The growth issue

My five most courageous decisions

Meeting the challenge of change — what’s next for specialty insurers looking to achieve growth?

Tax leakage: more than a drop in the ocean

SST versus Solvency II — shining a spotlight on how Swiss companies are working successfully

Taking a closer look at the latest flurry of transactions in the London market
In spring 2012, we published our final London and Bermuda journal, our main insight for the specialty (re)insurance markets. While this new publication replaces it, we maintain many of the things that worked well. Indeed, you will notice great similarities between these publications as we present our point of view on the most pressing issues facing this industry and its key players. However, we’ve changed our focus slightly to reflect the increasingly global nature of specialty (re)insurance: companies face common issues regardless of their location and there is little certainty around how the industry will look in five years.

As advisors to this market segment, we continue to help organizations make sense of this rapidly evolving environment and to support our clients whatever the future may hold. We’ve formed a new integrated specialty team with members who work closely together across the world to serve this market better. We recognize that a more global approach is required to provide truly world-class services.

We hope the articles in this publication provide you with some helpful insights.
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Clients often ask me, “How can I grow my business in a sustained soft market?” As I travel around many of the specialty locations, I hear this more and more, particularly as new capital and price competition further exacerbate the cycle.

The tragic events of tropical storm Sandy, which caused so much death and destruction in the Caribbean and Northeast seaboard, highlight the key role insurance plays in paying claims to help neighborhoods, families and businesses get back to normal. However, although some market participants expect staggering losses of US$20b and beyond, this does not appear to be significant enough to cause hardening of the market and a spur to growth.

There are many differing views on the ways to achieve growth in these market conditions; however, most CEOs I speak with predict several common avenues. As you will read, expansion to Asian markets remains a strong opportunity: Hong Kong and Singapore offer excellent potential for new capital and new business, though the infrastructure requirements and risk management considerations are very much “front of mind” for those with eastern expansion plans. While a change in location footprint is an option, regulatory challenges affect all specialty locations, albeit in differing ways. For example, while Europe continues to second-guess when—or even if—Solvency II will come into force, Hong Kong is trying to anticipate the Financial Services Authority’s decision on fund management rebates and the impact on its economic and operating models.

Given the high priority placed on growth by senior executives, our first issue concentrates on this theme. What are the best options for growth? Which markets are the most attractive? What changes should be made to operating models to facilitate growth? How might companies innovate? In the series of articles that follow, we seek to address these questions and more. We also speak with one of the industry’s prominent figures who has grown his business substantially in the years he has been at the helm — Robert Hiscox. Robert tells us about the most courageous business decisions he has made as leader of his internationally successful business and also where he sees the future of the market.

And finally, on a slightly different note, I’d like to share my excitement about the creation of our new global specialty team. We’ve created an integrated team across a number of locations whose remit is to focus solely on the business needs of specialty (re)insurers — companies will benefit from our more unified global view of this market as we bring the full weight of our knowledge to create options for the most complex of business issues.

We hope that this publication will provide some food for thought as to how players in the specialty (re)insurance markets can differentiate themselves and succeed in the uncertain times that lie ahead.

Shaun Crawford
Global Head of Insurance, Ernst & Young
Having spoken to a number of CEOs operating in the specialty insurance and reinsurance market, we found that the majority believe the industry is at an inflection point.

The 2012 half-year results of listed specialty insurers revealed robust earnings and a strong performance, despite a challenging backdrop of lower global GDP growth, anemic investment yields and the near-record catastrophe losses of 2011. Although the market has generated strong profits so far in 2012, growth is proving a significant challenge. The developed economies of the western hemisphere are largely stagnating or are in low-growth mode and will be for the foreseeable future, which is severely restricting the ability of insurance carriers to grow with their existing footprint. By contrast, expanding emerging economies offer tantalizing opportunities for the specialty market.

So what are the main factors influencing strategy and driving the specialty sector to seek growth? In this article, we outline our views on likely developments for the specialty market in the next five years.

The pressure to grow

Profitability from existing lines is not sufficient to beat market expectations

At the half year, the specialty market delivered a strong set of results and generated a better return on investment than other insurance sectors. These results could largely be explained by prior year reserve releases and a benign claims environment. Clearly, the second half of the year will be affected by tropical storm Sandy with initial indications showing that US primary carriers will be particularly badly hit: losses are estimated to be US$20b and beyond although this is likely to impact earnings and not capital. The half-year results announcements1 show that average earnings were better in 2012 than prior years and that the price-to-book multiples have increased to 1.35x compared with 1.15x2 at the start of 2012. In addition, the average price-to- earnings ratio of specialty insurers comes in at 9.8x, compared with 7.7x2 for the remaining insurance sector. These figures tally with the views of the majority of market practitioners, with CEOs prioritizing increased underwriting profitability over growth. The common themes identified from our discussions were a focus on disciplined and selective underwriting and appropriate pricing for risks being written.

Despite this positive picture, most investment analysts we speak to recommend holding specialty shares rather than buying. Investors are being urged to show caution, as delivering improved returns from existing lines of business is exceptionally challenging in an environment where rates are not expected to increase significantly, GDP growth is minimal and future prior-year reserve releases are drying up.

Regulation favors larger cross-border firms

The current and proposed regulatory environment is creating a drive for growth that may not be in the best interests of the specialty market overall.

Firstly, smaller carriers are disproportionately hurt by regulations, which are the same whether a carrier writes US$1b of premiums or US$100m. Smaller companies typically lack the scale to absorb the additional costs that regulation creates and generally have insufficient in-house capability to implement a plethora of changes. We have seen expense ratios rise across the sector (especially among the

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1 Specialty insurers listed on the LSE.
2 Deutsche Bank Markets Research, 8 August 2012.

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smaller players) as a result of both the soft market and the costs of implementing new regulation. We envision that these smaller carriers will be at a cost disadvantage as well as a capital disadvantage from a regulatory standpoint compared with the larger insurers, which will have lower expense ratios as well as more resources to implement regulatory change (such as better internal models).

Secondly, most regulatory requirements are effectively discouraging a narrow focus on fewer lines. The ratings agencies turned bearish on monoline carriers after 2004 and 2005, when losses from hurricanes hurt a number of pure-play property catastrophe (re)insurers. In addition, from a capital perspective, the Solvency II regime gives significant credit to (re)insurers with diversified businesses. We have seen a number of carriers pursue growth in “uncorrelated” lines of business to provide them with the diversification credit. However, returns have been diluted as the carrier may lack the underwriting expertise in the new areas, or the risk association with these new lines may not have been fully understood — e.g., international property treaty and the losses arising from the Thai floods of 2011.

Recovery and resolution planning is a notable exception. These changes encourage firms to focus on fewer lines and simplify their corporate structures.

Larger firms can negotiate more favorable terms from brokers

Specialty insurers, including Lloyd’s, have recognized the challenge posed by the largest brokers’ dominance. The largest three brokers (Aon, Marsh and Willis) have placed just over half of the business across all lines, and in reinsurance they control 75%.

Several of the CEOs who we spoke to highlighted their dependency on the “big three” brokers and said that the concentration of power with these players leaves them vulnerable. While larger carriers may have significant market share in certain lines, which they can leverage to resist the negotiating powers of brokers, smaller players are particularly vulnerable and lack the might to prevent their underwriting margins from being eroded. The implication of this is that the smaller carriers will need to pursue scale to counteract the might of the large brokers.

The underwriting cycle may flatten

Between 2008 and 2010, reinsurance capacity increased by 35% from US$342b to US$470b and insurance capacity increased by 46%. Given the severity of the major losses of 2010 and 2011, we would expect some of this capacity to have been depleted. However, it has remained stable during this period. The increase in it from 2008 to 2010 and the effect of the financial crisis of 2008 is not a coincidence. Capacity entered at the start of the crisis as investors, including large pension funds and private equity (PE) firms, sought alternative ways to boost yields amid volatile markets and anemic global growth. These investors were attracted by the fact that the insurance cycle is uncorrelated to the general economic cycle.

