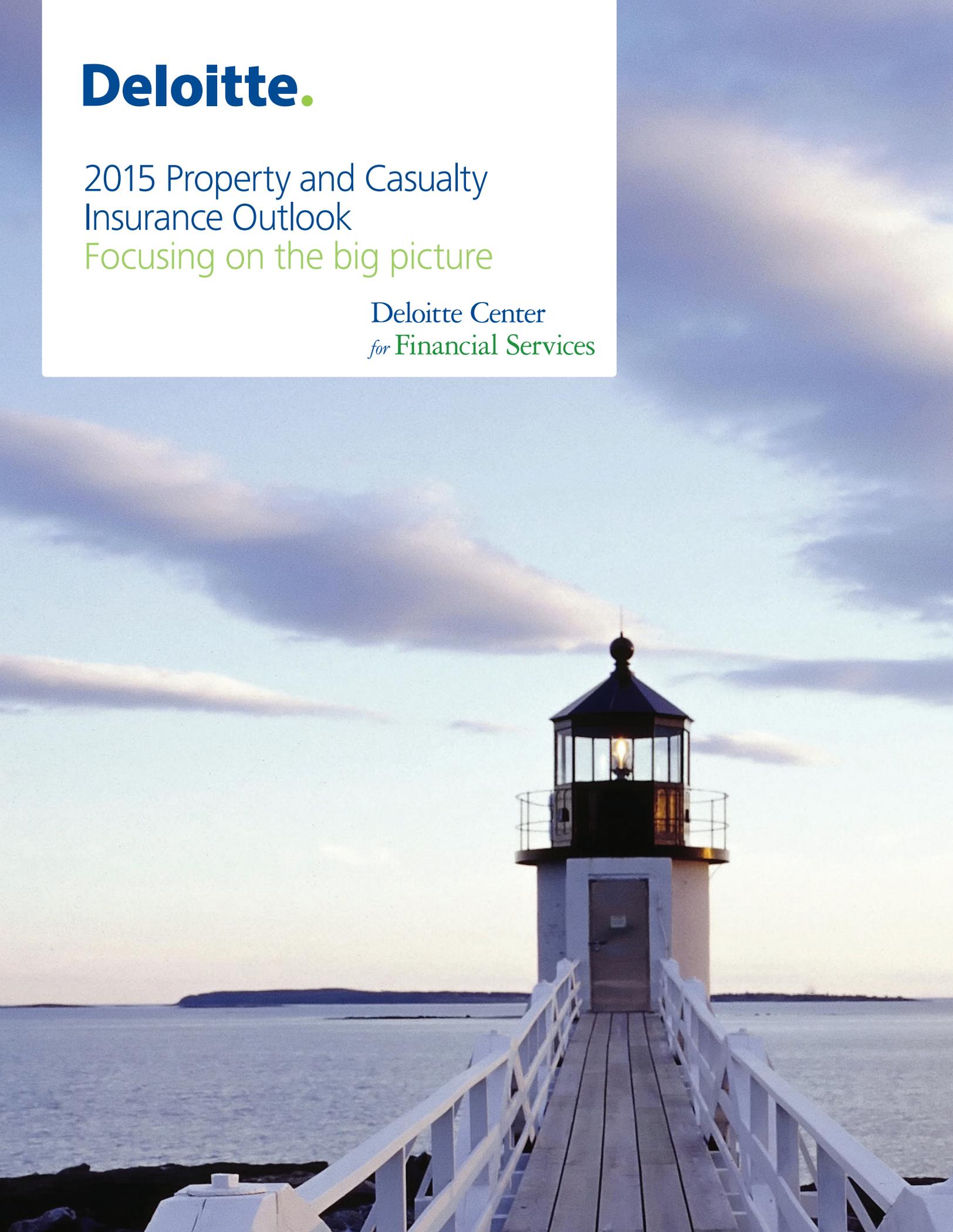


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2015 Property and Casualty
Insurance Outlook
Focusing on the big picture

Deloitte Center
for Financial Services



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Foreword

Dear colleagues:

In many ways, the property and casualty (P&C) insurance industry is better positioned to grow than it has been for quite some time. The US economy's recovery is gaining momentum, sparking stronger and steadier gains in the labor market — despite concerns about the falling price of oil, as well as lingering problems in both Europe and some emerging markets that have been roiling the stock markets. P&C premium income should continue to rise in 2015 as the industry benefits from an influx of additional insurable exposures in both personal and commercial lines.

Plenty of challenges remain — some new, some ongoing — to keep industry executives on their toes. Whether it's the evolving threat of cybercrime, the effort to quantify and mitigate the impact of climate change, or how to most effectively manage capital at a time when funds from alternative investors entering the market are expanding capacity while undermining pricing leverage and profitability, P&C leaders will have their hands full. Agility, innovation, and collaboration are therefore likely to be increasingly important to upgrade capabilities and spark sustainable growth.

In this outlook, we once again strive to alert the industry to the threats and opportunities that may lie ahead, as well as offer practical suggestions for what insurers ought to do about them. However, while touching upon the general impact of the economy and the state of cyclical insurance markets, we focus the bulk of our attention on more systemic, bigger-picture agenda items that are likely to have a significant effect on consumer behavior and insurer operations well beyond the year ahead.

Our views on industry trends and priorities for 2015 are based on the first-hand experience of many of Deloitte's leading practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing outlooks of this type has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we felt it was important to reflect on what we said a year ago, and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 outlooks. You will find this "looking back" analysis leading off this year's edition, followed by a "look forward" summary of our views about 2015.

The bulk of the report will explore a number of key areas for P&C companies to address over the coming year, each including a specific look at the focus for 2015 and a "bottom line" that provides some actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your company's strategic decisions. Please share your feedback or questions with us. We would value the opportunity to discuss the report directly with you and your team.

