

Insurance

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Sharing insights on key industry issues*

European edition • September 2008



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The European Insurance digest focuses on the key issues driving the insurance industry. If you would like to discuss further any of the issues raised, please contact the individual authors, whose details are listed at the end of each article.

We would also welcome your comments on Insurance digest. Your feedback will help us to ensure that our publications are addressing the issues about which you feel most strongly. Please email rebecca.j.pratley@uk.pwc.com.

Contents

European edition • September 2008

Editor's comment	2
Ray Kunz	
Riding the cycle: Keeping one step ahead of the competition	4
Jean-Bernard Crozet and Jan-Huug Lobregt	
Many insurers are struggling to sustain profitability in the face of a continued softening in non-life insurance rates. However, proactive management could turn the cycle into a source of competitive differentiation and advantage, as Jean-Bernard Crozet and Jan-Huug Lobregt report.	
Sustaining profitable growth	10
Damian Guly, Simon How, Steve Osei-Mensah and Rupert Taylor-Rea	
Incisive strategies for organic growth and M&A will prove critical as insurers come under increasing pressure to manage costs and shore up revenues in today's testing market conditions. Damian Guly, Simon How, Steve Osei-Mensah and Rupert Taylor-Rea assess the opportunities for sustaining profitable growth in the year ahead.	
Is your ERM delivering?	16
Robert Borja, Jan-Willem Deurvorst and Mark Train	
Enterprise risk management (ERM) in the European insurance industry has come to a crossroads as investment and expectations have soared, but many companies have yet to realise the full benefits. Robert Borja, Jan-Willem Deurvorst and Mark Train examine what a far-reaching new PricewaterhouseCoopers study reveals about how to deliver the competitive payback from effective ERM.	
Bridging risk and reward: Closer alignment between risk and finance	22
Ranjit Jaswal, James Smith and David Wong	
Closer alignment between risk and finance could not only ease the implementation of a series of new reporting requirements, but also enhance decision-making and strengthen stakeholder confidence. However, Ranjit Jaswal, James Smith and David Wong argue that full integration may be a mistake.	
Is this a good bet? Driving value amid uncertainty	28
Albertha Charles and Hsiu Min Lim	
How can life insurers be sure that they are targeting strategic investment where it can earn its best return and how can they convince analysts and investors they are making the right choices? Albertha Charles and Hsiu Min Lim look at how advanced techniques that match insight into customer preferences with dynamic financial analysis could provide a convincing answer.	
Confronting the down cycle: Seeking opportunity in uncertain times	34
Caroline Foulger, Colm Homan and Arthur Wightman	
How are Bermuda's insurers reacting to changing market conditions? Caroline Foulger, Colm Holman and Arthur Wightman discuss what a new PricewaterhouseCoopers survey reveals about the road ahead.	

Editor's comment

RAY KUNZ



Welcome to the second edition of European Insurance digest for 2008.

In May, Mervyn King, governor of the Bank of England, said that 'we are travelling along a bumpy road as the economy rebalances.... I think the events of the last six to nine months are not ones that people will forget in a hurry.'¹

For insurers, the pressing challenges include funding constraints, falling investment values and continued softening in non-life premium rates. They are also contending with the decline of consumer confidence and spending that has followed in the wake of the credit crisis. However, the current environment also provides renewed opportunities for companies to sharpen their competitive edge and realise the benefits of investment in enhanced information systems, more robust risk management and more incisive strategies for growth. This edition of digest looks at how to address both challenges and opportunities that are coming to the fore in today's market conditions.

Far from disappearing as some predicted, the underwriting cycle has simply become more fragmented and prolonged in recent years. Although the impact has tended to be most pronounced in the UK and the US, Continental markets have also become increasingly cyclical. One of the key reasons that the cycle persists is the often long lag in feeding rating movements into pricing and underwriting strategies. In 'Riding the cycle: Keeping one step ahead of the competition', Jean-Bernard Crozet and Jan-Huug Lobregt examine the strategies and forward-looking analysis that could help companies to develop a more proactive and profitable approach to cycle management.

