THE BOSTON CONSULTING GROUP

Collateral Damage: Industry Focus

Actions for Insurers amid the Global Financial Crisis

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In the first two installments of The Boston Consulting Group's Collateral Damage series, we explained the roots of the current global financial crisis, analyzed the impact of recent government interventions, explored the challenges that companies in virtually all industries face, and suggested robust actions that companies should take in order to respond to those challenges and emerge from the crisis as stronger institutions.

In this paper, one of a parallel series of sector-specific outlooks, we analyze the impact of the financial crisis on the insurance industry, addressing the actions that insurance companies must take not only to survive the crisis but to leverage it to their advantage in the long term.

1. Introduction

In our previous papers, we described how the week of September 15, 2008, marked the end of the United States' post-Depression-era financial system.[1] Indeed, the collapse of Bear Stearns in March turned out to be just an early warning. What followed, by mid-October, was a full-scale rout, not just of Wall Street but also of major institutions all over the United States and Europe. Beyond the uncertainties facing banks, there continues to be mounting concern about the so-called shadow banking system: hedge funds, private-equity funds, and other alternative investment vehicles. What began as a leverage crisis and a credit crunch has turned into a full-blown insolvency problem for companies in all regions and industrial sectors.

Moreover, we must reiterate that the true problem for banks is the deteriorating left side of their balance sheets, representing overleveraged consumers and corporations. As we have observed, the credit crunch is taking place against the backdrop of an enormous long-term increase in consumer indebtedness not only in the United States but in European countries—such as the United Kingdom and Spain—as well. Consumers overburdened with debt and suffering from declining home and investment values have no capacity to borrow. Even those fortunate enough to have maintained some borrowing ability will be less likely to take the risk amid looming job insecurity and deflating asset prices. Bank lending to businesses will be equally challenging, because companies facing lower demand will also be less inclined to borrow. The various government intervention programs that we have previously described may be helping to stabilize banks, but they are not stabilizing the real economy.

2. The Challenge for the Insurance Industry

The financial crisis affects the insurance industry in two ways: in the short term, largely through high pressure on the asset side of the balance sheet; and in the long term, through the damaging effects of the expected prolonged economic downturn.

A. The Short Term: Immediate Effects of the Financial Crisis

The financial crisis has sent stock markets tumbling. The Dow Jones Stoxx Global 1800 Index has declined by 46 percent in 2008 through November 25. We have witnessed significant losses in most asset classes, and there have been substantial write-offs related to equities, real estate, bonds, alternative investments, and derivatives. Direct effects from the credit crunch so far add up to more than $700 billion for banks and more than $150 billion for insurers. Moreover, higher volatility and concerns about the stability of financial counterparties have rendered hedging more difficult and significantly more expensive. The

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reactions of governments and investors have led to extremely low risk-free interest rates. For instance, the yield on the ten-year U.S. Treasury bond fell from 5.0 percent on June 30, 2007, to 3.1 percent on November 25, 2008. Risk premiums for bonds have returned to levels not seen since the dot-com crisis. Spreads for B-rated U.S. Composite bonds reached 1,160 basis points on November 25, 2008, having more than doubled from 512 basis points on December 31, 2007. During the dot-com crisis, spreads for B-rated U.S. Composite bonds rose to a maximum of 710 basis points.

The effects of the crisis are being felt not only on the asset side of the balance sheet but also in asset inflows. Volatile equity markets and the perceived instability of the global financial system have led consumers to seek safe havens for their deposits. Money has been moving to conservative products—especially short-term deposits—and to financial institutions known for conservative styles.

In addition, the volume of write-offs combined with the outlook for lower profitability has led to disproportionately high losses for insurance stocks. Indeed, the overall market capitalization of the insurance sector has been more than halved since the crisis first reared its head. The Dow Jones Stoxx Insurance Index fell by 57 percent between December 31, 2007, and November 25, 2008. These effects have hit individual insurers to varying degrees. Most institutions were at least partly hedged against market losses, and many write-offs stemmed from dealings with financial counterparties that were in serious difficulty, such as AIG and Lehman Brothers.

Nonetheless, the risk-taking capacity and embedded value of life insurers are suffering from the bleak interest-rate outlook. Low spreads between guarantees and returns from assets, coupled with increased hedging costs, are undermining the core profitability of the life insurance business. In addition, investors dislike the unattractive cash-flow profile associated with high up-front commissions financed by insurers.

