

Insurance

The day after tomorrow

Emerging from the storm: The day after tomorrow for insurance



‘The basic rule of storms is that they continue until the imbalance that created them is corrected.’

The Day After Tomorrow (2004)

Themes and imperatives for a new world

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About this report

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Drawing on input from a range of leading insurers, financial market participants and PricewaterhouseCoopers¹ specialists from around the world, ‘Emerging from the storm: The day after tomorrow for insurance’ examines how the financial crisis is set to reshape the industry as a whole, along with some of the key developments that are likely to affect particular segments and geographical markets.

In the latest in PricewaterhouseCoopers ‘The day after tomorrow’ perspective series, we begin by charting the immediate impact of the crisis (the world ‘today’) and how the current scepticism and uncertainty are likely to mould stakeholder expectations going forward (the world ‘tomorrow’). The main section looks at how the industry landscape will look in the aftermath of the crisis and how this will determine the strategic choices facing insurers over the next three to five years (the ‘day after tomorrow’).

¹ PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Executive summary

2

The insurance industry² landscape that emerges from the turmoil of the financial crisis is set to be markedly different from today, enabling some insurers to pull ahead from their competitors and leaving others at risk of being left behind.

² In this study, we refer to insurers and the insurance industry to describe the insurance and reinsurance industry as a whole, while making specific references to particular segments such as life, non life (property and casualty) and reinsurance where appropriate.

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

This shake-up will challenge the competitive relevance of some insurers. However, it also offers agile and farsighted firms a once-in-a-generation opportunity to catapult themselves to the front of what will be a very different racing order within many geographical markets and classes of business –

as Rahm Emanuel, White House Chief of Staff, has said: ‘Don’t waste a good crisis’.³ The companies that will come through strongest are not just looking at how to stabilise their businesses today and even tomorrow, but how the crisis will shape the competitive environment that emerges in the ‘day after tomorrow’ and what they need to do to adapt and succeed.

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

one

Organic restructuring: As insurers withdraw from some of their geographical markets and scale back particular lines of business, the market shares and opportunities for those that remain will sharply increase, leading to a significant reconfiguration in the list of leading players (see pages 12-13).

two

The end of innocence for retail investors: What customers demand from savings and investment products and how they want to buy them will take a new direction within many territories, with companies that are slow to catch on becoming increasingly irrelevant (see pages 14-15).

three

Reawakening of M&A: The strong underlying rationale for consolidation and restructuring within many markets means that acquisition activity is set to accelerate rapidly once valuation parameters are stabilised and funding becomes more readily available again (see pages 16-17).

four

Another rethink on reporting: Without an industry consensus on a genuinely relevant, intelligible and comparable basis of accounting and disclosure, insurers will find it increasingly difficult to compete for capital (see pages 18-21).

five

Blurring the lines: The relationship between the public and private sector will change as governments exert a stronger influence over the insurance market as a result of bailouts, regulatory reform and greater control over pensions and health care (see pages 22-24).

six

Overhaul of rewards: Insurers will base much more of their performance-related pay on risk-adjusted measures, aligned to their business strategy. They will also face tougher regulation over how compensation is governed (see pages 26-28).

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Mounting uncertainty over tax: Amid moves to increase tax revenues and tighten the tax rules on offshore business, the stability of the tax regime will be a key consideration in possible relocation, as will choosing where to domicile and where to do business (see pages 30-32).

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Challenging prospects for reinsurers: While demand for reinsurance is likely to increase within emerging markets, this is unlikely to offset the decline in reinsurance buying in developed markets and may force many reinsurers to rethink how they sustain profitability and growth (see pages 34-35).

nine

Tilting the regulatory playing field: Under pressure from governments, supervision will be more intense and regulations will be more subject to national priorities in their interpretation and application (see pages 36-38).

PricewaterhouseCoopers
The day after tomorrow for insurance



Today

Surveying the damage: The immediate impact of the financial crisis on the insurance industry

6

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

Short-term themes sparked by the financial crisis

Longer term themes

Globalisation

Demographics

Longevity

Regulation

Technology

Climate change

Pandemic

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

Monetary vacuum

The process of deleveraging that followed the bursting of the asset price bubble has yet to run its full course and there is still deep uncertainty over how to deal with the continuing downturn and the massive levels of distressed assets. This upheaval and uncertainty have created a monetary vacuum in which finance is constrained and much of the economy remains frozen. Immediate considerations include where best to concentrate limited capital and what areas to discontinue or divest to create a more streamlined and controllable business. Looking ahead, the ability to make sense of and respond to the uncertainty will distinguish the insurers who truly manage to capitalise on the crisis.

Classic renaissance

Heightened risk concerns and the need to rebuild balance sheets have encouraged many insurers to adopt more cautious investment strategies and refocus on their core competencies. This 'back to basics' approach is especially noticeable among some of the firms that were seen as leading the way in risk modelling and strategic innovation prior to the crisis.