Incisive strategies for acquisition and organic growth are likely to prove critical as insurers come under increasing pressure to manage costs and shore up revenues in the downturn. Acquisition could help companies to enhance scale and realise cost-saving synergies. As Damian Guly, Simon How, Steve Osei-Mensah and Rupert Taylor-Rea explain in their article 'Sustaining profitable growth', the good news is that opportunities for M&A are increasing. In particular, a growing number of banks are putting their insurance divisions up for sale as they seek to recoup capital and focus on their

1. Bank of England inflation press conference, 14.05.08.

core competencies. A number of insurers are also looking to strengthen client retention and boost organic growth through investment in enhanced distribution and customer relationship management (CRM) systems.

More effective control and understanding of risk are also likely to prove critical in navigating the difficult waters ahead. Drawing on a far-reaching study of enterprise risk management (ERM) in the insurance industry published by PricewaterhouseCoopers² earlier in the year,³ Robert Borja, Jan-Willem Deurvorst and Mark Train's article 'Is your ERM delivering?' assesses whether companies are equipped to deal with an increasingly complex and uncertain risk environment. It also looks at whether ERM systems are robust enough to meet the rising expectations of shareholders, regulators and rating agencies. If the key conclusion is that risk considerations are still insufficiently embedded into business decision-making to meet this rising bar and realise the full benefits of ERM, how can insurers close the gap?

Risk and finance have historically played quite distinct roles within the business. Today, however, both internal and external drivers are bringing these functions closer together.

In 'Bridging risk and reward: Closer alignment between risk and finance', Ranjit Jaswal, James Smith and David Wong look at how greater cooperation between risk and finance could help to create a better understanding of the trade-off between risk and reward. Bringing risk and finance closer together could also provide an important foundation for the implementation of Solvency II and IFRS Phase II.

Many life insurers are looking to strengthen their presence in emerging economies to make up for slower growth in their more mature home markets. Yet, difficulties in predicting customer behaviour and inadequate understanding of the uncertainty and risks of the target market could mean that strategic evaluations may not provide a sufficient basis to convince analysts of the merits of the investment. In their article, 'Is this a good bet? Driving value amid uncertainty', Albertha Charles and Hsiu Min Lim outline how advanced techniques that match insight into customer preferences with dynamic financial analysis could provide a more reliable measure of value.

Bermuda's insurers and reinsurers have earned a strong reputation for adapting to change in uncertain times. How are they

responding to the softening of rates and economic slowdown? In the spring of 2008, PricewaterhouseCoopers surveyed a substantial proportion of the island's insurers and reinsurers.⁴ In 'Confronting the down cycle: seeking opportunity in uncertain times', Caroline Foulger, Colm Homan and Arthur Wightman examine what the findings reveal about the road ahead for the market. While CEOs broadly agree that the downturn will be no more severe than in previous cycles, they generally expect the market to show year-on-year premium rate cuts through to 2010, across all business classes. Many companies are looking to product and geographical diversification to make up for any drop in income. Strategies include both acquisition and the establishment of representative offices in new territories.



Ray Kunz
Editor

Tel: 41 58 792 2380
ray.kunz@ch.pwc.com

2. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.
3. 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.
4. Confronting the down cycle: Seeking opportunity in uncertain times – Bermuda market survey 2008, published by PricewaterhouseCoopers in July 2008.

Riding the cycle: Keeping one step ahead of the competition

AUTHORS: JEAN-BERNARD CROZET AND JAN-HUUG LOBREGT



Non-life insurance rates are continuing to soften, exerting further downward pressure on margins and profitability. However, the dip in the underwriting cycle could also enable insurers with more effective pricing strategies, market intelligence and control of expenses to capitalise on their competitive advantages. Jean-Bernard Crozet and Jan-Huug Lobregt examine how the cycle is evolving and how two experienced industry professionals are seeking to manage the impact in a more proactive and competitive way.

RIDING THE CYCLE: KEEPING ONE STEP AHEAD OF THE COMPETITION

In 2007, the accident year combined ratio for the UK private motor insurance market reached 113%, an increase of 3% from the already high percentage of 2006.¹ These figures provide a clear indication of a sector that has been struggling to sustain profitability in the face of mounting competition, excess capacity and the resulting softening of premium rates across large parts of the non-life insurance market.