The way this new capacity has been deployed shows a changing dynamic in the (re)insurance market. The major losses of the last two years did not result in a “class of 2010-2011” like in 2001 and 2005. Instead, much of this capacity is being channeled through sidecars, cat bonds and investment-linked securities, as evidenced by the fact that the Bermuda Monetary Authority licensed 23 special purpose insurers in 2011. Never before has there been such flexibility in getting capital to the market and one consequence of this might be the flattening

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3 Lloyd’s 2011 Annual Report and Accounts under Strategic Review.
4 Insider 16 July 2012, The biggest 10 brokers place just over three-quarters of business across all lines; in reinsurance they control 95.7%.
5 Aon Benfield, 2012 J une and July Renewals Update.
6 Aon Benfield, 2012 J une and July Renewals Update – Between 2010 and Q1 2012, the reinsurance capacity has remained unchanged at US$470b, and the insurance capacity has increased by 5%
Taking market share through M&A is a well-worn path

One option available to carriers to achieve scale is through M&A. In recent months, there has been significant speculation concerning the prospect of M&A activity in the specialty markets. Several transactions have already been completed, and we understand that others are close to completion.7

Further activity is rumored, particularly in London and Bermuda, and unlisted privately owned companies also present interesting opportunities. In addition, the significant cash funds available to PE players means further PE buyouts are a credible possibility. Meanwhile, insurers from the US and Asia are facing similar challenges, including lack of organic growth in their home countries, and as a result are increasingly showing an interest in access to the Lloyd’s platform.

But getting it right is a challenge

Although most CEOs would consider inorganic growth strategies, numerous acquisitions or mergers have not delivered value for all stakeholders. In our experience, common challenges include:

► Insufficient knowledge and understanding of the underlying book of business (and corresponding reserves) being purchased
► Estimating correctly the economies of scale that can be achieved by combining two specialty businesses
► Execution of post-integration plans and a good understanding of the cultural differences between organizations. The importance of this cannot be underestimated; many a transaction has destroyed value as a result of management failing to find a way to meld the best of both the acquirer and acquired businesses’ cultures and working practices.

► Differences in internal IT systems, control environment and governance frameworks—for example, when managing expectations of dominant individuals.

Therefore, a good alternative avenue to achieve growth could be to pursue the sale and purchase of specific lines of business or to acquire a team of people. Key differences will still need to be addressed: the team should be integrated into the business, cultural differences identified and harmonised, and degrees of freedom communicated to the new team. It appears that there are opportunities to pursue this alternative avenue, especially with increasing private equity (PE) involvement with the Specialty sector. PE players pride themselves in being innovative with the businesses they own, and this could result in rationalization of books of business or the splitting or combining of businesses with a view to releasing the “trapped” value in a company.

A new product development strategy is often overlooked

Taking new products to market is a viable option for growth, but one that does not appear to be on the agenda for most specialty firms. While notable exceptions exist, such as successes around cyber liability, in general it appears that companies lack the appetite to invest time, money and resources in developing new or non-traditional products to serve new industries. A number of CEOs who we spoke to agreed that innovation (particularly product innovation) was not a key strength of the specialty market. At the same time, the constantly changing nature of the world’s economy provides a wealth of demand for new risk management products.

Moving into emerging markets is attractive ...

It is well publicized that GDP growth in emerging markets has significantly outpaced that of developed economies in recent years, and we have seen the specialty market take advantage of this. For instance, when capacity entered the market between 2007 and 2011, Lloyd’s saw a 5% increase in its business written in Central Asia and Asia Pacific. By contrast, during the same period, UK business written at Lloyd’s decreased by 6%.8

However, the decrease of the UK segment is not a result of lower premium volumes —on the contrary, premiums have grown year on year, albeit less than in emerging markets. Indeed, the volume of business written within countries in Latin and Central America, Central Asia and Asia Pacific has grown by 105% over the last five years, compared with growth of 31% within the US, Canada, UK and Europe.

7 Recent transactions completed or near completion include: Chaucer & Hanover Group (April 2011), Omega and Canopus (April 2012), Hardy & CNA (July 2012), Sea Bright Enstar (August 2012), Flagstone Re Validus (August 2012).
8 Society of Lloyd’s segment analysis—2007-11
9 Semiannual report, World Bank.
... and the best opportunities are in the tiger economies

Lloyd’s has been vocal and proactive about its intentions to grow in Latin America and Asia by strengthening its distribution channels in these areas. The change in the composition of its book supports this to some extent. In addition, the series of natural catastrophes in Asia has helped to raise risk awareness and prompt corporations to seek increased insurance.

Most CEOs recognize that the emerging economies present a great opportunity, although this will not be an option for everyone. In our view:

► Great opportunities exist to create hubs in the “tiger economies” in the Far East. This area is an increasingly exciting place to be, with access to a number of countries. We have seen some specialty players open offices, recruit local talent and invest in building and strengthening distribution channels in the region. This has enabled access to new business and, with more and more players increasing their presence, it will provide the ability to compete with existing large insurers in that region by writing risks on a subscription basis. Over time, the view that a large proportion of specialty business comes to London will diminish, and we believe these hubs will attract business from across Asia.

► Brazil presents another great opportunity and provides good access to the rest of Latin America. Brazil is one of the fast-growth emerging economies, and the entire region of Latin America is predicted to grow by 3.8%-4% in 2013. Lloyd’s has opened a franchise in Brazil and plans to strengthen its distribution channels. The 2016 Olympic Games in Rio de Janeiro presents some short-term opportunities, and is Brazil’s (and Latin America’s) opportunity to take center stage and showcase to the world the investment opportunities available.

► India and China also present enormous growth opportunities, but the political, regulatory, legal, social and cultural dynamics are extremely challenging. For example, legislation prevents full control of a company, and a local partner is required—a particularly delicate balancing act for carriers that wish to ensure their intellectual property is protected. We believe that both substantial investment and a long time frame is needed for a new entrant to the Chinese and Indian specialty insurance markets to take full advantage of the opportunities available.

Expanding into new markets in emerging economies offers clear attractions but is not without risk. Indeed, several CEO’s in the market have avoided the emerging economies and instead are focusing on developed economies with very large, mature insurance markets. In many ways, doubling their market share from 0.5% to 1% of a developed economies’ insurance market can be easier as the competition, ways of doing business, legal system, and culture are all known and familiar.

Our view is that carriers should simplify their business models and focus on fewer, narrower lines and fewer locations. A focus on simplification would enable carriers to concentrate on their core strengths and free management from being distracted by peripheral classes of business which are “nearly breaking even” or “just about to take off on a growth spurt”. Operating in fewer locations would also bring lower costs with less people issues, and systems should be more easily aligned with business processes.

Specialty in the future

We see this as an exciting yet challenging time for specialty insurers as they enter new markets and pursue new strategies. We predict:

► London, Bermuda, Switzerland and the US will continue to be the most prominent locations in this market, however we see the emergence of a competitive and sizeable local hub in Asia.

► Winners in the market will be those pursuing a strategy of growth by taking market share in developed economies or increasing market penetration in emerging economies. The complexity of trying to achieve both will be too difficult.

► The concentration of power and dominance of the brokers will continue, with further consolidation increasing the market share of the largest brokers.

► The race for talent, in a market where most CEOs recognize there is a shortage, will result in wage inflation, especially for specialized skills. This, along with the costs of compliance, places more pressure on the expense ratio.

► Building a brand new franchise will be more challenging. With significant barriers to entry, regulatory costs and concentration of brokers in distribution, significant scale will be required to deliver the returns demanded by the market.

► Building the franchises of today from scratch will no longer be possible. With significant barriers of entry, regulatory costs and scale required to deliver returns, the spirit of entrepreneurship, which is what built this market, will be lost.

