# Specialty

Insights for the specialty insurance and reinsurance market

Issue 2 | December 2013

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Building a better working world

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# Welcome

Welcome to our latest edition of *Specialty* – our main publication for specialty insurers and reinsurers globally.

In our last edition, we focused on growth. In this edition, we focus on a timely topic – profitability. The industry has delivered great returns for a number of years by holding its discipline. The impact is that Specialty is now a segment that has come into vogue and additional capital is flowing into the industry. On one hand, this is a testament to the rise of professionalism in our segment. However, we all know that success is a double-edged sword – the additional capacity flowing into the market will place increased pressure on the discipline that has been maintained to date.

In particular, we have alternative capital reducing pricing in a historically profitable (if volatile) property cat segment, in addition to new startups in the US and the various sidecars of the Lloyd's market affecting the landscape. The pressure is mounting and will only increase. We are also seeing a wave of consolidation as players recognize that scale will be essential to survive these large shifts, while acknowledging that in the past many companies in this segment have been successful by being smaller and agile.

These are deceptively challenging times – perhaps the most challenging for a decade. A lot is changing in this industry, and companies can expect a tougher operating environment in the future with an increased level of competition from a greater number of players in the market, some with leaner operating models. At the same time, discipline around underwriting management, both from a risk and a pricing perspective, will be a major differentiator. And while it is good news that some organizations are taking advantage of the positive M&A environment and deal flow is increasing, such transactions bring with them growing pains both short and long term.

Cost is clearly a major lever to improve profitability, perhaps the lever most in a company's control, and we discuss this in our cost benchmarking survey for the market. Our experience is that cost is one of the areas receiving the greatest attention. However, companies are not looking to "salami slice" their way to reduce their cost, but relooking at their systems and operating models to see that processes, outcomes and data can be delivered at a higher quality and for reduced cost.

In this edition, we discuss supporting underwriting as the major lever of sustainable profitability. Underwriting is at the heart of this market, arguably more so than any other segment. Many (re)insurers are considering taking steps to support their underwriting process – providing solutions and tools, which create the right workflow and better access to information and tools at the point of underwriting.

We also have an article focused on Bermuda, a market that continues to evolve and grow, and be an important part of the geographic spread for many major players in our market.

Finally, we have our interview with Mike McGavick. His (and our) view is that there are still great opportunities in the market. We are challenged as an industry to drive innovation forward and provide insurance for those many events that expose companies from new innovations and to the emerging market where underinsurance is material.

For all this talk of challenges, we remain optimistic. This is an industry that has innovation at its core, and has already found ways around the challenges in the past and continues to re-invent its relevance!

**Rodney Bonnard**, Partner, EY LLP (UK)

**Peter T. Cangany, Jr.**, Partner, Ernst & Young Ltd.

**Edward J. Majkowski, Jr.**, Partner, EY LLP

# Looking

In an uncertain economy with depressed investment returns, specialty insurers are under great pressure to achieve profitable growth. Advanced underwriting support technology can help companies address this challenging goal. We outline how.

As with the classes of 2002 and 2005, Specialty insurers have typically been formed in response to hard markets following major catastrophic events. To hit the ground running and take full advantage, they have focused, first, on recruiting underwriters with strong client and broker contacts, and only later on other areas of the operating model, such as claims, finance and IT.

The initial focus in the early days of these new (re)insurers has been on achieving strong ratings and investment returns rather than industrialized technology solutions. The priority is giving finance people the systems they need to report to investors and regulators — not using leading IT solutions to optimize underwriting.

Specialty insurers have tended to invest in essentially undifferentiated back-office systems, rather than technology designed to support underwriting decision-making and portfolio management. The reinsurance market is driven more by capital than operational efficiency, and underwriting efficiency delivers less competitive advantage in the specialty market than in retail.

Achieving sustained profitable growth has become a particular issue for specialty firms recently. Many have grown books of several billion dollars, only to see growth stall in a soft rating environment. Increased discipline on rates has encouraged underwriters to reduce their books in certain markets. To compensate, many companies have added new product lines and new teams to support these, as well as extending existing product lines into new geographies.

Growing front-office headcount to support profitable revenues requires significant investment. But, historically, there has been little investment in technology solutions to support underwriters in this market, either from an efficiency or effectiveness perspective. Most of the solutions in the market have focused on the policy space. As a result, most investment has been directed there.

However, technology solutions now available enable specialty firms to grow significantly by improving underwriting productivity — in terms of both sales focus and efficiency — rather than recruiting more underwriting staff. This can help bring scalability to the specialist underwriting model.

Investing in technology that helps underwriters make better decisions faster can deliver greater competitive advantage than back-office policy fulfillment capabilities. This is particularly true for specialty insurers, whose policy numbers are lower, and whose regulatory reporting obligations are lighter (certainly in the US) than are those of standard commercial lines insurers.

Working with the dedicated underwriting technology solutions that have been developed since the mid to late 90s, it is now possible to create a bespoke underwriting workstation solution that can radically empower specialty insurers' underwriting functions. This applies to both the transactional and portfolio management aspects of the underwriting role and to individual risk selection — supported by improved access to data and analytics.

Risk data capture that often currently takes place in spreadsheet form can now be captured centrally within the underwriting environment. This enables underwriters to share information rapidly and seamlessly with colleagues and with brokers, and to evaluate, price and quote risks more rapidly and scientifically.

Valuable insights can also flow from the ability to segment risks by, for example, product, industry or market. Underwriters may also be able to leverage quoting data from previous years to far greater effect to target specific business across classes. So capturing the best underwriting intelligence on pricing to support underwriting decisions is of far greater value than improved policy administration.

Improved collaboration, within the business and with brokers and reinsurers, can also drive major productivity gains. This massively accelerates, for example, the speed of referrals or authorizations. The advent of broker placement platforms has created a need for carriers to have an underwriting tool that can face off to these systems.

Process automation can also drive major productivity improvements by allowing underwriters to focus on risk selection and analysis. Automating processing tasks that add no significant value frees underwriters to focus on the higher-level aspects of their role.

# up: underwriting support technology as a driver for **productivity** and **growth**

Industrialization of product and risk pricing allows the seamless integration of a full range of exposure-based predictive pricing and catastrophe modeling tools into the underwriting process. This again saves time and supports informed risk analysis and selection.

Incorporating granular real-time analytics and risk benchmarking into the underwriting process also brings significant gains. Giving underwriters ready access to robust and timely data — and the ability to run a range of reports against it — helps them to understand individual risks better and benchmark these against portfolio.

A related gain is the ability to achieve more timely, insight-driven portfolio management, fueled by improved access to insights in market trends, risk management data, broker behavior and a range of other factors.

Another key part of the value proposition for advanced underwriting workstation environments is the greater consistency they bring to the risk selection process. An environment that delivers ready access to timely data and analytics shifts the process further toward the science end of the art-science spectrum.

