2015 Europe insurance outlook

Market summary

The year ahead is set to be a challenging one for the European insurance industry, with slow growth and low interest rates affecting the trading environment. Successful insurers in 2015 will look to seize opportunities to maximize their digital channels and make better use of the data they capture in order to personalize products and services. Insurers have traditionally lagged behind the retail sector in product innovation; it usually occurs incrementally and is transaction-led.

Building a better working world

Within general insurance in Europe, the widespread use of aggregators by customers, combined with low retention rates, means that there is continual pressure on margins. Insurers need to look at servicing customers more efficiently, finding new ways of encouraging loyalty and brand "stickiness," and providing fresh services for evolving customer needs. The disintermediation of life and pensions has also put more pressure on insurers to maximize the direct channel.

One possible solution lies in improving the client interface. The key themes here are technology, data and analytics. In order to make more of client interaction, insurers must refresh legacy systems and provide customers with a range of digital communication channels, while making better use of customer data to tailor products and services to the individual.

Within personal lines, where products are increasingly commoditized (partly as a result of price-driven distribution via aggregator channels), there is an environment in which differentiation becomes more problematic. While the growth of telematics has led to some personalization, it has yet to reach its full potential, with most products aimed at young drivers. Insurers will invest in using telematics data in a more innovative way to appeal to the mass market.

Insurers will also seize the marketing opportunities offered by the connected car, giving customers supermarket vouchers for the store they most commonly visit, for instance. In addition, they will be looking at refreshing their finance functions. With Solvency II and International Financial Reporting Standards (IFRS) 4 Phase II putting additional demands on finance and actuarial departments, European CFOs will have to maintain a strong focus on meeting the various regulatory requirements.

Insurers face a juggling act to use these opportunities to personalize products, find other ways of adding value, build greater loyalty, and increase customer retention and profitability while responding to the various regulatory and tax challenges. Having a robust proactive and reactive strategy will enable insurers to remain competitive in 2015. By keeping their products simple and transparent, and investing in areas such as data, analytics and technology, European insurers will be in a better position to build a rapport with their customers and differentiate their offerings from the competition.

Macroeconomic Eurozone focus: slow growth and low interest rates dominate challenging trading environment

The recovery throughout Europe looks delicately balanced, with signs of a slow recovery on the consumer side overshadowed by low business investment rates and slower global growth. Critically, unemployment has stopped rising and the reduced threat of imminent job losses has significantly boosted consumer confidence. Real incomes are now rising, and there are tentative signs of an improvement in European housing markets and car sales.

Against this, global growth appears to have slowed and sanctions against Russia have injected additional uncertainty. As a result, concerns about deflation have risen, prompting the European Central Bank (ECB) to introduce a range of measures designed to boost credit growth and extend their forward guidance.

Interest rates now look set to be lower for even longer, further increasing the pressure on life companies to reconcile investment guarantees with low yields. Insurers are therefore likely to be under continuing pressure to adapt their business models to this new paradigm of ultra-low interest rates and a steady regulatory treadmill.

The pressure on margins has prompted life insurers to move into more risk-based products on the liability side and, in some cases, asset-backed securities on the investment side. However, in 2015, the ECB will be a significant purchaser of senior tranches of these products, reducing supply and potentially leaving life insurers exploring alternative assets that offer attractive returns with an acceptable risk profile and capital charge.

Outside of Europe, the end of quantitative easing is likely to produce a year of significant financial market volatility in equity, fixed income and emerging market products. The key challenge for the life sector is, therefore, to balance the search for yield without taking on unwarranted risk and being caught out by the increase in market volatility.

Life insurers will have to intensify their efforts to make in-force business more profitable and more cash generating. In addition, tighter underwriting standards will need to be maintained, as low investment returns will not compensate for losses made elsewhere.

But 2015 will also be a year of significant opportunity. With the Solvency II framework now largely agreed, the challenge for the insurance industry is to provide other sources of funds to finance the investment and infrastructure that the nascent Eurozone recovery requires. The stronger consumer picture, meanwhile, supported by rising employment, should enable both life and nonlife premiums to grow at least modestly, especially in countries such as Spain, where the severity of the downturn now offers the prospect of a stronger recovery.

At the same time, Europe's aging demographics will drive demand for retirement products, although low investment returns here will again mean a continued focus on matching asset and liability management. Potential climate volatility remains an issue after another year of severe flooding, this time affecting southeastern Europe. Increased awareness of natural catastrophes will continue to boost demand for protection products.