Authors

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Four transactions across 2011 and 2012 (up to October 2012) related to the acquisitions of Lloyd’s platforms by overseas insurers where the respective acquirers were willing to pay a significant premium for the respective platforms. The Lloyd’s platform, which includes access to underwriting licenses in over 75 jurisdictions, is an attractive proposition to many buyers, particularly those who haven’t achieved organic growth in the current rating environment. CNA Financial’s Chairman and CEO, Tom Motamed, noted in reference to its acquisition of Hardy, “With its access to the US$35 billion Lloyd’s marketplace, Hardy will provide a solid platform for profitable growth and an attractive opportunity for CNA to deploy capital.”

Lloyd’s operations have proved popular in recent years, with the number of London Stock Exchange-listed Lloyd’s insurers falling to five following Apollo and CVC private equity’s acquisition of Brit, The Hanover Group’s acquisition of Chaucer, CNA’s acquisition of Hardy and Canopus’s tie-up with Omega. Since 2007, a majority of Lloyd’s listed vehicles, including Atrium, Kiln, Heritage, Brit and Chaucer, have been acquired. Novae, the smallest of the remaining listed Lloyd’s businesses by market capitalization, and once a suitor in the races to acquire Chaucer and Omega, remains an often-discussed potential takeover target in the trade press.

As a market, Lloyd’s has been managing its capacity carefully, with the number of syndicate start-ups approved by Lloyd’s falling from nine in both 2008 and 2009 to three in 2010 and 2011. This has effectively restricted new entrants from gaining access to the market through acquisitions or via a slower process of establishing a turnkey operation.

Following acquisitions of a number of listed players since 2007, some privately owned Lloyd’s insurance vehicles have been discussed in the trade press recently as either acquirers or targets. There are a number of potential transactions in process, and we expect some of them to be completed in the next 12-24 months.

Looking further afield, Bermuda has seen an influx of additional capital over the last 18 months, with substantial investments being made in side cars, hedge fund backed vehicles and other insurance-linked assets. This capital looks set to benefit from a positive return in 2012 albeit, with the impact of Sandy yet to be determined.

It will be interesting to see what happens to some of this capital if rates soften significantly, if substantial cat losses are incurred, if markets improve and generate alternative investment opportunities for hedge funds, or if a combination of these factors occurs.

Market conditions remain conducive to further transaction activity in the Lloyd’s market, and several insurance vehicles remain attractive acquisition targets for the purposes of gaining access to the Lloyd’s platform.
We have seen a flurry of transaction activity in the specialty market since the early part of 2011. Market conditions have been conducive for M&A activity, given the capital available within insurers and private investors, continued softness in rates and low investment yields.

An overview of recent activity

<table>
<thead>
<tr>
<th>Date</th>
<th>Buyer</th>
<th>Target</th>
<th>Consideration US$m</th>
<th>NTA multiple</th>
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<tr>
<td>August 2012</td>
<td>Validus</td>
<td>Flagstone Re</td>
<td>623</td>
<td>0.7x</td>
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<tr>
<td>August 2012</td>
<td>Enstar</td>
<td>SeaBright</td>
<td>252</td>
<td>0.7x</td>
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<tr>
<td>August 2012</td>
<td>Tower</td>
<td>Canopius Bermuda</td>
<td>240-290</td>
<td>1.0x</td>
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<tr>
<td>July 2012</td>
<td>CNA</td>
<td>Hardy</td>
<td>255</td>
<td>1.5x</td>
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<tr>
<td>May 2012</td>
<td>Tokio Marine</td>
<td>Delphi</td>
<td>2,700</td>
<td>1.5x</td>
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<td>April 2012</td>
<td>QBE</td>
<td>Brit UK</td>
<td>63</td>
<td>n/a</td>
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<tr>
<td>April 2012</td>
<td>ANV</td>
<td>Flagstone Re at Lloyd's</td>
<td>210</td>
<td>1.3x</td>
</tr>
<tr>
<td>April 2012</td>
<td>Canopius</td>
<td>Omega</td>
<td>255</td>
<td>0.9x</td>
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<td>March 2012</td>
<td>Alleghany</td>
<td>Transatlantic Re</td>
<td>3,400</td>
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<td>March 2012</td>
<td>Goldman Sachs</td>
<td>Ariel Re</td>
<td>n/a</td>
<td>n/a</td>
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<td>March 2012</td>
<td>Arch</td>
<td>Ariel Credit and Surety</td>
<td>n/a</td>
<td>n/a</td>
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<td>January 2012</td>
<td>Tawa/Paraline/Skuld</td>
<td>Whittington</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>September 2011</td>
<td>Ryan Specialty</td>
<td>Jubilee</td>
<td>57</td>
<td>3.0x</td>
</tr>
<tr>
<td>May 2011</td>
<td>Apollo/CVC</td>
<td>Brit</td>
<td>1,423</td>
<td>1.0x</td>
</tr>
<tr>
<td>April 2011</td>
<td>The Hanover Group</td>
<td>Chaucer</td>
<td>510</td>
<td>1.3x</td>
</tr>
</tbody>
</table>

Source: Ernst & Young

Author

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There is welcome news for specialty insurers keen to optimize opportunities in the London markets as the latest ITEM forecast for financial services sees a return to growth for the UK economy in the second half of 2012. GDP is down only 0.2% on the year as a whole. Growth then picks up to 1.2% next year and to 2.4% in 2014 and 2015. The forecast includes a mild recovery in consumption, thanks to falling inflation and rising employment. CPI inflation is expected to ease back into line with its target over the winter. In this article, we summarize the latest findings and how they affect general insurance (property and casualty) companies.

Table 1: forecasts of the UK economy

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<thead>
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<tr>
<td>GDP</td>
<td>0.9</td>
<td>-0.2</td>
<td>1.2</td>
<td>2.4</td>
<td>2.4</td>
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<tr>
<td>Consumer prices</td>
<td>4.5</td>
<td>2.8</td>
<td>2.1</td>
<td>2.0</td>
<td>2.0</td>
<td>2.0</td>
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<tr>
<td>Average earnings</td>
<td>2.6</td>
<td>2.0</td>
<td>2.8</td>
<td>3.2</td>
<td>3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Unemployment rate (%)</td>
<td>4.7</td>
<td>4.8</td>
<td>4.9</td>
<td>4.5</td>
<td>4.1</td>
<td>3.8</td>
</tr>
<tr>
<td>Government net borrowing (% of GDP)</td>
<td>8.2</td>
<td>6.7</td>
<td>6.7</td>
<td>5.0</td>
<td>3.5</td>
<td>1.9</td>
</tr>
<tr>
<td>Three-month interbank rate (%)</td>
<td>0.9</td>
<td>0.9</td>
<td>0.8</td>
<td>1.6</td>
<td>2.5</td>
<td>3.5</td>
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<tr>
<td>Effective exchange rate</td>
<td>79.9</td>
<td>83.2</td>
<td>84.2</td>
<td>83.6</td>
<td>81.8</td>
<td>79.4</td>
</tr>
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</table>

Source: ITEM
Key summary for general insurers

The combination of low interest rates, higher hedging costs, lower business volumes and more onerous capital requirements is proving to be a challenging environment for UK insurance companies. In response, management remains focused on cost cutting and process re-engineering. M&A activity will continue, with the aim of reducing capacity and improving topline growth. Property and casualty insurance prices need to rise and annuity rates need to fall in order to rebuild profitability. The benefits of restructuring are already visible in a rise in profit margins from a low of -0.3% in 2009 to 3.2% in Q2 2012.

Although margins are now back above their historical average of 2.7% they are still around one percentage point below the level prevailing before the financial crisis. Improved margins will help the contraction in profits slow to 9.5% in 2012 from 31% in 2011. We then expect profits to start recovering in 2013 as nominal GDP growth doubles to 4.1%, boosting business volumes and making price rises easier to achieve. The expected 7.1% rise in equity prices will also support investment returns. Even allowing for expected growth of almost 19% in 2013, profits will remain about 25% below the £7.8b peak hit in 2010 and are not expected to exceed it until 2017 (Chart 1.1).