Lack of trust and transparency

The financial crisis has dented confidence in financial services businesses, including insurers. This clearly threatens the viability of a sector that depends on policyholders' faith in providers' willingness and indeed ability to pay out following insured events ranging from fire and accidents to retirement and mortality. As many pension and investment customers see the value of their policies fall, some have inevitably questioned whether the charges were justified and whether the investment returns reflected the true level of risk. Among capital providers, a perceived lack of transparency by insurers has heightened the downturn in share values and added a risk premium to the cost of capital.

'Never again' regulation

The response to the crisis has varied from country to country, which has created uncertainty for global insurers. Many governments and supervisors have responded to the volatility in the markets by relaxing solvency margins and/or the rules on marking down assets in the short term as they seek to avoid the downward spiral in confidence that has faced many banks. However, these emergency expedients cannot last indefinitely. Supervisors will follow investors and rating agencies in insisting on more open disclosure, more demonstrably effective risk management and increased capital buffers as they seek to guard against a repeat of the recent turmoil. Tougher regulation in areas such as compensation is also beginning to spill over from banks.

Government 'inside the tent'

Several leading insurers have required government finance, part of the price of which is closer political scrutiny and influence over strategy and compensation. Even companies that have not required bailouts are facing pressure to modify their behaviour as governments increasingly call the shots over regulation. Immediate challenges include balancing the need to restore profitability with the heightened government scrutiny and expectations of being a responsible corporate citizen. Some companies are also concerned that government support for some of their competitors could distort pricing and impede the takeover/withdrawal of weaker entities.

Unprecedented fiscal pressure

Having committed significant resources to stabilising the financial services sector, cash-strapped governments are set to exert strong moral pressure on businesses to pay their 'fair share' of tax. The fact that most of this support was aimed at banks will not save insurers from scrutiny, with a particular focus on tax planning and tax haven operations.

Rising power of the emerging economies

The crisis has accelerated the shift towards multi-polar economic power and influence, developments which have been highlighted by the emergence of the G20 as a key driver of global economic policy. As international companies divest offshore holdings and withdraw to their core markets, there will be acquisition opportunities and market openings to enable local firms to strengthen their position.

Dealing with the downturn

The insurance industry continues to grapple with the economic downturn set off by the financial crisis. All companies have been forced to rein in on cost and many are now reassessing their operational model amid the pressure on premiums, capital, asset returns and compliance costs. Life insurers in many of the more mature markets have already seen a sharp fall in demand for savings and investment products and could face further asset price volatility and loss of business as a result of an adverse range of inflation and deflation scenarios. Non-life insurance is generally non-discretionary and therefore the impact of the downturn has been less marked. However, the falls in investment returns have necessitated tighter underwriting discipline and, where feasible, higher premiums. The sector has also seen a rise in problems associated with recession such as increased fraud and claims frequency.

Tomorrow

The emerging environment: Changing stakeholder expectations

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

Customers

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

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

Clearly, customers cannot batten down the hatches indefinitely; not least as the underlying drivers of growth, such as the ageing of the population or the search for more effective risk protection, will continue to exert a strong influence on demand. The key question is therefore on what terms customers will choose to re-engage with insurers and how product/distribution strategies may need to change to encourage them back (see pages 14-15 for analysis of the long-term trends in customer demand).

Regulators

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

However, how these developments are applied in practice will differ quite markedly. While regulators were until recently believed to be 'hunting in packs', the financial crisis has highlighted a divergence of approach. The limited international co-ordination of regulatory intervention could have unintended systemic consequences for insurers and a knock-on impact on financial markets. For example, changes in accounting standards and asset admissibility could affect insurers' levels of equity holdings and other aspects of their investment strategies. The financial crisis has also highlighted the importance of the personalities at the helm in setting and applying policies. With so much depending on the people in charge, changes in key personnel can only heighten regulatory uncertainty. Although supervisors have been given further resources and political impetus by governments, it will take some time to build up the expected capabilities (see pages 36-38 for analysis of the long-term trends in regulation).