Regards,

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Looking back

Industry transformation initiatives are underway, but some require more time to gain traction

Our 2014 P&C outlook evaluated the general state and direction of the market, while offering suggestions and making a number of predictions about a wide range of issues. However, when it comes to fulfilling the headline and overall theme of last year's report, "Transforming for growth: Innovation leading the way," efforts to significantly upgrade insurer efficiency, effectiveness, and capabilities remain very much a work in progress.

Consider the following recap of what we saw in our crystal ball a year ago:

- **New avenues for expansion:** We cited the likelihood of accelerating growth in usage-based auto insurance, fueled in part by smaller and midsized carriers sharing telematics data and analytical tools via third-party aggregators so they could compete with the industry's giants on a more level playing field. Such collaborative efforts are now indeed underway. However, we also spotlighted the potential for growth in direct sales of small-business insurance coverage to buyers online, bypassing agents. But while this distribution innovation has moved beyond the drawing board, its development is still in the very early stages.

In addition, we speculated that the establishment of private online health insurance exchanges, prompted by implementation of the Affordable Care Act, could set the stage for cross-selling of P&C personal lines coverage, but thus far that development has been limited to life insurance and ancillary group benefit options.

- **Regulatory threats:** When the long-awaited Federal Insurance Office (FIO) report on state regulation finally came out just before we published our 2014 outlook, we reassured the industry that there was "no immediate threat to state supremacy" because most of the recommendations either required Congressional action (which we didn't see as likely in the currently deadlocked political environment) or called on the states to make changes themselves (which FIO could not compel). Our assessment turned out to be well founded, as the FIO report generated far more media attention than actual regulation or legislation.

Overall, however, we noted that insurers would be left operating somewhat in a state of limbo, as regulators both in the United States and abroad worked out major changes to capital and reserving standards. As expected, while there has been progress, final rules and their application remain unresolved.

- **Talent transformation:** Here we spotlighted the industry's need to bolster its "people power" by launching more creative and flexible talent development programs. We warned such initiatives would be necessary to account for a looming number of retirements in an aging insurer work force, while offsetting chronic shortages in critical skill sets such as technology support and analytics. Many carriers are at least starting to upgrade their core human resource systems, but they've been slow to broadly revamp traditional approaches to recruitment, retention, and cross-training, particularly in adding badly needed specialists, such as data scientists.
- **Tech to the rescue:** We emphasized the need for carriers to substantially upgrade their technology capabilities, and a number of major carriers are at least starting down that road, including efforts to enhance online self-service, mobile capabilities, and communications tools for producers and policyholders.

We also noted the potential for usage-based auto insurers to transform this emerging market and offer more differentiating services by collecting telematic data over a smartphone; but for now the vast majority of carriers still use a device installed in the insured vehicle. That's likely to change as more carriers offer mobile phone apps to monitor driving and interact with policyholders, even as more "connected cars" hit the road, able to link to the Web with telematic devices pre-installed by manufacturers.

Meanwhile, we warned data-rich insurers about growing cyber risk, which might have even been understated in light of the number of massive breaches among banking, retail, and even entertainment companies this past year. Carriers are typically aware of the exposure they face, both in terms of potential liability and harm to their reputation. But many should still take additional steps to become more secure, vigilant, and resilient to prevent a systems breach and be prepared to respond decisively if a successful attack is launched.

- **Growth by acquisition:** We cautioned that the increase in capital flowing into the market was creating excess capacity, thereby threatening to undermine pricing leverage and profitability. The industry’s rate of return did indeed reverse course and began dropping as surplus hit record levels. We suggested that this phenomenon might kick-start relatively quiet mergers and acquisitions (M&A) activity, telling insurers to “brace for a more dynamic M&A market.”

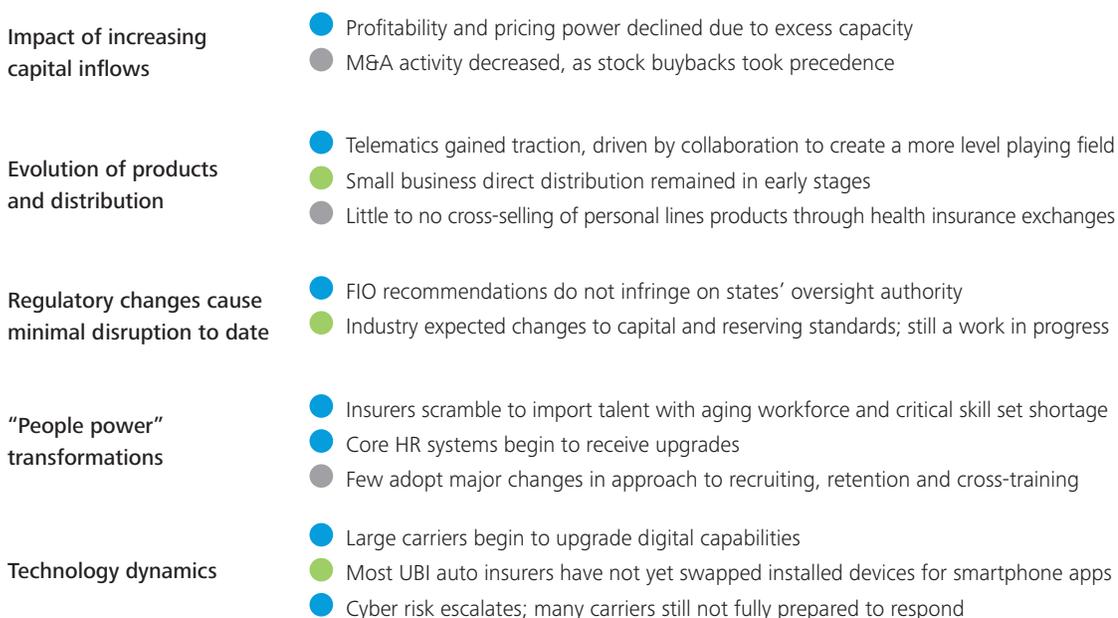
Yet M&A deal volume initiated by US P&C carriers was actually down 20 percent in the first three quarters of 2014 compared to the same period a year earlier,¹ as most chose to allocate any excess capital at their disposal to finance stock buybacks and/or dividends rather than attempt potentially more problematic M&As. Still, activity picked up a bit in the fourth quarter,

and the prospect of interest rates starting to rise later in 2015 may spur more insurers to take the plunge and initiate a sale or acquisition to take advantage of currently favorable financing rates.

