



2016 European insurance outlook



Market summary

2016 represents something of a watershed for the European insurance industry, with a number of insurers engaged on a substantive transformation process. After years of in-depth discussion and revision, as well as considerable time and resource spent on preparation by the market itself, the new Solvency II regulatory regime finally became a reality on 1 January. Yet, adjusting to the new landscape will not be easy as the macroeconomic pressures on insurers have not relented, despite years of turbulence. Continuing low interest rates, in particular across the Eurozone, bring with them a number of challenges, especially on the life side. For some markets, companies need to address unsustainable levels of guarantees in their products, while for others the issue is coming to terms with a post-guarantee operating environment which itself necessitates a new set of products and increased competition.

The low interest rate environment is also changing the asset allocation strategies of companies across the continent, with political pressure combined with the search for yield-supported by the new Solvency II landscape – encouraging investment in areas such as infrastructure.

For general insurers, the continued plentiful supply of capital – from “traditional” sources and the insurance-linked securities market – combined with another below average year for catastrophe claims in 2015, means the soft market endures. Meanwhile, developing areas of risk such as cyber bring new challenges as claims continue to grow in size and frequency, but also present a huge opportunity for growth for property underwriters.

Distribution

2016 is also a pivotal year for European insurers in terms of distribution, as EU member states will have to come to terms with the ramifications of the Insurance Distribution Directive (IDD), which was ratified at the end of 2015. Although existing regulation that covers most of the IDD is in place in mature markets, it is expected to come into force across the continent by 2017. It carries with it a wide range of obligations in relation to product oversight, remuneration and information disclosure that relate to the intermediary channel. On the underwriting side, distribution strategies this year will also continue to be of key importance. For commercial insurers and those in the specialty market, the dominance of brokers, creeping levels of commission and the rise of mega-facilities are expected to continue to generate lively discussion given continuing soft market conditions.

The digital opportunity

Alongside these factors, the importance of operating in the evolving digital landscape in 2016 and beyond cannot be understated. The need to deal with the advent of Solvency II in a low interest rate operating environment has understandably dominated the agenda of boards of late, but there can be little doubt that over the next couple of years the digital opportunities will be an even more pressing agenda item for insurance executives. European insurers may not have had to contend with the threat posed by one of the main digital operators entering their space so far. However, the need to respond adequately to consumer demand in an increasingly digitized marketplace will be paramount, presenting a unique opportunity for the market to demonstrate it has the appetite and capability to seize the digital opportunity.





IFRS 4 and IFRS 9

2016 is also a key year for changes to major International Financial Reporting Standards (IFRS). After years in the making, IFRS 9, which deals with changes in accounting for assets, has finally taken off. Most European insurers have now completed the gap analyses and impact studies required in readiness for adoption on 1 January 2018. Some insurance entities will be allowed to defer the implementation of IFRS 9 until the earlier of the effective date of a new insurance standard (IFRS 4, phase II) and 2021. However, many insurance groups include entities that will not qualify for deferral, requiring the group to provide guidance on implementation policies to ensure consistency and that judgments are made in ways that also make sense for insurers adopting the standard later.

This year could also turn out to be interesting in the development of IFRS 4 phase II, which deals in the main with insurance contract liabilities. We can expect a final standard to be issued toward the end of this year, although implementation will not occur before 2020 at the earliest.

Mergers and acquisitions (M&A) uptick

Given the rapid pace of transformation across the sector, the impact of Solvency II and general re-shaping of business models, it is hardly surprising that there has been a marked uptick in insurance M&A across the Eurozone. This has been reflected both on the life and general side, with insurers keen to achieve economies-of-scale and to position for the significant project spend and business transformation required over coming years. A number of insurers have been divesting businesses that were not consistent with their future strategy or substantially underperforming, in particular in life insurance. There has also been continued acquisition activity by insurers in search of growth opportunities, whether in higher growth markets or in new capabilities. M&A activity has also been supported by the significant levels of investor demand, with capital flowing into the sector. The M&A impetus is expected to continue in 2016, as insurers continue to transform and as large-scale private equity, Asian investors and others seek deals within the European insurance market.

Macroeconomic European focus

The economic outlook in Europe is poised at a critical juncture where the recovery needs to broaden out to encompass all sectors, not just financial services. Significantly, financial services have a key role to play in taking the European recovery to the next stage. Consumer spending continues to support growth amid solid job creation and a renewed boost to disposable incomes resulting from the recent decline in energy prices.

The export outlook in 2016 poses concerns but the economic recovery in Europe has so far remained resilient in the face of external headwinds. Despite the recent troubles in emerging markets, not least China, European exports have held up well thanks to reasonable growth in other advanced economies – collectively, a much more important market for the region. We expect demand growth in Europe's key export markets will pick up in 2016, supporting continued solid growth in exports.