A more industrialized underwriting process also enables specialty insurers to generate more predictable and reliable results by optimizing their ability to apply rules and carry out real-time portfolio management.

This technology also provides greater insight into performance across portfolios and across a business. Integrating analytics fully with underwriting helps specialty insurers manage loss ratios more effectively, refining their approach to particular industries, market segments and brokers, and highlights opportunities for product development.

Technology investments in the underwriting space tend to be much smaller than in the policy space, and a business case is usually easier to identify in this area of the value chain. Solutions typically support phased rollout of new underwriting capability over a number of years, spreading the cost of investment. Over the next few years, we expect to see a significant uplift in underwriting support technology investment. S

"Investing in technology that helps underwriters make better decisions faster can deliver greater competitive advantage than back-office policy fulfillment capabilities."

**Gail McGiffin**, Principal, EY LLP


## Authors

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# The **benchmark**

Now in its second year, our 2013 cost benchmarking survey takes a wider and deeper view of the market than ever before.[1] Representing approximately a quarter of the specialty (re)insurance market globally, this survey offers one of the most comprehensive benchmarks available.

## Complexity and cost reduction

While the drivers of cost vary across the market, many of the (re)insurers we spoke to described reaching a point of unsustainable complexity, particularly when writing multiple products in multiple locations. Organizational simplification – in particular the reduction of duplication across geography – has become a key focus area for cost reduction programs.

## Key focus areas

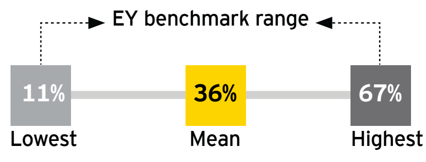
Eighty-five percent of the participants of this survey are actively delivering or considering some form of cost reduction in 2013 and 2014. The key target areas for cost reduction in 2013 have been:

1. **Expense ratios** – There has been only a small reduction in total net expense ratio from last year's average of 15.2% to this year's average of 15.1%. However, if we examine the results from the participants of last year's survey, we see an average net expense ratio of 14.6% this year, indicating a real reduction in costs among this group. For the whole survey group, net expense ratios ranged from 9% to 24% (gross ratio ranged from 6% to 18%), with similar levels of inconsistency within individual segments. This indicates a varying maturity of cost reduction and operational efficiency initiatives within the market.
2. **The underwriting function** – Only 15% of participants had not established some form of underwriting operations team to reduce the cost of the function while supporting scalable growth. Underwriting had the widest cost range and size variability of any function (from 11% to 67% of full-time employees (FTEs)). This partially reflects the different approaches to defining underwriting and organizational design.
3. **Support functions** – Despite a market-wide focus on back-office cost reduction, finance, risk, actuarial and other functions still represent over 50% of costs and approximately 45% of FTEs. Support function costs overall have decreased in the last year, but this is largely due to lowering the cost of the finance function. It is interesting to note that many people working in support functions, or on routine activities, remain in expensive locations.
4. **Claims** – This remains the highest cost overall in composite segments, with little success being achieved in reducing cost between 2012 and 2013.
5. **Risk operating models** – Costs have decreased, but the size of the function overall is increasing.

## Going down – underwriting costs

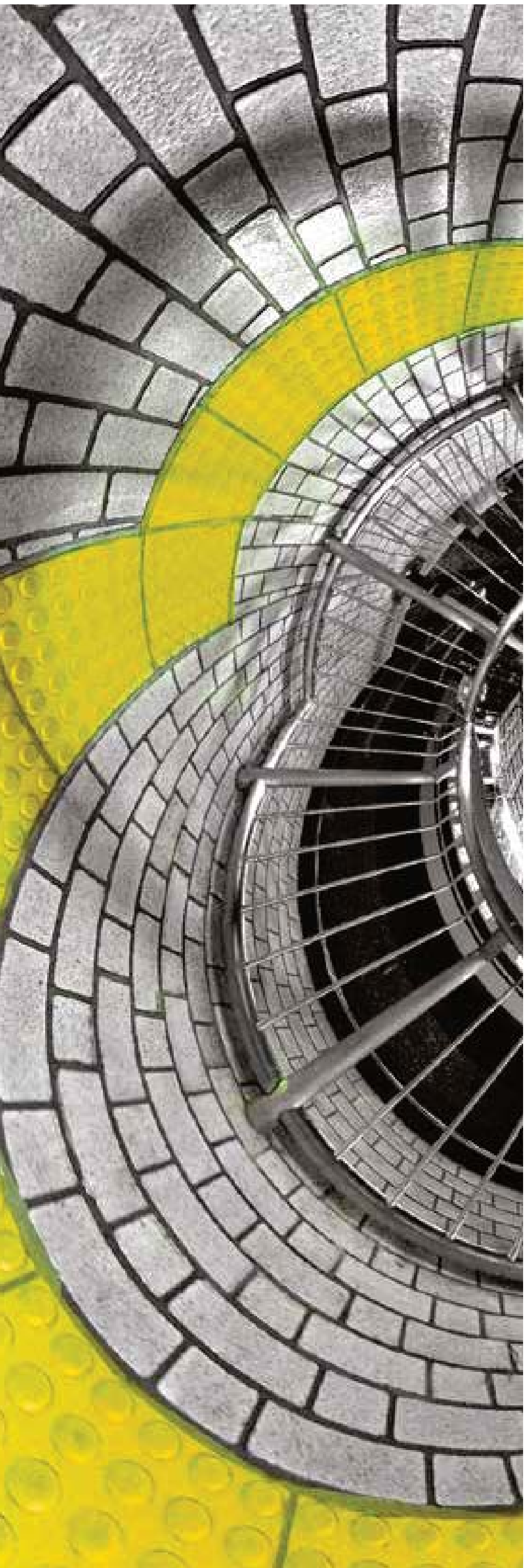
Top of the priority list for specialty (re)insurers over the next year is to target the cost of underwriting operations. In common with the 2012 survey, the size and cost of underwriting functions as a proportion of the total organization varied widely. Composites tended to have larger and more costly underwriting functions – driven by multiple types of business and a focus by these insurers on cost reduction in other areas. A large and costly underwriting function may indicate that some underwriting activities could be moved to operational or support functions. Indeed, we have found that many insurers are considering moving new activities to underwriting operations. This is particularly important in the context of geographical expansion, where new underwriting locations can be supported by central support teams.

**Underwriting FTEs as a percentage of total FTEs**




Source: EY analysis

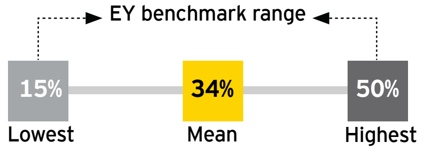
1 Twenty-five (re)insurers are included and participants ranged in size from under 20 to over 4,000 FTEs and from US$200m gross written premium (GWP) to over US$7b.



