

Global Insurance Industry Outlook



*Finding the
Right Fit in a
Changing World*

Dear Colleague:

For the past eight years, the Financial Services practice of the member firms of Deloitte Touche Tohmatsu (DTT member firms) has produced the annual *Global Insurance Industry Outlook* to address the “top 10” issues affecting companies in the year ahead. This year, we took a new approach, working with the Economist Intelligence Unit to develop both a long-term industry view, entitled *Global Financial Services Industry Outlook: Shaping Your Strategy in a Changing World*, as well as companion reports that considers the same issues at a more focused level by sector.

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Our *Global Insurance Industry Outlook: Finding the Right Fit in a Changing World* report finds that managing risks remains the most significant concern, followed by the cost of regulatory compliance and the hazards associated with noncompliance. Despite these prevailing issues, numerous opportunities exist, primarily by growing globally through new markets, innovating products and their delivery and adapting to the shifts in the population and the aging of the baby-boomers.

To identify critical market drivers for our *Global Industry Outlook* reports, we conducted an online survey of 175 board members and global executives across the financial services industry, of which 48 were from the insurance industry. Based on our findings and our client experiences, we believe that the issues identified within this report will have the greatest impact on the insurance industry as they approach 2010. Life, property and casualty companies, reinsurers, health insurers and brokers should embrace the imperatives we have outlined in this report to achieve long-term success.

We plan on continuing our research into the future of the insurance industry and examining other ways in which insurers can sustain growth and find the right fit in a changing and dynamic world. In the meantime, we hope you find this report valuable.

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Leading insurance companies are positioning themselves to succeed in a future requiring significant changes in the way they do business. The details have yet to be filled in, but the challenges – unprecedented volatility, a changing customer base and exacting regulators – are clear today. Despite the challenges ahead, opportunities for growth can be found by expanding globally, adopting the latest technologies to enhance service delivery and providing services to meet the needs of the next generation of retirees. Major insurance companies are reinventing themselves to address these issues, among others.

In this paper, we focus on the five most important issues over the next three to five years as revealed through an industry survey, interviews with senior executives and practice leaders from the DTT member firms. The five top issues on the insurance watch list include:

- **Manage risk.** The most significant concern for insurance companies is risk in all its forms. Increasingly insurance companies are adopting an enterprise-wide view of managing risks – employing a framework to address them across the organization.
- **Promote compliance.** The cost of regulatory compliance – and the attendant reputational risk of noncompliance – is growing.
- **Grow globally.** Expansion into new markets will help drive profits, as developed economies see slower growth in demand for insurance.
- **Innovate in products and delivery.** By harnessing technology and emphasizing innovation to provide better service and delivery, institutions can strengthen ties with customers and differentiate themselves from the competition.
- **Adapt to demographic shifts.** The greying of North America, Europe, Japan and other areas is starting to shift assets from equities to annuities and other fixed-income products.

Cautious optimism on margins

Insurance industry survey respondents (board members, C-level officers, business unit heads and other senior executives) offered a cautiously positive picture on the economics of the insurance industry. About 15% of insurance industry respondents expect costs to grow faster than revenues over the next three to five years, while just over half think revenues will grow faster than costs. The remainder thinks cost and revenue will grow at about the same rate.

Among the trends cited by survey participants are:

- Fast-growing overseas markets offer potential for higher revenues, but startup costs can be high.

- There should be greater demand from an aging population for fixed-income products. But whether the insurance industry will succeed in marketing these products is an open question.
- Catastrophe modeling and risk and capital management practices will improve.
- Although insurance companies will adopt a more consistent and less ad-hoc approach to regulatory compliance, compliance costs will continue to be a drag on earnings.

The five issues to watch

1. Manage risk

Insurance companies see risk as the most important concern in the years ahead. More than two-thirds of survey respondents identify it as a key transformative issue over the next three to five years.

- Financial market volatility is considered the top risk, cited by 58% of respondents, though interviewees say they are able to manage this through quantitative financial strategies.
- Operational and reputational risk will also significantly affect profits.
- 46% of respondents cite operational risk as a major concern, and 38% cite reputational risk.

Risks from catastrophe and terrorism loom large in the property and casualty arena, though mitigated by the availability of reinsurance, greater capital markets access and, in the US, the Terrorism Risk Insurance Act. Hurricane Andrew in 1992 caused a dozen industry failures or near failures. Catastrophe modeling has improved dramatically since then, and better models helped the property and casualty business pull through the natural disasters in the US that accounted for almost 90% of all global insured catastrophe losses. In many cases, however, losses greatly exceeded predictions, indicating improvement is still needed.

The insurance industry has always faced significant operational risk. The more complex an organization's technology and products, the more difficult it is to quantify and manage that risk.

In Europe, Solvency II will provide a framework to address operational risk issues, improving the ability of insurers to develop key risk indicators, quantify the risk of operational “loss events” and understand the capital cost of that risk.

