



## Emerging from the Storm: The Day after Tomorrow for Insurance

by PricewaterhouseCoopers

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**Drawing on input from a range of leading insurers, financial market participants and PricewaterhouseCoopers specialists from around the world, *Emerging from the storm: The day after tomorrow for insurance* examines how the financial crisis is set to reshape the industry as a whole, along with some of the key developments that are likely to affect particular segments and geographical markets.**

This report begins by charting the immediate impact of the crisis (the world “today”) and how the current scepticism and uncertainty are likely to mould stakeholder expectations going forward (the world “tomorrow”). The main section looks at how the industry landscape will look in the aftermath of the crisis and how this will determine the strategic choices facing insurers over the next three to five years (the “day after tomorrow”).

The insurance industry landscape that emerges from the turmoil of the financial crisis is set to be markedly different from today, enabling some insurers to pull ahead from their competitors and leaving others at risk of being left behind.

The financial crisis has already proved to be a watershed for the insurance industry in many parts of the world. What customers, investors, governments and regulators expect from insurers is changing rapidly and pervasively and the developments we see today are only the beginning. The environment will continue to evolve at a rapid pace over the next two to three years, ruling out any return to the relative stability and certainty that preceded the crisis.

This shake-up will challenge the competitive relevance of some insurers. However, it also offers agile and farsighted firms a once-in-a-generation opportunity to catapult themselves to the front of what will be a very different racing order within many geographical markets and classes of business—as Rahm Emanuel, White House Chief of Staff, has said: “*Don’t waste a good crisis*”. The companies that will come through strongest are not just looking at how to stabilise their businesses today and even tomorrow, but how the crisis will shape the competitive environment that emerges in the “day after tomorrow” and what they need to do to adapt and succeed.

This report examines how the financial crisis will change the industry landscape and the key considerations this presents for insurers. We believe the main features of this new environment can be summarised as follows:

### 1. Organic restructuring:

As insurers withdraw from some of their geographical markets and scale back particular lines of business, the market shares and opportunities for those that remain will sharply increase, leading to a significant reconfiguration in the list of leading players.

**2. The end of innocence for retail investors:**

What customers demand from savings and investment products and how they want to buy them will take a new direction within many territories, with companies that are slow to catch on becoming increasingly irrelevant.

**3. Reawakening of M&A:**

The strong underlying rationale for consolidation and restructuring within many markets means that acquisition activity is set to accelerate rapidly once valuation parameters are stabilised and funding becomes more readily available again.

**4. Another rethink on reporting:**

Without an industry consensus on a genuinely relevant, intelligent and comparable basis of accounting and disclosure, insurers will find it increasingly difficult to compete for capital.

**5. Blurring the lines:**

The relationship between the public and private sector will change as governments exert a stronger influence over the insurance market as a result of bailouts, regulatory reform and greater control over pensions and health care.

**6. Overhaul of rewards:**

Insurers will base much more of their performance-related pay on risk-adjusted measures, aligned to their business strategy. They will also face tougher regulation over how compensation is governed.

**7. Mounting uncertainty over tax:**

Amid moves to increase tax revenues and tighten the tax rules on offshore business, the stability of the tax regime will be a key consideration in possible relocation, as will choosing where to domicile and where to do business.

**8. Challenging prospects for reinsurers:**

While demand for reinsurance is likely to increase within emerging markets, this is unlikely to offset the decline in reinsurance buying in developed markets and may force many reinsurers to rethink how they sustain profitability and growth.

**9. Tilting the regulatory playing field:**

Under pressure from governments, supervision will be more intense and regulations will be more subject to national priorities in their interpretation and application.

If you asked an insurance executive in 2007, "What are the key developments shaping your industry?" most would have cited at least some of the longer term themes listed below. These underlying trends have not gone away and some have been accelerated by the financial crisis. However, as insurers survey the immediate impact of the financial equivalent of a major hurricane, more pressing concerns have come to the fore. The market and economic environment in which insurers operate is subject to considerable uncertainty. Success will depend on close monitoring of developments and the ability to move quickly to capitalise on opportunities as the situation becomes clearer.