The unfolding consumer sector recovery in Europe brings with it the prospect of higher motor and home sales and associated insurance policies, although the extent of the recovery in premium income in Europe will be constrained by the region's already high penetration rates. Pricing power generally remains weak in Europe, although Germany and Spain represent two bright spots, with good rate momentum in non-life driven by motor insurance.

Another key challenge facing insurers stems from the sustained low interest rate environment. Although economic growth is picking up, inflation is likely to remain subdued for some time, meaning that the European Central Bank's key policy interest rate may even see further cuts before the possibility of a rise occurs. Continued central bank asset purchases, which are now likely to continue until March 2017, will continue to put downward pressure on bond yields. Low interest rates will therefore continue to pose substantial challenges to the insurance industry by constraining investment yields and maintaining an environment that will be very unforgiving of poor investment decisions.

Meanwhile, the introduction of Solvency II will compound the strains on capital from low interest rates by introducing more volatility into reported capital positions. Insurers are responding by optimizing their asset allocations and using reinsurance to help reduce capital needs.



Over the medium-term, an aging population should buoy demand for retirement and savings products, and we expect sales of homes and cars to rise.



2016 priorities

1	The impact of the current low interest rate environment
2	Customer vs. product
3	Operational capabilities
4	Data analytics and the customer relationship
5	Regulation and its impact on the market
6	Cybersecurity
7	Conduct risk

1 The impact of the current low interest rate environment

Despite indications from senior figures within the EU, such as Governor of the Bank of England Mark Carney, that the long-awaited uptick in interest rates will soon be a consideration, the reality going into 2016 is a continuance of the low interest rate environment that has plagued insurers in recent years. The continuing repercussions of low rates include the inability to make products work effectively and make the hunt for yield all the more challenging, though a potential concern for the market should also be a sudden movement in the other direction.

There is a suggestion that the way that insurers are looking at prospective risks at the moment remains too narrow given historic parameters for inflation and interest rates. As such, the stress test scenarios that have been run recently by the European Insurance and Occupational Pensions Authority (EIOPA), while testing a stress on the balance sheet, are not necessarily testing a real catastrophic scenario, and the industry needs to consider longer-term inflation scenarios.

“ The ideal scenario for the industry is a progressive rise in interest rates, but this is not expected before 2019. ”

2 Customer vs. product

Offering appropriate and innovative products remains a challenge for the European insurance market, with different markets still struggling to come to terms with the continuing low yield environment, particularly for long-term savings. Markets such as Germany had historically unsustainable levels of guarantees in products, but have steadily moved to non-guaranteed products. The simple fact remains that whether or not one believes that yields are going to improve, there has already been substantial ground lost to alternative providers of savings solutions, insurance-as-a-savings-vehicle requires a more compelling proposition in order to survive.

So, many insurers are seeking to realign their business to be more focused on customer requirements and experience. Yet the European insurance market has often been criticized for being slow to innovate on the product side, and a poor cousin to the banking sector, especially on the retail side.

Despite the difficulty that insurers have historically had interacting with customers and developing appropriate products, steps are being taken:

- In some European countries a pan-financial services digital passport is being developed, providing customers with the ability to have a single digital identity that can then be used across different financial services organizations. Such an initiative follows work done by Estonia and Sweden, which both have existing digital identity systems for transactions.
- European insurers continue to be engaged in other initiatives that will help to make significant inroads into the customer vs. product conundrum. Robotic process automation (RPA), or software robotics, means that insurers can have a digital front-end on almost any legacy system, which could be of huge benefit to customers and insurers alike, potentially providing greater access and transparency with regard to multiple product portfolios.

Clearly, insurers who invest in wider propositions and smart and timely products are most likely to be winners in the market, and embracing technology offers a unique route to customer re-engagement and product relevance, as well as creating value for insurers. For example, EY has just worked with a large general insurer and has identified how software robotics can help them to go digital in 6-9 months, and to improve operational efficiency, increasing process speed and reducing cost.

“ It does feel like there is a genuine opportunity today to reconnect customer and product through technology. ”

3 Operational capabilities

In 2016 it remains a case that the operational capabilities of the European insurance market are lagging their financial services competitors. Legacy systems remain a real bugbear, with current systems old and often extremely complex, with high maintenance costs. Consumers' change in behavior is driven by the choice they have and the service they receive from companies, with product choice and transparency of pricing critical, but the ability of insurers, both in the life and general insurance market, to meet expectations is somewhat hampered by their operational effectiveness.