In 2008, premiums have come under further pressure in insurance classes, ranging from motor and property to more specialised wholesale lines. Although the peaks and troughs in the underwriting cycle have always tended to be most pronounced in the UK and the US, Continental markets have become increasingly cyclical as the market globalises and competition intensifies. With the current economic landscape leaving less investment income to fall back on, 2008 could be an especially challenging year for the non-life sector.

Force of nature

In a perfectly rational market there would be no cycles; capacity would be swiftly adjusted to match demand

and insurers would stop underwriting business once it becomes unprofitable or subject to unacceptable risk. Yet, despite efforts to improve market intelligence and underwriting discipline, there have always been some companies prepared to undercut rates and unknowingly lead the market down to unsustainably unprofitable depths. 'In the past, insurers have simply accepted the insurance cycle, seeing it as a force of nature with an uncontrollable impact on their business', said Rolf Tolle, Lloyd's franchise performance director, at the launch of a report into how to improve cycle management in December 2006.²

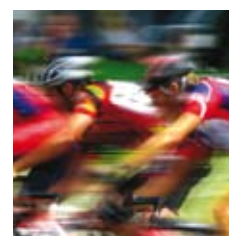
Cycle movements are to some extent driven by market forces. In a typical cycle, a decline in profitability leads to a reduction in capacity and supply, and hence an increase in rates. As these higher rates fuel increases in profitability, capacity re-enters the market and rates begin to soften. Within the property market, the latest cycle began in the aftermath of Hurricane Katrina, as severely affected insurers either withdrew cover from catastrophe-exposed regions or raised prices to recoup their losses. This was a good time to enter the market, with

opportunistic investors moving in to take advantage of the shortfall in supply and hardening of rates. During 2007, capacity continued to increase and premiums began to fall back.

However, these market forces are only part of the story. Although companies would naturally avoid underwriting unprofitable business if at all possible, they may choose to do so to maintain a valued customer relationship. Others may want to establish or sustain market share, although such a strategy could severely erode bottom-line growth and shareholder value. It is notable that the bonuses of many underwriters continue to be based on short-term metrics rather than longer term value measures. The temptation to follow the market down is especially marked within subscription business and highly competitive segments.

Information lag

Even companies that are willing to scale back capacity to sustain profitable margins may be slow to respond, especially as it can take two years or more for corrective rating action to feed into the profit and loss (P&L) account.



Continental markets have become increasingly cyclical as the market globalises and competition intensifies.

1. Post Magazine, 10.07.08, based on Financial Services Authority (FSA) returns (the accident year combined ratio excludes the release of reserves and therefore provides a more accurate indication of the trading position than the reported combined ratio).
2. Lloyd's press release to launch 'Seven steps to managing the cycle', 07.12.06.

For many insurers, the first indication that business has been written at a loss only comes when claims are submitted, which can take months or even years in some cases. The company can then undertake pricing analysis and make appropriate recommendations to underwriters. However, they will still need to wait until the renewal season to enact price rises, which in turn takes some time to earn through P&L. Even then, competition will typically limit rate increases, especially if there is no 'big event' such as Hurricane Katrina to prompt a sudden turn in the cycle.

For this article, we interviewed Frank Strobbe, who divides his time between heading the business intelligence unit of ING Insurance Services and working as a senior actuary in the non-life

department of Nationale-Nederlanden (NN), a subsidiary of ING. ING now actively uses the underwriting cycle in its pricing process for motor insurance. However, the business used to be managed on the basis of the combined ratio. If the ratio was decreasing, there was room to increase premium levels; if it increased, then premiums were reduced. 'The problem was that it could take more than a year for the company to adjust premiums. This is still the case for most companies in the Dutch market', said Mr Strobbe.

The potential problems created by 'information lag' were further highlighted in PricewaterhouseCoopers' recent survey of enterprise risk management (ERM) in the insurance industry.³ Less than one-third of participants strongly

agreed that they have a clear strategy to respond to a softening market. Less than a quarter strongly agreed that their underwriters track and aggregate deviations from indicated prices or that their process for identifying the stage in the cycle is credible enough to drive business decisions. It would appear that like supertankers, many insurers are slow to turn, even when they find themselves in hazardous waters, a problem compounded by the delays in getting relevant messages to the bridge.