B. The Long Term: Ongoing Effects of the Expected Economic Downturn

Previous crises and recessions provide an indicator of the reactions of policyholders, and we foresee no significant changes in behavior from the patterns of the past. This expectation is supported by current data from the United States and Europe, where we are seeing trends similar to those that occurred during the dot-com crisis, with unit-linked life products and variable annuities declining and classic life insurance products taking over. That said, we believe that the long-term effects of the present crisis will differ between life and non-life businesses and between mature and emerging markets.

Life Business in Mature Markets

Overall, in terms of premiums, we expect relatively stable life insurance business in mature markets, albeit with a measurably lower level of new business, a shift in product mix, and dramatically lower profitability. More specifically:

- Lower spending capacity and low equity returns will lead to a decline in new business for all long-term investments, including life products
- Cancellation rates of contracts have increased in past crises and will likely do the same in the present one, but not dramatically
- There will be a marked shift from equity-linked products (such as unit-linked and variable annuities) to traditional products with guaranteed benefits
- The low-interest environment and the high cost of hedging in volatile markets—hedging costs for variable annuities have topped 300 basis points in the United States in some cases—will lead to very low profitability for legacy business and increase the challenge of coming up with attractive products
- The relative attractiveness of life business for investors will shrink as its risks become more apparent and chances for profits evaporate

Life Business in Emerging Markets

The long-term effect of the crisis on the life insurance business in emerging markets will depend largely on the region. So far, Asia has been less affected than Eastern Europe or Latin America. In addition, the overall nature of the reaction has been similar to that of mature markets, although we expect a more dramatic degree of change in emerging economies going forward. For example:

- Spending capacity will be affected more sharply in emerging markets because social safety nets are less secure. This will lead to more significant reductions of new business and to higher cancellation rates—despite built-in incentives not to cancel.
- With respect to the product mix, many customers will likely cancel the savings elements of their life products and keep only the risk-protection elements.

We have seen such developments in countries such as Mexico, Indonesia, South Korea, and Thailand during previous economic upheavals. For example, during the Asian financial crisis of the late 1990s, household purchasing power declined in many markets, and so did insurance premiums. In Thailand, in 1998, non-life premiums declined by more than 15 percent (although they recovered quickly thereafter). And life insurers suffered not only from declining new business (a slide of 29 percent) but also from a threefold rise in contract cancellations. A similar pattern was seen in Indonesia, where new life business fell by 12.6 percent in 1998. Cancellation rates rose from 2.6 percent in 1997 to 12.8 percent in 1999. Life contracts with a savings component were hit hard, whereas contracts with risk coverage became more popular.

Non-Life Business in Mature Markets

The loss of underwriting capacity resulting mainly from write-offs and low asset returns is likely to induce non-life insurers to increase prices in order to replenish capacity and stabilize earnings. Lower sales of new cars and new houses have also hurt insurers and changed the mix of underwritten risks. But the number of policies should not decline significantly. Indeed, if the experience of past crises is any indication, many soft markets (across all regions) are likely to end on the next round of renewals. The overall size of the market may even become larger, as price effects could outweigh mix effects. But price increases will not succeed if customers are willing to switch to cheaper distribution routes—such as direct channels—or if competitors act strategically to prompt a shakeout of weaker companies.

Apart from these effects, significant increases in claims ratios are not expected. Many insurers already handle claims processes and fraud detection in a way that results in low growth rates for successful claims. In addition, an increase in inflation above currently forecasted levels in mature markets is unlikely given the current economic outlook. On the other hand, deflation is likely to improve profitability as it drives down claims. Still, insurers in most developed markets will experience significant cost pressure from the heightened competitive climate.

Non-Life Business in Emerging Markets

The effects of the economic downturn on the non-life business in emerging markets is likely to be driven by changing foreign-exchange rates, rising inflation, and an increasing overall poverty level. More specifically:

- Dwindling currency values in relation to the U.S. dollar, the euro, and the yen will hit insurers directly as the costs of parts and materials for motor and property claims increase. In addition, rising inflation rates will increase nominal claims expenditures.
- The frequency of claims is likely to increase significantly in line with rising levels of poverty in some emerging markets.

Ultimately, higher claims ratios will lead to higher price levels as insurers try to recover. Also, in marked contrast to mature markets, customers in emerging markets are more likely to adapt their coverage of risks, especially for private lines. During past crises, consumers canceled policies or reduced coverage, while commercial insurance lines remained stable because banks mandated coverage in return for providing loans.

C. Planning for Action

In our view, insurers must take three core actions to not only survive the financial crisis but emerge from it as leading, optimally positioned institutions.

1. Protect financial fundamentals. Deal immediately with the direct effects of the crisis: ensure sufficient liquidity and solvency, review your risk profile (and avoid more risk than you can take), and avoid being perceived by the market as financially unstable.