Investors

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

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

Governments

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

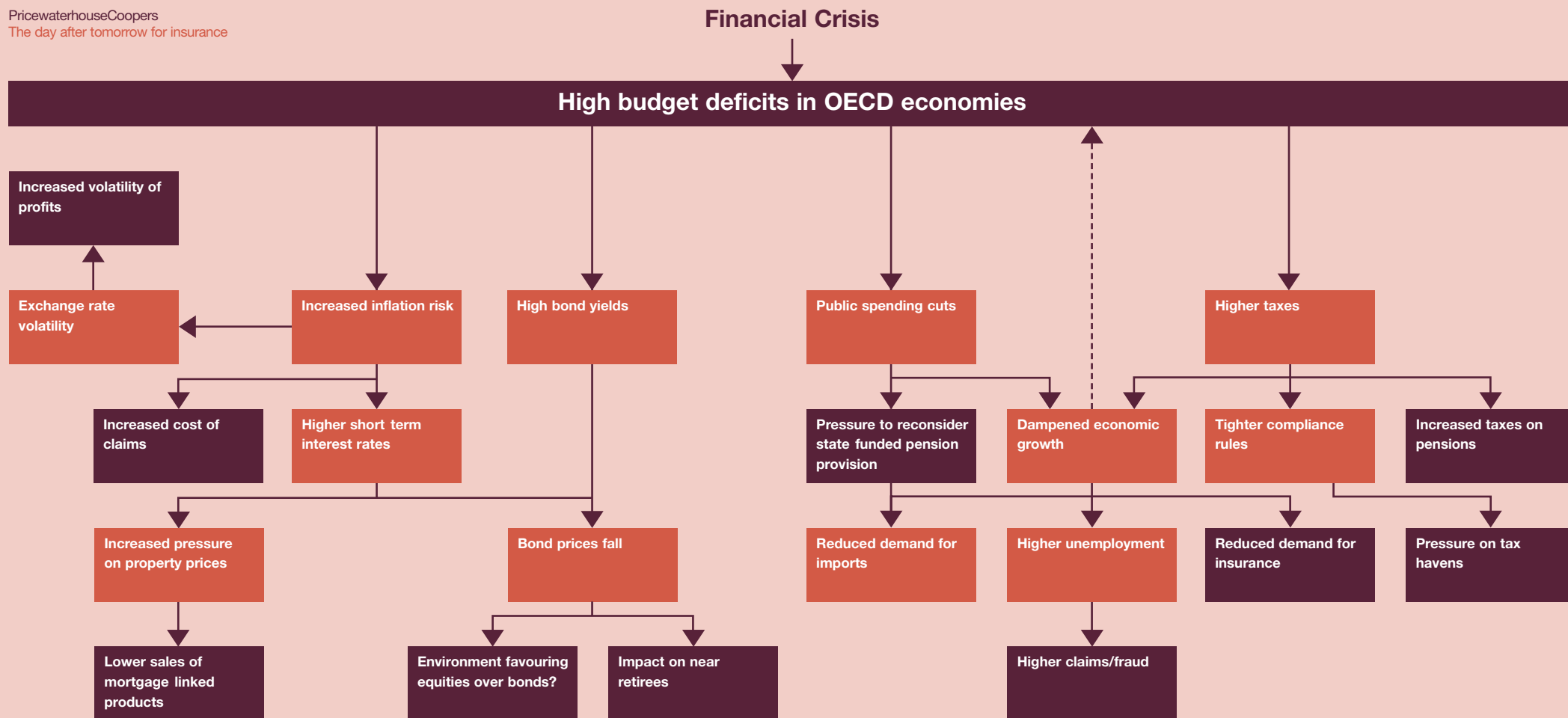
Governments that have recapitalised parts of the insurance sector may insist that taxpayers should expect a more favourable deal from the industry. There will also be considerable debate about the implicit capital underpinning of being considered 'too big to fail' and the increased shareholder exposure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

The day after tomorrow

A reshaped industry: Key developments and their strategic implications

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The financial crisis will continue to reshape the competitive and regulatory environment within the insurance industry over the next three to five years. As we set out in the nine key developments and their strategic implications (from page 12), the landscape that emerges in the aftermath of the ‘storm’ will present both transformational opportunities and significant threats for businesses that fail to anticipate and adapt to the changes ahead.



Source: PricewaterhouseCoopers

OECD = Organisation for Economic Cooperation and Development

The shake-up within the insurance industry is taking place against the background of a highly volatile economic environment. There is continuing uncertainty over how the various different demand, inflation, stock market and budget deficit scenarios will play out and interact. Insurers should plan how to respond to significant shifts in the variables when developing their strategies.

Focusing on markets most affected by the financial crisis and its fallout, the chart above outlines various scenarios, how they could interact and the potential impact on insurers. The most marked break from the past is the mounting budget deficits in many countries, which will lead to a combination of higher taxes, lower public spending and increased inflation risk

(the chart highlights some of the potential ramifications). Reductions in public spending are likely to lead to a scaling back of state health and pension provision and create valuable opportunities for insurers.

The direct impact of the crisis has been more limited in leading emerging markets such as China and India. Developing

domestic consumer demand and trade between emerging markets will help to offset falling business in the EU and US and will continue to provide important growth opportunities for insurers.

one

12

Organic restructuring

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

Prior to the financial crisis, growth was propelled by plentiful finance. Firms aggressively pursued new business and were happy to compete on a wide range of fronts. Within the more mature markets, leadership positions were fairly constant. With capital scarce and many companies being forced to deleverage and rein in their exposures, this stable equilibrium is no more.