In addition, while stock buybacks are likely to continue, some companies may reassess whether they still represent the best possible use of excess capital, as such an option has become a less efficient capital management alternative with the rise in the stock markets to near record levels in 2014.

In the end, while some of the issues we raised in last year’s outlook have been slow to develop, those observations remain relevant, and these trends will likely continue to evolve and mature over the course of 2015 and beyond.

Figure 1: 2014 Property & Casualty outlook scorecard



Key:

- Turned out as expected
- Partially turned out as expected
- Did not turn out as expected or unresolved

Source: Deloitte Center for Financial Services analysis

¹ SNL Financial.

Looking forward

Insurers may struggle to adapt as fundamental shifts challenge traditional business models

Despite recent turbulence in the global economy due to concerns about a double-dip recession in Europe, a precipitous drop in oil prices, and troubles in some emerging markets, prospects for organic growth in the P&C insurance industry should be bolstered if the US economic recovery continues as anticipated, gaining momentum in 2015 and thereby boosting the number of properties, people, and exposures requiring coverage.

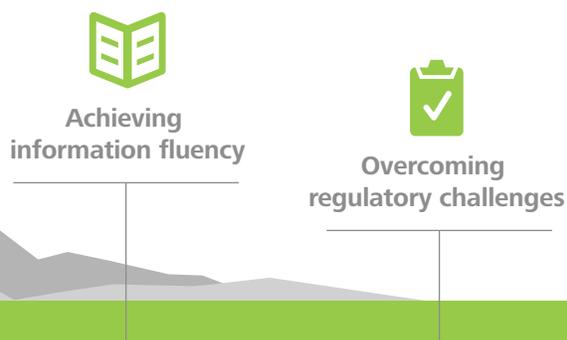
The most likely scenario in Deloitte's "US Economic Forecast" foresees real GDP rebounding to 3.5 percent in 2015 and 4.2 percent the year after.² At the same time, the unemployment rate is expected to keep dropping, from 6.3 percent in 2014 to 5.9 percent in 2015, before leveling out at around 5.5 percent for the rest of this decade.³

However, there are microeconomic headwinds that could lower the rate of growth in premium volume. For example, rising capacity as capital pours into the market is

undermining pricing leverage, prompting many carriers to keep renewal rates level or bid only slightly higher. On the flip side of the revenue picture, the impact of an expected rise in interest rates later in 2015 may not manifest itself on carrier balance sheets for quite some time, as fixed-income investment portfolios of P&C carriers gradually turn over to higher-yielding bonds. As a result, many insurers may be hard put to maintain a positive combined ratio and keep their returns on equity from continuing to deteriorate in the coming year.

In any case, P&C carriers should not be relying solely on the rising tide of an improving economy to lift all boats. Over the next few years, insurers will likely have to adapt to fundamental sea changes underway that threaten to upend their business models, standard operating procedures, and distribution systems.

Figure 2: Four priorities for property and casualty insurers



² Dr. Daniel Bachman, "US Economic Forecast: Volume 2 Issue 3," Deloitte University Press, September 18, 2014.

³ Ibid.

Longer-term considerations

In this year's outlook, we're encouraging insurers to look beyond the short-term ups and downs of their own particular markets and the economy as a whole to consider the bigger picture. We focus on four pillars for long-term success that should rank high on insurer strategic agendas.

The agility with which carriers take on these challenges and convert them to opportunities for growth and performance enhancement will potentially determine which companies are most effectively positioned to lead the industry. They are:

- **Achieving information fluency:** Most insurers are not positioned to fully leverage the vast amount of data they already have, let alone the new sources of information and real-time analysis at their disposal through emerging outlets such as auto telematics and the Internet of Things. A new data management infrastructure and governance architecture would likely

help many carriers break free of outdated, siloed systems, while turning proprietary information into both a strategic asset and a competitive advantage. The scope of these efforts should encompass client-targeting through service and supplemental sales.

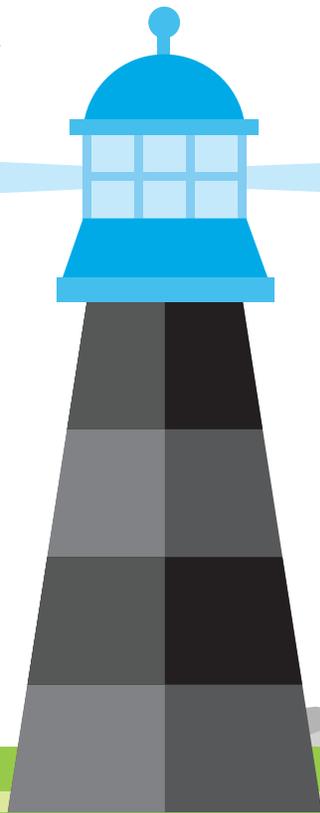
- **Overcoming regulatory challenges:** Insurers can rely on regulatory uncertainty as an ongoing way of life rather than a passing conundrum, as multiple overseers — state, federal, and international — sort out new standards and rules. In addition, we see the potential for ongoing disputes and perhaps overlapping rules, as regulators from different jurisdictions compete for supremacy. Meanwhile, even if certain companies aren't technically subject to new rules at first, they may be swept up into meeting these standards over time.