**Short-term themes sparked by the financial crisis**

**Longer term themes**

- Globalisation
- Demographics
- Longevity
- Regulation
- Technology
- Climate change
- Pandemic

*Many organisations have strategies based upon a view of the world arising from what may now be an outdated understanding of what is driving change in the insurance industry*

<b>Monetary vacuum</b>	<p>The process of deleveraging that followed the bursting of the asset price bubble has yet to run its full course and there is still deep uncertainty over how to deal with the continuing downturn and the massive levels of distressed assets. This upheaval and uncertainty have created a monetary vacuum in which finance is constrained and much of the economy remains frozen. Immediate considerations include where best to concentrate limited capital and what areas to discontinue or divest to create a more streamlined and controllable business. Looking ahead, the ability to make sense of and respond to the uncertainty will distinguish the insurers who truly manage to capitalise on the crisis.</p>
<b>Classic renaissance</b>	<p>Heightened risk concerns and the need to rebuild balance sheets have encouraged many insurers to adopt more cautious investment strategies and refocus on their core competencies.</p> <p>This “back to basics” approach is especially noticeable among some of the firms that were seen as leading the way in risk modelling and strategic innovation prior to the crisis.</p>
<b>Lack of trust and transparency</b>	<p>The financial crisis has dented confidence in financial services businesses, including insurers. This clearly threatens the viability of a sector that depends on policyholders’ faith in providers’ willingness and indeed ability to pay out following insured events ranging from fire and accidents to retirement and mortality. As many pension and investment customers see the value of their policies fall, some have inevitably questioned whether the charges were justified and whether the investment returns reflected the true level of risk. Among capital providers, a perceived lack of transparency by insurers has heightened the downturn in share values and added a risk premium to the cost of capital.</p>
<b>“Never again” regulation</b>	<p>The response to the crisis has varied from country to country, which has created uncertainty for global insurers. Many governments and supervisors have responded to the volatility in the markets by relaxing solvency margins and/or the rules on marking down assets in the short term as they seek to avoid the downward spiral in confidence that has faced many banks. However, these emergency expedients cannot last indefinitely. Supervisors will follow investors and rating agencies in insisting on more open disclosure, more demonstrably effective risk management and increased capital buffers as they seek to guard against a repeat of the recent turmoil. Tougher regulation in areas such as compensation is also beginning to spill over from banks.</p>
<b>Government “inside the tent”</b>	<p>Several leading insurers have required government finance, part of the price of which is closer political scrutiny and influence over strategy and compensation. Even companies that have not required bailouts are facing pressure to modify their behaviour as governments increasingly call the shots over regulation. Immediate challenges include balancing the need to restore profitability with the heightened government scrutiny and expectations of being a responsible corporate citizen. Some companies are also concerned that government support for some of their competitors could distort pricing and impede the takeover/withdrawal of weaker entities.</p>
<b>Unprecedented fiscal pressure</b>	<p>Having committed significant resources to stabilising the financial services sector, cash-strapped governments are set to exert strong moral pressure on businesses to pay their “fair share” of tax. The fact that most of this support was aimed at banks will not save insurers from scrutiny, with a particular focus on tax planning and tax haven operations.</p>
<b>Rising power of the emerging economies</b>	<p>The crisis has accelerated the shift towards multi-polar economic power and influence, developments which have been highlighted by the emergence of the G-20 as a key driver of global economic policy. As international companies divest offshore holdings and withdraw to their core markets, there will be acquisition opportunities and market openings to enable local firms to strengthen their position.</p>
<b>Dealing with the downturn</b>	<p>The insurance industry continues to grapple with the economic downturn set off by the financial crisis. All companies have been forced to rein in on cost and many are now reassessing their operational model amid the pressure on premiums, capital, asset returns and compliance costs. Life insurers in many of the more mature markets have already seen a sharp fall in demand for savings and investment products and could face further asset price volatility and loss of business as a result of an adverse range of inflation and deflation scenarios. Non-life insurance is generally non-discretionary and therefore the impact of the downturn has been less marked. However, the falls in investment returns have necessitated tighter underwriting discipline and, where feasible, higher premiums. The sector has also seen a rise in problems associated with recession such as increased fraud and claims frequency.</p>

The financial crisis has come as an unwelcome jolt for customers, investors, regulators and governments, creating scepticism and uncertainty and spurring stakeholders to take a harder line with insurers, particularly in relation to risk. How might the shifts in expectations of different stakeholders affect strategies?

- **Customers:**

The faith of customers who believed that returns would keep coming, and the confidence in the financial institutions that appeared to be making this possible have given way to shock, disillusionment and caution.

As wealth/capital has been reduced, the search for return has given way to uncertainty and risk aversion, which is encouraging cautious customers to pay down debt (deleverage), hold on to their cash and, if they are prepared to invest, favour simpler and less risky products. Another sign of customer disillusionment affecting life insurers in a number of countries is the sharp rise in mis-selling claims. On the non-life side, concerns over credit and counterparty risk have hastened a flight to quality among some customers, while others have sought to avoid concentration by spreading their business.