Many insurers have been forced to raise prices, restrict the pursuit of new business or withdraw from high risk and peripheral markets. Even where companies have the advantage of strong balance sheets, many face pressure from stakeholders to preserve their capital base and are therefore unable to commit large-scale investment to acquisitions.

However, these funding pressures will serve to open up the market and create fresh opportunities for organic growth and restructuring. By design or default, many insurers will find that they have a much larger market share and less competition than before in certain segments. As many companies retreat to the comfort zone of familiar low-risk products, such markets will become increasingly saturated, while there will be less competition and greater scope to grow and strengthen margins in other areas. Stronger companies should be able to step in to take advantage of the market exit or an increase in prices by weaker competitors.

The overriding challenges are how to target limited investment most effectively and how to ensure the business is

equipped to respond quickly to gaps in the market. The most successful insurers will be ruthless in judging where they have the most sustainable competitive advantages and matching opportunities to their core institutional capabilities. Companies with a better understanding of their risks will be in a stronger position to spot and capitalise on openings that less informed and assured competitors may well miss or be reluctant to pursue. As we examine on pages 16-17, successful growth will also depend on being able to anticipate and respond to customers' rapidly changing demands. Where funding is available, investors will favour companies that can present the clearest business case and explanation of their risk/reward profile – in short, where they know the score.

Lesson from a previous recession

One man's loss is another man's gain. During the recession of the early 1990s in the UK, many insurers were suffering from huge losses in mortgage indemnity guarantee (MIG) insurance, which forced them to raise prices and divert investment from personal lines. Into this vacuum came Direct Line, selling motor insurance over the phone at prices unencumbered by MIG losses. The launch of Direct Line was at the time revolutionary and its low-cost delivery model has been widely copied around the world. Could this downturn throw up another equally opportunistic and innovative market breakthrough?

two

14

The end of innocence for retail investors

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

Before the financial crisis, customers' expectations were evolving quite slowly and the resulting changes were relatively easy to manage. Retail investors had also become accustomed to high yields and were largely unaware of the full extent of the risks this entailed. Following the current shock and resulting scepticism, business will eventually pick up again. However, the demand profile will have changed significantly within many markets, with crucial implications for both product design and distribution.

Where products are capital intensive, difficult for customers to understand or inherently tricky to manage, there will be pressure to move to a more straightforward product range. Many countries have already seen a sharp rise in demand for simpler and more transparent products, such as index-linked investments, while other customers are coming to insist on investment guarantees. A case in point is the resurgence in demand for whole life insurance in the US. The

greater desire for guarantees could create dilemmas for insurance companies that wish to scale back such products as they seek to limit the risks they carry. The focus of demand and marketing is also set to shift from the level of return to demonstrable stability as part of a flight to perceived quality.

While customers in many mature markets will have come full circle in their renewed preference for more straightforward policies, the growing demand for more sophisticated products in many emerging markets is set to continue, albeit from a relatively low level of complexity at present. The warning provided by the financial crisis is likely to increase the desire to spread risk more widely.

The disillusionment created by the crisis in many of the more developed markets could affect channel preferences. In Germany and Switzerland, for example, there has been strong unease about the charges and

plummeting returns from many annuities. This is leading to a growing switch from tied to independent advisory channels, as customers seek more thorough and unbiased advice about which products match their risk appetite and demand profile. This echoes developments in the US in the 1990s and in the UK in 2000 and after. In some countries, Hong Kong for example, buying insurance through strong and trusted banks is becoming increasingly popular once again. Companies will naturally need to keep their ears to the ground and adapt their channel strategies to what could be rapidly changing preferences.

The potentially higher costs of risk, lapse and guarantees, along with what may be higher commission payments to distributors who 'own the customers', will change product economics. Smart companies are already developing a better understanding of their component costs, pricing and profit profile as they look at where best to compete.

three

16

Reawakening of M&A

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

Many governments now hold numerous insurance assets as a result of the financial crisis. Many banks and insurance companies are also still short of capital and are therefore looking to divest their non-core businesses. Yet, while there are many willing sellers, capital constraints and uncertainty over the direction of the economy and the extent of potential write-downs mean that there are few buyers at present.

However, insurance is still a relatively fragmented sector in many countries. Consolidation will help to deliver the capital stability and economies of scale

that will be so important in attracting customers in a more prudent market. The triggers for a renewed wave of restructuring will be an increase in available finance, the stabilisation of valuation parameters and alignment on fair value that factors in the shift in future business prospects. As more buyers come forward, governments will look to divest their insurance assets.