Upgrading capital management



Getting ahead of climate change



- **Upgrading capital management:** To start, many insurers will probably need better frameworks and models to meet the increasing demands of stakeholders for more robust stress testing and scenario planning. Eventually carriers will likely have to show an improved understanding of capital consumption among different products to facilitate or justify capital deployment decisions and assess risk-adjusted returns. More effective capital management could also support growth needs, particularly at a time when alternative investors are pouring funds into the P&C sector, helping to establish record levels of capacity.
- **Getting ahead of climate change:** Insurers have long been on the front lines when it comes to compensating for the impact of climate change, as they help policyholders recover from the damages of increasingly frequent and severe weather-related events across wider regions of the country, problems that are likely to worsen. Indeed, a recent report from the United Nations warned of “severe, pervasive, and irreversible” weather and climate extremes if the global community doesn’t start doing a better job containing greenhouse gasses.⁴

While some major European carriers have enthusiastically taken up that cause, US insurers have been slow to follow, given the controversial nature of the political debate on the subject here at home. Still, American insurers are likely to become more engaged for a number of reasons. One is regulatory and rating agency scrutiny into how insurers are accounting for climate change issues. Second is the likelihood that it is better to prepare for the potential impact of climate change in case scientific warnings are indeed well founded. Third, there is the potential for insurers to capitalize on a growing market for sustainability-related products and services.

Overall, the bottom line is that while macro- and microeconomic factors will continue to fluctuate and likely require ongoing adjustments, the four pillars explored in this outlook present tremendous opportunities to grow the business and make it more profitable and sustainable.

⁴ Doyle Rice, “U.N. Panel Warns of ‘Irreversible’ Climate Extremes,” *USA Today*, Oct. 28, 2014.

Achieving information fluency

Insurer intelligence should be enhanced by an increasingly interconnected world, but data barriers persist



Insurers thrive on data. The more they have at their disposal, the greater the potential competitive edge. Carriers should therefore take steps to make sure they can capitalize on the increasing variety, volume, and velocity of data being collected and analyzed.

New types of information are already transforming certain lines of business, such as the telematics flow of real-time driving performance data, fueling usage-based auto insurance. Yet this is only the tip of the data iceberg. A similar trend will likely impact a growing number of non-auto personal and commercial lines, as sensors driving the Internet of Things proliferate at home, work, and everywhere in between.

For example, smart homes may allow policyholders and their insurers to monitor and receive alerts about overheating wires, boilers, or outright fires; anyone entering their house; as well as potentially dangerous changes in temperature, wind speed, roof pressure, or carbon monoxide levels. On the commercial side, telematic data can help insurers and policyholders spot and control the risk of loss for vehicles, warehouses, factory floors, retail outlets, and office buildings.

Those carriers that most effectively leverage this deluge of additional input are likely to have a leg up on competitors. Yet many companies have not taken the necessary steps to

fully realize the massive amount of data they already collect as an enterprise-wide strategic asset, let alone utilize new sources being developed.

The full value of data is still rarely optimized by insurers because it often remains isolated in siloed, legacy technology systems and operating structures. To date, few insurers are equipped to harvest and harness data to its fullest value. So, while carriers may be information rich, many to a large extent remain knowledge poor.

Further exacerbating this conundrum is that regulatory requirements now emphasize information management as a foundational element of compliance reporting and enterprise risk management. That means data systems should be adapted not just to facilitate enhancements of insurer operations, but also to meet evolving government oversight and rating agency demands.

Insurers could soon find themselves at a distinct disadvantage if they continue to pursue a slow, continuous improvement path instead of taking a more transformative approach to make information management a differentiator and a competitive strength.

Figure 3: Achieving data fluency



Focus for 2015

As a growing number of insurers are looking to capitalize on both legacy and new sources of information to enhance business performance, but have yet to overcome the technological and operational obstacles of leveraging their data, the need to improve enterprise-wide information management is likely to become more prominent in 2015. More carriers should begin to strategically transform the way they amass, store, define, govern, analyze, and disseminate information. This could enable more effective marketing, underwriting, pricing, and claims decision-making, as well as the delivery of a more positive customer experience. Meanwhile, improved data fluency will potentially enrich an insurer's insights into the needs and behaviors of both personal and commercial lines buyers, as well as those of the distribution partners with which they engage.

The flip side of the data management coin is the ever-present privacy and cybersecurity challenge, especially as the use of social media, mobile platforms, and other non-traditional information sources proliferates. As many insurers expand their global footprints, they should establish data management systems that not only effectively thwart potential hackers, but must also comply with a wide variety of local privacy and security laws.

Ironically, while cyber liability might be one of the biggest P&C coverage growth areas over the next few years, it also represents perhaps the most dangerous exposure for insurers. The treasure trove of personally identifiable information insurers keep in their various servers, systems, and devices makes them highly attractive targets for hackers, and as insurers increasingly digitize their marketing, sales, and communication systems, the vulnerability level of their proprietary information also rises.

The bottom line

The Internet of Things, auto telematics, and other information technology initiatives are dramatically increasing the amount and variety of new data being processed by insurer systems. Yet many carriers are still struggling to organize and come to grips with the enormous amounts of data they've always had in house, adding greater urgency to transformation efforts.

Advancing information fluency throughout an insurance company should be treated as an ongoing journey rather than a final destination, since internal systems need to be regularly reassessed and revamped to process new types of information from additional sources, while better capitalizing on data already on hand.

Efficiently staying on top of regulatory mandates, given insurers' largely siloed operating environment, can be cumbersome and costly. Therefore, carriers that incorporate ongoing regulatory compliance into their overall strategic data management goals will likely gain advantages in their ability to more nimbly react to new and updated directives.