![Chart 1.1: UK insurance industry profits](image-url)
In the near term, the UK non-life-insurance business will be affected by weakness in both the housing market and new car sales (Chart 1.2). Slow household income growth and credit constraints mean that we expect house prices to decline by 0.7% in 2012 and then rise by just 2.3% in 2013. The same factors mean that we expect new car registrations to decline by 1.2% in 2012 and then rise by just 0.5% in 2013. As a result, we expect non-life premium growth of just 1.4% in 2012. Corporate business should be a source of support, with the number of companies expected to grow by 9% in 2012 and 10% in 2013. After that, as the economic recovery strengthens, premium growth should rise to 3%-6% between 2013 and 2016.

**Table 2: insurance**

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<tr>
<td>Non-life gross premium (£b)</td>
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<td>74</td>
<td>77</td>
<td>80</td>
<td>85</td>
<td>89</td>
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<tr>
<td>%year</td>
<td>5.9</td>
<td>1.4</td>
<td>3.6</td>
<td>4.7</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Non-life gross claims payments (£b)</td>
<td>36</td>
<td>37</td>
<td>38</td>
<td>38</td>
<td>39</td>
<td>40</td>
</tr>
<tr>
<td>Paid claims ratio (%)</td>
<td>49</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Net profit (£b)</td>
<td>5.4</td>
<td>4.9</td>
<td>5.8</td>
<td>6.7</td>
<td>7.3</td>
<td>7.7</td>
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Source: ITEM/Haver Analytics

*FS ITEM Club economic outlook for financial services—autumn 2012*
Table 3: forecast for the UK economy

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<tr>
<td>Nominal GDP growth (%)</td>
<td>3.6</td>
<td>2.2</td>
<td>4.1</td>
<td>5.4</td>
<td>5.0</td>
<td>5.8</td>
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<tr>
<td>Real GDP growth (%)</td>
<td>0.9</td>
<td>-0.2</td>
<td>1.2</td>
<td>2.4</td>
<td>2.4</td>
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<tr>
<td>CPI (%yoy)</td>
<td>4.5</td>
<td>2.8</td>
<td>2.1</td>
<td>2.0</td>
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<tr>
<td>Total employment (thousands)</td>
<td>29,166</td>
<td>29,493</td>
<td>29,779</td>
<td>30,059</td>
<td>30,374</td>
<td>30,709</td>
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<tr>
<td>Employment in manufacturing (thousands)</td>
<td>2,524</td>
<td>2,507</td>
<td>2,485</td>
<td>2,465</td>
<td>2,442</td>
<td>2,422</td>
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<tr>
<td>Employment in non-manufacturing (thousands)</td>
<td>23,540</td>
<td>23,765</td>
<td>24,050</td>
<td>24,429</td>
<td>24,844</td>
<td>25,270</td>
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<tr>
<td>Unemployment (thousands)</td>
<td>2,564</td>
<td>2,604</td>
<td>2,646</td>
<td>2,532</td>
<td>2,390</td>
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<tr>
<td>Population (thousands)</td>
<td>63,005</td>
<td>63,479</td>
<td>63,923</td>
<td>64,342</td>
<td>64,753</td>
<td>65,159</td>
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<tr>
<td>Population of working age (thousands)</td>
<td>39,188</td>
<td>39,488</td>
<td>39,774</td>
<td>40,042</td>
<td>40,301</td>
<td>40,546</td>
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<tr>
<td>Population, 65+ (thousands)</td>
<td>12,072</td>
<td>12,143</td>
<td>12,189</td>
<td>12,215</td>
<td>12,228</td>
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<tr>
<td>Nominal personal disposable income (%yoy)</td>
<td>3.1</td>
<td>3.9</td>
<td>3.9</td>
<td>3.9</td>
<td>4.7</td>
<td>4.4</td>
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<tr>
<td>Gross household financial wealth (£b)</td>
<td>4,284</td>
<td>4,516</td>
<td>4,693</td>
<td>4,872</td>
<td>5,063</td>
<td>5,206</td>
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<tr>
<td>Personal loans outstanding (£b)</td>
<td>151</td>
<td>152</td>
<td>155</td>
<td>159</td>
<td>166</td>
<td>174</td>
</tr>
<tr>
<td>Credit card lending outstanding (£b)</td>
<td>56</td>
<td>54</td>
<td>54</td>
<td>56</td>
<td>59</td>
<td>64</td>
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<tr>
<td>Personal insolvencies (thousands)</td>
<td>142</td>
<td>134</td>
<td>129</td>
<td>118</td>
<td>100</td>
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<td>Car registrations (thousands)</td>
<td>1,941</td>
<td>1,918</td>
<td>1,927</td>
<td>1,969</td>
<td>2,114</td>
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<tbody>
<tr>
<td>House prices (%yoy)</td>
<td>-2.6</td>
<td>-0.7</td>
<td>2.3</td>
<td>4.5</td>
<td>5.7</td>
<td>5.5</td>
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<tr>
<td>Number of households (thousands)</td>
<td>26,204</td>
<td>26,386</td>
<td>26,569</td>
<td>26,754</td>
<td>26,940</td>
<td>27,127</td>
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<tr>
<td>Property transactions (thousands)</td>
<td>883</td>
<td>916</td>
<td>926</td>
<td>994</td>
<td>1,073</td>
<td>1,147</td>
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<tbody>
<tr>
<td>Gross mortgage lending (£b)</td>
<td>141</td>
<td>144</td>
<td>143</td>
<td>166</td>
<td>199</td>
<td>238</td>
</tr>
<tr>
<td>Net mortgage advances (£b)</td>
<td>10</td>
<td>8</td>
<td>3</td>
<td>18</td>
<td>35</td>
<td>48</td>
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<tr>
<td>Number of mortgages approved</td>
<td>593,143</td>
<td>592,604</td>
<td>596,771</td>
<td>640,755</td>
<td>700,028</td>
<td>763,600</td>
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<tr>
<td>Total number of mortgages (thousands)</td>
<td>11,260</td>
<td>11,265</td>
<td>11,329</td>
<td>11,409</td>
<td>11,501</td>
<td>11,603</td>
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<th>Corporate sector</th>
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<tr>
<td>New companies (%active companies)</td>
<td>0.19</td>
<td>0.24</td>
<td>0.25</td>
<td>0.21</td>
<td>0.19</td>
<td>0.20</td>
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<tr>
<td>Insolvencies (%active companies)</td>
<td>0.0079</td>
<td>0.0079</td>
<td>0.0078</td>
<td>0.0078</td>
<td>0.0077</td>
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<tr>
<td>Total number of companies</td>
<td>2,375,315</td>
<td>2,590,540</td>
<td>2,846,484</td>
<td>3,008,628</td>
<td>3,101,237</td>
<td>3,194,717</td>
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<tr>
<td>Company profits (£b)</td>
<td>323</td>
<td>318</td>
<td>334</td>
<td>353</td>
<td>367</td>
<td>374</td>
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<tr>
<td>3-month interbank rate (%)</td>
<td>0.9</td>
<td>0.9</td>
<td>0.8</td>
<td>1.6</td>
<td>2.5</td>
<td>3.5</td>
</tr>
<tr>
<td>20-year government bond yields (%)</td>
<td>3.1</td>
<td>1.9</td>
<td>2.1</td>
<td>2.9</td>
<td>3.7</td>
<td>4.2</td>
</tr>
<tr>
<td>FTSE All-Share (%yoy)</td>
<td>2.6</td>
<td>2.0</td>
<td>7.1</td>
<td>13.6</td>
<td>10.2</td>
<td>7.8</td>
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Source: ITEM
Investing in the finance function as a prerequisite for achieving growth

Many specialty (re)insurers take great pride in being highly entrepreneurial and able to respond quickly to emerging opportunities. Companies pursuing growth do so either by mergers and acquisition or by expanding the business through new products, offices, locations and teams.