Macroeconomic UK focus: economic expansion continues, but regulatory and taxation changes will continue to present a challenge

The UK economy is set to enjoy a robust expansion in 2015, with economic growth outstripping that in the Eurozone for the fifth successive year. Unemployment should continue to drop, aided by modest growth in wage costs. But subdued rises in pay packets will constrain growth in nominal personal disposable income and see consumers' appetite to spend cooling down slightly.

General insurers should continue to benefit from a buoyant housing market and corresponding demand for "big-ticket" items. That said, growth in home and motor insurance premiums will remain squeezed, in part because of regulatory changes (the decision by the Competition and Markets Authority to ban exclusive pricing deals between motor insurers and price comparison websites being a recent example). But the rollout of telematics and action to tackle fraudulent claims means that general insurers' costs should also be cushioned.

Meanwhile, tax reforms will add to an already tough environment for the UK life sector. For example, the current 55% tax rate on pension savings passed on in the event of death will be abolished from April 2015, making annuities more unattractive to retirees. So annuity providers, already suffering from the scrapping of compulsory annuities in the March 2014 Budget reforms, face extra pain.

Admittedly, the further broadening of pensions auto-enrollment to small and micro employers from April 2015 will be a positive for pension providers. But a cap of 0.75% on charges for these schemes will squeeze providers' margins.

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Although the Bank of England is likely to start raising interest rates in the early part of 2015, any upward movement in borrowing costs is set to be a slow and gradual process. So insurers' business models will continue to be challenged by a low rate environment. In this respect, the Bank of England has made clear that the risks around insurers investing in less traditional assets in a hunt for yield are firmly on their radar.

The bank has also warned that regulators will take a tough stance against UK insurers that seek to play down risks in an attempt to reduce the amount of capital they hold under Solvency II. So, to avoid a jump in capital requirements, insurance companies will have to tread carefully in presenting their risk models in the run-up to Solvency II's implementation on 1 January 2016.

What will be on the mind of insurers in Europe during 2015?

- Walking a tightrope: navigating market
- Building trust: becoming more customercentric
- Digital consumer: opportunities and challenge
- Joining the dots: using data in a more connected way
- Regulation: from Solvency II to consumer protection
- Change is the only constant: time for a finance refresh
- Tax: insurers embrace for shifting landscape

Walking a tightrope: navigating market volatility

European insurers will continue to be challenged on both sides of the balance sheet in 2015. Excess capacity and high levels of competition are reducing margins overall. In markets such as the UK and the Netherlands, this has been further exacerbated by the continued rise of aggregator websites, allowing customers to shop around for the best deals in home, travel, motor and other classes of retail insurance.

The result is heightened levels of competition in many classes of business; dynamics that are expected to continue into 2015. According to broker Aon Benfield, even a US$100b insurance loss from a catastrophe event could be insufficient to disrupt the market and halt the softening trend in non-life (re)insurance,[1] particularly as capital can more easily flow into the industry postevent now than in the past, as we discuss later in this publication.

There are obvious benefits to being a composite insurer in the new environment. Insurers are able to decrease the amount of capital they are required to hold by diversifying their liabilities across different lines of business and geographies (with Solvency II offering a diversification credit). However, it is worth noting that the same effect cannot be achieved by an investor that diversifies its portfolio via a series of investments into monoliners or domestic players. There is a premium to such diversification under Solvency II. While, traditionally, life insurers were able to boost their assets using the equity markets to create additional performance, over the last few years, the level of safety on offer from the equity markets has decreased significantly, with high levels of volatility from quarter to quarter and day to day. The big danger is a short-term but large-scale increase in interest rates. Some providers are hedging against this eventuality, while others are altering their portfolio of products to reduce the risk of write-offs in bond portfolios.

The prolonged low interest rate environment will continue to challenge European life insurers in 2015, reducing their investment income and squeezing product margins. Guaranteed liabilities pose a particular threat, as subdued earnings may be too small to meet long-term obligations.

With multibillions of euros worth of in-force contracts putting balance sheets under stress, the providers that will successfully navigate this environment will overhaul their business models. In some countries this takes place by placing a greater emphasis on selling and marketing unit-linked products; in some other countries there is more attention for pension products with defined contribution features. While the types of product vary from country to country, most offer an insurance and regulatory tax wrapper around asset management tools, allowing more risk to be transferred to policyholders.