Clearly, customers cannot batten down the hatches indefinitely; not least as the underlying drivers of growth, such as the ageing of the population or the search for more effective risk protection, will continue to exert a strong influence on demand. The key question is therefore on what terms customers will choose to reengage with insurers and how product/distribution strategies may need to change to encourage them back.

- **Regulators:**

Under a strong lead from governments, the intensity of supervision is increasing. Indeed, some countries appear to be vying to be seen to have the toughest regulatory regime, starting from the top with a strong focus on governance and risk management. The crisis has also led to a review of mark-to-market valuation, which will impinge on the continuing development of accounting within the industry, including the search for an agreed IFRS for insurance contracts.

However, how these developments are applied in practice will differ quite markedly. While regulators were until recently believed to be "hunting in packs", the financial crisis has highlighted a divergence of approach. The limited international co-ordination of regulatory intervention could have unintended systemic consequences for insurers and a knock-on impact on financial markets. For example, changes in accounting standards and asset admissibility could affect insurers' levels of equity holdings and other aspects of their investment strategies. The financial crisis has also highlighted the importance of the personalities at the helm in setting and applying policies. With so much depending on the people in charge, changes in key personnel can only heighten regulatory uncertainty. Although supervisors have been given further resources and political impetus by governments, it will take some time to build up the expected capabilities.

- **Investors:**

The pursuit of innovation and capital efficiency has given way to a focus on stability and risk management, with phrases like asset leverage now seen as off-putting. Even once the initial caution generated by the losses of 2008 subsides, there is growing recognition among analysts and investors that risks are far more systemically correlated than previously thought. As a result, the cost of capital may remain high to reflect what market professionals now perceive as the true level of risk and the greater possibility of what were once seen as improbable and unrelated risk scenarios.

Greater transparency and comparability of financial and risk disclosure will be critical in gaining access to a more limited supply of available capital. However, the absence of a relevant and globally consistent accounting standard for insurance contracts, and lingering concerns over the consistency of embedded value methodologies and assumptions, continue to undermine market confidence.

- **Governments:**

Although governments are eventually likely to divest their direct holdings in supported insurers,

their influence across the sector will persist. Some governments will continue to offer insurance substitutes such as trade credit schemes, in addition to tariff setting and being the insurer of last resort in some higher risk markets such as the Florida coast. This can create competitive distortions and impede market development and once in place can be politically difficult to withdraw.

Governments that have recapitalised parts of the insurance sector may insist that taxpayers should expect a more favourable deal from the industry. There will also be considerable debate about the implicit capital underpinning of being considered “too big to fail” and the increased shareholder exposure for those that are not. In normal circumstances, weak companies go under, but in this new environment they may be propped up by government guarantee and a resulting competitive distortion.

The financial crisis will continue to reshape the competitive and regulatory environment within the insurance industry over the next three to five years. As we set out in the nine key developments and their strategic implications, the landscape that emerges in the aftermath of the “storm” will present both transformational opportunities and significant threats for businesses that fail to anticipate and adapt to the changes ahead.

The shake-up within the insurance industry is taking place against the background of a highly volatile economic environment. There is continuing uncertainty over how the various different demand, inflation, stock market and budget deficit scenarios will play out and interact. Insurers should plan how to respond to significant shifts in the variables when developing their strategies. Focusing on markets most affected by the financial crisis and its fallout, the report outlines various scenarios, how they could interact and the potential impact on insurers. The most marked break from the past is the mounting budget deficits in many countries, which will lead to a combination of higher taxes, lower public spending and increased inflation risk. Reductions in public spending are likely to lead to a scaling back of state health and pension provision and create valuable opportunities for insurers.

The direct impact of the crisis has been more limited in leading emerging markets such as China and India. Developing domestic consumer demand and trade between emerging markets will help to offset falling business in the EU and U.S. and will continue to provide important growth opportunities for insurers.

As insurers withdraw from some of their geographical markets and scale back particular lines of business, the market shares and opportunities for those that remain will sharply increase, leading to a significant reconfiguration in the list of leading players.

*The complete report is available from PricewaterhouseCoopers at [www.pwc.com/dayaftertomorrow](http://www.pwc.com/dayaftertomorrow). We thank Ian Dilkes of PricewaterhouseCoopers for his kind support.*

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