celia Kapsomera
Vice President, Risk and Investment Management, GLOBAL Reinsurance Corporation of America

Mark Chaplin
Group Enterprise
Risk Director, Aviva

David Suetens
International Chief Risk Officer,
State Street

Risk management is a core competency for insurance companies, who live or die by their ability to evaluate and price risks in a fast-changing world. Increasingly, however, expertise in underwriting risks needs to be augmented with a broader set of risk management capabilities.

Key challenges include understanding an array of emerging risks caused by such factors as political risk, climate change, disruptive technology and the impact of regulation. Insurance companies are also seeking to strengthen their risk capabilities on the investment side of the business.

State Street, in partnership with Clear Path Analysis, hosted an executive roundtable to discuss how a fast-evolving risk environment is affecting the insurance industry. This section captures some of key insights shared during that discussion.

Gareth Lofthouse: Insurers are in many ways the masters of risk management. But where do you think the industry is exposed to new sources of risk?

Mark Chaplin: Political forces and political uncertainty have become stronger drivers of financial markets and understanding pure economics is no longer sufficient. This has been seen through the Eurozone crisis and perhaps will continue as a result of high levels of unemployment and the austerity-related pain felt in some countries. Regulatory changes are also not unlinked to political factors. These include the development of Solvency II, the increased powers of EIOPA [European Insurance and Occupational Pensions Authority], resolution planning for insurers and the increased focus on the consumer agenda.

Another evolving risk for me is how technology will change both business models and customer decision-making processes and the products that customers want. You only have to look at other industries to see how rapidly well-established and long-serving business models have been replaced, whether it is Amazon replacing traditional bookshops or the way travel products are now bought and sold.

Celia Kapsomera: In new sources of risk, I would include IT risk, emerging and yet to emerge risks — the "unknown unknowns" — and reputational risk. By IT risk, I mean protection of client, product or other sensitive data. Also, IT systems can be rendered inoperable during a physical or man-made disaster. Disaster recovery procedures should be up-to-date and periodically tested. In terms of emerging risks, these are the ones that are difficult to quantify but may have a major impact on an organization. Some examples of the unknown unknowns are new man-made risks — for example, terrorism, cybercrime, social networking misuse or a combination of events that individually are not a threat but collectively pose a risk. Also, nature has a way of surprising us. Volcanic ash has been a recent example.

Reputational risk is greater now because of the increased speed in transmission of damaging information. For example, the misuse of social media by employees to transmit sensitive information about a company is much easier nowadays with the proliferation of devices — BlackBerries, iPads, iPhones, etc. — and this can lead to serious reputational damage to a company or a legal action against the company.

Jostein Amdal: We like to think of risks not just as threats but in some cases as business opportunities. One could develop new products that fit these risks, if there is some willingness to pay for protection against them. Or do something on the reinsurance side. For the technical, climate change and legal-type risks, there are certainly possibilities to do something about them.

David Suetens: In general, our insurance clients are obviously strong at managing risks on the product side. Shocks and surprises will be more likely to come from the investment side, not least because of the trend to take on more alternative assets. Regulation is also still evolving and a lot of insurance companies have been hit by surprises across EMEA and globally, either on the investment or product design sides.

Gareth: How would you prioritize your efforts to innovate in risk management?

Jostein: First, we have established a more coherent and consistent framework for risk management in terms of defining risk appetites, risk limits, reports and so on. Second, we are moving towards steadily increasing the quantification of the risks wherever possible. The third part is culture, to get this risk management framework ingrained in the way we manage the company — essentially to make risk management a part of management.

David: We see that risk themes with our insurance clients are developing really to protect both sides of their balance sheet: the liability and investment side. Managing risks on product design has always been a core part of what insurance companies do. However, the more recent trend towards direct distribution means that product suitability now becomes part of the insurance companies' responsibility. This opens the way to liability for mis-selling.