Management, not unreasonably, expects integrating a new business operation into existing finance processes and systems to be as easy as “plug and play.” However, regardless of the strategy pursued, the experience of many specialty (re)insurers is that growth just adds cost and complexity without realizing the desired back-office cost synergies and economies of scale.

For example, as organizations grow organically over time, local finance teams customize processes and bolt on custom-made applications to meet local requirements. Existing corporate systems that were appropriate for a smaller finance organization become a limiting factor for larger ones—an inability to provide granular analysis and reporting or to support internal restructuring are key issues. International expansion brings the additional challenges of operating in multiple currencies, requiring seamless translation and revaluation processes as well as intercompany service charges and allocations.

Organizations that grow through mergers and acquisitions experience a different set of issues. Many firms choose not to integrate acquisitions operationally. The acquired company continues to operate its existing processes and systems, mapping financial results to the new parent’s chart of accounts for external reporting and retaining their internal management information. Even where a corporate general ledger is deployed across the business, the existence of multiple legacy underwriting platforms can result in numerous challenges. The most prominent issues relate to the quality, completeness and consistency of underwriting data taken from multiple sources, which can result in considerable excess work to normalize data for reporting or to analyze to the level required for management reporting.

Successful growth requires efficient and effective, streamlined support functions that have the flexibility to respond to business change. The majority of the industry needs to make a real step change in order to realize growth opportunities. However, we are aware of a number of companies that are launching major process improvement initiatives and large-scale IT implementations to address these challenges.

What does good look like?
An effective, flexible and scalable finance function has the following characteristics:

► Processes should be standardized and streamlined and procedures supported by common policies and strong financial controls. Process standardization can deliver significant efficiencies and facilitate centralization of transactional...
processes in shared services, delivering further economies of scale.

- There should be a high degree of straight-through processing and automation of period-end adjustments and reporting with a corresponding reduction in the number of critical spreadsheets used in the process.

- There should be common global finance transaction and reporting systems, including a flexible and scalable general ledger to ensure emerging business requirements can be met. A single general ledger instance provides a common control environment, facilitates reporting from one source of the truth and can deliver significant savings in the cost of finance systems ownership.

The increasing volume, complexity, frequency and speed of reporting required under Solvency II and IFRS 4 Phase II is shining a spotlight on these issues as the lack of globally standardized processes and common systems limits the ability to define corporate solutions, driving up the cost and complexity of implementation projects.

How can you achieve this?

We would recommend companies start by thinking about conducting a rapid assessment to uncover all the issues with current processes and systems, and setting out what can be done to address the challenges, as well as articulating the business case for change. From this, we would then recommend devising a high-impact short-to-medium-term plan to identify where the greatest benefits could be achieved. This is something where there are a whole range of opportunities tailored to suit varying budgets and appetites for change, from pragmatic and tactical process initiatives to longer-term changes to finance systems.

Companies that successfully build flexible and scalable operations have typically invested significantly in systems and processes over a number of years to ensure their finance functions deliver the benefits described above; however, in our experience, an effectively designed program of change can deliver significant improvements within just 6 to 18 months. Companies that proactively do this, rather than being forced to change in response to a transaction or other event, are able to design a solution that is better optimized for the long term and can be implemented at a lower cost.

What outcomes can be expected?

In addition to the growth benefits previously outlined, creating a more efficient and effective finance function can deliver significant cost reduction as well as a range of qualitative benefits, which all contribute to the business case for change. Typical benefits include:

- **Lower costs due to the “leaner” nature of the operating model**—resulting from business process streamlining and simplification, adoption of leading practices and economies of scale through increased global centralization. Finance cost savings in excess of 20% are typical.

- **Better control and a reduced risk of generating incorrect information for regulatory reporting and management information**—greater automation, cutting out the human element and reducing the reliance on spreadsheets decreases the risk of error and the complexity involved in generating information. A single global general ledger provides a common control environment and facilitates reporting from one source of the truth.

- **Better, faster and more reliable management information**—resulting from accelerated processes, data governance and data quality. Common group-wide finance systems and a global chart of accounts can accommodate the management reporting dimensions and analysis required by more complex organizations.

Ian Stewart (istewart@uk.ey.com) is a London-based director in the financial services performance improvement practice of Ernst & Young LLP (UK) and has extensive experience of implementing change within insurance company finance functions.
Taking control at the age of 27 on the death of his father

“We were a partnership of seven running two small Lloyd’s syndicates and had lost money for five years. I had a 5% share and my father had 20% (which was extinguished on his death). On his death in 1970, I managed by straight persuasion and force to make four of the partners resign, and the remaining partner and I had 50% each. I will never forget, while on my way in to work the day after we had succeeded in getting Lloyd’s to agree, having a mental moan about some decision that needed to be made then realizing with a surge of sheer joy that it was now entirely my decision. The buck now stopped with me. No more moaning.”

Introducing corporate capital into Lloyd’s

“I became Deputy Chairman of Lloyd’s in 1993 as Lloyd’s was in crisis. David Rowland, the Chairman, asked me to find capital as the “Names” were resigning in droves, capacity of the market had dropped to £5 billion and some Names were refusing to pay their losses. The worldwide media was writing Lloyd’s off. I knew nothing about the capital markets but with Freshfields and J.P. Morgan we seized an opportunity, adapted the by-laws and obtained all the regulatory permissions needed, essentially in every state in the US. Limited liability corporate membership was invented, and we raised £900 million. The Names who were running for the door thought that if sophisticated capital wanted in, they should stay, so Lloyd’s was well capitalized again. “Strong regulation was put in place, and by the time of the tragic events of the World Trade Center in 2001 (which could have been totally catastrophic for Lloyd’s in previous times), the market could absorb that enormous loss. The market then rode 10 years of great profits. But I never thought that bringing in corporate capital was a brave decision; it was pure necessity.”
Serious expansion in the United States in 2006

Hiscox, in tandem with most of the Lloyd’s market, has sold insurance to US businesses through its Lloyd’s of London syndicates forever. In 2006, however, it took the bold decision to establish offices across the country and is now licensed to operate in all US states and the District of Columbia.

“We have grown organically at a pretty rapid rate. We did pay a lot of money to attract a very good underwriter, but we would rather do that than buy a small company with all the problems that go with it. We have also started the first business to business internet business in the US, which is frightening as we usually don’t pioneer, we shoot pioneers in the back. Let the first guy in make all the mistakes. (Even Rockefeller said ‘pioneering don’t pay’.) But we have the knowledge and skill, as we had a successful similar business in the UK, so it seemed logical, if brave. I am delighted to say that it is going very well indeed.”

Floating on AIM in 1995

“At the moment of signing to raise our first capital to become principals, after nearly 100 years of being an agent with no real risk in the business, we had a considerable wobble. There was a hesitation when we thought to ourselves, “Why are we doing this?” We were an agent being handsomely rewarded with no capital in the business. Then we did six rights issues, which did seem brave at the time. We were the first company to form a corporate vehicle to support a spread of syndicates, and then the only company in 1993 to raise capital to become principals, after nearly 100 years of being an agent with no capital in the business. And our final rights issue was the last to raise money at a modest 10% discount to the share price when all others by then were going at deep discounts of around 45%. I dislike deep discounts as they make it dead easy for the investment bankers and penalize the small investor. “I have found being a public company relatively easy, as we have to explain our business to professional, intelligent investors who have actually put money into the company, whereas under the old system of Names, we were dealing with emotional individuals and their agents (of differing quality!) who had only pledged their capital, which they could withdraw at any time.”