Strong executive buy-in, robust change management programs, and dedicated data champions should be the foundation of data management initiatives. Through an effectively communicated shared vision and commitment to collaboration and change, both at the top of the organization and through its ranks, information can be shared and leveraged across multiple business units, functions, and geographies.

For insurers anxious about initiating a strategy to improve information fluency, one option may be to delve into the project in multiple stages — dividing implementation of the overall data management strategy into short-, medium-, and long-term objectives with definitive milestones.

The potential payoff for such an investment is significant: improved market competitiveness, enhanced customer relations, more responsive and reliable compliance reporting, more insightful enterprise risk management and decision-making, as well as enhanced business growth and a better bottom line.

Overcoming regulatory challenges

Insurers should prepare for some major changes, as well as continuing uncertainty on key issues



While uncertainty has been the norm when it comes to assessing the regulatory outlook for P&C insurers, this particular crystal ball is becoming slightly less cloudy, at least as a directional prognosticator.

One major concern for many US insurers — whether there should be group capital standards — has been resolved, and not in favor of the status quo in this country. US regulation is legal entity-based, so industry officials and domestic regulators are both voicing opposition to group capital standards. However, as group capital regulation gains currency internationally, US insurers operating in other jurisdictions will have to comply with group capital requirements. US regulators and industry groups are working to develop standards suitable for the US market that may help provide a safe harbor for domestic insurers.

Still, carriers should be prepared to roll with the punches on a variety of potentially critical issues as state, federal, and international regulators continue to jockey for position and debate which rules the industry must follow. Take, for example, the expiration at year's end of the federal terrorism reinsurance facility, forcing insurers to scramble to reexamine coverage terms and conditions in a wide variety of policies. Fortunately for insurers and buyers alike, the new Congress passed an extension of the enabling legislation as one of the first orders of business in 2015, restoring certainty to the terrorism insurance market.

producer trade groups, have long lobbied for the passage of NARAB II, presenting it as a measure that would aid consumers by making it less costly and easier for agents to be licensed and thus compete across state lines. The new law could make carrier relations with producers much more dynamic in the year ahead by prompting more agents to serve consumers in multiple states.

Meanwhile, on a number of regulatory fronts, insurers will be called upon to implement significant changes in compliance for 2015.

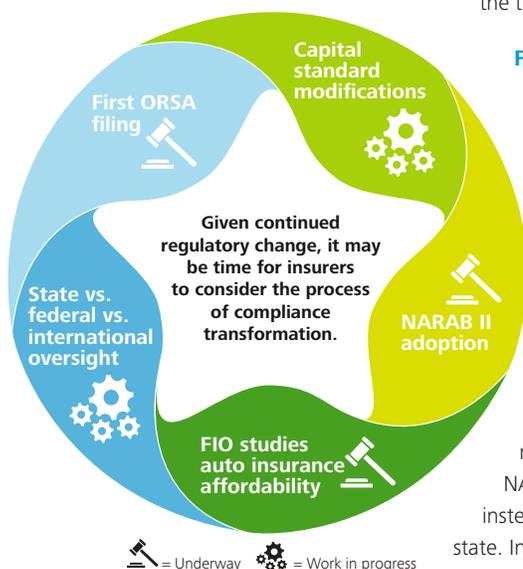
For one, this will be the year for the first Own Risk and Solvency Assessment (ORSA) filing. ORSA reflects the new wave of insurance regulation, in which static examinations conducted every five years are replaced by an ongoing dialogue between regulators and the regulated, engineered on a framework of real-time, in-depth, customized, relevant information.

Capital, while more obviously a concern for life insurers, may increase in importance for P&C companies as well. For example, a National Association of Insurance Commissioners (NAIC) committee meeting has presented a framework for a US group capital standard using two possible constructs, one of which — cash-flow testing — would involve a significant departure from current P&C practices and probably additional costs. At least one proposal made to an earlier NAIC working group meeting suggested a risk-based capital (RBC) calibration at a 99.5 percent confidence level for a year. If group RBC were to be calibrated at a one-in-200-year Value at Risk level for groups, why not for all insurers?

The few carriers designated as a global systemically important insurer will be the first directly affected by the upcoming wave of capital standards, with the Basic Capital Requirement adopted by the International Association of Insurance Supervisors (IAIS) in October. Work is likely to accelerate in 2015 on other capital standards, including those on Internationally Active Insurance Groups.

Current RBC modifications continue. There's a good chance the R6 and R7 catastrophe risk components of the RBC charge will be tweaked throughout the year as this change moves forward.

Figure 4: P&C regulatory hot spots



Focus for 2015

The law Congress passed to extend federal terrorism coverage also created a national clearinghouse to allow for reciprocal nonresident producer licensing called the National Association of Registered Agents and Brokers, commonly known as NARAB II. Producers licensed in their home state will now be allowed to apply through NARAB for licenses in other states, instead of having to apply state by state. Industry representatives, especially

The P&C industry may also face new challenges in terms of federal oversight. In its September 2014 annual report on insurance, the FIO highlighted two topics of particular interest. The FIO's mandated examination of the affordability and availability of auto insurance in designated communities is ongoing. The agency also focused on the use of marital status as an underwriting and rating factor, especially with regard to uninsured motorist coverage and title insurance in the remaining states where same-sex marriage is not recognized.

One positive for the industry is the dismissal by a federal court of a "disparate impact" lawsuit, which might have limited the use of certain risk factors — however valid actuarially they might be — if their impact on protected classes was disproportionate.

While the regulatory focus has been on captives owned by life insurance companies, the Internal Revenue Service (IRS) has also increased its scrutiny of microcaptives — small P&C insurers formed under Section 831(b) of the tax code that may offer some federal tax advantages. But captives must exist primarily for insurance, not tax purposes, and being properly structured may mean the difference between a microcaptive being treated as an insurance vehicle or as a tax shelter for tax purposes.