Mark: There are two interpretations of the question — innovations in the risk management process and innovations in the way we shape our risk profile. For the first, there is an increased trend of taking a more integrated approach to risk management rather than relying solely on a separate risk management function. This is achieved by increasing the whole organization's understanding of risk and how to manage it. On a more specific note, we have seen significant investments in modeling and stress and scenario testing to aid our understanding of risk.

For the second, technology has facilitated better analysis to support more accurate underwriting and pricing, product designs have evolved to produce more targeted risk profiles, and insurers have become more adept users of derivatives to hedge their risks. Other risks, such as cybercrime and the potential opportunities and threats associated with social media, have required insurers to continue to update their approaches to risk management to keep pace with developments.

Celia: I am very much in agreement with Jostein, in that we are integrating risk management into the business unit decision-making. We place more emphasis on using the massive data sets that insurance companies collect as well as all the tools and processes to reach down to more granular levels within product lines and business units. This integration and granular drilling down to where greater opportunities can be found is imperative.

Gareth: Is there a trend to explore alternative assets to drive greater investment returns? If so, what new risks does this raise?

Celia: As insurance companies are stretching for yield these days, large insurers have been reaching out to alternative asset classes including private equity, buyouts, distressed debt and real estate. Traditionally, however, insurers and reinsurers have been conservative investors due to the nature of their business and so this has not happened on a large scale. Some real estate investments, exchange traded funds (ETFs) and a portion of mortgage-backed securities (MBS) are usually found in insurers and reinsurers' portfolios. But generally speaking, I see investment colleagues and insurance analysts adjusting their return expectations downwards. This shows that they are finally understanding that you cannot really have as much yield as you would like, and you would rather accept that instead of risking capital on many exotic financial instruments.

In alternative assets, a major advantage of low correlation with fixed income and equities and, therefore, a measurable degree of independence from systematic market risk factors is accompanied by a major disadvantage of being illiquid and often thinly traded. This makes them more opaque and therefore harder to measure both their risk and return. Although these risks are not completely unfamiliar, they seem to be more frequent and more likely. Examples include the risk of debt haircuts and the volatility of the price of gold recently.

Jostein: We have changed the pricing of the products rather than doing anything drastic on the asset side. There is more of a tendency to look at alternatives, for example commodities, infrastructure equity, direct loans and maybe a willingness to increase the leverage somehow. Probably more on the life insurance side than with non-life insurance companies.

Mark: It's easy to identify a number of investments that you like less now and disinvest from them, but it's far harder to identify new ones you would want to go into. I see alternatives also as a strategy for diversification rather than simply a search for yield.

Yes, there are risks with alternative assets because there is less data or history, which can hamper an analysis of the associated risks. This is exacerbated by the fact that these types of assets are relatively heterogeneous and so quite an investment is required to understand each individual asset class or, in the case of infrastructure debt for example, even each individual asset. Finally, the relatively low level of liquidity in these investments, while being a useful source of yield and potentially well matched to a long-term investor like a life insurer, means that you have to be prepared to bear the risks for a substantial period of time. Investing without understanding is not an option and so managing the risk is about either building the in-house expertise or sharing expertise with other potential investors, while ensuring that incentives are well aligned. Some insurance groups have access to the relevant expertise through their fund management arms.

Gareth: David, what is your perspective on this and how is risk managed when insurers do experiment with these alternative assets?

David: I agree that the move into alternative assets has been cautious and generally it is more advanced on the life insurance side. Focusing on liquidity also becomes important. Maybe for once, regulation can help insurance companies because the Alternative Investment Fund Managers Directive (AIFMD) will force alternatives or a certain segment of investments to be much more transparent, which in turn will help the asset owners.

Gareth: Can you think of an example in your organizations where you are pushing the boundaries with data and analytics?

Mark: Developments in our technology capabilities include the increased use of telematics and data analytics for improved pricing. For example, we have developed behavioral "feedback loops," like the "Aviva Drive" app, which encourages users to drive more carefully by taking data generated by their mobile phone as they drive and creating a safe driving score for them to "beat." The opportunity to take some of the predictive analytics techniques widely used in personal lines general insurance and apply them to other areas, such as life insurance, is a further area of development.