Purchasing Economic Insurance in 1996

“I decided that we had to have an insurance company to underwrite outside the Lloyd’s market. Lloyd’s has a limit of 15% for any business inside Lloyd’s, so I had known since I arrived in the market that we would have to go outside. Prior to the introduction of corporate capital, no one in Lloyd’s was allowed to underwrite outside the Lloyd’s umbrella, but I managed to change that rule in the restructuring of the market. We bid to buy Economic Insurance for £30 million in 1996 against the advice of the investment banker, who said we were betting the bank. Considering it had £24 million capital, it seems amazing that that was such a brave move such a short time ago. Mind you, it was making losses at the time but we just wanted the shell, so we got rid of 80% of the business. Under the ridiculous Department of Trade and Industry rules of the time, we had to keep the management in place for a year as Bronek Masojada didn’t qualify to run the company as he was South African, and I didn’t as I had only Lloyd’s experience. A difficult year for us and them.”

“People congratulate you if you buy a business, but not if you start one up.”

“The investment banker advised against and thought we were betting the bank.”
The age of the super-syndicates?

“Lloyd’s is a great incubator, but it won’t let you become more than 15% of the overall business. As an ambitious young man driving my motorbike to work, I would look at the great Guardian Royal Exchange building and think that one day we would be a big insurance company and couldn’t stay entirely in Lloyd’s. So this 15% rule is quite interesting as it means that if people like Catlin and us grow successfully, we have to move out. Do they really want that?”

Dialogue with Downing Street

“I was having lunch the other day, and this man (needless to say a banker) said that we have lost the right to explain the success of the general insurance industry to politicians. I think he is entirely wrong, but the lack of lobbying is appalling. The Association of British Insurers (ABI) is focused on corporate governance and life insurance, with us coming a poor third. The general insurance parts of the Chartered Insurance Institute and the ABI should join together with Lloyd’s, and perhaps the broker associations, to form a powerful general insurance association with real clout. We do a vital job every bit as important as banks and need our own lobby. But who’s going to do it?”

Heading east

“I want us to head east. We look east the whole time but China is very difficult. You show me someone making money there and I will write a quota share. Nobody seems to be making any money in Singapore, and Lloyd’s Japan has similarly been tough financially. But we are looking at the east very closely—it’s all about the right way to do it. In general, in so-called emerging markets, we are often fighting with one hand tied behind our back because of our tight regulation, whereas the Africans, Indians, South Americans, Chinese, Russians and others don’t seem to have the same problem.”

The Apple test: becoming more savvy

“How we sell insurance better is crucial. Lloyd’s has a nasty habit of sitting and waiting for it and, in general, we tend (apart from our internet business) to sell the same products in the same old way as we did 40 years ago. The question I ask myself is: “Do we do enough research and development?” I’ve just looked at our household policy and asked, ‘Is it as good as an Apple product?’ I don’t fear other insurers; I fear Apple, Google and Amazon. If they start selling insurance, we are in trouble.”
The Swiss Solvency

Seen by many as a direct comparator to Solvency II (SII), the Swiss Solvency Test (SST), in force since 1 January 2011, is a mandatory risk-based economic solvency regime for Swiss-domiciled companies and groups. Here we shine a spotlight on the similarities and differences between the two regimes and examine the strategic implications for insurers that are looking to grow in Switzerland and other locations.
The SST defines how much capital is required on average at the beginning of the year for insurers to cover their liabilities at the end of the year, even in an adverse situation — i.e., to have enough capital to cover the average of the 1% worst situations. Having adopted this framework, Swiss-based (re)insurers will have an advantage when European Insurance and Occupational Pensions Authority (EIOPA) meets expectations to grant “equivalence” status to SST. They are already prepared and used to working within a similar environment based on experience with the SST. However, this would also mean that the requirements around Pillar 2 and Pillar 3 topics will increase. For companies looking to domicile in Switzerland, or indeed acquire a Swiss company, the SST raises some interesting issues.

The SST framework and the key differences with SII

While Solvency II is still in development, and a level of uncertainty remains around the final requirements, SST provides useful insight on what’s to come for European insurers. The underlying principles of Solvency II and the SST capital calculation are broadly similar. Companies use the SST to manage risk, to define the reinsurance structure and exposure steering, and to increase awareness of a portfolio’s risk. Even though the underlying principles of the two solvency regimes are similar, there are significant differences.

The standard model for SST differs from the standard formula of SII. There is a relatively sophisticated SST standard model available from the Swiss Financial Market Supervisory Authority (FINMA), covering all risks on an analytical and stochastic basis. The standard model still requires companies to derive their own input parameters (e.g., around reserve risk). In this way, a full distribution function is derived for each risk type.
The SII standard model is very much factor-based and does not derive a full distribution function.

Internal SST models are mandatory for some companies, which is not the case in SII. SST internal models are mandatory for:

► Insurance groups and conglomerates
► Reinsurance companies
► All other insurance companies for which the standard model is not appropriate

Companies are relatively free to choose and develop their internal model, because the SST is principle-based. It has to reflect the risk of the business appropriately and needs to be documented in detail. Internal models can be full or partial. Partial internal models can use components of the standard model if these are deemed to reflect the risk of the company appropriately.

The internal model has to pass a “use test”; the company has to demonstrate that the model is integrated into the company’s core processes and that its outcomes are considered in business decision-making. The model has to be fully documented for the model approval process. In addition, the complete SST report for transferred portfolios of new companies is required.

If the model and the report meet certain minimum standards, FINMA typically gives a temporary approval of the internal SST model within the normal license application process period; a more rigorous model investigation is usually initiated after the license has been granted. Currently, FINMA has approved few models unconditionally (approval can be unconditional, conditional, provisional or declined).

There are special rules for reinsurance companies. The difference in treatment is legally justified by the different nature of the policyholders (undertakings, not natural persons). Reinsurers shall develop an internal model based on the principles of the SST with (few) exceptions that can be allowed by FINMA. However, the internal model can, to a large extent, be identical to the standard model, for components where this is deemed appropriate.

SST considers additional scenarios.
Of particular relevance within the SST is the description and evaluation of prescribed and company-specific scenarios. Scenarios reflect the monetary consequences of (loss) events the company is exposed to, but are not reflected within the modeling of the other risk types. They are expected to play an important role in the company’s risk management framework. Scenarios are considered as a fundamental element of quantifying the required SST solvency capital and allow FINMA to assess systematic risks in the industry and to appraise the quality of the company’s risk management.

The solvency capital calculation schemes vary considerably between SST and SII.
As a consequence, the solvency capital requirements in the two solvency regimes can be quite different; the disparity might depend on the products underwritten.

SII is based on a more comprehensive and integrated risk management framework.
Apart from the pure solvency capital calculation (Pillar 1), the framework also includes extensive risk governance (Pillar 2) as well as public and regulatory disclosure requirements (Pillar 3). So far, the SST has primarily focused on Pillar 1, while the other two are not yet developed to the same extent.

The SST quantifies insurance risk, financial risk and credit risk but not operational risk, in contrast to SII.
Operational risks are considered from a qualitative point of view only. Required capital is calculated over a one-year time frame.

SST equivalence with SII
SST is deemed to be nearly equivalent to SII, according to EIOPA. Under Solvency II, the European Commission may determine whether the solvency regime of a country outside the EU (third country), such as Switzerland, is equivalent to the one laid down in SII in relation to three areas of focus (i.e., Articles 172, 227, 260). The respective decision of the European Commission is based on EIOPA’s final advice, which itself is based on an equivalence assessment regarding a preset catalog of different criteria.

Although the European Commission has not made a definitive decision on recognizing the equivalence of the Swiss (re)insurance supervision system (including the SST regime) with SII, it is very likely that it will be positive, due to the fact that:

► Possible caveats are related only to governance and disclosure requirements
► Switzerland has declared it will address these points
The benefits experienced from SST

The introduction of the SST has proven its value in terms of allowing firms to demonstrate their reliability internationally in a more robust way. While challenges still remain we believe some of the main benefits are as follows:

► From a market and regulatory perspective
  — The regulator gets a comparable measure for the solvency of the insurance market.
  — Adjustments can be made, especially to the standard model, if this is deemed to not adequately reflect the economic environment anymore (e.g., around market risks).
  — This protects the customer by ensuring sufficient available capital.