Affiliated captives are also targeted on a federal level with H.R.2054. Rep. Richard Neal, D-Mass., the bill's sponsor and ranking member of the House Ways and Means Select Revenue Subcommittee, said his proposal "effectively defers any deduction for premiums paid to foreign-affiliated insurance companies if the premium is not subject to US tax." The legislation is aimed at affiliated reinsurers operating in jurisdictions such as Bermuda and the Cayman Islands.

The bottom line

The pace of regulatory evolution is unlikely to slacken soon, so it may be time for insurers to consider the process of compliance transformation. This may include enterprise-wide aggregation of core regulatory change activities, the creation of a coordinated response for foreseeable regulations, and the utilization of scenario planning techniques for the unknowns, along with the formation of rapid response teams. Such a revision may help the ongoing process of planning for change, and create value from mandatory regulatory exercises.

In addition, the compliance bar will likely continue to be raised as state, federal, and international regulators battle for supremacy in terms of which standards and regimes must be followed. Even if certain companies aren't technically subject to new regulations at first, they may very well eventually get swept up in having to meet these higher standards.

In any case, carriers should expect ongoing regulatory uncertainty as the various regulatory authorities jockey for position and debate whose set of rules the industry must ultimately follow.

Upgrading capital management

Insurers look to integrate internal, external capital frameworks for more effective decision-making



Capitalization of the P&C insurance industry continues to trend higher, breaking records with each quarterly consolidated results report. Accumulation is being driven by a combination of rising prices for coverage, economic growth spurring an expansion in insurable exposures, and relatively modest disaster losses in the past few years. As a result, industry-wide policyholder surplus has risen by nearly 20 percent over the past two years alone, reaching \$671.6 billion as of June 30, 2014.⁵

Overall capacity is also being enhanced by an influx of new capital flowing in from a variety of alternative market sources. For example, hedge funds have been launching reinsurers. In addition, institutional and individual investors are buying catastrophe bonds in droves, seeking non-correlated risks for portfolio diversification as well as the potential for higher returns than most fixed income securities offer in this low interest rate environment. The result has been an excess of capital, particularly in property-catastrophe reinsurance, which has increased pressure on insurers struggling to maintain, let alone generate, a higher return on equity (ROE).

In a bid to maximize returns and better assess the potential offered by various businesses, many insurers have developed some form of internal framework based on the economic capital approach, defined by in-house assessments of the amount of capital needed to sufficiently cover all major business risks. These range from primary factors such as insurance, market, operational, and liquidity risks (which are more quantifiable and can be mitigated to a certain extent) to secondary factors such as strategic, modeling, and reputational risks (which are less quantifiable and generally considered more difficult to mitigate).

However, insurers have often tended to use internal capital frameworks on a limited basis, such as allocating capital notionally to business units for the purpose of performance benchmarks, rather than utilizing them for day-to-day operational decision-making, potentially causing disconnects with pricing and risk management functions and limiting their efficacy.

In addition to managing capital utilization internally, insurers also have to be constantly cognizant of external capital frameworks mandated by regulators and those advocated by rating agencies. Regulators have imposed a variety of statutory capital requirements on carriers designed to protect consumer interests under different scenarios. Likewise, rating agencies as well as analysts tracking listed insurance companies use proprietary capital models to evaluate an insurer's financial strength and stability, along with their preparedness to withstand varied stress situations.

Several regulatory enhancements — including the NAIC's Own Risk and Solvency Assessment, the federal systemically important financial institution designation, state enterprise risk management standards, and continuing influence from international developments such as Solvency II and IAIS's global capital standards — are pushing carriers to embrace a more rigorous and holistic process. This includes the formal approval of annual capital sources, stress testing, formalizing risk appetite, and risk tolerance statements, as well as robust reporting tied to risk-adjusted capital.

Rating agency capital frameworks have also undergone changes, with an increasing trend of agencies viewing capital on a "look-through" basis that does not give as much credit for on- or off-shore captive/reinsurance solutions or structures in their assessment of capital adequacy.

⁵ Industry-wide figures compiled by ISO (a Verisk Analytics company) and the Property Casualty Insurers Association of America.

Such changes in external capital standards are prompting insurers to embrace processes that enhance collaboration among capital management and associated functions, while also pushing them to reassess the way they incorporate external frameworks in their operations.

As investment yields continue to languish in this low interest rate environment, P&C insurers have had to review the return potential and pricing of many of their products, especially for longer tail lines such as workers' compensation and environmental liability that present unique reserving and capital challenges, underscoring the need for carriers to reexamine their capital management approach.

Finally, advancements in technology — ranging from analytics to modeling to information management — have made projection of capital requirements and understanding of the intersection of different capital frameworks more manageable and efficient.

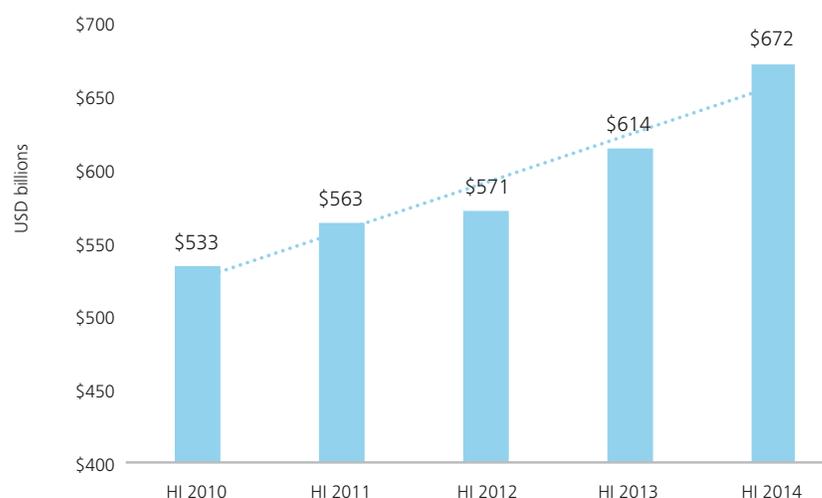
These converging factors spotlight the need for a more robust internal risk-adjusted capital framework that incorporates different approaches, including economic, accounting, and regulatory capital management, while at the same time providing clarity to other functions within the company on how capital is deployed and measured.