2. Protect existing businesses. Prepare for the worst, because the downturn is likely to be long and steep. Develop countermeasures based on downside scenario planning. Reduce costs and make your entire cost structure more variable. Most important, act quickly and decisively now—a wait-and-see approach is no longer viable.

3. Manage for the long term. Define your company's long-term aspirations. Why should you just defend your position when you might be able to attack weaker competitors to build momentum for the future? Since the rules of the game can be changed, try changing them to your advantage by positioning your business to thrive in the upturn. Finally, consider increasing your focus on potential M&A activity.

3. The Path Ahead for Life Insurance

When markets first began to feel the effects of the crisis, challenges materialized more slowly for insurance companies than for banks because business models for insurers make liquidity tightness less likely. Where such tightness did occur, most notably at AIG, the problems were related to credit insurance (resulting from increasing defaults in guaranteed mortgages in the United States) and to credit derivatives (involving margin calls), not to traditional life or non-life business.

Nevertheless, life insurers eventually began to face—and will continue to grapple with—massive write-offs and significantly higher hedging costs. These dynamics combined with extremely low risk-free returns have made it much more difficult to manage a life insurance business profitably—or at least to earn sufficient returns to cover legacy guarantees. Risks for shareholders have increased significantly, and the perception of life businesses for investors has changed.

The crisis and its collateral damage will also continue to curb new business linked to stock markets, such as unit-linked and variable annuities. Obviously, a big opportunity exists to push traditional guaranteed products, but life insurers will have to determine whether current conditions offer acceptable risk/return profiles. Moreover, in most countries, banks are the most important sales channel for life insurance. Many banks will try to push deposits onto their own balance sheets as long as their liquidity situation remains difficult. Clearly, in order to sell new business—indeed, in order to survive the crisis—life insurers will have to develop compelling offers.

In order to **protect financial fundamentals,** life insurers will need to ensure optimal liquidity management and asset allocation. Liquidity management should focus both on avoiding margin calls (on the financial side) and on avoiding mass policy cancellations (on the business side). In addition, to ensure overall solvency, insurers must take the following actions:

- Review asset management strategies with the goal of achieving sufficient returns at acceptable risk levels
- Enhance risk management to better monitor counterparty risks
- Analyze existing portfolios to find ways to free capital through runoff or divestiture of noncore activities or divisions

Moreover, life insurers must maintain a strong balance sheet. They should signal strength to the market by paying out dividends, provided they can afford to. Communications to customers and shareholders—particularly on the subject of financial stability—should be carefully crafted. Indeed, silence may be the best option if no relevant rumors or news surfaces. But insurers need to prepare in advance for any possible negative publicity and act fast if it happens.

In order to **protect existing businesses,** life insurers must first act to increase customer retention. Sales force initiatives can be launched both to reassure customers and to counter competitors. In addition, products must be made more flexible to support the sales force. Possibilities include short-term offerings that are similar to cash accounts, as well as alternatives to cancellation (such as policy-based loans to fill a customer cash-flow shortage, temporary dormancy of contracts, and mortgages linked to policies). The strength of guaranteed products (compared with similar banking products) should be aggressively marketed, while the level of marketing spending should at the same time be reexamined.

Life insurers should also review distribution costs and consider options for lowering intermediary compensation and up-front payments. Channel mixes should be rigorously studied, and relatively cost-efficient alternatives such as direct selling (especially for risk products) explored. Structural costs should be trimmed to help balance lower asset returns. Insurers must also make every effort to identify and retain key personnel, because the circulation of human resources will certainly speed up amid the crisis as various companies seek talent that competitors have cut for economic reasons.

Finally, in order to **manage for the long term,** life insurers must sharply redefine their core business and consider changing their landscape if possible—by, for example, stretching their capabilities with respect to products and regions. The primary focus should be an opportunistic one, concentrated on areas where competitors have been hit hardest. The overall strategic position in core businesses should be reviewed, and options to improve it identified and implemented. Buying weakened competitors, if they can be acquired relatively cheaply, may be a viable move both for self-protection and for future growth.

Of course, the current crisis affects different aspects of the life insurance business in different ways. Your organization must be sufficiently agile to answer various challenges in a highly targeted manner.

4. The Path Ahead for Non–Life Insurance

Overall, non-life insurers should be less affected by the financial crisis than life insurers. Non-life balance sheets usually have higher equity ratios, resulting in higher risk-taking capacity. Non-life companies generally have a lower level of assets to invest and can balance relatively modest asset returns with technical results.