► From a risk management perspective
  — This provides an overview of the capitalization of one’s own company.
  — The SST is a tool to identify risks in the business and within the company and can support the company to steer the risks of its portfolio.

Key considerations for companies pursuing growth

For companies that are looking to redomicile, open or acquire new entities in Switzerland, there are a number of key considerations:

► For reinsurance companies looking to relocate or open a new entity in Switzerland, an internal model needs to be developed. Existing models (e.g., SII, ICA) can be leveraged. But, based on the differences laid out in this article, the capital requirements might be different, and adjustments to any existing models may need to be made.

► The development of an internal model should not be underestimated (from a time and an effort perspective). This includes the development of the model itself, but also the documentation of the model and the methodology. External support can be used.

► The capital requirements under SST differ from other regimes. There is no general rule if these are higher or lower.

► Future changes to the SST regime should be followed closely, especially Pillar 2 and Pillar 3 changes, which are expected soon.

► A detailed plan should be developed early, taking into account that the regulator would need to review internal model applications before granting a license.
Tax leakage: more than a drop in the ocean

As the sluggish world economy continues to place increasing pressure on investment returns, firms are looking for every possible opportunity to improve their performance. While companies can try to maximize investment returns in a range of ways, including entering new markets and new asset classes, we think firms need to take a hard look at how to improve their management of the withholding tax cost on cross-border investment income. In short, they need to prevent tax leakage as a quick win to drive improved performance.

Tax leakage in this context relates to cross-border investments where double tax treaty benefits or claims under domestic law have not been applied. A recent European Commission study identified that the amount of foregone withholding tax relief within the European Union could be as high as €5.47b annually¹ across all sectors. We know of one global insurance group that reclaimed around US$90m of withholding and other taxes after a review.

In our experience, many organizations are understandably confused about who owns the withholding tax process. It is often difficult to be sufficiently aware about what they should be receiving in terms of post-tax investment return from the various countries they invest in. As each country has its own rates, regulations and tax forms, there will always be a level of complexity around getting this right and receiving the optimum cash return. However, it is relatively simple to perform a diagnostic exercise and identify areas of tax leakage across multiple jurisdictions. We would urge senior executives to focus on this as it does not involve complex or aggressive tax planning, but rather involves better controls and processes to ensure taxes that are due to be paid are paid—but nothing more.

Understanding the context

Cross-border investments are becoming increasingly important in terms of asset allocation. For example, statistics compiled by the Association of British Insurers show that the proportion of long-term and general insurance investment assets that are invested in overseas securities has increased as a percentage of the total of both UK and overseas securities from 38% in 2005 to 56% in 2010. However, cross-border investors may suffer withholding tax on investment income arising from holding cross-border assets, and these withholding taxes need to be managed to ensure the optimum position is achieved.

The insurance company will generally hold these portfolio debt and equity investments through a global custodian. The custodian’s role is in the post-trade space, but of relevance here is its role in assisting its clients with securing access to lower rates of withholding tax pursuant to a double tax treaty or source country’s domestic law. Accordingly, the custodian’s tax services in this context focuses on the collecting and filing of tax documentation to enable investors to make such claims. To claim the benefit of a treaty, some form of documentation is generally required to prove entitlement. Such documentation may include a certificate of tax residence, a treaty claim form or income payment information.

When opening an account, a typical global custodian will ask the client to provide certain documentation to determine the appropriate tax service. Often, this will take the form of a number of representations such as:

► A representation as to the legal form of the entity
► Whether the entity is as a general matter treaty-entitled
► Whether the entity is the beneficial owner of the income

Furthermore, the custodian may ask for a power of attorney to allow it to complete certain tax forms and request documentation, etc., on behalf of the client.

The global custodian will collect any necessary documentation from its clients in order to support its tax servicing proposition. The global custodian will in turn pass this documentation, if needed, to the local sub-custodian, which may in turn be required to pass it up through the chain.

Given the complexity of the process and the number of potential markets to invest in, mistakes are common. Some of the headlines here would include: incorrect withholding tax rates, failure to claim treaty benefits and failure to comply with local source country obligations. With the increased focus on maximizing returns and general tax authority scrutiny, organizations must have robust operational processes to manage withholding taxes.
Who watches the custodian?

In order for the custodian to provide a tax service—such as filing tax reclaims and collecting tax documentation—a number of requirements need to be fulfilled.

Firstly, and this may seem self-evident, the custodian needs to be able and willing to offer a tax service in an investment market. This is not always the case for a number of reasons, stretching from a lack of client demand to unclear processes and procedures. This may be more of an issue in emerging markets where treaty claim processes are not always clear or defined. Secondly, the lack of a service offering may not always be that apparent to the client, as custodians are unlikely to publicize any service limitation. While it is common for custodians to provide tax services in markets with clear regulations and procedures, they may not necessarily include it within their offering where they have little demand for such a service or the process is either unclear or costly. As a practical matter, this may mean that an investor potentially entitled to a treaty is effectively leaving money on the table.

What is the answer? Understanding who is responsible for the tax position is key—is it the company, is it the custodian, or is it both? Insurers should perform a regular periodic review to identify where treaty claims are not being filed and learn why. Where withholding tax claims are material, it may be worthwhile to either ask the custodian bank to consider filing such claims or appoint a third-party advisor to assist. Potential claims should be considered on a rolling basis to ensure that any possible statutes of limitations are managed.

Where do the errors typically occur?

A custodian tax service is generally predicated on the client taking appropriate action when required. Thus, a custodian will typically inform clients through a market information news service update when there is a change in process and a need for new documentation or additional representations to be made, etc. If the client fails to respond, the custodian may take no further action, and a potential benefit is lost. The flipside to lack of investor action is that the custodian may, through poor processes, miss a change or incorrectly set up a client. Unless such errors are identified, reduced withholding tax rates could be missed. It can be extremely hard or impossible to reclaim such tax relief in some markets if it isn’t obtained at point of payment.

Accounts that are set up incorrectly are a real area of concern, anecdotal evidence shows. Insurers should periodically review the custodian bank’s rates and check against what’s theoretically possible. Discrepancies should be pursued when identified.

Another common problem is a lack of general understanding regarding the appropriate investor analysis. This means that certain categories of investor—e.g., pension schemes arranged through insurance companies—may be entitled to an exemption from withholding tax in the source country. In addition, global groups may be missing opportunities to manage exposure to withholding taxes through careful management of which entities invest in which assets. Where a group is able to manage its investment portfolio globally, it can ensure that as many investments fall within the protection of treaties as possible. However, if the custodian is not sophisticated enough to ask the right questions at the time of onboarding the client, and the client is not sufficiently aware of such potential benefits, the opportunities can be lost.

i) Impact of European Union law

Insurers should consider the potentially positive impact of recent European Court of Justice decisions that relate to cross-border withholding tax on dividend payments. A non-resident portfolio investor receiving dividend payments cannot be treated in a less favorable manner than a comparable domestic investor. Where such discrimination is held to exist, there may be a claim to be made by reference to the principles set out in the EU Treaty. This is relevant in a portfolio investment scenario where a local insurer may have suffered a lesser withholding tax rate than a comparable foreign insurer. The amounts of tax involved are substantial, with billions of dollars at stake.

ii) Tax authority scrutiny

Many governments are presently under acute fiscal pressure. This poses a further challenge for cross-border investors. As a general trend, withholding tax rates are creeping up—e.g., recent changes in Portugal. Countries are also introducing more onerous documentation, Korea and Indonesia being two recent well-publicized examples. This is in part designed to repair fiscal shortfalls but is also a product of tax authorities trying to clamp down on perceived abuses of process. These new forms often attempt to collate detailed beneficiary information to help tax authorities determine whether the claimant is treaty-entitled. From a general compliance perspective, it is therefore important to understand what representations have
been made and what tax claims are being submitted on your behalf. The cash tax risk (i.e., the tax exposure) of getting a claim wrong is one issue, but the potential damage to reputation and associated franchise risk is greater.

iii) Assessing market changes
Tax laws are notorious for regular change, and, given where we are in terms of the general fiscal cycle, it seems that such changes are becoming more frequent. From the perspective of a non-resident investor, changes in withholding tax rules—or, say, an interpretation regarding treaty eligibility—can require a material change in investment strategy. Organizational best practice is to have a defined process with clear lines of ownership to deal with such changes. This is often the missing piece on the investor side. Investors generally have a good new product, investment, market or due diligence process in place, but the ongoing maintenance is often put to one side.