Another option for insurers is to find a new balance between biometric risks such as health, long-term care and disability and their mortality exposure. By taking an innovative approach to service and cost it is possible to generate an appropriate margin. Some health insurers for instance, are offering incentives to policyholders who share health and fitness information via apps and wearable devices.

[1] http://thoughtleadership.aonbenfield.com/Documents/20140910_ab_ils_annual_report_2014.pdf

Non-life reinsurers adapt to a growing capital market presence

The influx of capital into the property catastrophe reinsurance industry from pension funds and other institutional investors has gained pace over the past five years. In the low interest rate environment, investors have grown their allocations to the insurance sector as an alternative asset class, drawn by the non-correlating nature of insurance investments and reasonable returns on offer.

This trend has exerted downward pressure on reinsurance pricing and displaced capacity from traditional providers into other classes of business. Reinsurance broker Guy Carpenter estimates that alternative capacity now accounts for roughly US$50b, or 15% of the global property catastrophe limit.[2]

For European providers, the alternative capacity — particularly for property catastrophe classes of business — will heighten levels of competition and force traditional players to adapt their business models. While pension allocations to insurance-linked securities remain relatively low, typically around 1% of total funds, appetite for insurance appears to be long-term in nature.

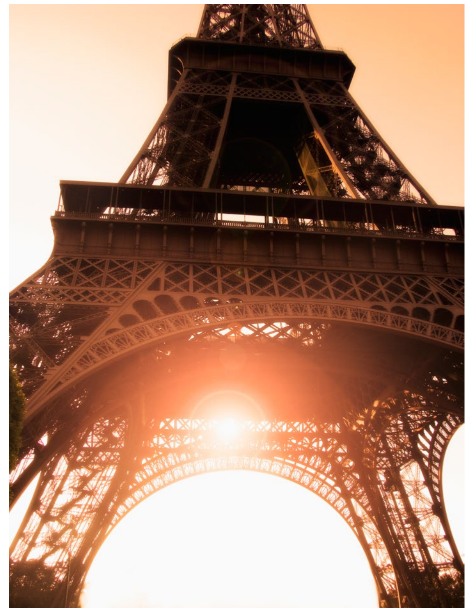
Building trust: becoming more customer-centric

Levels of trust in the insurance sector are, at present, among the lowest in any consumer industry. This is intrinsically linked with low levels of customer retention and changing distribution patterns, particularly with the rise of the aggregators in many European countries. The financial crisis further dampened consumer support for financial services in general, while additional tainting from scandals, such as payment protection insurance mis-selling, has also left its mark.

Findings from EY's *Global Insurance Consumer Survey* 2014 tell us that there are ever-reducing "touchpoints" between insurer and customer in today's environment. While the annual renewal cycle offers more opportunities in non-life to communicate with customers, these are not being fully exploited in the digital channels increasingly used by consumers. Many insurers leave relationship management to the intermediary, missing out on opportunities for greater dialogue with customers.

The ability to foster loyalty and build relationships with customers in life and pensions is even more of a challenge. There may be little communication with the insured for many years after a policy is taken out.

The aftermath of the retail distribution review (RDR) in the UK, and the Dutch equivalent, is leaving behind an "advice gap" in both cases. This is forcing life insurers and pension providers to consider other routes to market beyond the investment advisor or broker channel.



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In our 2013 publication *Beyond 2020: skills required for future success in UK life, pensions and health insurance*, we predicted that the number of registered investment advisors in the UK would fall from 30,000 to 21,000 by 2015. Instead, there is growing consideration and investment in a direct-to-consumer presence. Online platforms will continue their strong growth into 2015, as consumers choose self-service as an alternative to paying for advice.

The lessons here may cross over into general insurance, particularly with European regulators turning their attention to consumer conduct. In comparison with other retail products or services, the nature and complexity of insurance products places a greater burden on providers to put customers at the heart of the business.

[2] http://www.guycarp.com/content/dam/guycarp/en/documents/PressRelease/2014/Reinsurance%20Pricing%20Falls%20Again%20at%20June%20 1,%202014%20as%20Competition%20Heightens,%20Guy%20Carpenter%20Reports.pdf

One of the consequences of conduct supervision will be the need to better educate customers about insurance products in general.