Celia: We try to think ahead instead of just waiting for events to unravel and then react. For example, we have an annual survey of business unit heads assessing the likelihood and the loss potential of a number of events. I collect all of these risks, quantify them and assign probabilities using a model to rank them and see which are the most significant ones. This provides the opportunity for people to think of what might go wrong and what mitigating measures can be taken.

We also use quantitative tools like benchmarking, loss assessment, risk-based capital, as well as non-probabilistic approaches such as sensitivity analysis, scenarios and stress testing. We aim to be less reactive, more anticipatory.

Jostein: We have risk-related data at the fingertips of the employee discussing the policy with the customer and setting the price. We already have a high quality on the input side for production systems of the company and a good data warehouse, which puts the correct data in front of the person in contact with the customer. The same is true on the claims handling side where you have a system that raises "red flags" when there is a claim that has fraudulent characteristics. This has more to do with having an efficient use of existing data than pushing the boundaries of what types of data you have to put into the system.

David: Understanding liability is a nuts-and-bolts competency for insurance companies. But they are asking themselves some searching questions about organizational setups on the investment side. For example, how well developed are their look-through capabilities for their investment portfolio, particularly given the shift toward alternatives? In terms of innovation, clients are looking to distinguish between reporting and analytics. Can they do reporting in lower-cost locations, and analytics closer to home?

Operational Excellence

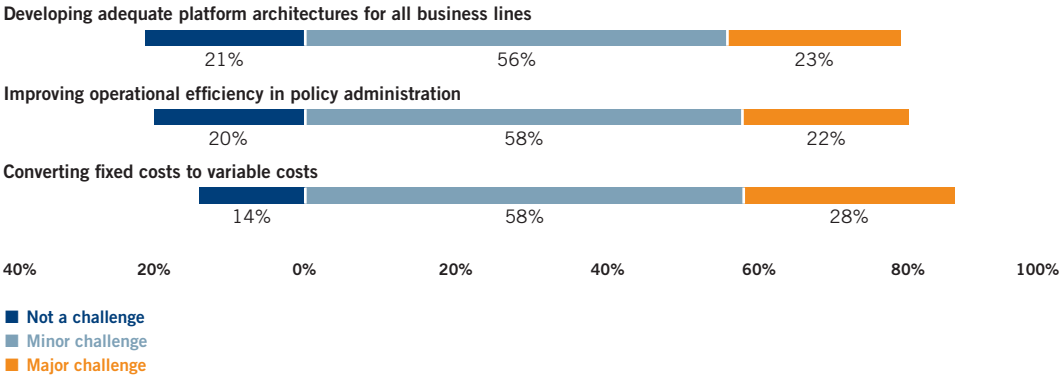
Operational Excellence

For insurers, the challenges of increasing premium and investment income currently have a higher profile than improving business efficiency. Nevertheless, today's environment has also made cost reduction a key area of focus. Deloitte's Morgan says that even areas such as asset management that previously tended to escape efficiency drives have come under scrutiny. "They are dealing with increased pressure to streamline operations not just to meet regulatory requirements, but to decrease costs through greater efficiency," he says.

Many companies are now on their second or third wave of cost reductions in five to six years, and it is becoming harder to make real savings without damaging core capabilities. Eighty-six percent of respondents to our survey, for example, report that converting fixed costs into variable costs is a challenge, and 80 percent say the same of improving the operational efficiency of policy administration. (See Figure 14.)

ALL INSURERS ARE LOOKING TO REDUCE COSTS, ALTHOUGH IT IS BECOMING HARDER TO FIND EASY WINS

Figure 14: Challenges in Operational Efficiency



Source: 2013 State Street Insurance Survey conducted by the Economist Intelligence Unit.

Consolidate IT Systems

As companies look to reduce costs, many in the industry need to consider two particular areas. The first is improved integration within the company, especially in IT. Between 2007 and 2010, the industry saw a wave of M&A activity, in the latter years driven by rapid divestitures. Although the pace of such activity then declined, it picked up again in the last quarter of 2012.[13] Looking ahead, 41 percent of respondents expect M&A to grow over the next five years, compared with 26 percent who foresee a decline.