Across the survey group, underwriting operations is a more common function for composites than reinsurers, and for larger rather than smaller organizations. Every Lloyd's participant in the survey had an underwriting operations function. The largest organizations tended to have the largest underwriting operations function, yet even a smaller participant had over 10% of staff in this function. We see:

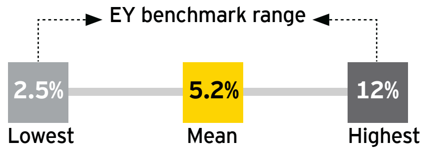
- (Re)insurers with established underwriting operations now considering how they can further optimize this function – firstly by creating centralized roles that work across classes of business
- Movement of additional activities into underwriting operations – for example, endorsements, along with some modeling activity, are under active consideration
- Centers in low-cost locations, such as India or Malaysia, as an established practice
- The outsourcing of some aspects, or even the majority, of this activity by some specialty (re)insurers

**Underwriting cost as a percentage of total cost**




Source: EY analysis

**Underwriting cost as a percentage of NEP**




Source: EY analysis

"As the largest and most costly function – and an area of cost increase – underwriting, and underwriting operations, should become focus areas for further cost reduction: as (re)insurers look at how they can remove silos and move routine activities to lower-cost locations. IT and claims are also shown to be areas of increasing cost, warranting the current focus that many of our clients have on cost reduction within these functions."

**Ben Reid,** Director, EY LLP (UK)

## What's new for 2013?

Analysing the proportional cost and FTEs shows a change across almost all functions for original participants, and highlights particular focus areas for cost reduction. Comparison of net expense ratios from the 2012–13 surveys shows:

- Total cost as a percentage of net earned premium (NEP) has decreased by 0.1% from 2012 overall and by 0.6% for the original participants. The benefits from the cost reduction work undertaken by many original survey participants are beginning to be reflected in results.

Comparison of proportional cost and FTEs 2012–13 surveys shows:

- No functions have remained static in proportional size or cost between the 2012 and 2013 surveys, and some (IT, underwriting and finance) have seen substantial changes. This indicates an ongoing focus on operating model development and cost reduction.
- The proportional size of risk and actuarial functions has increased for original participants, while the proportional cost of these functions has decreased. This indicates a reduction in cost per FTE of these functions between the two surveys.
- Claims did not decrease significantly in proportional size or cost between 2012 and 2013, despite this becoming a focus area for cost reduction. Claims cost reduction may become evident in our 2014 survey.

## Key differences between company types

Comparing the main specialty segments for the first time in 2013 (Lloyd's, insurers, composites and reinsurers)[2] reveals some interesting cost pressure differences emerging among these four groups:

- The Lloyd's segment had lower net and gross expense ratios than both the composite and insurance segments, driven by both a lower number of locations and lower costs of being a Lloyd's-only platform.
- The insurer segment has the lowest proportional balance of cost and FTEs for support functions (non-underwriting and claims). This is likely to demonstrate the greatest focus on support function cost reduction by insurers.
- At 17.9%, the net expense ratio was highest for the composite segment. This is likely to reflect the relatively greater complexity and substantially larger global operations of many of the participants, as well as the wider number of segments they operate within.
- Among reinsurers, high actuarial and risk costs demonstrate the importance of these support functions to this segment. Modeling costs drive up the cost of risk functions, as well as the wide range of cost within this function.

"Despite the majority of survey participants having told us that they are focused on some form of cost reduction, there has not been a step-change reduction in expense ratios. However, the significant range in expense ratios for participants demonstrates the success that some (re)insurers have had in reducing costs."

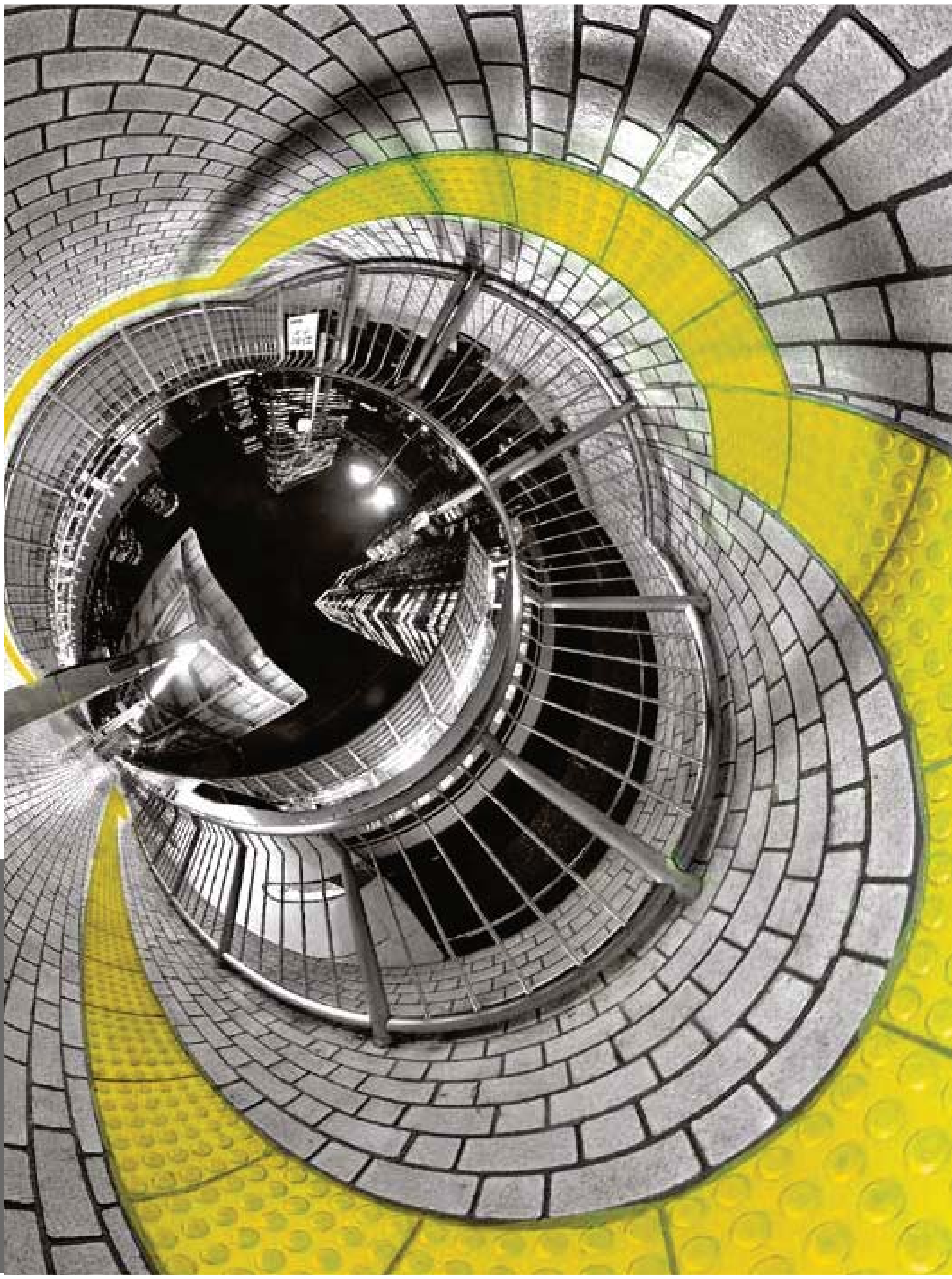
**Rodney Bonnard**, Partner, EY LLP (UK)

2 These segments are: Lloyd's (pure Lloyd's businesses), insurers (that write lower volumes of reinsurance), composites (participants that write both insurance and reinsurance business) and reinsurers (that principally write reinsurance, but it also includes insurance-linked securities platforms).

