Reprinted from Volume 11, Issue 1

CrossCurrents

Ernst & Young's magazine for financial services executives

Hazards on the horizon

The risk outlook for insurers

A report from Ernst & Young's Global Insurance Center

Key points

- Even if systemic risk abates, the consequences of the financial crisis are likely to shape the financial services industry for the next decade.
- The risk management process can add value even if the feared events never occur.
- Companies may find that tightening processes and controls make them more agile and enhance their ability to operate more effectively in whatever market conditions arise.

The financial services industry has been severely battered by volatile financial markets and global economic turmoil. A 2009 report explores the lingering effects of the financial market crisis, global regulatory intervention and the demographic shift in core markets.

The leading threats to insurers

Ernst & Young's *Second annual business risk report – insurance 2009* presents the top 10 risks for the insurance sector during 2009. This is not an exhaustive list, but rather a snapshot of our view of those risks at the time. As a result of current economic conditions, there have been significant changes in the risks since the release of the 2008 report on strategic business risk. In our most recent study, we have identified the present top 10 as the most important risks driving the fortunes of the global insurance sector over the next five years:

1. **Financial market crisis.** Even if systemic risk abates, the consequences have been so profound that they are like to shape the financial services industry for the next decade.
2. **Model risk.** The failure to recognize the shortcomings of models and to adequately capture the nature of risk has left some insurance companies unprepared for the depth of recent financial events.
3. **Regulatory intervention.** Organizations must prepare for a globally interconnected regulatory landscape with sweeping changes around Solvency II, International Financial Reporting Standards (IFRS) and US federal and state regulation.

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Many consumers are focusing on savings and the stability of the return rather than the "market potential."

4. **Managing the nonlife underwriting cycle.** The future can be improved through enhanced branding and expense reduction; mismanaging the cycle is arguably the number one cause of insolvency and the number one contributor to losses in stakeholder value.
5. **Geopolitical shocks.** This risk is heightened by economic slowdown as falling incomes generate political pressures and collapsing tax revenues threaten governments' capacity to respond.
6. **Demographic shifts in core markets.** Infinite opportunities exist for insurers to impact the consumer market and meet the needs of baby boomers who are postponing retirement.
7. **Emerging markets.** These are proving to be an area of expansion for many large, diversified insurers to grow, launch new products, expand their customer base and build a better infrastructure.
8. **Channel management.** Given market conditions and the new era of expense reduction, there is still significant risk in investing in multidistribution strategies.
9. **Legal risk.** Unexpected changes in both the forms and sources of liability continue to be one of the greatest challenges facing nonlife insurance companies.
10. **Climate change and catastrophic events.** Extreme events are major strategic risks for the industry and have far-reaching implications for insurers paying the price for the escalating costs of risks of catastrophic losses.

Recent events have influenced all of the risks we have identified. Although the economy is showing signs of improvement, many uncertainties still remain. We have chosen to explore, in greater depth, three key risks for the insurance industry: the lingering effects of the financial market crisis, global regulatory intervention and the demographic shift in core markets.

Financial market crisis

The financial services industry has been severely battered by volatile financial markets and global economic turmoil. Although much of the downside systemic risk has already occurred, the market crisis still poses a major threat. Many insurance companies have suffered a substantial depletion of capital. Uncertainty about when asset values will recover continues to impede liquidity and limit financial flexibility.

At this critical time, insurance companies need to protect their assets and capital base, mitigate exposures to losses, instill customer confidence and maintain their agency ratings. Change involves regulation, capital requirements and the strengthening of investment, market and distribution strategies. Many insurers are already addressing the challenges with a number of tactical responses:

- Some companies are de-risking their balance sheets wherever possible by selectively exiting positions and reducing exposures when the market allows.
- Nearly all of the top variable annuity issuers have announced product redesigns, price increases or other product rollbacks as strategic alternatives to rebalancing company risk appetite with consumer benefits.
- Organizational changes and staff reductions are being employed to support a lower level of operating income in the short term and a more focused business model for the future.

- There is a conscious effort to strengthen the core business, shed marginal operations and focus on market and distribution strategies.