Given that insurers have multiple legacy systems that limit their operational capabilities, some insurers are now moving back into distribution, with investment in front-and mid-end systems. However, the degree of involvement here varies by market. In general, Northern and Western European markets have tended to be more active and have invested in new and emerging distribution channels. In other markets, where non-tied and tied sales agents tend to play a more prominent role, there is still more work to do here if they are to embrace a broader range of distribution alternatives beyond traditional historic parameters.

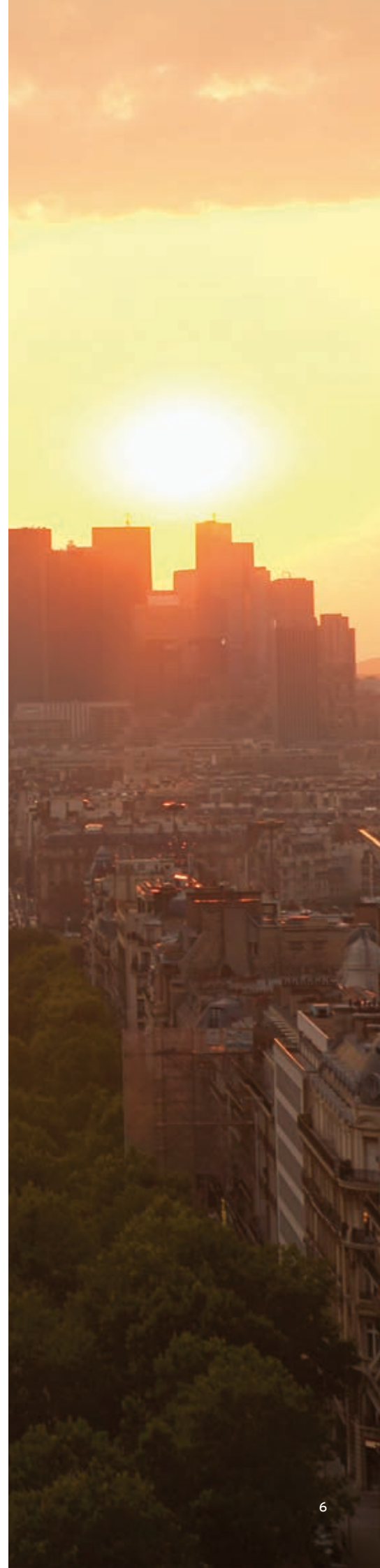
It's fair to say that the market is alive to these issues. There can be little doubt that digital strategy is currently one of the top-three issues for most European insurance executives, and will rise up the agenda if it has not done so already.

- ▶ Now is a critical time to make these changes. Some players have started, and Solvency II creates a necessity for change. Besides, European insurers cannot afford to be left behind here or else the wider financial services markets could overtake them. Insurers need to ensure they are nimble and efficient given that a number of organizations from outside the sector could enter the market.
- ▶ There is now a great opportunity to transform business. Put simply, for most insurers the cost base remains too high and margins are too low. In this context the only thing you can do is try and cut your long-term costs.

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4 Data analytics and the customer relationship

How best to leverage so-called “big data” was one of the main talking points for European insurers in 2015, and the debate is only set to intensify in 2016, especially given the increased regulatory scrutiny of insurers’ use of customer data. For example, this year will see the Joint Committee of the European Supervisory Authorities (JCESA) examine the use of big data by financial institutions in what it claims is a bid to prioritize consumer protection. JCESA is made up of the European Securities and Markets Authority, the European Banking Authority and EIOPA.

In the meantime, the leveraging of big data to offer more bespoke products, such as term insurance policies that more accurately reflect customer lifestyles or motor insurance products that embrace telematics more effectively, will continue apace. As more insurers across the continent invest in their analytical capabilities, they will be able to make better use of data, including more bespoke product design, better underwriting and a more efficient claims cycle.

The core challenge for the European insurance market here will be its ability to turn disparate, low quality data into useful insights in a cost effective manner. Smarter data management, reporting and advanced analytics will be the key differentiators for those leading the big data race in 2016.

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5 Regulation and its impact on the market

Following a lengthy implementation process, European insurers are now operating in a Solvency II world. Solvency II came into force on 1 January 2016 and European insurance companies are starting to get to grips with the impact of this new world on the running of the business.