## What lies ahead?

Given what we've heard from the participants in the market, and also having consulted a wide range of our own experts, we expect to see the following by the time of our next survey (June 2014):

- Average expense ratios will drop to less than 15%, as cost reduction becomes a key source of competitive advantage for the market. The most substantial cost reductions come from the composite and Lloyd's segments.
- Support function cost reduction will increase average size and cost of the front office to more than 50% of the total. Overall the underwriting expense ratio will decrease as more activities move to lower-cost locations.
- Underwriting operations and shared services for support functions will be developed in lower-cost locations by over 80% of the market. As well as allowing cost reduction, such services foster scalable growth by allowing back-office activities for new organic or acquired business to be more easily absorbed. S

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**Ben Reid** (breid@uk.ey.com) and **Philip Burrill** (philip.burrill@bm.ey.com) are currently working with a number of specialty companies to help deliver expense reduction, including finance transformation by improving process efficiency, reducing duplication and consolidating financial systems. Please contact them for more information about the survey.

# Playing for the long game: Bermuda looks to the future

With the fourth-highest GDP per capita in the world, Bermuda continues to enjoy the benefits of being home to many financial services businesses. A number of reinsurance companies relocated to the island following Hurricane Katrina in August 2005, and this, along with other major events, contributed to the expansion of Bermuda's international business sector.

However, even before the turn of the century, Bermuda had enjoyed 50 years of international business growth. While the beautiful island ambience certainly makes Bermuda an attractive place to live and in which to do business, the robust business infrastructure, close proximity to the US and the lack of corporate income tax has attracted many businesses to relocate here.

However, a global recession, coupled with Bermuda's burgeoning debt levels and the increasing cost of doing business on the island, has caused some corporate executives to think again about basing themselves there. In reality, it is not just Bermuda that is being challenged as a place to do business; corporate executives continue to examine their strategic plans in every location. It's nothing personal – it's just good business. The global macroeconomic conditions, a suppressed interest rate environment and modest, albeit improving, rate increases – all make for engaging discussions.

## A concentration of talent

So what exactly does go up on the "white board" during a Bermuda strategic planning day? Fortunately, many Bermudian companies have a good starting point.

Let us begin with the strength of the (re)insurance market infrastructure on the island. One look down the streets of Hamilton reveals why reinsurers continue to incorporate in Bermuda. The vast wealth of talent, including underwriters, actuaries, risk managers, third-party service providers and specialists with deep reinsurance expertise, they are all within walking distance of each other. Senior executives and other influential decision-makers in the industry are regularly seen here – largely due to their investments on the island.

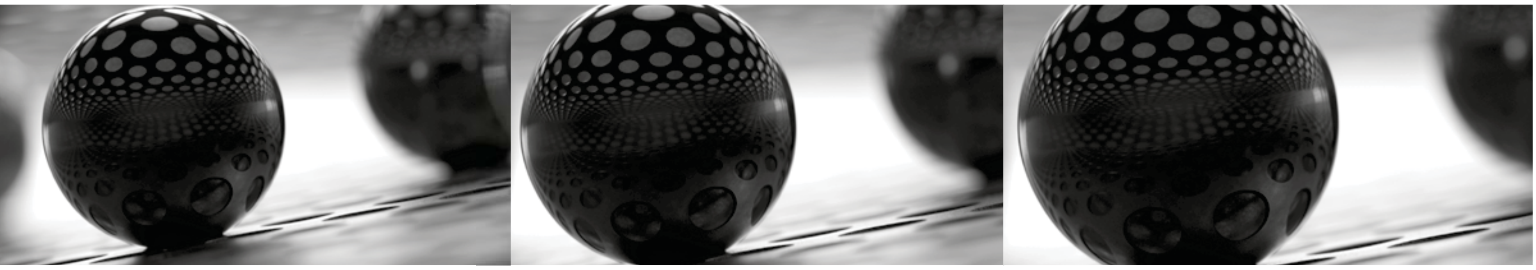
Admittedly, there are several jurisdictions that compete on the global stage for (re)insurance market share with Bermuda, including the Cayman Islands, Ireland and Switzerland. And while those locations may have slightly increased their market share, nowhere else has been able to displace Bermuda as the offshore jurisdiction of choice for (re)insurance platforms – particularly in the convergence space. The success of companies on the island, ranging from behemoths such as XL Group, ACE, PartnerRe and RenaissanceRe, to newly formed startups such as Third Point Re (which recently went public), S.A.C. Re and PaCRe, demonstrates Bermuda's solid track record of developing strong companies with excellent brands.

## Regulatory framework

Bermuda is well known for its sound regulatory framework. The Bermuda Monetary Authority (BMA) is the integrated regulator of the financial services sector in Bermuda. The BMA has taken a very pragmatic and balanced approach to its regulatory responsibilities. That point of view, coupled with active global participation in international solvency frameworks, has gained the BMA an excellent reputation among its peers, and this is an often-noted reason why many companies move to Bermuda – and remain here. In fact, through the first nine months of 2013, approximately 50 new insurers have registered with the BMA.

"Reinsurers in Bermuda continue to innovate and provide a needed mechanism for the spreading of risk."

**Peter T. Cangany, Jr.,** Partner, Ernst & Young Ltd.



## Developing its asset management sector

Also favorable to the business community is activity by the BMA and the Bermuda Business Development Corporation to provide active support for Bermuda's asset management sector. If successful, this strategic alignment of the (re)insurance community and the asset management community will result in an even more vigorous environment for local companies to compete on a global scale. In fact, legislation was recently put forward by Bermuda's Minister of Finance that is "designed to make Bermuda a major player in the global funds industry." In remarks to Bermuda's House of Assembly, the Minister of Finance comments that "Bermuda has built a reputation as a leading reinsurance market — one of the top three markets in the world."