As a result, winning insurers will focus on providing simple and transparent products to consumers in 2015, with fewer lock-ins, making it clear where and how profits are generated. Innovation must also touch on "moments of truth," offering customers the best possible service in dealing with claims and policy adjustments, as well as in the general maintenance of the relationship. One of the consequences of conduct supervision will be the need to better educate customers about insurance products in general. Insurance companies will seize this opportunity to become more customer-centric.

Our research suggests customers are receptive to having greater contact with their insurers. Even within retail insurance, where customers are more likely to shop around, levels of brand loyalty remain high even after they have switched to another provider.

Insurers have a strong foundation on which to base their growth from here, but they will need to evolve their customer engagement approach. The contact that customers' desire needs to be made more personalized, relevant and timely. Some insurers have begun this journey by using telematics to deliver robust pricing strategies that reward customers for things such as their good driving habits or healthy lifestyle choices, but many more options could be explored to use customer data to tailor and create bespoke products to suit specific needs at specific touchpoints.

As an example, customers may not always want the most comprehensive cover available: at certain life stages, they may prefer a cheaper product with reduced coverage that better suits their financial needs. Offering a Ferrari every time is not always what people want. The more the customer feels the contact they receive is relevant and fits with their personal needs, the more they will want to hear from their insurer and keep them front of mind. Creating a two-way dialogue that works for both parties is key to building the customer loyalty that will lead to higher customer retention rates.

Making more of the shop window

Claims are the shop window by which the insurance industry is typically judged, and it is during the big events — typically catastrophe events — that the industry's role and profile generates widespread attention. The Central European floods in 2013 caused economic losses of US$16.5b across Germany, the Czech Republic, Hungary and Poland, and insurers paid out on claims worth US$4.1b (according to Swiss Re Sigma).[3]

What was missing was a more coordinated and visible response from the industry, both in its approach to handling claims from the floods and in contributing in more practical ways to the wider relief efforts. Being more actively involved in coordinating post-disaster responses following future European events should boost the industry's reputation in the eyes of the public.

A more proactive approach to big loss events underlines the industry's role in building more resilient communities. At the International Insurance Society Conference in June 2014 in London, Britain's Prince Charles encouraged the insurance industry to develop its ClimateWise program to tackle disaster preparedness and climate change.

Digital consumer: opportunities and challenge

There is a constant drive for insurers to understand, communicate with, service and retain customers better. Yet there are many challenges in doing so, not least of which is the advice gap mentioned before, which, created by the RDR, is forcing life and pension providers to go direct to their customers.

[3] http://www.swissre.com/media/news_releases/nr_20140326_sigma_insured_losses_in_2013.html

It is also becoming a more complicated environment for customers to make decisions about financial products, with no fixed retirement age, people living longer and the scrapping of compulsory annuities in the UK. There is a greater responsibility on insurance companies to communicate with the customer, provide information and tailor products to their needs.

In most European countries, the channels to reach the customer are becoming more digital, particularly with the expanding use of mobile devices. One industry analysis predicts that digital interactions with financial services organizations will outnumber face-to-face by 250 to 1 by 2016 and mobile interactions will outnumber calls by 30 to 1. In order to maximize on this shift, insurers must first tackle their digital deficit.

This is a challenge in an era of inflexible and aging legacy systems. The typical policy administration system is 15 to 20 years old, and they are getting in the way of doing business, rather than acting as an enabler. Migrating to new systems with modern user interfaces is one solution, but a costly one that brings with it significant migration risks.

Instead, an increasing number of insurers are using robotics to bring together disparate legacy systems. Robotic process automation (RPA) is a cost-effective and flexible solution for extracting, compiling and processing information held across multiple systems, as well as updating them with new policy information.

Another important trend within financial services is the use of digital passports and personal data stores (PDS), with the UK and other European governments providing a single digital identity that can be used across any government product or service. But, importantly, this digital identity and passport can also be used across financial services. In this model, the customer uses the same logon and identity across any company, owns their own personal data, constantly enriches this and can simply share it with insurers — so no more time-consuming form filling or providing proof of identity. Encouraging customers to use PDS means that insurers will get more up-to-date information — with the potential for far more information than traditional approaches — and hence has far better customer understanding and chance of matching products to customer needs, to form the basis of truly trusted relationships.

