Optimism and Bold Strokes in 2013

In this New Year's note, we share our thoughts on the agenda for the European Insurance industry in 2013. We have two main messages:

Despite all the macro concerns, there are reasons for optimism.

But bold moves are required to capture the opportunities.

Recovery in sector share prices

2012 was a strong year for the European insurance sector with the EuroStoxx Insurance climbing 34% YTD (28 Dec 2012) while the EuroStoxx TMI gained 16% and the EuroStoxx Banking gained only 11%. Over the last three years insurers' market value has grown by 1% while the total market is down 5% and banking is down 50%. This shows the relative confidence investors still have in the insurance sector.

There are good reasons for investors' perspective: a sound business model with proven economics and well understood risks, and a prudent management culture, reinforced by the actuarial profession. For the most part, insurers have avoided the kind of scandals that bedevil banks.

Insurers remain in defensive mode

This gradual return of investor sentiment has not translated into strong management optimism. Rather than taking bold moves to capture profit opportunities, senior managers at insurance firms are taking tactical and defensive measures. We attribute this to four immediate concerns:

- The weakened macro-economic outlook in Western Europe and a fear that above-GDP growth in P&C is hard to achieve. Meanwhile, the prospects for Life businesses are dimmed by financial pressures on the middle class
- Solvency II is becoming a never-ending story. Many insurers wonder how to respond to new amendments and further delays
- Investment income has been declining. In P&C, this is largely due to low returns across all asset classes for most institutional investors. In Life, low interest rates have increased the burden of costly guarantees on traditional policies
- Managers are reacting to the lack of growth and reduced profit margins and investment returns by trying to minimise payments and operating costs. This understandable short-term priority often leaves insufficient space to think ahead and innovate for growth.

Each new round of tactical operational improvements delivers decreasing marginal value. Instead, we recommend thinking ahead to the new emerging opportunities. Where and how can your businesses succeed? What should each function contribute?

Play both sides of the balance sheet

We see tremendous opportunity for insurers to use their long-dated liabilities as a source of funds for investing in illiquid assets of long duration. Such assets match insurers' naturally long-term liability profiles and provide excess returns. Acquiring assets such as commercial mortgages or unsecured loans will require insurers to build new capabilities in origination and credit risk management that most now lack. Yet the return on the investment could be huge. (And the increased maturity matching in credit markets would have stabilising effects for the wider economy).

Take control of Solvency II

Solvency II has crippled both financial and strategic decision making for many years. The latest deferral and growing uncertainty over when it will be introduced, and what it will eventually look like, offers you an opportunity to take back control of your business. Many profit opportunities can be taken before Solvency II is implemented. For example, the accumulated returns from the asset side opportunities mentioned above would more than cover the additional capital requirement brought in with Solvency II.

Similarly there is no reason to delay the development of a capital and performance management regimes for your business. As things stand, you can already decide where and how to use internal models, how to steer businesses for value creation and how to combine the accounting and economic views of capital and performance. The postponement of Solvency II allows the sector to be proactive rather than merely reacting to legislative moves. You should use this window of opportunity.

Identify and capture new growth

It is not a law of nature that growth in P&C is correlated with GDP growth or that life insurance depends on middle class savings. Private households, corporates and governments still bear many non-strategic risks that they would like to mitigate. We believe there are significant opportunities in new direct models and in new sources of the data, such as telematics. There is also clear opportunity in developing new relationship-based models that look beyond the immediate distribution channel and product push to provide what clients really want, managing the economics to "average out" profitability on a lifetime basis.

New value chain opportunities – identify where you can play profitably

Operations remain very complex throughout the sector despite the recent wave of operational excellence programs. It is now clear that significant cost efficiencies require step change redesign of delivery models and value chains. Back book restructuring and consolidation of closed books have generated significant shareholder value in the UK, and we expect similar businesses to emerge across Europe. In P&C the "connected car" opportunity is bringing new players into the motor value chain. Similar trends are emerging with the "connected home", as home security is integrated into home entertainment.

Culture and people

A cripplingly defensive culture has recently gained ground at too many firms, often driven by regulatory requirements. Insurers need to be optimistic, go on the offensive and take action. This requires the right kind of people and institutional culture. It means being creative and innovative in connecting dots across industries and value chains. Perhaps most importantly, it means being confident about the insurance sector and its players.