The cost of capital will still be higher than before the crisis, reinforcing the importance of smart targeting, thorough due diligence, a clear business case and effective post-merger integration in

making the most of limited available investment. Among the companies best able to win investor support and capitalise on the M&A opportunities will be those which had a more conservative approach prior to the crisis, which has enabled them to come through with a strong balance sheet and a trusted management team. Some companies will also opt for less capital-intensive targets to help build their business, including distribution channels, for example.

four

18

Another rethink on reporting

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

Many insurance executives justifiably complain that their share prices fail to reflect the true level of value being created within their businesses. The problem is that financial reporting in the global insurance industry continues to fall short of users' expectations. There is no agreed international standard for insurance accounting or the measurement of value generation, for example, and insurance is the only major industry not to have a relevant IFRS for its contracts. The lack of relevant and comparable reporting standards has long been regarded by many investors as a problem, but when capital was plentiful and investors were less focused on risk it was manageable, though it has led to a higher cost of capital for the industry. However, in times of capital constraints and greater risk awareness, the problem is more pronounced.

The financial crisis also provided an unfortunate baptism of fire for the launch of the Market Consistent Embedded Value Principles (MCEV®), the latest attempt by the European industry to create a more relevant and uniform basis of reporting. Many companies balked at how their values would have looked under the new model in the dislocated markets and therefore responded in different ways, undermining the confidence in MCEV of the more expert analysts/investors and leaving others bemused. The market's response has been to focus on short-term measures of financial health such as regulatory capital surplus and US GAAP/IFRS earnings as a proxy for cash generation and dividend cover.

As the markets perceive that threats to survival are diminishing, interest in other measures of value generation will return. However, with funds constrained, many portfolio investors may simply choose to put their money elsewhere, leaving the industry with major challenges. The difficulties are compounded by the fact that it is a diverse and complex sector, and therefore developing a single standard, which will be relevant globally and to all types of insurance, is an enormous challenge.

Part of the solution lies outside the industry's control. The Financial Accounting Standards Board and International Accounting Standards Board continue to work towards a new standard for insurance contract accounting, but this is at least three

years away even if agreement is reached. More importantly, major challenges to the current direction of proposals are coming from within some political circles. In particular, there are misgivings about the prospect of the increased use of mark-to-market accounting, though the parallel track envisaged under Solvency II should ultimately help. Some investors are also unconvinced about the relevance of the (currently) proposed changes. So depending on the direction the new standards take, there is a risk that the proposed changes could make matters worse rather than better, at least in the short term. It is also likely that no one standard will meet the needs of investors in all aspects of the industry in all parts of the world.

This is therefore the time for the industry to come together to develop a basis of relevant disclosures that reflect the nuances of their business and satisfy analyst and investor demands. Success will provide an important boost for their share prices and ability to attract capital. Failure to reach an industry consensus risks putting insurers further back in the queue for investment.



five

22

Blurring the lines

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

There has never been a crystal clear delineation between the private and public sector in insurance. For example, the prices for various types of cover ranging from health care to flood insurance are often determined by public policy. However, the financial crisis has brought the paths of state and insurer closer than ever before. Governments now control sizeable insurance assets. They have also stepped in to complement traditional insurance in areas such as mortgage support and trade credit insurance.

The future will see further blurring of the lines, creating both threats and opportunities. Where governments have gained greater influence they may be reluctant to relinquish it and they may have a stronger appetite to control

prices. In the US, the federal government is set to play a much stronger role in providing health care (see panel overleaf). In contrast, socialised systems such as the UK's National Health Service (NHS) are increasingly collaborating with private providers, steps which may increase as budget deficits force cuts in public expenditure. A similar picture is emerging in relation to savings and pensions. This is likely to require more active engagement at policy level and closer cooperation in delivery than in the past.

Health care reform in the US

Although US health care has traditionally been seen as a private insurance-led system, public spending now funds the majority of the costs.⁴ As the financial crisis leads to growing unemployment, more people will need government help to pay for care.