The strategy underlying the Investment Funds Amendment Act 2013 is that "Bermuda will be seen not only as a reinsurance center but also as a major player in the global funds industry." In short, the amendment changes Bermuda's Investment Funds Act 2006, providing new criteria for the exemption of funds from the requirements of authorization and supervision. Along with the momentum of the convergence space, it is likely that this amendment, if enacted, will provide an even greater reason to come here.

## Attracting new companies to the island

Recent legislative changes contained in the Bermuda Immigration and Protection Amendment Act 2013 and Job Makers Act 2013 were also passed by the Bermuda Government. These changes were enacted to provide added incentives for "job makers" (most notably, CEOs and other executive officers) to stay in Bermuda, and encourage increased interest in Bermuda's international business community, with the hope of attracting new companies to the island and deterring others from leaving. Among the more significant changes are new rules to cut fees, which will allow job creators to apply for permanent residency. Another change will see a reduction in the minimum number of Bermudian staff that companies need to employ in order to seek exemptions, down from 25 to 10.

Judging by recent history, Bermudian company indicators demonstrate that the island's strategic benefits are paying off. GWPs continue their expanding global footprint, 2012 income was vastly improved over the previous year, and 2013 continues to look promising, despite a series of flood-related catastrophes in Europe, Argentina and Canada, along with hailstorm activity in the US (although the quiet US catastrophe activity has been duly noted).

## The challenges ahead

As multi-national carriers continue to purchase less reinsurance coverage, even greater strategic initiative will be required, and Bermuda provides an excellent platform from which to deliver those actions. Fee income from sidecars, significant growth in catastrophe bonds, insurance-linked asset structures and expanding product lines are all strategic directions that Bermudian companies are exploring. The added benefits of a practical regulator and increasingly friendly business environment are "icing on the cake."

As the old saying goes, "The more things change, the more they stay the same." Reinsurers in Bermuda continue to innovate and provide a needed mechanism for the spreading of risk. Double-digit returns have eluded many, but more and more, we are seeing the groundwork laid for increased returns to stakeholders. Despite a challenging few years, Bermuda has not lost its place among the major reinsurance markets and, with continued focus (and perhaps a little luck), the island will continue to receive more than its fair share of the market. S

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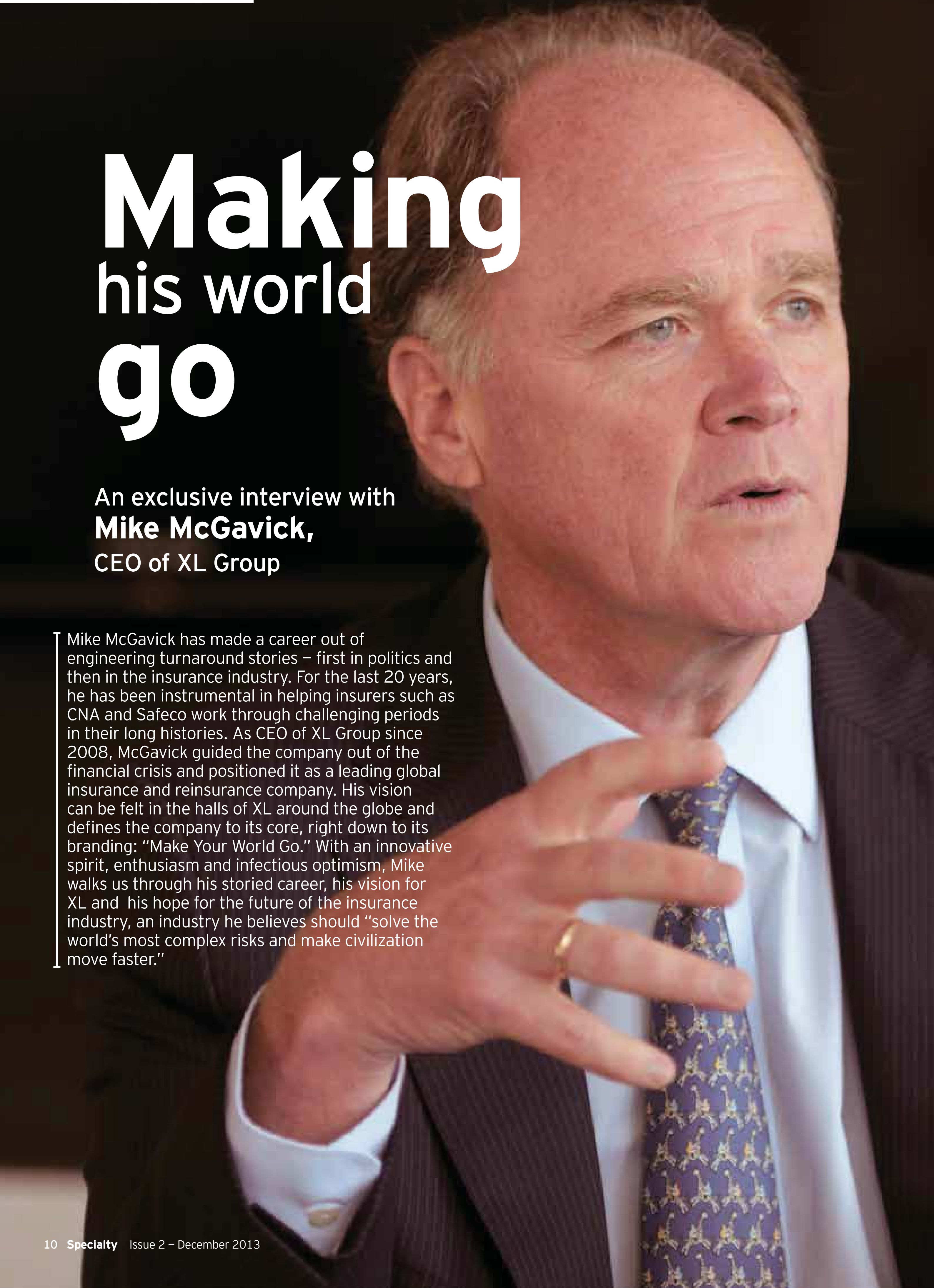


# Making his world go

## An exclusive interview with **Mike McGavick,** CEO of XL Group

Mike McGavick has made a career out of engineering turnaround stories – first in politics and then in the insurance industry. For the last 20 years, he has been instrumental in helping insurers such as CNA and Safeco work through challenging periods in their long histories. As CEO of XL Group since 2008, McGavick guided the company out of the financial crisis and positioned it as a leading global insurance and reinsurance company. His vision can be felt in the halls of XL around the globe and defines the company to its core, right down to its branding: "Make Your World Go." With an innovative spirit, enthusiasm and infectious optimism, Mike walks us through his storied career, his vision for XL and his hope for the future of the insurance industry, an industry he believes should "solve the world's most complex risks and make civilization move faster."

> Simply put, insurance gears human progress forward.