Data privacy and data security breaches loom large among operational risks in coming years, as insurers collect an unprecedented amount of data on their customers. That data is being used in more sophisticated modeling that enables insurance companies to individualize pricing in ways not previously possible. However, those customers view protection of their data as critical to the relationship with their provider.

Until the adoption of global standards for authentication and identity theft management, insurance companies must develop enterprise-wide solutions, while adapting to local market requirements and practices. Increasingly, they must look to manage the risk of abuse by employees. The US Federal Bureau of Investigation urges setting up grievance procedures for employees; documenting employee misconduct and sharing that information; and layering security for remote access and monitoring failed remote logins.¹

While market, operational and reputational risks are a central focus of attention, insurance companies must go further to assess and manage the spectrum of risks across the organization. Driven by greater transparency, more demanding stakeholders and increased scrutiny by rating agencies, leading insurers are turning to an enterprise risk management framework, integrating the actuarial practices of insurance with a capital markets perspective to optimize capital structures, implement effective controls, improve strategic decision-making, enhance risk-adjusted returns and minimize surprises. Rating agencies tend to reward effective risk management with higher ratings that lower the cost of capital and ultimately boost shareholder value.

In addition, a new generation of insurance company leaders is far more focused on finance and risk. Business lines, products and markets are no longer static; stakeholders vigorously debate the optimal allocation of precious capital to drive growth in a mature industry. As in other industries, chief financial officers (CFO) who can bind business initiatives to financial metrics have become major influencers of corporate strategy.

Finally, the chief risk officer (CRO) is a relatively new position in the insurance industry. Many insurance companies don't have CROs – the job is folded into the responsibilities of the CFO. Regardless of who manages risk, the function is evolving and its stature is growing. To deal effectively with risk across the enterprise, the senior risk executive should be given the requisite authority, ideally working closely with the board of directors and the CFO.

2. Promote compliance

Regulation ranks second behind risk as a transformative issue. Fully half of the insurance executives responding to our survey cite regulation as one of the top influences on profits over the next three to five years. Within regulation, seven out of 10 say the implementation cost of compliance will have the greatest impact on profits. Over half (56%) see the risk of non-compliance as a major concern, and 31% cite finding and training the right people.

Stricter enforcement by state and federal regulators in the US and the specter of increased regulation worldwide have raised the cost of compliance and amplified the consequences of non-compliance. Bid-rigging and accounting scandals led to a number of hefty settlements by insurers and insurance brokers, the largest being American International Group's (AIG) \$1.64 billion payment. The disclosures may have slowed momentum in the US toward an optional federal regulator, favored by most large insurers, as states will likely be less willing to relinquish their oversight.

Regulators may eventually move to reward insurers that adopt a principles-based, disciplined approach to compliance, giving an advantage to providers that have already done the work. In response to legal crises, some industry participants, such as AIG and Marsh & McLennan, have created board-level compliance committees. Other companies are likely to follow.

Going forward, insurers need to adopt an enterprise-wide approach, developing processes to monitor and document risks and implement training and controls throughout the organization. The industry must embrace transparent fee arrangements and greater disclosure of ownership interests that can create conflicts.

While intermediaries are currently seen as playing a valuable role, they risk becoming less important over time. In the UK, the Association of Insurance and Risk Managers has demanded that the industry make contingent commission payments completely transparent by the end of 2006; otherwise it will go to the Financial Services Authority to demand new regulations.

The roles of insurers and insurance brokers must be redefined to reveal ownership interests or fee arrangements that can lead to conflicts of interest. Deloitte Research's report, *Reshaping the Business Model: How the Insurance Placement Process will be Redefined by Compliance Pressures and New Business Economics*, notes that cross-subsidies in insurance, much like soft-dollar payments in the securities industry, can make it difficult to assess the value provided by insurance brokers and ultimately result in disintermediation. It advocates linking broker fees to measures such as:

- Policy profitability, which rewards risk analysis/management.
- Flow of qualified submissions, rewarding marketing and distribution.
- Consulting on product development and providing industry analysis.

¹FBI Report Underscores Insider Data-Theft Threat, *The American Banker*, November 29, 2005

Brokers should consider either adding value to justify their prices or lower their prices where they cannot add value. The true debate may be less about compliance than about how much value brokers add in an increasingly transparent industry.

In the rush to comply with Sarbanes-Oxley and implement other initiatives, some US insurers may have been less than rigorous in delineating the responsibilities and interactions of such functions as internal and independent audit, the legal department and the controller's office. To control costs, they will need to reengineer their processes, taking a more disciplined approach to eliminate overlap.

3. Grow globally

The insurance executives who responded to the survey were less focused on global expansion than those in other industries. Nevertheless, they ranked it third among major issues having an impact on profits, with 42% of respondents predicting globalization will be a top profit driver in the next three years. When asked about globalization, four of 10 cite distribution opportunities in new markets as a major influence on profits.

Whether through sales in new markets or overseas acquisitions, insurance companies are looking to grow globally more than ever before. The logic is hard to refute: growth in the North American and European insurance markets is slowing, and countries with a growing middle class and relatively stable economies offer good prospects for expanding sales. By moving into these markets, insurers can grow by exporting their core competencies – a potentially less risky strategy than expanding into new product lines.