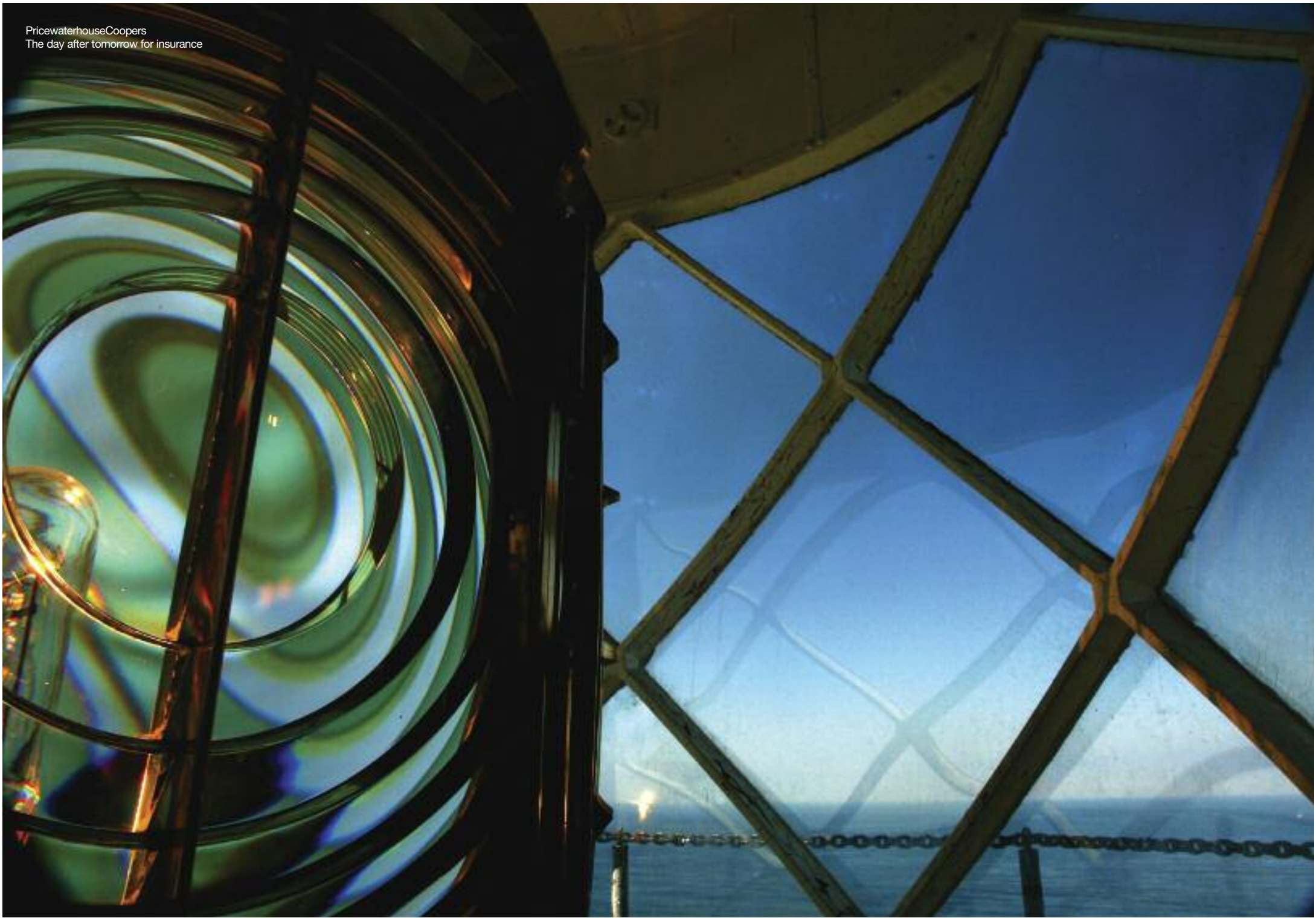
The Obama administration has promised universal coverage (nearly 50 million Americans have no health insurance cover).⁵ Measures have already included extending entitlement to all children. However, a fully socialised system on the lines of the UK NHS would lead to unsustainable budget deficits in the US, where health care spending already accounts for more than 15% of economic output and is rising far faster than GDP.⁶ Numerous public/private solutions have been proposed, both now and in the past, but all have flaws. For example, the state or federal government could offer a low-cost subsidised health plan as an alternative to private insurance. However, many private sector policyholders would inevitably defect to the public alternative, putting many health insurers out of business and making the costs virtually impossible for the public purse to bear.

A possible compromise would be to require citizens to hold insurance, which would be bought from private providers and publicly subsidised according to income. Governments and insurers might also collaborate on 'wellness' programmes to help reduce treatment costs. Whatever path is followed, it will require far greater interaction between governments and insurers as part of a changed business model that blurs the lines between private and public sectors.

4 'Distribution of public spending for health care in the US', 2008 update published by the Policy Journal of the Health Sphere.

5 US Census Bureau 2007 Stats Report, published in August 2008 / North Carolina Institute of Medicine analysis of impact of unemployment on uninsured levels, published in March 2009.

6 'World Health Statistics', published by the World Health Organisation on 30.08.08.



six

26

Overhaul of rewards

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

In April 2009, the Financial Stability Forum (FSF) published new guidelines on sound compensation practices,⁷ which are emerging as the model for regulatory reform in many countries. The principles include the 'alignment of rewards with prudent risk taking' and a more systemic approach to compensation governance. There are also calls for supervisors to increase capital requirements if they discover incentive practices that could weaken the 'soundness' of the enterprise. Although the primary focus of the FSF principles is banking, a number of regulators are looking to apply them to other systemically critical sectors. Life insurance is high on this priority list. While lower, non-life insurers may also be subject to a degree of reform.