## On his proudest accomplishment ...

This is so difficult for me to answer because in no way do I view myself as being at a point of reflection. I am very much one of those people who looks completely forward. I'm not interested in the past at all. So when I reflect on my career, what really comes to mind at this stage is more the body of work instead of any one event. I feel like I've had the privilege – but some would say the dubious honor – of always being pulled into jobs no one else wanted and, by any real definition, I wasn't qualified for. That's been true of every job I've ever had of any significance. And this reality has been great for me, because I learned early on that I really enjoyed working on things that others said can't be done – and I really get a big kick out of it when it does work out.

This was true when I ran [former Washington US Senator] Slade Gorton's comeback campaign in 1988, and it was true when I joined CNA, after working on the Superfund initiative. Then I joined Safeco, and, in many ways, that company was left for dead. A lot of people interviewed for that job that were vastly more qualified than I was but they turned it down. They missed out on something incredible, though. I took that job and had the chance to go back to my hometown of Seattle to work with a company that truly meant something to the Northwest. And similarly, to be at XL is just an incredible thing. XL is a very special place, and always has been, but it was on a path that wasn't going to work out. Former XL CEO Brian O'Hara once said to me, "Other companies were too big to fail, but XL was too good to fail." And I think that's right.

So re-energizing places that are special, or people that are special, gives me a lot of satisfaction. But by no means do I feel like I've made my biggest contribution or repayment for the gift of being alive. I feel like that's still to come, and I think we have a lot left to do at XL to take this great company to the next level.

## On taking on roles no one else wants ...

It all started with my early career in politics. Gorton's win captured a lot of attention in Washington, D.C., so I had the opportunity to work on some exciting and interesting things, as well as some other turnaround Senate campaigns. But in 1990, I decided to leave politics. In the world of politics, the game is so skewed to win re-election in Congress that the best are not always in office, and you don't always get to work with and support the people you believe in and respect. It wasn't in my soul to do that. But it was difficult and scary to leave a world that I knew and was good at, the only real career that I had ever had. I didn't have any experience beyond politics, but I knew that I could lead turnaround stories; I just needed to find something new to do. I realized early on that I would need to do something political to bridge me into a new industry.

A friend called me and said there was a big campaign in the insurance industry around Superfund, and they were looking for someone to run it. So I wound up working for the insurance industry, almost by accident, and always with the idea in the back of my head that if I did a good job on the Superfund campaign, someone would hire me. That went well – and shortly after, I started at CNA as a strategist, to help turn that place around. And it was scary – it was my first time in a corporation – but it was exciting and rewarding, because I believed in it.

So on taking roles no one else wants, I really believe it's about picking your spots, applying your skills and strengths, and rallying around something you believe in. I didn't have an insurance background, but I knew how to run campaigns and turn around struggling entities. In many ways, my time as a political strategist was almost like foreshadowing for a life in the corporate world. It led me to insurance, an industry I now love, working with companies like CNA, Safeco, XL – all special franchises with unique stories.

## On why insurance matters ...

Simply put, insurance gears human progress forward. It is really that simple and important. If we can take work, challenges and issues off of our clients' plates, solve problems that are extraneous to their strategic purpose in the world, they will progress faster. The world will progress faster. Yet, people don't think of it that way. We all learn as we grow up that insurance is this bad thing that the bank makes us do, that costs more than we think it should, and that we don't believe will ever pay off fairly. That's not the right way to think about it. It's actually about social purpose. Think about how powerful that is. When something bad happens, we put lives back together. If you can do that, if you can view yourself propelling the world forward, you want to get up in the morning and come to work. It sounds corny, but it's true. And what a cool thing to be a part of. But it's really hard to do well, because often our tools are about looking backward to guess what happens next. That's the equivalent of driving 100 mph forward and being focused on the rearview mirror. That is a really dangerous way to drive.

If you're selling products to solve the complex risks of the world to some of the largest, most complicated companies – which is a big piece of what we do around here – there's no way that what you are selling them this year could possibly solve next year's problem, because the game's changing too fast. The question becomes: How do we organize XL and give it the right tools and culture and framework to keep these core attributes but make them effective in an ever-more rapidly changing world? We have so much to do; I'm quite sure I can do this the rest of my life and not feel satisfied that we've made all the difference we can make in the world.

# Improving insurance

“Innovation is at the heart of who we are.”

## On XL's business model as a point of differentiation ...

Innovation is at the heart of who we are. We want to be the company that the world turns to for its most complex risk needs. A big part of how we got there – and how we stay there – is through empowerment of the underwriter. How did we do that? By completely flipping our operating model on its head – one of our most important innovations ever. The heart of this company, where its money is made, is our underwriters solving problems. It is my job to empower and enable them to do so. We call it an upside-down organization and we have consciously created an organizational model where the jewels of this crown are those underwriting groups and what they do, and everyone else is focused on getting them better tools, lowering the cost of capital and creating a system that supports them. That's our job. This can be hard to sell to people, but it's fantastic, and it's why we're winning the race for talent.

operations

# And next?

"It's not enough to solve problems; you also need to think about what's next."

## On his most important lesson learned ...

When I arrived at XL, it was obvious there were some immediate issues. We had gone into the financial guarantee business and had also become pretty creative around our investment portfolio. In a way, that actually meant that those two risks were linked – and, in fact, they were linked rather catastrophically. We assigned a small team to focus on solving these problems while the rest of our people focused on doing their jobs, continuing business as usual, working for clients and making a difference. We had a great team to attack that problem, and, in three months over the summer of 2008, we solved the problem. But it's not enough to solve problems; you also need to think about what's next. I trusted too much that the patient would quickly revive. I underestimated the damage that had been done to daily trading. We were a little too comfortable that excising one problem would fix everything else. We needed a world-class solution to set in motion the strategy process that's now working wonderfully well for us. But I feel personally guilty – I feel like we lost a year.

## On the future of XL ...

This place has unlimited potential because it's so uniquely positioned to solve some of the world's greatest problems. I learned a long time ago that if the trend is your friend, you have a real opportunity. I like everything about the trends and where XL is positioned. And while I don't always want it to be true, at this stage, I really like that we're of a manageable size. We can still react to things at a faster and more effective pace than our competitors. That superior ability to adapt will be crucial. I think it makes us more innovative. Around here, it's all about how we keep thinking creatively to unleash talent at hand. I'm more excited than ever about the unfulfilled piece of what we're doing here.

## On the future of the industry ...

I've been talking about my sense that as an industry, we're vulnerable, mostly because of a lack of innovation and declining relevance. That means we're not making the difference we're supposed to make. There are so many examples of this. The earthquake in China in 2008 – just 1% of the loss was insured. We had Hurricane Sandy last year in arguably the most advanced economy in the world, and there was still a massive gap between actual loss and insurance loss. The tsunami in Japan in 2011 and all of the subsequent fallout from the supply chain – and insurers were nowhere to be found. Is this the best we can do as an industry? Cyber liability is a serious business, but it's currently not even scratching the surface of the big issues. The list goes on. All of this represents real opportunity for this industry. We need to be viewed as relevant to all sorts of industries – energy, tech, pharma, etc. We need to look at the trends that will matter and ask: Where is insurance and what is our role?