Focus for 2015

A growing number of insurers are likely to follow the lead of other institutions in the financial services industry, such as banks, by implementing an internal risk-adjusted capital adequacy framework that accounts for economic as well as regulatory factors under one integrated capital management system.

Having a combined view of capital should enable insurers to conduct a thorough bottom-up analysis of their risks by product line and risk type, and apply the approach that is most meaningful for mitigating the particular exposures to each, leading to greater transparency and consistency in pricing and underwriting.

Figure 5: P&C industry surplus keeps rising



Source: Industry-wide figures compiled by ISO (a Verisk Analytics business) and the Property Casualty Insurers Association of America

At the same time, an integrated framework allows those in capital management — both directly and indirectly through related functions such as pricing and asset liability management (ALM) — to better collaborate with other core functions including actuarial, corporate planning, and investment management, with a clearer appreciation of the impact their individual strategies might have on one another.

Such a strategy should also help insurers to better understand the capital consumed by different business units at a more granular level. This would enhance the return on risk-adjusted capital assessment by insurers, allowing them to more effectively differentiate among businesses that generate high levels of absolute profits but consume more than a commensurate capital requirement, and those that seemingly deliver low gross profits but can provide higher risk-adjusted returns.

The strengthening of such capabilities should help carriers better assess the effect of product design as well as pricing on enterprise risks and the capital required to back them under different scenarios. This should also facilitate the engineering of products that are better aligned with the strategy that articulates how the firm balances policyholder capital needs with ROE targets.

In addition, companies that are looking to commit capital to large initiatives such as mergers and acquisitions, technology investments, distributions deals, product or geographic expansion, or similar significant moves should be able to make more informed decisions based on this approach.

Implementing an integrated capital framework would require a multipronged effort, including improved information management and advanced analytics, more holistic capital management processes, and a governance mechanism that enables a more granular, real-time assessment of capital deployed.

Carriers should also take a fresh look at how to better integrate capital and risk management with their particular operating model and strategic decision-making process.

The bottom line

Driven by regulatory pressures, institutions in the banking sector are ahead of many insurers in terms of creating sophisticated capital models that allow them to analyze risk-adjusted returns at a granular level and effectively utilize such data in making operational and strategic decisions. But many insurers are looking to rectify that by adopting a similarly holistic approach to capital management.

Insurers that invest in a more integrated internal capital framework, in conjunction with an enabling mechanism that effectively brings together people, process, technology, and governance, can expect greater clarity for internal as well as external stakeholders.

Internally, product development, treasury, investments, ALM, and other related functions can operate more effectively with a clearer articulation of how capital is viewed and optimized. Externally, the differences among various accounting and capital bases can be more effectively explained, with the firm's own view and objectives — rather than external benchmarks — driving stakeholder communications.

Such an integrated capital management framework could form a strong base for meeting the increasing demands of a variety of stakeholders for more robust stress testing and scenario planning, while facilitating more accurate long-term executive decisions and enhancing product pricing, reinsurance strategies, and other day-to-day operational business decisions.

Getting ahead of climate change

Rising weather exposures offer opportunities for insurers to innovate with risk management, new products



The causes, pace, and repercussions of climate change may remain controversial for some, scientifically and politically. However, since it is often insurers that have to pay for damages from weather-related catastrophes, the industry is by definition on the front lines when it comes to financing the rising cost of cleanup and recovery efforts. Climate exposures have the potential to impact a wide range of carriers, including insurers of homes, businesses, and vehicles.

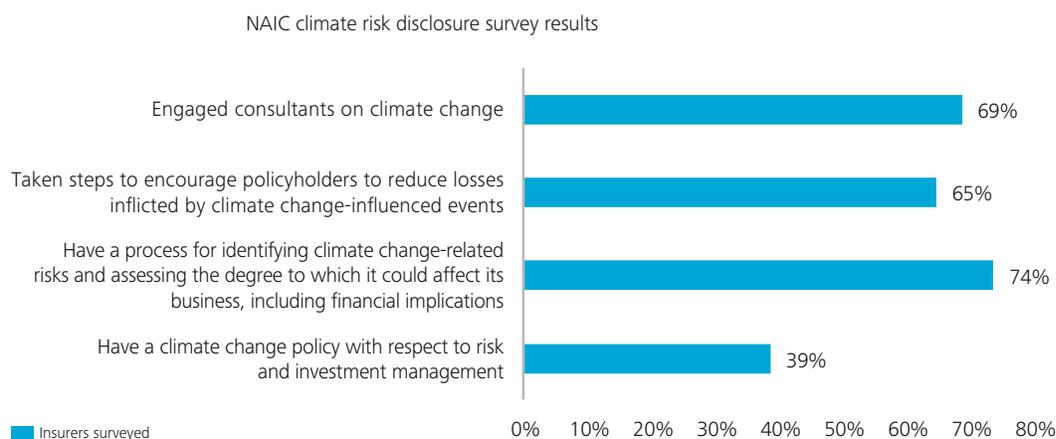
While US insurers have been at the forefront in terms of advocating stronger building codes, updated flood mapping, and more hazard-sensitive zoning laws for property development, up until recently they have tended to take a far lower profile than a number of their European counterparts in efforts to limit global warming at its source by increasing sustainability and limiting carbon emissions. A recent report from Ceres, a nonprofit organization advocating for sustainability leadership, accused the insurance industry of generally being out of touch with climate change issues, based on a survey of 330 carriers.⁶

The industry was quick to defend its response to the implications of climate change, noting its longstanding efforts to identify and quantify the phenomenon's potential fallout in terms of the frequency, severity, and location of disasters involving high winds, flooding, wildfires, and drought.