Joining the dots: using data in a more connected way

Key findings in EY's new global financial services data analytics report The science of winning in financial services state that many firms agree that data is their most valuable strategic asset and a holistic approach to data is crucial for success; it's not just a technology problem. Many insurers within Europe are only beginning to tap the immense potential that the data captured by the business has to offer. The sheer breadth of data on offer to insurers, internal and external, structured and unstructured, is one way providers will seek to differentiate and gain a competitive advantage.

Early on in the data and analytics journey, the enthusiasm to get going is (within some businesses) leading to the rapid expansion of analytics activities. But this is without due consideration of a suitable strategy to support business goals. With so much customer information already being captured, the upgrading of legacy systems is essential in order to analyze individual risks better and tailor products to customers.

A growing number of insurers are scaling up their analytical capabilities and, as a result, will be in a better position to use data in a more connected way. Meaningful insights can be drawn through more efficient use of data at virtually every stage of the insurance life cycle, from customer targeting to product design and pricing, underwriting, claims and reporting, but also through creating new associated services, giving opportunities for more touchpoints (disease prevention via wearable devices and wellness programs, for instance).

Within the mass market retail space, big data — such as credit checking and motoring conviction verification — is also being used to provide supplemental rating factors. There is a clear desire to gain more consistency in terms of how risks are priced in real time; a journey that will lead toward more external data being sourced.

Cross-industry collaborations to combat fraud have resulted in much greater levels of cooperation and data sharing.

This raises a challenge in its own right: the more data that can be used to differentiate individual customers from each other, the greater the risk that some customers' premiums become unaffordable, as their personal risk is so high. While that might be the right answer from an insurer's perspective, and an effective use of data, there will be increased focus on the question of customer protection and maintaining insurance at a price that the customer can afford.

Preventing claims leakage is another big area for insurers, particularly in personal lines. Here, better analytics could be put to work, optimizing claims processes and identifying suspected fraud. This is a huge untapped source of value for many insurers, given that around 70% of the premiums charged can go toward paying claims.

Cross-industry collaborations to combat fraud have resulted in much greater levels of cooperation and data sharing. As a result, fraud identification — both on the claims and application side — has improved and is often real-time enabled. Insurers are clearly alert to the opportunities, but more investment is needed.

Insurers looking to gain a competitive edge in 2015 will use this data to offer individuals more bespoke products. Telematics is a good example as, to date, most of the products are geared toward young drivers, whereas research suggests the wider mass market would be receptive to such offerings if suitably tailored to the customer. The challenge for insurers is to differentiate their offerings from what is already available and to come up with products that customers want to buy at key points in the life cycle.

Regulation: from Solvency II to consumer protection

While Solvency II remains a challenge for insurers until 2016 in terms of implementation, the regulators' focus will shift in 2015 as consumer protection increases in importance. Insurers will need to plan for, and begin to make, operational, and potentially strategic, changes in response to the second Insurance Mediation Directive (IMD2), the Packaged Retail Investment Products (PRIPS) initiative and the second Market in Financial Instruments Directive (MiFID2), all of which must be complied with by 2017.

IMD2, which is currently the subject of trilogue discussion between the European Commission, European Parliament and European Council, provides local regulators with the option of banning commission payments. It also includes specific requirements on product oversight and governance, and is therefore likely to create significant changes to product and sales procedures and controls going forward.

Taken as a whole, these European regulatory initiatives require greater transparency in terms of the information provided to customers, revisions to relationships with distributors, and greater governance and oversight over new and existing products. During 2015, insurers will need to assess the impact of these initiatives on their governance, control and risk frameworks, sales processes and customer operations, and the IT and people that support them.

They should also consider the strategic impact of these changes on distributor relationships and product pricing. Change plans should be developed and started during 2015 to ensure that the early 2017 deadline can be achieved and appropriate market strategies can be executed to maintain, or gain, market share.

Meanwhile, for many, the Solvency II programs that they had in place during

2013 have been re-energized, as efforts have been made to complete their model development and associated validation to support their applications for internal model approval. Capital optimization is also receiving a new focus as firms look to change the composition of their balance sheets. While not all firms are going for internal model approval, they are all subject to the governance requirements set out under the directive and have to complete and submit to their regulator(s) a Forward Looking Assessment of Own Risks (FLAOR) or Own Risk and Solvency Assessment (ORSA) during 2014 and 2015 as preparation for Solvency II.