Although a great deal of preparatory work has been undertaken in the run up to 1 January, we can still see some activity in 2016 as firms complete the tail end of the implementation and begin to operationalize Solvency II. Many firms will be in the final stages of preparation of Pillar 3 reporting, including testing processes, controls and systems ahead of the first submissions over the course of 2016. The next step will be optimizing many of these operational processes as the reporting timelines start to reduce, and undertaking initiatives to bring the cost of ongoing regulatory compliance under control. A number of leading firms have achieved regulatory approval for use of internal models. For the many others that did not apply for model approval in the first round, now is the time to consider (partial) internal models for certain components where this makes sense given the business profile. Sufficient capitalization lies at the heart of the Solvency II project, with the need for insurers to be sufficiently capitalized, and after the pro-forma data has been submitted to the regulators. Based on the results of these submissions we can expect significant activity across the European insurance market, especially:

- ▶ Hedging of asset risks and the utilization of reinsurance and contingent capital or ancillary own funds
- ▶ Restructuring and greater use of internal capital transfer instruments
- ▶ Possible market consolidation as insurers dispose of legacy or non-core assets

Thus far, however, we have not witnessed a great deal of M&A activity across Europe that can be linked specifically to Solvency II, though this could now change. Solvency II also presents investment opportunities by opening up a whole universe of assets to insurers with the skills and appetite to manage them. We are starting to see some insurers branching out into illiquid assets and infrastructure as a response to the low yield environment, for example. Certainly governments would like them to do more, but are firms responding as much as governments would like? They are still a little cautious and it will be fascinating to see the extent to which the industry engages with “nontraditional” assets in 2016.

6 Cybersecurity



88%

of respondents to EY's Global Information Security Survey 2015 do not believe their information security fully meets the organization's needs



57%

of respondents to EY's Global Information Security Survey 2015 say that lack of skilled resources is challenging information security's contribution and value to the organization

Cybersecurity attacks have unfortunately become recurring news items in recent months, with October 2015's hacking attack on a UK mobile phone and broadband provider set to generate one of the largest cyber claims in Europe to date.

The phone and broadband provider released official figures based on an internal investigation showing how many customers were affected, revealing that some 20,000 bank account numbers and 28,000 partially obscured credit card details were accessed. The investigation also showed that some 1,200,000 customer email addresses, names and phone numbers were accessed. In another high profile attacks earlier in the year, global French-language television network had been virtually disabled by a massive cyberattack that affected all of its 11 channels, its social media outlets and its websites.

Such breaches further highlight the need for boards to take the threat of cyberattacks more seriously, and while the market may help to mitigate risk for the commercial sector through the provision of bespoke cyber covers, insurers themselves are also vulnerable to unwarranted cyber attention. Indeed, it would not be overstating the case to say that cybersecurity issues are increasing exponentially for insurers.

For insurers, cybersecurity concerns relate to both fraud and data protection, and the problem is exacerbated because insurer systems are often difficult to monitor. Pensions providers are an obvious target here, with unscrupulous criminals seeking to take over lost pensions. More generally, a downside of the expansion of digital platforms is that insurers, through their increasing use of apps and mobile websites, are opening up more doors, potentially exposing themselves to future cyberattacks.

Of course, the growing prevalence of cyberattacks presents a real opportunity for the insurance market in terms of material new business, especially with commercial clients, with cyber risk one of the fastest growing business segments for the non-life market.

Cybersecurity attacks are increasing exponentially for insurers.



7 Conduct risk

In recent years the regulatory mood across Europe has seen an increased emphasis on compliance and conduct risk. The French regulator is now taking an interest in this, charging insurers to find the beneficiaries of dormant policies, while the UK's Financial Conduct Authority has for some time been at the vanguard of conduct-related action, carrying out a thematic review of the annuities market and exploring competition in the wholesale market, with plans to review retirement sales practices in the life and pensions sector.

Other EU insurance regulators that have embraced the conduct agenda and are setting the tone include the Netherlands and Germany, which has introduced a code of conduct relating to how advice is given, though at present this is a voluntary code.



We can expect the conduct agenda to extend further across the continent as a result of the new European Insurance Distribution Directive (IDD):

- ▶ The existing IMD also applies to the regulation of insurance intermediaries, whereas the new IDD applies to the wider regulation of insurance “distributors,” encompassing all sellers of insurance products, including insurance undertakings that sell directly to customers. It also extends to those involved in claims management activities.
- ▶ Like its predecessor, 2002's Insurance Mediation Directive, the IDD will be a “minimum harmonizing” directive and member states will be able to “gold-plate” it by adding extra requirements when implementing. We can expect a range of attitudes here as some countries with historically light-touch regulation will have no desire to gold-plate.

This year we can expect to see conduct issues and professionalism move up the agenda in 2016, with an increasing awareness by C-suite executives with regard to conduct risk. The approach so far has been a reactive one, however, and has been partially fear-driven, as so far insurers have not really made compliance a virtue. Whether or not this approach will change in 2016 will be an interesting dynamic; while insurers are more ready to respond to conduct issues, they are loathe to self-impose.

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If you would like to discuss any of the issues covered in this publication, please get in touch with your usual EY contact or alternatively contact:

Andreas Freiling
EMEIA Insurance leader

E: andreas.freiling@de.ey.com

T: + 49 6196 9961 2587

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