Tough line on pay

Bonuses have been a particular focus of political and public anger in the light of the financial turmoil and its cost. Even tougher reforms may therefore be in the pipeline. In China, the government has instituted a retrospective clawback of pay from executives in state-owned financial services enterprises. Executives will need to repay any money received in 2008 that exceeded 90% of their 2007 salaries and give back a further 10% if the 2008 operating results of their company fell short of the 2007 level.

For insurers, the risk-adjusted approach to compensation envisaged under these principles will help to create a more sustainable balance between risk and reward, especially if integrated into the enterprise risk management (ERM) framework and aligned with business strategy rather than simply regulatory compliance. The key challenge is how to develop risk-based performance metrics for a sector in which contracts, be they life policies or long-tail casualty contracts, can run for 30 years or more. Earnings may also be affected by movements in asset prices or the unwinding of decades-old reserves that may not reflect the underlying performance of the business.

Leading firms are already responding by seeking to develop a better understanding of how the actions of executives, underwriters and other front-line teams influence returns. In future, the determination of remuneration may also call for greater input from actuarial and compliance teams. While deferral of pay may encourage a longer term perspective, basing bonuses on anything more long term than three years' performance will require a change in many organisations' compensation frameworks.

Two concerns raised by the financial crisis were the lack of understanding of risk within the Board and remuneration committees' narrow focus on the most senior employees rather than those

⁷ FSF Principles for sound compensation practices, published on 02.04.09.

taking risks. The more effective remuneration committees will therefore focus on pay arrangements for both senior employees and risk-takers across the enterprise. This would also be a good juncture to review the composition of the remuneration committee to ensure it encompasses an appropriate mix of skills and experience. In turn, input and advice from HR, compliance and risk management would help to ensure there is appropriate and demonstrable oversight of the determination of rewards within the business.

The underlying requirement is effective oversight and accountability. Growing political scrutiny has been highlighted in the US by the introduction of a new executive compensation tsar. Shareholders are also being given a greater, albeit as yet non-binding, say over pay. This has increased the pressure on remuneration committee chairs to ensure appropriate governance and compliance, with many now likely to be consulting their lawyers for assurance.



seven

30

Mounting uncertainty over tax

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

As debts and fiscal deficits mount, governments are looking at how to increase their tax revenues and limit avoidance. Insurance will be at the forefront of the pressure as the industry is a major source of potential tax receipts and a significant amount of capital and business capacity has been located offshore in recent years. For example, US policyholders now pay more than \$25 billion per year in insurance and reinsurance premiums to Bermuda-based companies.⁸

As part of the moral pressure being exerted by governments following their support for the financial services sector, insurers can expect renewed scrutiny of their tax planning and mitigation techniques. They also face increased requirements on transparency and

information exchange relating to clients (the revised EU Savings Directive will cover insurers for the first time, for instance). However, headline corporate tax rates may not increase, as governments are acutely aware of the risk of losing business to other countries.

The US is at the forefront of an international review of policy over tax havens. Proposals include stronger enforcement of international tax treaties and tighter restrictions on the mechanisms by which funds are transferred and cover is underwritten offshore.⁹ Other governments are also reviewing the position of offshore financial centres. The initial priority is encouraging tax havens to agree to greater transparency and exchange of information and most offshore

⁸ US-Bermuda: Economic Relations Study, published by the Bermuda International Business Association on 04.06.09.

⁹ Proposed legislation in the US includes the Neal Bill, Corporate Residency Legislation and Tax Treaty OverRide Legislation.

governments recognise that cooperation is crucial if they are to continue as viable financial centres. There may be some specifically targeted measures, particularly from the US. However, most tax havens will argue that interfering with their low tax rates is an infringement of their sovereign rights.

Facing heightened tax pressures at home and a renewed focus on offshore business, a number of insurance groups have or are likely to consider moving their place of incorporation as they seek out stable, efficient, transparent and internationally recognised tax arrangements. Many clients of offshore firms will also be reviewing their options if legislation reduces the tax effectiveness of placing business offshore.

If firms are looking at moving headquarters, key considerations include how a planned transfer would play with management, employees, customers and governments. Those with significant offshore operations will also be assessing how to retain the value of what may be significant investment in an offshore operating platform.

Many offshore locations can continue to prosper. Bermuda, for example, should remain a leading centre of insurance expertise and administration, with redomiciling companies looking to retain their infrastructure on the island by turning their Bermudian operations into a branch. Other less well-established centres may find it more difficult to adapt.



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Challenging prospects for reinsurers

While some believe that reinsurance has strong long-term prospects, others predict that demand will fall away in many developed markets and be concentrated on the more uncertain long tail and high severity risks. This would increase reinsurers' capital requirements and the return expectations of investors within these markets, and ultimately force a rethink of the business model.

Views on the future of reinsurance fall into two polarised camps. One believes that reinsurance demand will revert to pre-crisis levels and may even increase as primary insurers seek to transfer more risk. The other view predicts a far rockier and uncertain future for the sector. Firms are making strategic plans based on markedly different expectations of the growth prospects ahead and those that make the right bets will clearly win out.