Damaging impact

As insurers face falling returns in a softening market, many analysts will look closely at whether reserves are being released to smooth reported earnings, and if so to what extent. Depleting their capital

could leave insurers more vulnerable to the impact of a major loss. Their susceptibility to risk may be heightened by the more favourable policy terms and conditions that tend to go hand in hand with declining rates as companies seek to sustain business.

More broadly, the fluctuations in the cycle may discourage investment in the industry as a whole. For this article, we also interviewed John Seaton, who until recently was UK director of underwriting at Norwich Union and is now underwriting director of MMA UK. Although Mr Seaton believes that cycle fluctuations stem from a number of factors, some of which may be beyond insurers' control, the plain fact is that 'analysts simply see the cycle as evidence



3. 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.



of an industry that cannot manage itself'. 'This is fair to a point,' he believes, 'many insurers have not taken a long enough view by investing in the right tools to monitor performance and seeking to structure rewards appropriately.'

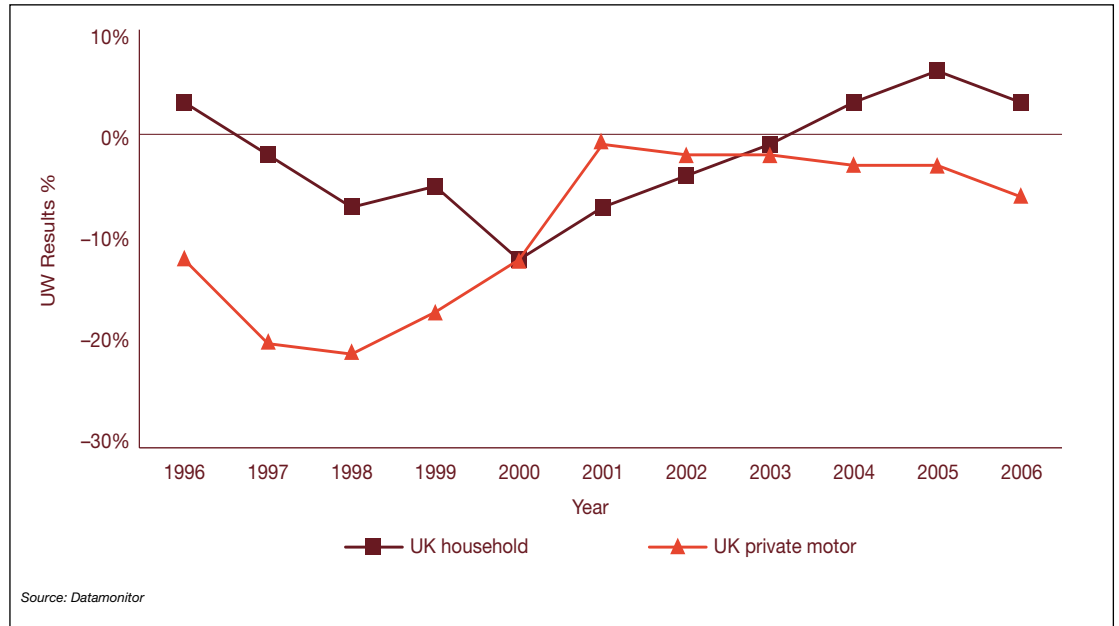
Evolving cycle

In recent years, consolidation has eased the pressure of competition in some markets. Advances in modelling and analysis have led to improved lead indicators and more precise technical pricing. Regulators, including the Lloyd's Franchise Board and FSA in the UK are seeking to impose greater price and risk management discipline. In theory, these developments should make the impact of the cycle less pronounced. However, far from disappearing, the cycle has simply become flatter and more prolonged overall, particularly for UK private motor. Figure 1 highlights the change in cycle shape of the UK private motor class relative to the UK household class.