There's nothing that says XL – or any company – has the right to exist. We exist because we go out and make a difference so that we are justified into our existence. The same can be said for the insurance industry as a whole. If we're only going to be so creative as to take new capital and apply it to a problem we already have lit, shame on us. If we're going to go after risks keeping people up at night, now there's a reason to have new capital come in. Just because there may be some declining relevance today doesn't mean that's the only outcome for this industry.

We have a lot of work to do, but the opportunity for innovation is tremendous. S

# Business simplification: a strategy for sustainable success

What is the key to success in an environment with a sluggish economy, low investment returns, soft rates, potentially changing weather patterns, ever increasing regulatory intervention and a wide disparity between the growth and risk data available? We know that growth opportunities vary dramatically by geographical market, but so does the amount of data available to underwrite risks in new markets. We believe the answer to this is business simplification.

By simplification, we mean clarity of purpose underpinned by a clearly articulated strategy (that all employees can mobilize around) and the elimination of operational complexity in order to achieve a more stable platform for growth. Our hypothesis is that simpler organizations tend to outperform overly complex ones, and an analysis we've conducted appears to support this correlation (more details below).

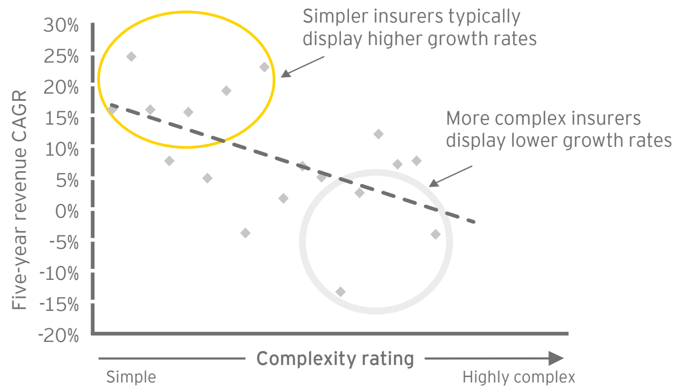
There are a few important points to mention here: we are not saying that small, simple businesses will always outperform large ones, but rather that we have demonstrated that large multi-line, multi-geography businesses can also benefit from relative simplicity to outperform their peers. We also understand that no senior executive deliberately chooses to operate in a highly fragmented, multi-dimensional matrix business with duplication of processes, a vast array of legal entities, and a lack of consistent and transparent performance metrics. However, many organizations find themselves grappling with this challenge because they have made decisions that are, in their own right, individually sensible, but when added together create an organizational burden that is just too complex to lead. In this article, we present the benefits of business simplification as we see them.

## Context

When we originally decided to test our hypothesis that more simple businesses would outperform more complex ones, we expected there to be a correlation. But the extent of some of the findings and the scale of differences in performance that we found surprised even us. In order to test our hypothesis, we looked at a sample of 32 insurers and brokers of varying scale and on a cross section of geographic coverage.

### Relatively simpler businesses sustain growth more effectively than more complex ones

Insurers' performance variation – compound annual growth rate (CAGR) versus complexity, 2007 to 2011




Source: EY analysis

Our research found that insurers with simpler operating models are more likely to deliver higher sustainable growth through a challenging financial period (see figure above). By contrast, more complex insurers generally display lower growth rates over the same period. The most successful examples have implemented a cycle of growth and simplification to promote ongoing "external agility." This has allowed them to respond to changing market conditions to sustain higher performance more effectively, realize value from opportunities more quickly, and inspire confidence in shareholders and analysts in order to maintain a consistent valuation.

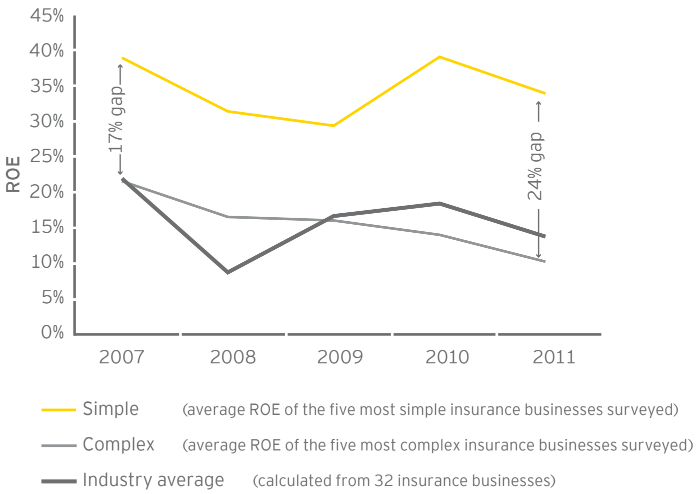
Strategies that focus on the fundamentals, such as underwriting and claims excellence, or targeted or integrated distribution models, ensure that incremental complexity does not creep in. By diversifying successfully, for example, into businesses that can be integrated easily and create synergy, acquisitions don't have to increase complexity. Simplicity can be maintained through clarity of purpose and speed and repeatability of assimilation.

## Simplification increases profitability

Simplified insurers also maintain stronger profitability than more complex insurers, as well as stronger growth. There can be as much as a 24% gap in return on equity (ROE) between the simplest insurers and the most complex. This is because they have combined their "external agility" with "internal agility" — using simplification to provide the ability to impact internal cost drivers more effectively. Simplification activities have included streamlining of management structure and decision-making processes and avoiding the formation of convoluted management hierarchies. This enables faster decision-making to respond quickly to changes in customer needs.

Simplified insurers have also tightened control over technology and processes — aiming to evolve in line with ongoing developments in the marketplace, while ensuring each improvement is integrated based on "simplification principles." Finally, as part of their simplification efforts, some insurers have minimized "non-productive" costs by ensuring investments and resource efforts are always targeted at driving core value, not getting diluted by internal complexities.

Percentage gap in ROE performance by level of complexity



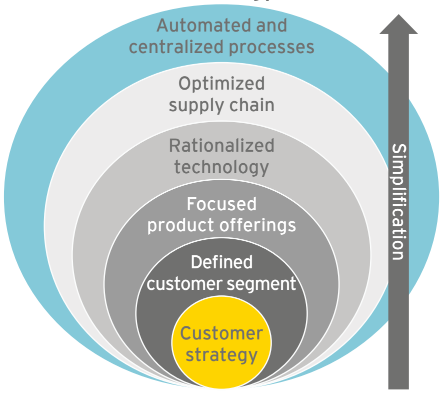

Source: EY analysis

## A customer-centric strategy is a key factor in achieving successful simplification

By simplifying their product offering, insurers are then able to simplify all aspects of their business model. A consolidated product offering also improves the quality of insurers' and insurance brokers' propositions – an increasingly important factor when targeting today's more sophisticated and demanding customers.