While these initiatives will consume a great deal of management's time, opportunities remain. In a "survival of the fittest" situation, those companies that are able to rebuild and strengthen their positions are likely to see a rise in their brand and market share.

Regulatory intervention

The financial crisis has created unprecedented issues that challenge existing and future regulation. The landscape has changed so quickly that companies must now rethink regulatory intervention from a more holistic perspective, recognizing that it will impact every aspect of their operations.

As regulatory initiatives converge globally, there will be new directives in financial accounting and a shift towards principles-based approaches for life insurance companies. As we have seen in past months, several companies have received accounting relief from local US insurance regulators, and global firms have had injections of government-provided capital. Within the European Union, IFRS and Solvency II have planned implementation dates of 2012. This will involve a huge operational undertaking, even in the best of times, but the financial crisis and recession have increased the pressures. Other developments in play throughout the world, such as revenue recognition and International Accounting Standards Board projects, may also influence insurance companies' financial reporting. In the US, the debate continues over whether financial services firms should be regulated at a state or federal level, which is anyone's guess for now.

Clearly, insurers must adapt, align their strategies with a new economic landscape and prepare for the sweeping changes ahead. While the full extent of regulatory change is yet unknown, early signs are that revisions to insurance sector regulation have the potential to be dramatic.

Demographic shifts in core markets

Recent events and changing consumer mindsets have created limitless opportunities for the insurance industry. As a result of the financial crisis, a growing number of baby boomers may need to extend their time frames for retirement and work longer to gain back the invested income they have lost. Overall, consumers have less disposable net income, lower retirement plan balances, a greater sensitivity to loss and increased risk aversion. Many are focusing on savings and the stability of the return rather than the "market potential." There is also heightened concern about longevity issues.

Against this backdrop, life insurance companies are offering savings products (such as fixed annuities) that meet consumer demand for more stable returns. Revenue will be achieved by switching from fee-based to spread-based

Companies must now rethink regulatory intervention from a more holistic perspective.

Defining the top risks for insurance

In our *Second annual business risk report – insurance 2009*, Ernst & Young identified the top risks most likely to shape the insurance industry, offering a snapshot of our view of the risks at the time. When you review the entire report, we encourage you to do so in a questioning manner since some of the risks, and the weightings that we attach to them in the rankings, may differ from those that you would apply.

As part of the methodology, Ernst & Young utilizes a simple risk radar device that allows us to present a snapshot of the top 10 business risks for a company or industry sector. The risks at the center of the radar are those that we and analysts we interviewed thought would pose the greatest challenge to leading global insurers in the year ahead. The radar is divided into four sections that correspond to the Ernst & Young Risk Universe™ model. Compliance threats originate in politics, law, regulation or corporate governance. Financial threats stem from volatility in economic markets. Strategic threats are related to customers, competitors and investors. And, finally, operations threats impact the processes, systems, people and overall value chain of a business.

To read the full text of the report, go to: http://www.ey.com/US/en/Industries/Insurance/Insurance_Overview.

products, which will also increase the life insurance industry's ability to strategically manage capital market risk. The combination of demographic shifts and continuing market volatility has increased the likelihood that insurers will capture wallet share sooner than predicted in prior years.

We believe that company leadership must:

- Conduct an annual risk assessment that defines key risks and weighs probability and impact on business drivers.
- Assess risks in the wider environment in which the organization operates.
- Conduct scenario planning for major risks that are identified and develop operational responses.
- Evaluate the organization's ability to manage the risks they identify.
- Develop effective monitoring and control processes that provide earlier warning signs and improved ability to respond.
- Keep an open mind about the potential for risks.

The economic downturn has taught us that the most important risks are the ones we did not see or anticipate. Yet, few of the risks that have devastated the financial services sector and severely impacted the wider economy were unpredictable — economic bubbles generally burst. It is now, in the hardest of times, when seeking to gain opportunity from adversity, that we will see evidence of effective risk management and recognize those companies that mastered it. ∆

To learn more, please visit the website of Ernst & Young's Global Insurance Center, www.ey.com/insurance.