Difficulty in fully integrating new acquisitions has exacerbated a longer-term failure to create coherent IT infrastructures. Fully three-quarters of respondents say that using data effectively across the organization is a challenge, and this is partly because of siloed and antiquated legacy systems. Insurers, however, have been reluctant to address this so far, largely because of the cost and complexity involved in replacing those systems. "Many seem to be struggling with the scale of IT investment and system redesign that it entails, given that existing systems sometimes don't even provide a consistent view on what might be considered comparatively basic data points, like number of customers or policies," says McKinsey's Matthias.

Regulators are demanding that companies grasp the nettle of consolidating IT so that they have appropriate data to assess risk. Tomorrow's leading companies will go further. They will use regulatory-driven technology investment to address inefficiencies and create the data and

[13] "2012 insurance M&A value at 9-year low," February 1, 2013, *Intelligence Insurer*, http://www.intelligentinsurer.com; "Insurance M&A fell in 2012 to $54bn," January 4, 2013, *Reactions*, www.reactions.net.

integration needed to make better business decisions. “There are still huge gains to be had out there, from IT that has already been successfully adopted in other industries,” says Morgan.

New Approaches to Outsourcing

Compared with many other industries, the insurance sector has been relatively slow to embrace outsourcing. Insurance companies are complex organizations that typically have a patchwork of different systems, processes and technology components. That makes it potentially difficult to carve out discrete processes and direct them to a third party without having implications elsewhere in the business. Ownership structures have also slowed progress. With many insurance companies coming from a legacy as mutual organizations, there has been less pressure on them to increase efficiency than in a public company.

In recent years, however, this has started to change. The financial crisis forced many insurance companies to pay much closer attention to human capital costs and, in many cases, downsize. This meant that certain pockets of in-house expertise were lost, or that companies became exposed to dependency on a small number of key individuals. Regulatory pressures increased significantly the compliance and reporting demands on the sector, creating the need for additional resources. At the same time, insurance companies have faced an environment of persistent low interest rates, which has forced them to think differently about how they can enhance yield. But often, they lack the knowledge and experience to handle unfamiliar asset classes, such as alternatives.

Technology has also been a factor. For many years, insurance companies have delayed making investments in the infrastructure, data and systems that they need to monitor and analyze their investment portfolio. But with the explosion of new technologies, like Big Data, insurance companies now recognize that they need to invest. Equally, they need to be able to manage this data and effectively analyze to make informed decisions. This has encouraged them to turn to third-party providers, which already have the infrastructure and expertise in place to provide the data and analysis that the sector needs.

This combination of forces has taken outsourcing far beyond a focus on cost efficiencies and the hiving off of commoditized processes. With the growth in regulation and complexity, insurance companies face the prospect of year-on-year investment in headcount, technology and expertise to keep pace. Many of them are choosing instead to direct certain non-core activities to servicing partners that are experts in these areas. Fifty-eight percent of respondents to our survey say that their companies are currently considering outsourcing some aspect of

middle- and back-office functions for the investment portfolio, with one-third contemplating taking action within the next 12 months. Other key areas for consideration include securities accounting, investment analytics and investment management. There is also interest in alternative asset servicing expertise as insurance companies increase their exposure in this space.

Reporting and analysis of the investment portfolio has been a fruitful area. Insurance companies today are finding that they need to report to a wide variety of external stakeholders, including rating agencies and regulators. This is an important activity, but not one that is necessarily core to the insurer's business of creating policies and servicing the client base. As a result, many companies are handing over reporting and analysis to third parties that have the technology and infrastructure to give them the data in the format they need. Armed with this data and analysis, insurance companies are better able to manage risks, enhance yield and grow their core business.