So what is the emerging picture?

Reinsurance volumes might have been expected to rise in many of the countries as primary insurers seek to safeguard their capital base in the face of market instability. However, apart from a few segments it is noticeable that neither demand nor prices have increased. Nonetheless, a number of reinsurers have benefited as some primary insurers seek to spread their reinsurance buying in order to diversify their risk.

Looking ahead, the trend towards higher retention of straightforward risks, that had already been evident in many developed markets prior to the crisis, could be accelerated. As companies become more risk aware through advances in enterprise risk management (ERM), they will be better able to choose what risks to retain and what risks to reinsure. What many expected to be the capital benefits of reinsurance under a risk-based approach will also be reduced by an increased loading for credit risk, especially if reinsurers face downgrades. The bulk of the exposures that large insurers in developed markets seek to transfer to reinsurers could thus be the most volatile, which will change the risk profile of many reinsurers, increase their capital requirements and raise the return expectations of capital providers. This would in turn raise reinsurance prices and force many reinsurers to rethink how they sustain growth.

The financial crisis has forced many international insurers to scale back their operations in emerging markets. Domestic insurers in these territories will be able to take up the slack, which will in turn increase demand for reinsurance within these markets. However, whether these markets are as yet sufficiently developed to offset possible declines in business elsewhere is doubtful in the short- and medium-terms.

Some leading reinsurers have already been looking at how to adapt to these challenges through seeking opportunities for consolidation and building up their advisory and fee business. Many reinsurers will also seek to improve margins and the stability of their risk profile by getting closer to primary insurers and their risks. Further opportunities will be opened up through the development of a better understanding of risk and extending the boundaries of insurability.

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Tilting the regulatory playing field

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

Governments are shifting the regulatory emphasis to the macro-prudential fundamentals of solvency, governance and prudent risk management. While customer protection and micro-prudential supervision will continue to be important, there is a growing focus on systemic risks. Of particular note to larger groups is the growing scrutiny of companies that are deemed to be 'too big to fail'. There have even been calls for such groups to be broken up. A further sign of this shift in approach is the renewed primacy of rules over principles, even in countries such as the UK that had until recently championed moves to the latter. Within emerging markets, the pace of liberalisation is set to slow considerably.

As balance sheet strength comes back to the fore, regulators will insist on tougher stress tests that gauge companies' ability

to withstand a range of extreme and potentially interacting scenarios. Firms will also face greater scepticism over model outputs and a higher burden of proof in demonstrating capital adequacy. Key questions include whether the company is able to cope with further reductions in asset values and increased levels of exposure created by a possibly deepening recession. This may well lead to demands to modify their level of debt and their mix of capital.

Governments have been the main drivers of this change of emphasis. The whip hand of national governments has been strengthened because they, rather than international regulators, have generally footed the bill for the bailout and stimulus programmes. The renewed power of governments to preside over regulation was highlighted by the withdrawal of

group capital support from Solvency II in favour of setting capital at a national level. Indeed, while most governments publicly support greater international regulatory harmonisation and cooperation, the interpretation and intensity of application on the ground may well vary according to national interests, which will create both potential distortions and opportunities for arbitrage and competitive advantage.

Another common thread is the emphasis on strong ERM. Even in countries that are not covered by Solvency II-type regulation (see panel overleaf), companies will still face pressure from investors and rating agencies to demonstrate that they understand and can control the full spectrum and interaction of their risks.

Solvency II: Gearing up for tougher implementation

The financial crisis has inevitably raised questions about whether Solvency II is appropriately focused and sufficiently rigorous. Such doubts may have contributed to the withdrawal of the group capital support proposals contained in the draft framework. Once in place, the rigour of implementation and calibration of models will reflect this more sceptical and cautious approach. In particular, companies will be under greater pressure to prove beyond doubt that they hold enough capital and that risk is appropriately understood, controlled and integrated into strategy, management and compensation. Opportunities to reduce capital levels will be more limited than if the crisis had not materialised. Leading supervisors are at pains to assure insurers that the move to risk-based regulation is not designed to curb risk-taking or dictate strategy. However, in practice, potentially higher capital charges for certain types of products will affect business thinking.



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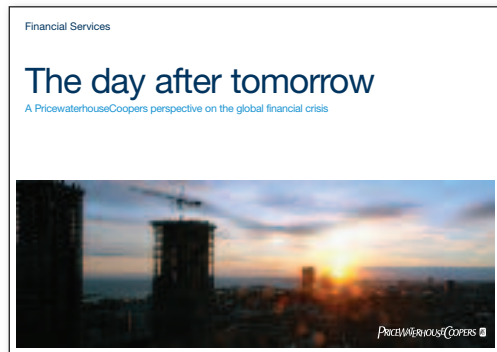
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