In the UK, the rapid increase in insurance sold via internet price comparison sites (aggregators) is sharpening price competition. Although the impact is especially marked in the motor market, where aggregator-instigated private vehicle insurance accounted for just under a quarter of all new business in 2007,⁴ household insurance is beginning to follow suit. Recent research carried out by confused.com, a leading aggregator, found that

FIGURE 1

Underwriting result as a % of net written premium



customers could save an average of around €150 on their home insurance and €160 on their car insurance by using its site.⁵ With reductions like these, it is more than likely that the aggregator model and its impact on prices will eventually take hold on the Continent. John Seaton describes aggregators as 'commoditisation taken to its ultimate degree'.

Other factors that may be prolonging the cycle include the variety of different labels and channels through which large groups now market insurance products, which can make it harder to formulate and coordinate an appropriate response to market movements.

A series of relatively mild winters have also reduced motor claims and spurred price reductions.

Turning the cycle into an advantage

Insurers could simply choose to withdraw as competition, commoditisation and declining rates make certain business classes unprofitable. However, they would still need sufficiently timely and reliable information upon which to base their decision on exactly when to pull out, while ensuring that the enterprise is nimble and disciplined enough to respond in an appropriately swift, decisive and coordinated way. In some high-volume classes, such as motor or buildings cover, a leading

insurer may also find it difficult to scale down without losing critical mass. The challenge is therefore how to maintain price competitiveness, while sustaining profitability and investor confidence. For John Seaton and Frank Strobbe, this is an opportunity for well-run companies to steal a march on their more vulnerable competitors through more prospective market analysis and more proactive underwriting strategies.

'Understanding the point in the cycle and where the market is going over the next two to three years should be a fundamental part of the strategic agenda', says John Seaton. While price is the key driver for customer choice, he believes that there has to be a

4. 'Aggregators in UK general insurance 2008: A growing force', published by Datamonitor in March 2008.

5. 'Save money by shopping around for car insurance', published in Cornhill Allianz 'Car Insurance News', 22.07.08.

walk-away premium level. An example would be Aviva's commitment to 'meeting or beating a 98% combined ratio'.⁶

For companies to remain competitive while maintaining this line in the sand requires five key attributes, according to John Seaton:

- Control of expense ratio – ensure business is price-competitive and provide assurance for analysts;
- Good management information that includes effective lead and lag indicators – insurers need up-to-date information on where they are in relation to their walk-away price and future market developments;
- Good risk management and financial modelling – understanding of key risks enables insurers to control exposures, price more keenly and have the confidence to accept business that other less well-informed competitors may reject;
- Consistent and relevant reward strategy geared to 'economic' rather than top-line returns – encouraging underwriters to adopt a sustainable approach to pricing and selecting risk,

capable of enhancing shareholder value, even if this means scaling back business; and

- Investment in good people with experience of previous cycles, who understand the economics of their business and the financial dynamics of the market.

The underlying basis for success is the 'discipline, professionalism and market understanding needed to build the demands of the cycle into the DNA of the organisation', says John Seaton. For many companies, this is as much of a cultural as a technical challenge as they seek to change the way underwriters judge performance and the basis upon which they are rewarded. For example, it could be difficult to convince an underwriter that they are meeting the overall objectives of the company by accepting very little business at a low point in the cycle.

Frank Strobbe also recognises the importance of bringing the underwriting cycle into the forefront of business planning. ING is one of the few companies in the Netherlands that actively uses the cycle in its pricing strategy. His business intelligence unit analyses the competition,

ING's position in the market and developments in key risk factors on a monthly basis. A particular focus is the motor market, which is especially competitive in the Netherlands, along with fire insurance, which is becoming increasingly commoditised through a rapid increase in internet sales. 'We have moved from a reactive approach to more proactive monitoring and analysis capable of predicting the trajectory of market movements and responding accordingly', says Frank Strobbe.

ING has just launched new motor insurance through its Postbank label. The Dutch motor market is at a low point in the cycle. However, by understanding the trajectory of the cycle and carefully managing costs, ING can successfully introduce the Postbank motor insurance product. Belgium is at a different point in the cycle as rates begin to climb down from their current peak, enabling ING to launch a new motor policy at a relatively favourably priced premium. 'The main advantage of our cycle analysis is that we are aware of the reward profile and how it is likely to develop and can therefore judge our strategic timing and expectations accordingly', says Frank Strobbe.