"Push" and "Pull" Drivers of Outsourcing

Push	Pull
Cost pressures — High costs have forced many companies to downsize, losing expertise in the process and leaving them exposed to dependency on a small number of key individuals	**Opportunity to make costs more variable** — Transform fixed costs into variable and focus resources and headcount on high-value activities. Eliminate risk of dependency on a small number of internal specialists
Stakeholder demands — Changing requirements of regulators, rating agencies and other stakeholders require access to new resources and expertise	**Manage risk and compliance** — Gain access to specialists who can help ensure that the overall investment risk profile is adequately monitored and managed, particularly as new investment strategies are adopted
Technology shortcomings — Historic lack of investment means that companies do not have the right infrastructure or systems to make use of Big Data and other trends	**Enhanced access to data** — Gain access to expertise and infrastructure that enables analysis of increasing amounts of data to support more informed decision-making
Low-interest rate environment — Persistent low interest rates are encouraging companies to search for yield, but they lack the experience and expertise to deal with unfamiliar asset classes	**Tap in to investment expertise** — Gain external expertise in new asset classes and strategies

OUTSOURCING CAN HELP TRANSFORM FIXED COSTS INTO VARIABLE

Conclusion: The Road to the Future

Insurance companies face a difficult environment. Premium growth is stalled, investment opportunities diminished, and regulators are substantially reshaping the marketplace. Nevertheless, our survey reveals an undercurrent of optimism. Sustained growth can be achieved, particularly for those insurers that show leadership in the following key areas:

- **Compliance:** Most companies are already actively addressing regulatory changes. This should be an opportunity for strategic reflection rather than a box-ticking exercise. Companies should consider which business activities remain core, and how substantial compliance-related investment, especially IT, can help improve business management more generally.
- **New markets:** The growth in emerging markets is very attractive and many firms are already finding ways to enter. Buying your way in is increasingly expensive, but as with other industries, the long-term winners will be those who put in the effort to understand local conditions and source local talent. Since global players have more experience than domestic companies in managing regulatory complexity, they also have an opportunity to position themselves favorably in the new regulatory landscape that is developing in several rapid-growth markets.
- **Innovative products and seamless distribution:** Despite shrinking premiums, the potential for increased sales exist. Life insurers especially need to adjust offerings to find profitable ones that attract the growing market of older consumers. Meanwhile, customers are demanding better communication, which is in turn leading to more direct relationships with companies. This presents strategic choices about how to maximize the benefits of multiple channels and whether to specialize to serve specific segments better.
- **Increased investment income:** Every insurer is seeking out the enhanced returns offered by new asset classes. Finding the right ones will not be as easy as in the past. They will have to meet tougher capital requirements while matching income to the liabilities companies can expect to pay out. The businesses that will benefit most are those that develop the skills and information systems to understand the risks and benefits of what they are buying, and the ability to tightly match income and liabilities.

- **New frontiers in risk management:** In many ways, insurance companies are the masters of risk management, but they are increasingly being challenged by new sources of risk. They are well equipped to understand and address these issues on the product side, but more innovative approaches to investment management will stretch their capabilities into new areas. The move into alternative assets can help diversify the investment portfolio as well as improve yield, but they will need more sophisticated tools to understand new risks in this fast-evolving area.
- **Optimization:** All companies are seeking ways to reduce costs. Insurers have already cut away much of the fat. Now they face sometimes difficult choices about investments to improve internal integration — especially in IT — and about which activities to outsource and which to retain in-house.

Although some choices are already easier to discern than others, no single route to the future will be right for every company. It is clear, however, that the industry has entered a period of far-reaching, structural change. Understanding how to drive value in each of the areas above will be key to securing a strong and profitable future. This will require companies to travel away from a status quo into new types of investment, new products, new uses of IT, new types of customer interaction and distribution, even new business models that focus on the core and outsource the peripheral — all of which bring their own new risks as well as opportunities. This journey is not a choice. Some insurers will struggle with the scale of change required, but those that maintain comfortable traditions will slowly disappear. The winners will be those that successfully cross the bridge to the future.

BETTER IT INTEGRATION COULD STILL YIELD MAJOR EFFICIENCY GAINS, WHILE IMPROVED DATA ANALYTICS CREATES NEW OPPORTUNITIES TO DIFFERENTIATE

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