Success is dependent on ensuring the right products are available through the right channels at the right times, thereby avoiding incurring any non-benefit-driven costs. Ensuring that a multi-channel offering is executed in a streamlined manner is critical to avoid complexity.

Customer-centric strategy




Source: EY analysis

## Insurers can be global and maintain a sustainable low expense ratio through simplification

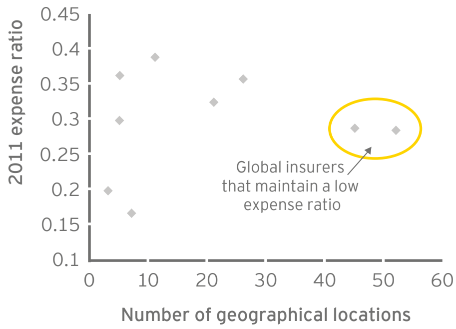
Received wisdom is that companies with a large geographical reach drive a higher expense ratio; however, we have found examples of insurers being able to maintain relatively low expense ratios with an extensive geographical reach.

One of the factors that has contributed to favorable expense ratios is the ability to align back-office and operational footprints. Insurers that manage their global business with a smaller, simpler, central infrastructure tend to have a lower expense ratio than those with multiple layers of management in separate locations.

Businesses with either fully integrated global models or fully independent regional models can succeed in running a low expense ratio.

However, those that confuse the two models tend to add too much management complexity and overhead.

Locations versus expense ratio




Source: EY analysis

## A thematic, enterprise-level response to insurance regulation drives business simplification

Some insurers have successfully turned the increasing burden of regulation into an opportunity to simplify their capital, entity and organizational structure, as well as their operating processes. They have embedded their response to multiple finance-themed regulations within a broad finance, risk and actuarial transformation program. They are delivering sustainable value by combining the organizational response to multiple complex regulations, incorporating this response with other required finance change (e.g., system replacement) and targeting specific benefit delivery through simplification.

## Conclusion

Clearly, this article presents only a snapshot of some of our findings around business simplification, and we are not able to cover them all here. For example, there is a large technology element to achieving simplification that we have not touched upon in any depth. Our key challenge to companies at this time is: In this current period of sustained economic turmoil, can you afford not to simplify? S

There can be as much as a 24% gap in ROE between the simplest insurers and the most complex.

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# **Understanding** the regulatory **expectations** for oversight of your **coverholders**

In recent months, there has been an increasing level of interest from the Financial Conduct Authority (FCA) and Lloyd's on the role of coverholders in the London Market product distribution chain. The regulatory authorities have begun to question whether insurers and reinsurers have insufficient oversight of their coverholders' business models, control frameworks and distribution channels. Potentially, there may be business risks associated with coverholders that (re)insurers may not be aware of, but for which they could be held accountable as product providers.

The enhanced level of regulatory scrutiny, and recent fines levied in relation to the sale and distribution of general insurance products, has made it even more important for insurers to understand the risks they are exposed to from third-party arrangements and to assess the level of oversight they provide on their networks of coverholders. This senior executive update looks at the steps insurers should take to assess the potential risks arising from their coverholder networks and the business benefits that can be gained from a greater understanding of these risks.

## Increased regulatory focus on coverholder networks

The FCA and Lloyd's have begun to examine firms' coverholder networks, and their expectations are starting to emerge. These include the following:

- Underwriters and senior personnel are expected to understand and monitor the conduct of business risks arising from delegated authority arrangements – both generally and with individual schemes.
- The regulatory focus includes both UK and incoming international coverholders that bring business into the UK.
- Both insurers and coverholders are regulated entities and, therefore, responsible for maintaining an adequate control framework around sales processes; both are potentially liable for regulatory breaches and censure.
- While the regulator has historically placed the balance of responsibility on the distributor for failing to control misselling, there are signs of a shift toward placing greater responsibility on providers going forward.
- The emerging view of Lloyd's and the FCA is that the (re)insurer remains fully responsible for all activities carried out by the coverholder in relation to the sale and post-sale handling of the insurer's products.

The FCA has also indicated that it will examine delegated underwriting and claims authorities as part of its recently announced thematic review of conflicts of interest in the broker market; whereas Lloyd's is examining the arrangements for delegated authorities as part of its review of underwriting standards.

## What you should consider

Given the increasing level of regulatory attention, (re)insurers need to review their coverholder network now. They will need to assess the level of conduct risk across their portfolio and determine whether there are any areas of operational or control weakness that might need to be addressed to meet the regulator's revised expectations.

Operational and control functions within the organization will have an interest in ensuring that coverholders are properly overseen, from the underwriting and claims teams who manage the coverholder relationships and delegate authority, through to the second line of defense, the risk and compliance teams that provide monitoring and risk assessments of coverholder controls. Internal audit departments should also consider including assessment of coverholder controls as part of their audit plan.

Some of the potential control issues include:

- Inadequate assessment of the coverholder's conduct of business risk during the due diligence for selection or renewal of binders
- Limited analysis of conduct risks inherent in the coverholder's business model, arising from customer base, distribution methods, conflicts of interest, incentives, training and competency
- Lack of oversight from senior management – often when the coverholder book is not part of the firm's core London Market business
- Poor evidence base around coverholder audits, underwriter visits and other monitoring in relation to follow-up of treating customers fairly (TCF) issues identified
- Coverholder audits focused purely on performance and adherence to binding authority agreement, with limited assessment of the coverholder's controls around sales process, including where the coverholder has been given authority to handle claims and complaints
- Risk of regulatory censure and reputational damage not currently factored into the insurer's assessment of coverholder performance

Our experience suggests there is more insurers could do to ensure that they fully understand the risks arising from their coverholder relationships.

## Benefits of reviewing your coverholder networks

Insurers may have developed large coverholder networks, often through acquisition, without a corresponding increase or improvement in oversight controls. Reviewing coverholder networks can provide tangible business, commercial and operational benefits that include:

- A greater board-level understanding of the risks associated with existing coverholders, better assessments of the risks of new potential relationships and more assurance that the established risk appetites are being upheld
- A deeper understanding from the insurer of the true value of each delegated authority by better assessing the coverholder's conduct of business risks against the level of premium they bring into the business – some coverholders may not be as profitable as they seem
- An improved understanding of risk that enables the business to establish improved governance and controls over the delegated businesses
- The ability to align the establishment of new coverholder relationships to the strategic objectives of the business to maximize the alignment to and penetration of target markets, with the potential to increase sales and reduce claims and complaints which, in turn, reduces cost to the business S


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