Knowing the score

Far from disappearing, the underwriting cycle is becoming more prolonged and unpredictable and spreading to markets that had until recently been relatively stable. While some insurers may continue to passively accept the cycle as an 'uncontrollable force of nature', the challenges it presents could provide an opportunity for well-informed and well-managed insurers to manage market movements more proactively and realise the competitive advantages of keener pricing, lower losses and more sustainable underwriting strategies. This approach could in turn help to enhance market confidence and alleviate the fluctuations in returns that have deterred investment in the sector.

Success depends on the ability to define a walk-away price and ensure that this is competitive through effective cost and risk management. Insurers also need reliable forward-looking indicators and tight discipline so they know when this line in the sand is likely to be breached and can ensure that underwriters scale back business accordingly. According to John Seaton, the ultimate aim is a business that is capable of 'competing on knowledge'. □

AUTHORS



Jean-Bernard Crozet

Associate Director, Actuarial and Insurance Management Solutions
PricewaterhouseCoopers (UK)

Tel: 44 20 7212 1265

jean-bernard.crozet@uk.pwc.com



Jan-Huug Lobregt

Senior Manager, Actuarial and Insurance Management Solutions
PricewaterhouseCoopers (The Netherlands)

Tel: 31 20 568 5322

jan-huug.lobregt@nl.pwc.com

6. 'Industry excellence in UK P&C', a presentation by Igal Mayer, CEO of Norwich Union Insurance, to the Goldman Sachs European Financial Conference, Berlin 2008, 11.06.08.



RIDING THE CYCLE: KEEPING ONE STEP AHEAD OF THE COMPETITION continued



Sustaining profitable growth

AUTHORS: DAMIAN GULY, SIMON HOW, STEVE OSEI-MENSAH AND RUPERT TAYLOR-REA



European insurers are striving to sustain profitability in the face of an increasingly tough market climate. Realising opportunities for mergers and acquisitions (M&A) and organic growth could help companies to manage costs and strengthen revenues. Damian Guly, Simon How, Steve Osei-Mensah and Rupert Taylor-Rea examine the drivers and developments that are set to shape deal activity and revenue growth strategies in the year ahead.

SUSTAINING PROFITABLE GROWTH

'The uncertainty surrounding the outlook for economic activity remains high', said Jean-Claude Trichet, president of the European Central Bank, at a press conference in July.¹

For European insurers, one of the most challenging aspects of this 'uncertainty' is the difficulty of predicting customer behaviour when the depth and duration of the economic slowdown is still largely unknown. As concerns over inflation and unemployment increase, discretionary spending is likely to be curtailed. The stalling in the property market could affect demand for term life, buildings cover and payment protection insurance, and further dislocation could follow. On the life side, the impact could include reduced demand for savings and investment plans. On the non-life side, people may buy less travel insurance or choose third-party motor insurance rather than more expensive comprehensive cover, for example. Whether the downturn is beginning to bottom out or worse is yet to come is a matter of conjecture; the challenge for insurers is planning for all economic eventualities amid the wider problems of softening non-life premium rates, falling investment returns and declining asset values.

In the deal market, the spectre of recession and how this may affect customer demand and corporate profitability are creating their own uncertainty. In particular, the uncertain prospects are making it more difficult to value businesses. Moreover, in the view of many commentators, sellers have not yet sufficiently lowered their price expectations to attract the committed interest needed to secure a sale.

However, in an insurance sector that remains fragmented, the case for continued consolidation is strong, especially as this could help realise opportunities for cost-saving synergies. As banking groups seek to release capital and sharpen their strategic focus in the wake of the credit crisis, some may choose to sell their insurance subsidiaries. An increased availability of acquisition targets could in turn help purchasers to secure deals at more realistic prices.