Those that do move overseas have to analyze the potential of different business lines in different markets. Chubb, for example, which has expanded organically rather than through acquisition, focuses on specific segments, such as the high-net-worth and ultra-high-net-worth segments in personal insurance.

China's receding regulatory barriers, growing middle class and aging population in need of retirement security and long-term care make it a compelling long-term target for foreign insurance companies. The products needed span the spectrum from investment and retirement services to auto, health and life insurance. Despite substantial risks and costs, four out of 10 survey respondents say that China will be important or very important to their organization by 2010. A third say the same about India.

Globalization is also creating a need for better risk management. The same forces that prompt insurers to develop far-flung business operations make risk aggregation more challenging, blur the lines among businesses and cause exposures to become more interrelated.

About the online survey

In November of 2005, we polled 48 senior insurance executives out of 175 across the financial services industry to identify the key transformative issues over the next three to five years. An online questionnaire was used. Respondents were comprised of board members, C-level executives, business unit heads and other senior executives at large insurers. The executives surveyed were based mainly in Asia-Pacific (15%), Europe (31%) and North America (50%). The average asset size of the insurers surveyed was approximately \$100 billion.

4. Innovate products and delivery

Four out of 10 insurance industry respondents see innovation as a top profit driver over the next three to five years. Nearly two-thirds cite delivery channel innovation, and 54% focus on product innovation. In the category of technology, respondents homed in on technology-enabled products and services and the technology required to build strategic alliances with customers, partners and other stakeholders.

Successful insurance companies will focus on building relationships with customers to counteract increasing product commoditization. By harnessing technology and innovation to provide better service and delivery, institutions can strengthen ties with customers and differentiate themselves from the competition.

A key to success is winning customer loyalty, achieved by transforming into a customer-centric organization. Allstate, for example, exploits relationships created early in the consumer lifecycle, moving customers from car insurance along the product spectrum as they accumulate assets.

Insurance intermediaries will be squeezed at both the big and small ends of the market and will need to demonstrate how they add value. The US bid-rigging scandal undermined the credibility of business insurance brokers; the availability of product and price comparisons on the Internet has squeezed retail brokers. According to National Underwriter's *Fall 2004 State of the Market Survey*, only half as many buyers as brokers (38% versus 76%) said they rely heavily on brokers' advice to navigate the insurance market. Based on other results of the survey and additional field research, Deloitte Research's *Reshaping the Business Model* concludes that brokers will be in the game for the foreseeable future. Technology can strengthen relationships with intermediaries, who welcome technology that helps them operate more efficiently and reduces their costs.

5. Adapt to demographic shifts

The prospect of baby-boomers drawing down trillions in retirement assets offers insurance companies a unique opportunity to take market share from asset management firms and brokerage houses. But insurers need to move more quickly and aggressively than in the past to develop and market new products. Few individual investors think of insurers as the place to go for investment products.

Annuities tend to suffer from a reputation as complex and overpriced. And most providers have yet to pull together a full array of protection products, including health and long-term care, in addition to life and annuities. Bancassurance has made headway in Europe and is well established in Singapore and Korea. It has expanded rapidly in Japan following regulatory changes. And China is the most fertile area of long-term opportunity.

The aging of the population also presents insurers with a dilemma. The industry has a more difficult time attracting and retaining talent than other sectors of the financial services industry. That situation is poised to worsen at all job levels as baby-boomers retire, few top graduates move into the field and overlap among financial services encourages a loss of talent to banking and asset management. Executives are concerned about the traditional career path from insurance company hire to insurance agent. If this feed dries up, the industry's sales force will diminish. At the same time, a lack of depth at top and middle management could damage the industry's future.

A Deloitte Research study, *It's 2008: Do You Know Where Your Talent Is? How Insurance Companies Can Beat the Talent Crisis* prescribes shifting the focus from the end points of managing talent – hiring and retention – to the mid points of development, deployment and connection. Rather than relying on traditional classroom training, development puts critical talent into real-life learning situations, especially “trial by fire” experiences that stretch their capabilities. Deployment involves helping key talent identify the role within the organization that provides the best fit for their skills, interest and knowledge rather than for their resume. Connection provides key employees with tools and guidance to build performance-enhancing networks and improve the quality of their interaction with others.

Looking ahead

Despite the challenges they face, most of the insurance executives we surveyed felt that their margins would grow over the next several years. To make this growth in profitability a reality, they will need to do several things. First, they must either move into fast-growing markets or find ways to wring more business out of slower-growing developed markets. If they pursue the former, China – with its rapidly expanding middle class – is an obvious choice; if the latter, the options include diversification, innovative products and specialty markets. Second, they must improve risk management, particularly in the areas of catastrophe modeling, operational risk and reputational risk. Third, the worldwide scrutiny of broker compensation highlights the need to improve transparency and demonstrate how intermediaries add value. Finally, insurers need to work quickly to develop and market a broad array of products aimed at older consumers.

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