

# 2010 outlook

Global Insurance Center



## US life insurance industry outlook

### Executive summary

The year 2010 will be difficult for life insurers as the US economy slowly recovers from the aftermath of financial events. Lagging employment with falling aggregate wages, tight credit, weakened residential and commercial real estate and a behavioral shift on the part of consumers from consumption to savings are factors contributing to a delayed economic recovery. The US life-annuity insurance industry will likely face an extended period of weak earnings, slow growth and greater regulatory oversight.

Many insurers are reacting to these challenges by following a “back-to-basics” strategy. This approach may help life insurers weather the storm, but just hunkering down may not be enough to succeed. Regaining profitability and growing the business within the current economy will require creative, pro-active steps to improve strategy and execution. Particular attention should be paid to the following areas:

1. Optimize capital in response to ongoing pressures
2. Build more robust risk management capacity with stronger governance and transparency
3. Focus on core businesses and readdress product and distribution strategies
4. Operate successfully in a continually changing regulatory environment
5. Improve the effectiveness of company infrastructure

### Optimize capital in response to ongoing pressures

Industry surplus (plus AVR) declined 13% from 2007 to 2008, and 2009 to date remains flat. Even as debt and equity markets recover value, life insurance companies will need to optimize their deployment of capital in response to continuing challenges. This includes threats posed by credit losses, increased funding levels required by the Commissioners Annuity Reserve Valuation Method for variable annuities (known as VA CARVM) and a likely rough ride from commercial real estate.

As Solvency II takes effect in 2012, insurers with operations in Europe may face additional pressure on already constrained capital levels.

In the short term, traditional sources of capital will meet most of the industry’s needs, and well-capitalized reinsurers will continue to selectively assume risks. With spreads over treasuries

returning to pre-crisis levels, the cost of debt will be more attractive in 2010.

When it comes to non-traditional sources of capital (securitization and other risk transfer mechanisms), a full market recovery is still years away. Offshore and onshore captives may serve as non-traditional sources of capital; however, their future seems more in doubt as regulators and rating agencies cautiously evaluate how to consider these structures in their capital assessments. Insurers should consider this when developing product portfolios and possibly re-design or eliminate products that have strong dependencies on non-traditional capital flows.

Internally generated sources of capital will be critical and, with investment yields remaining low, companies should be exploring ways to strengthen prices for in-force business, such as increasing non-guaranteed fees. As product portfolios are re-designed and re-priced, risk/reward trade-offs need to favor capital strength and profitability. In short, capital and fiscal discipline should be the criteria for decision making at all levels. This is likely to result in higher prices for most customers.

During the financial crisis, most companies found that the capital cushion required to weather the storm far exceeded levels indicated by their existing economic capital models. Many capital models mistakenly used entity survival as the minimal acceptable outcome, rather than maintenance of the company's ratings. In hindsight, it is clear that capital levels high enough to sustain ratings and preclude regulatory action were essential to maintain even after the effects of the crisis. In 2010, companies will need to heed this lesson by developing contingency plans that encompass a wider range of extreme events, including liquidity crises, forced liquidation of assets into frozen secondary markets and limitations on transfers of capital within the enterprise. While the residential mortgage crisis may be fading, it could be followed soon by problems with exposure to commercial real estate or even municipal debt investments. In addition to these known risks, companies must think about unforeseen risks.

Enterprise-wide contingency plans will be essential for responding to future crises.

### **Build more robust 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 operating companies, 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 and potentially new regulators set guidelines for enterprise reporting, the demands will undoubtedly increase for operating companies as well. In addition to collaborating on setting enterprise risk levels, local operating companies 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 explicitly 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.

### **Focus on core businesses and readdress 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 their companies 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.

As insurers seek ways to reduce the risks they face, they are re-designing and re-pricing products. Re-design will focus on the simplification of guarantees and benefits, including the elimination of some that require

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excess capital to support. Insurers will need to balance price increases that lower product risk against rising consumer resistance.

Product re-design also creates an opportunity for insurers to reach broader markets by developing products to match consumer demands altered by the financial crisis. For example, pension and retirement markets may be an area for product innovation in 2010 as the loss of accumulated retirement assets have heightened concerns about the adequacy of retirement income. Innovation in this area will likely be incremental, rather than drastic. Most insurers remain focused on continuing to rebuild capital and surplus and de-risking product portfolios. Companies with relatively strong capital and surplus who are willing to innovate in key product areas have an opportunity to gain market share in 2010.

Distribution channel changes must be addressed as well. The economic conditions in 2008 and 2009 led to a consolidation of independent distributors. This decrease in the number of distributors is resulting in greater competition among insurers for “shelf space” among those that remain. Traditionally, this has generated higher commission levels, which will likely be the case now. However, this time distributors will also focus more on due diligence and transparency of information from insurers. Distributors, prodded by their customers, no longer rely just on insurer ratings as a proxy for stability. Insurers able to provide greater transparency in these areas may be better positioned to gain distribution and access to customers.

### Operate 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. At the same time, initiatives already underway are aimed at changing accounting rules and applying new

reserve and capital adequacy requirements. 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.

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. Concerns about product complexity, especially in variable products, could lead to insurer compliance issues, which could impact operational costs. At the same time, both plan sponsors and participants are demanding greater fee transparency on group retirement products and expressing concern about the effectiveness of some investment allocation strategies and fund types.

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 and greater complexity 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.

Another likely element of the regulatory mix is the health care debate. It will be several years before many of the structural implications of health reform go into effect. However, the reform package is likely to increase 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. Provided insurers retain the tax-advantaged status of their products, they may find themselves with a competitive advantage over other financial service providers.

### Improve the effectiveness of company infrastructure

As a result of the recent recession, there has been a decline in premium and investment income, an increase in policy lapses and loans and greater regulatory and other stakeholder demands on reporting and governance. Expense levels, compared to business volumes, are rising. For some companies, the immediate need to reduce expenses may be a matter of survival. However, insurers need to examine cost reduction across their entire infrastructure, and look for ways to optimize their operations

for a low-growth environment in 2010 that could last several years.

Companies are asking themselves whether the current operating model (the combination of people, organization, processes and systems) is best suited to the current market environment. More sophisticated insurers are examining their infrastructure to ensure that it is aligned with the strategic objectives of the business, and that it is ready to respond to the upturn of the market.

Historically, insurers have considered process re-engineering and head count reduction as ways 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; (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.

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.

Making an investment in IT can add efficiencies to business processes, encourage people to become more productive and support sustainable cost reduction in key business units. Implementation of IT efficiencies may be more readily adopted at a time of reduced headcount, with lower training costs and increased acceptance of change that leads to improved workflow. Areas where insurers are making IT investments for both cost reduction

and operations improvement include service oriented architecture, customer intelligence and communications, and straight-through processing.

Advances in IT resource management are making other infrastructure improvements possible. The pooling and sharing of physical IT resources (virtualization) and the outsourcing of computer hardware and applications (cloud computing) can lower cost, enable rapid business model innovation and provide for better disaster recovery and mitigation. Also, consolidation and simplification of current IT systems can free up money spent on maintenance to work on transformational technologies that improve competitive abilities. With all of these developments, control and data security are key issues.

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