As competition intensifies, the need to manage costs and enhance efficiency will become more urgent. Companies may also need to focus more closely on client retention and cross-selling at a time when capital constraints and uncertainty over consumer spending could make customer acquisition and new product

launches riskier and less cost-effective. As a recent PricewaterhouseCoopers survey highlighted,² the focus of investment in revenue growth is set to include multi-channel distribution and improved customer analytics. Customer 'ownership' will be especially important in enabling life insurers to win pension and investment business, as welfare reform and an ageing population rapidly increase demand.

In this article, we consider the challenges and opportunities for both acquisitive and organic growth within the current market environment. We will reflect on the level of M&A during 2007 and assess some selected deals and the underlying themes, before considering the prospects for, and possible drivers of, transaction activity in 2008 and beyond. We will also examine how leading companies are looking to enhance customer understanding, service and retention as part of their organic growth strategies.

Deal activity in 2007

Financial service deal activity accounted for almost one-fifth of all European M&A by value in 2007 (€207.7 billion³), a rise of more than 50% from 2006. European insurance deals made



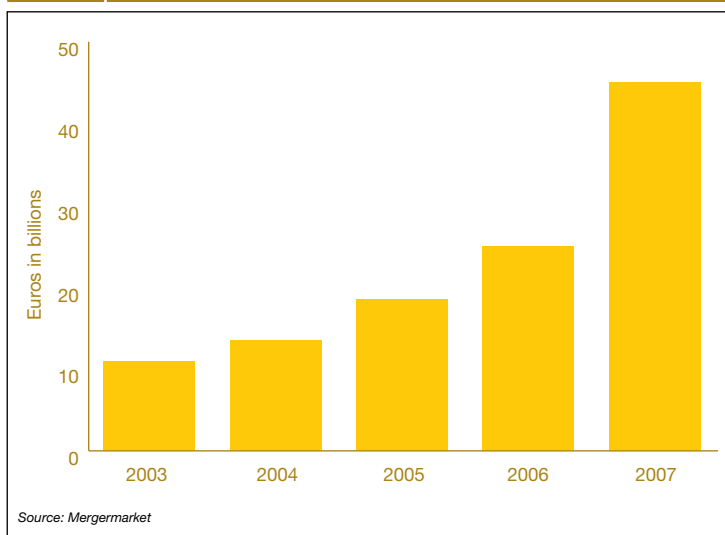
...in an insurance sector that remains fragmented, the case for continued consolidation is strong....

1 Transcript of ECB press conference, 03.07.08.

2. Survey conducted by PricewaterhouseCoopers and the findings presented at 'The Insurance Network Half Day Workshop', 15.05.08.

3. Mergermarket announced deals in 2007 excluding those that, in our view, are not 'true' financial services deals, e.g. real estate.

FIGURE 1 European insurance deals total announced value



up €44.8 billion⁴ of the total, an increase of 76% from 2006. This rise was significant, given the growth rates of around 30% already recorded in 2005 and 2006 (see Figure 1).

Figure 2 lists the 10 largest European insurance transactions in 2007. A key driver was the desire for cross-border growth and diversification, as exemplified by Allianz's acquisition of the remaining 42% of Assurance Générales de France (AGF), the year's most valuable deal. Allianz believes that its 'home' market is Europe as a whole rather than just Germany. 'The transaction will strengthen Allianz's position in

its core home markets and business lines', said Michael Diekmann, CEO of Allianz SE.⁵ Similarly, the acquisition of Converium by SCOR, the French reinsurer, demonstrated a desire to achieve critical scale and leveraging of complementary markets and business lines. 'The consolidation in the insurance and reinsurance industries shows that size, diversification and expertise are critical success factors', said Denis Kessler, chairman of SCOR.⁶

Another key motivator was the opportunity to realise synergies in cost and efficiency, as was evident in the acquisition of

Resolution by Pearl and the merger of Saga and the AA. Completed in May 2008, the takeover of Resolution illustrated the continued willingness and ability of major insurers to undertake transformational deals. At above embedded value, the price also indicated that Pearl sees significant opportunities to develop and extract value from the merged businesses. Hugh Osmond, Director of Pearl Group Ltd, said: 'We wish to combine the proven strength and expertise of both teams to create one organisation capable of delivering far more than either of its constituent parts.'⁷ The merger between Saga and the AA also highlighted the increasing influence of private equity in the European financial services sector. The link-up of the two private equity-owned businesses is designed to achieve greater scale and synergies. 'Both organisations can grow and benefit from sharing expertise and systems', said Andrew Goodsell, CEO of Saga.⁸

Developments ahead

The search for competitive scale and cost-saving synergies will be even more important in the challenging market conditions of 2008 and beyond. The strategic reviews and realignment within the financial services sector as a

whole could also open up new opportunities for acquisition and revenue growth.