A number of insurers have also looked to capitalize on and support sustainability efforts by issuing new types of "green" insurance products that facilitate construction of more environmentally friendly buildings and retrofitting to upgrade existing facilities.

Still, pressure on the industry to deal more comprehensively with climate change risks is likely to rise due to new demands from regulators and rating agencies. The National Association of Insurance Commissioners, for example, has a Climate Change and Global Warming Working Group in place to investigate the possible effect of weather pattern changes on insurer catastrophe modeling and investment portfolios, among other oversight tasks.

Figure 6: What are insurers doing about climate change?



Source: California Department of Insurance, based on 2013 risk disclosure data on climate change collected in five states for National Association of Insurance Commissioners (California, Connecticut, Minnesota, New York, and Washington).

⁶ Arthur D. Postal, "Insurers Still Don't 'Get' Climate Change," National Underwriter/PropertyCasualty360, October 30, 2014.

However, some insurers have also been assuming a higher profile on their own initiative. Indeed, the International Insurance Society devoted an entire day of its 2014 annual seminar to co-host a United Nations Financial and Private Sector Disaster Resilience Global Summit. In addition, a number of actuarial groups have joined forces to develop an Actuaries Climate Change Index. The benchmark is designed to help insurers and policyholders better assess climate-related exposures, while prompting more proactive risk management.

Meanwhile, five P&C associations recently issued a joint statement that emphasizes their commitment to working with the federal and state governments to promote risk mitigation and resilience against the potential for increasingly extreme weather events.⁷

Focus for 2015

Industry efforts to quantify and limit the impact of climate change will likely proliferate over the next few years. Carriers can expect heightened scrutiny and more data calls from overseers evaluating how the phenomenon is being accounted for in underwriting and pricing models, reserving decisions, investment policies, and business continuity planning. These considerations could fit neatly into broader enterprise risk management transformations.

Beyond any mandatory compliance responsibilities and costs, the possibility of increased frequency and severity of climate-related disaster losses should motivate insurers to voluntarily expand their research efforts into how climate change may be disrupting the communities they serve, as well as affecting their bottom lines. Carriers will likely need additional capabilities and skill sets to get a better handle on weather trends. One can imagine climatologists becoming valuable members of an insurance company's modeling team and underwriting department as carriers look to become more adept in pricing climate-change-related exposures.

Another major opportunity may be greater privatization of the flood insurance market. Given the growing number of exposed areas and the relatively low take-up rate on federally insured policies, this underserved market potentially represents the largest single growth opportunity in the property-casualty industry today — but only if carriers are able (and permitted to) assess the exposure with a high degree of confidence and charge actuarially-sound rates.

The bottom line

Climate change is not a new topic of conversation, particularly in international insurance company circles. Indeed, European insurers have been outspoken about how the industry might help mitigate this risk for quite some time. However, US insurers have been comparatively quiet on the front end of this issue. That's likely to change.

Carriers should expect mounting pressure — from regulators, rating agencies, federal and local lawmakers, media, and the general public — to help fill the void in getting a better handle on exactly what the risks of climate change are, how to better predict their consequences, and what might be done to limit exposure and losses. Some may choose to launch their own initiatives, while others could contribute through industry-wide efforts already underway or yet to come.

Beyond risk management, however, insurers should be able to seize an opportunity around product innovation, perhaps even building a brand that resonates with sustainability-conscious consumers and businesses.

⁷ Mark A. Hofmann, "Property/Casualty Groups Stress Resilience to Extreme Weather: Statement," *Business Insurance*, September 23, 2014.

Next steps

Where do insurers go from here?



There's much that's beyond the control of P&C insurers that nevertheless has a major impact on their top and bottom lines, such as the growth rate of the economy, or the direction of stock and bond markets. Carriers should always be prepared to make midcourse corrections in their operating and investment strategies to compensate.



The emphasis in this outlook, however, is for insurers to focus on bigger picture elements that are very much in the control of their leadership team and which will likely affect their ability to remain competitive over the long haul, regardless of market conditions. Addressing these issues will likely put them in a much stronger position to adapt to ongoing changes in the economy, their individual markets, and consumer preferences.



Take data management. Insurers already have a veritable treasure trove of information at their disposal and rich deposits of raw material to mine from emerging as well as untapped sources. Yet unless they initiate a comprehensive effort to widen access to data across their organization and put the analytical tools and talent in place to make sense of it, much of the information may be like crude oil, its inherent value unrealized because it cannot be refined effectively.

The same goes for capital management. Without a cohesive game plan and operating model in place to better integrate finance with risk management and business planning, carriers might be hard pressed to get the best return from the dollars that ultimately fuel their strategies to grow revenue and profitability.



Even in areas that might appear to be outside an insurer's control — such as the regulations that govern them, or the ultimate wild card, that being the weather — proactive carriers can better position themselves to adapt more quickly and be more innovative to turn threats into opportunities.

Indeed, insurers should be adopting more of a strategic risk management approach to deal with potentially disruptive trends and marketplace shifts. Unlike traditional risks, which are avoided at best or contained at worst, strategic risks could actually have big upside potential. If anticipated early enough, a nimble insurer can flip such risks into strategic opportunities, giving early adapters at least a temporary competitive edge.

Those that can respond quickly and proactively to strategic risks are less likely to be disrupted, let alone displaced. They should be better able to alter business models, adjust internal processes, upgrade technology infrastructure, and reconstitute distribution systems to benefit from evolutionary and even revolutionary changes reshaping the business.

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