Final thoughts
Forward-thinking insurers concerned with ensuring that they maximize total investment returns must scrutinize their withholding tax position. By running regular review exercises and involving the tax function more in the investment process, they can often identify areas where claims have not been made. This can be for a variety of reasons, ranging from complexity of process to missed opportunities. This review should be married up with a fundamental review of the governance and control processes surrounding operational taxes to ensure that the correct level of tax is being paid.

It is not clear when the market will turn and premium rates will rise to a level to allow the pressure to be taken off the investment return. In the meantime, the pressure will remain on the investment function to drive ever-greater returns and to support the profitability of the business. With the challenges in the wider economy showing no sign of easing, managing tax paid on investments is one simple way to drive a better return.

Key questions to ask
1. Is responsibility for operational taxes clearly defined within your organization? Where does it lie?
2. Who is responsible for the tax relationship with your custodian bank(s)?
3. How comfortable are you that your organization is not suffering any unnecessary withholding tax being paid in relation to your investment assets or investment return?
4. Do you have a robust process to monitor operational tax changes and consider any impact?

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The results of Ernst & Young’s benchmarking survey—the first focusing only on the specialty market—show substantial opportunities for global specialty (re)insurers to reduce costs by transforming their operating models and simplifying their businesses. For those firms that are challenged to drive margins in a sustained soft market, we’ve identified a number of ways to improve efficiency.

The 2012 Ernst & Young cost benchmarking survey was designed to identify key operational transformation opportunities for specialty (re)insurers. Participants of the survey include 16 (re)insurers, mostly headquartered in Bermuda with offices in a range of countries, including the US and UK. Participants ranged from some of the smallest companies in the market to the largest: Gross Written Premiums ranged from US$500m to over US$3b and FTE (full time equivalent) employees from under 100 to over 3,000. Participants were asked to provide details of the cost and FTE breakdown by function and by cost type to allow detailed comparisons between peers.

Significant savings can be achieved in underwriting, finance and IT

The underwriting function was the largest and most costly function for the majority of our survey participants. However, the range of results was very wide and indicated varied approaches to balancing ‘front office’ and ‘back office’ costs. The majority of insurers had some form of underwriting support in place, but this was often in higher cost locations or segmented by line of business which reduces the cost efficiency of these activities. Compared with the benchmark, this may indicate that some underwriting activities could be moved to operational or support functions.

The size of IT functions depended on project activity taking place within the organizations concerned and also the amount of offshoring and outsourcing that has taken place; the cost of this function can indicate the scale of operational transformation. Significant IT investment did not appear to be widespread; while the IT spend per FTE ranged from US$9k–US$120k, the average was US$38k. However, many participants told us they were considering investment in claims, policy and finance system replacement, as well as simplifying the overall IT landscape.

Significant savings can be achieved in underwriting, finance and IT

Finance functions also varied widely in size and cost—the finance functions for all participants were significantly larger and more costly than their equivalents in commercial or retail insurers. These larger and more expensive finance functions indicate complexity and inefficiency in underlying processes. This may be caused by role duplication, manual processes and system inefficiencies resulting from front-office versus back-office investment prioritization. They may also be attributed to the complexity of the legal entity structure.

Claims, risk and actuarial are also important areas for cost reduction

Organizations with a composite book of insurance and reinsurance tended to have larger and more costly claims functions; in comparison, organizations with smaller or less costly claims functions may have outsourced claims or may handle lower volumes.

Market trends showed that claims system replacements are being put in place to increase efficiency and control, such as the use of Guidewire and claims leakage reviews to identify ongoing opportunities to reduce the claims ratio.
Risk costs were high, reflecting a recent focus on Solvency II and other compliance activities. This increased the amount of risk-based capital required and also senior management accountability, putting pressure on compliance and risk departments.

Our results indicated that there was some disparity between the size of the actuarial function; we discussed opportunities for synergies between finance and actuarial, where there are common support functions. Also, there is potential for co-location of pricing actuaries with underwriting teams as well as actuarial function rationalization.

“Few specialty (re)insurers have focused on simplifying their business models and in my view will miss out on substantial cost savings as they increase in size unless they prioritize this.”

Ben Reid, Director, Ernst & Young LLP (UK)

Some specialty (re)insurers are already implementing opportunities to reduce cost, and many more need to be fast followers

Globally, a number of (re)insurers are implementing operational transformation or cost reduction programs, with a particular focus on underwriting, finance and IT efficiencies in these complex areas of the cost base.

Those organizations that have implemented cost reduction showed smaller or less costly functions than those that have not. For example, the finance functions of two organizations that had implemented finance effectiveness initiatives were 9% and 13% of the total cost compared with the average benchmark of 15%.

“In my view, trends such as this have really generated a lot of interest in cost reduction. With the excess of capital in the market, providing reasonable returns to shareholders must include a focus on efficiencies in all back-office functions.”

Philip Burrill, Partner, Ernst & Young Ltd (Bermuda)
In order to achieve a substantial reduction in costs, underwriting should be a key focus area for any expense initiative. A typical objective is to move routine activities from underwriters to operational or support roles, which can release up to 30% of underwriters’ time to be used on increased trading, or released as a cost saving.

Concerns about high-cost locations and personnel costs have increased activity focused on offshoring processing and outsourcing in the IT function. Some (re)insurers have a fully insourced model in high-cost locations, whereas others are beginning the process of outsourcing infrastructure and application development to lower-cost locations.

“This is a trend we are seeing — whether or not companies actually make the decision to move resources to other locations, it is something that most players have at least contemplated. The locations considered are also not restricted to ‘offshore’ locations such as India, but could include locations that are back ‘onshore’ as well, if the economics make sense.”

Philip Burrill, Partner, Ernst & Young Ltd (Bermuda)

There are a series of “get rights” to achieving cost reduction, notably executive sponsorship, clear objectives and robust ROI

Initially, a powerful guiding coalition and clear objectives need to be put in place to establish a clear definition of success and to provide ownership and accountability for individual business units and a core group of influential stakeholders.

Secondly, a sense of urgency is required to drive the program forward, establish a sense of executive sponsorship and aim for measurable wins.

This is complemented by a balance between analysis and action, which will drive pace and delivery focus; in addition, utilizing benchmarks such as those from our survey will stretch conventional thinking.

“This tallies with what I’m seeing in the market — cost reduction programs with clear leadership from the CEO and CFO are more successful for a number of reasons: accountability is sharper and delivery is more successful as benefits are tracked and measured regularly against targets set by the team and the sponsors. It’s vital to have clear commitment and leadership.”

Paul Cooper, Partner, Ernst & Young LLP (UK)

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Ben Reid (breid@uk.ey.com), Philip Burrill (philip.burrill@bm.ey.com) and Carolyn Myers (carolyn.myers@bm.ey.com) are currently working with a number of specialty companies to help deliver expense reduction, including finance transformation by improving process efficiency, reducing duplication and consolidating financial systems. Please contact them for more information about the survey.
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