This has led many to re-evaluate their business processes to see how the forward-looking assessment is integrated into decision-making, ensuring activities such as business planning and stress and scenario testing are aligned to what is required under Solvency II. Inevitably, gaps have been identified, and firms are considering how to ensure their governance structures are robust and their ORSA processes are effective.

Change is the only constant: time for a finance refresh

The pressure on insurers' finance functions is unlikely to abate in 2015, with Solvency II and IFRS 4 Phase II putting additional demands on finance and actuarial departments. Change is the only constant, and today's financial and actuarial staff will need to demonstrate they can be effective change specialists — now an inherent part of the job.

Finance is increasingly being called upon to adapt to new reporting requirements; in particular, as companies carry out dry runs ahead of Solvency II coming into force on 1 January 2016. With so many pressures and the need to get priority projects over the line, European CFOs are maintaining a strong focus on meeting the various regulatory requirements.

The requirements under Pillar 3 of Solvency II are now clear. The regulator's approach in the transition period until 1 January 2016 differs in each country regarding Solvency II. For example, in Belgium and the UK, there are requirements to involve auditors. However, in the Netherlands, this is not the case. Companies are seeking to ensure that transitional reporting is reliable and that disclosures are clear and of high quality, recognizing that the audiences of these documents will be looking carefully at them for the first time.

If they have not already done so, insurers will need to refresh their systems in order

to produce financial information very quickly and tailor reports to IFRS, local Generally Accepted Accounting Principles (GAAP) or Solvency II requirements. Many companies have concentrated on making the processes mechanized or automated to run in a similar way to those around the production of the report and accounts.

Although a significant challenge, it remains a high priority for European insurers. Companies need to get the most out of limited resources and look to see how the volume of activities can be spread across the year.

Cost pressures and the need for finance to support the growth of the organization are other drivers for finance change programs. CEOs will be looking to get far more for less from their finance functions, and there will be a heavy focus on investing in streamlined "scalable" architecture that can support the growth of the business. Finance is under pressure to show it can be a better business partner, adding more value while also responding to regulatory requirements.

As EY's *2014 Global Insurance CFO Survey* indicates, an ongoing trend is the integration of actuarial and finance with consideration of the risk and regulatory aspects. Nearly 40% of respondents had complete or nearly complete integration, while a further 42% had partial integration with plans for full integration by 2020.

Better integration of the two functions will enable finance to become a better business partner in the cycle of planning, budgeting and forecasting. How such information is utilized throughout that cycle, to highlight action plans and opportunities, or simply keep performance on track, will be a key success factor.

Tax: insurers brace for shifting landscape

The tax landscape for global insurance groups is now subject to significant uncertainty as a result of the ongoing organization for economic co-operation and development (OECD) Base Erosion and Profit Shifting Project, which is now halfway through. Many insurers are now starting to assess the economic impacts of these proposals, which are wide-reaching and could include:

- A requirement to report revenues, taxes paid and headcount for every jurisdiction in which business is carried out
- Limitations on the tax deductibility of interest on debt and hybrid regulatory capital
- Lowering of the threshold for creating an offshore taxable presence
- Restrictions on the deductibility and pricing of intragroup reinsurance

At the same time, the Court of Justice of the European Union's recent decision in the Skandia case could result in value added tax (VAT) becoming chargeable on a large number of crossborder intercompany flows. As insurers are typically not able to recover their VAT costs, this additional amount would give rise to a significant "above the line" cost.

As part of the continued global pressure on tax avoidance and following the success of the Foreign Account Tax Compliance Act (FATCA), over 40 jurisdictions have volunteered to be early adopters of the OECD-published Common Reporting Standard (CRS). Early adopting jurisdictions are required to be CRS compliant by 1 January 2016.

Crucially for the insurance industry, there is no "back book" exemption for policies sold on or before 1 January 2016. In addition, there is no de minimis threshold, which would exempt low-value accounts held by individuals. The expected cost and effort required in reaching compliance is estimated to be in excess of £100m across the industry, with additional requirements to update IT systems.

For many insurers, there are also tax and other implications around globally mobilizing employees that will come under the microscope in 2015. International mobility is changing and seems to be moving away from long-term expatriate assignments to short-term business travel. This is an increasing area of focus for tax authorities, so insurers should act now to understand their exposure to the potential regulatory, immigration and customs risks.

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