Nonetheless, in many countries, soft markets combined with low risk-free returns are forcing non-life insurers to rely more heavily on asset returns. As a result, many non-life companies have invested more aggressively than life companies in search of better returns. Yet the frequent write-offs that can result from an ambitious investment policy strongly influence available risk-taking capacity going forward. Roughly speaking, a 1 percent decrease in risk capital can lower the capacity to write premiums by 4 to 5 percent.[2] Amid the current crisis, capacity has already declined among non-life insurers in all regions—albeit to differing degrees depending on each company's asset allocation profile when the storm first hit.

Premium increases are likely unless non-life companies act strategically to provoke an industry shakeout or steer their channel mixes more toward direct sales (including online). Indeed, asset returns are likely to remain low unless high risk is taken, and the relative attractiveness of various markets will change. In addition, non-life companies will likely have to cope with increased reinsurance costs.

2. This assumes no overcapitalization and a Solvency I requirement of 18 percent of premiums.

In order to **protect financial fundamentals,** non-life companies must closely monitor counterparty risk and spread it sufficiently. Their main source of liquidity risk is large claims, for which they usually have arrangements with banks and reinsurers to secure additional liquidity. Yet the viability of these agreements depends, of course, on the ability of counterparties to pay. With respect to solvency and financial policy, non-life insurers need to review their reinsurance accords and balance higher reinsurance prices with the higher cost of their own solvency capital.

In order to **protect existing businesses,** non-life companies must allocate available capacity more prudently. The cost and relative attractiveness of different products and regions have changed. Non-life insurers also need to review their portfolios—carefully considering the strategic relevance of all offerings—as well as adjust price levels and consider divestments or runoff in order to free capacity for the most attractive parts of their business. Underwriting capacity should be focused on distribution channels that are strategically important and not self-controlled (such as brokers in some countries). Such channels require continuous efforts if a strong position is to be built and maintained.

Since low asset returns require strong technical results, non-life insurers must also further reduce operational costs and improve claims management (including fraud detection). The current crisis offers the opportunity to convince stakeholders that decisive action is necessary. And as with life businesses, it is critical to retain your best talent.

Finally, non-life companies should **manage for the long term** in the same fashion as do life companies.

5. Moving Forward Boldly

BCG has developed an eight-week, three-phase framework through which insurers can diagnose the nature of their market position and preparedness for change; develop a rigorous plan of action; and take action. (See the exhibit "From Diagnosis to Action in Eight Weeks.")

The initial phase involves developing a deep understanding of all possible market scenarios and how they might affect your company given the countries and regions in which you are active, your specific strengths

From Diagnosis to Action in Eight Weeks

1 Diagnose preparedness (~ 3 weeks)

Check understanding of the full range of downturn scenarios—including the most damaging set of circumstances
- Changing demand patterns
- Impact of further asset meltdowns
- Hardening reinsurance markets
- Inflation

Check results of available stress-test scenarios on financial outcomes
- Solvency and liquidity
- Return on assets
- Technical results
- Quick assessment relative to key competitors (financial ratios and metrics)

Identify priority levers to cope with identified challenges

Agree with management where to act first on the basis of early identification of quick wins/ "no regrets" actions

2 Develop action plan (~ 3 weeks)

1. Protect financial fundamentals
- Ensure adequate liquidity
- Ensure adequate solvency

2. Protect the existing business
- Review portfolio
- Improve cost and efficiency
- Optimize pricing
- Review risk selection
- Adapt distribution channels

3. Manage for the long term
- Prioritize long-term investments
- Check opportunistic M&A
- Adapt channels and products

Roll out quick wins/"no regrets" actions and optimize relative valuation (including marketing and internal messaging)

3 Take action (~ 2 weeks)

Prioritize areas for action
- Urgency and ease of implementation
- Timing of benefits
- Risk to long-term business fundamentals

Resolve outstanding issues for final prioritization

Create a crisis monitoring team to lead the work and continually evaluate initiatives and response

Align on action plan and execute

Ensure that company leadership is clear on its role and what is required
- Create rapid decision loops

Company leadership team needs to be clear on its role and on required actions and decisions

and weaknesses, and your capacity for meaningful change. The second phase entails planning in detail how you would approach the three necessary core actions that we have described in this paper: protecting financial fundamentals, protecting existing businesses, and managing for the long term. The third phase involves prioritizing areas for immediate action, creating a crisis monitoring team to lead all initiatives (and continually evaluate their progress), and executing your overall plan—always seeking quick wins, "no regrets" actions, consistent internal and external communications, and true leadership from the CEO, senior executives, and crisis team.

As the current financial crisis runs its course, only insurers that move forward boldly—seeking to gain market share and competitive edge over slower-moving rivals—will emerge as true industry leaders. Ultimately, we remain convinced that all insurers can largely control their own destinies by determining which type of company they aspire to be.

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