Divestment

Events so far in 2008 indicate a possible shift away from the bancassurance model in some markets as banks look to release capital and refocus on their core activities. In an interview with La Repubblica earlier in the year, Henri de Castries, chairman of AXA, said that he expects banks with a stretched capital base to reduce their presence in the insurance sector, mainly in the second half of 2008.⁹

The Royal Bank of Scotland (RBS) has announced plans to sell its insurance division. The assets on offer include the well-known UK brands Direct Line and Churchill. 'RBS Insurance... remains an excellent business, but is not central to the very strong banking franchises we have now built', said Sir Tom McKillop, chairman of RBS.¹⁰ Grupo Santander is also reported to be considering a sale of its insurance business.¹¹ A number of insurers are themselves carrying out reviews that may result in the sale of non-core operations. Examples include Friends Provident, which is seeking to release Lombard as part of its renewed focus on life and pensions.¹²

4. Mergermarket announced deals in 2007.
 5. Allianz media release, 18.01.07.
 6. SCOR media release, 26.02.07.
 7. Pearl media release, 16.11.07.
 8. Saga media release, 25.06.07.
 9. La Repubblica, 21.04.08.
 10. RBS General Meeting statement, 14.05.08.
 11. Reuters, 19.07.08.
 12. Friends Provident media release, 31.01.08.



FIGURE 2

Top ten insurance deals by value in 2007

Rank	Announced date	Target company	Target country	Bidder company	Bidder country	Deal value EUR (m)
1	Jan-07	Assurance Generales de France	France	Allianz	Germany	9,800
2	Oct-07	Resolution Plc	UK	Pearl Group Limited	UK	6,582
3	Jun-07	Saga Group Ltd	UK	Automobile Association Limited	UK	4,156
4	Apr-07	Generali PPF Holding	Czech Republic	Assicurazioni Generali SpA; PPF Group NV	Italy; Netherlands	2,600
5	Feb-07	Converium Holding AG	Switzerland	Scor SA	France	1,951
6	Jun-07	SPP Livforsakring AB	Sweden	Storebrand ASA	Norway	1,914
7	Apr-07	AXA Nederland BV; DBV Verzekeringen; Winterthur Verzekeringen Holding BV	France, Netherlands	SNS Reaal NV	Netherlands	1,797
8	Jul-07	Abbey Life Assurance Company Ltd	UK	Deutsche Bank AG	Germany	1,451
9	Feb-07	Nuova Tirrena S.p.A.	Italy	Groupama SA	France	1,250
10	Mar-07	Banca Monte del Paschi Siena SpA (50.0% stake); Montepaschi Assicurazioni Danni S.p.A (50.0% stake); Montepaschi Vita SPA (50.0% stake)	Italy	AXA SA	France	1,150
Total top 10						32,651
Other						12,156
Total Europe						44,807

Source: Mergermarket

Increasing private equity focus

Although private equity has been less of an active buyer in financial services than some other sectors, its presence has been growing. Much of the investment has focused on non-risk carrying businesses such as intermediaries, brokers and outsourced activities, which typically have lower capital requirements and are subject to a comparatively lighter regulatory touch. However, many private equity firms are now seeking to develop greater expertise in financial services as they come to recognise that the sector is too significant an element of the European economy to be ignored.

Although the rising cost of debt is making it more difficult for private equity buyers to secure the necessary finance for large transactions, many still have considerable funds to invest. The appearance of distressed sellers (troubled UK bank Bradford & Bingley has been one of a number to attract private equity interest), and a belief that the more difficult economic climate may increase the prospects for securing deals at attractive prices, is likely to draw further interest from private equity in financial services going forward. Targets could include insurance divestments.

Softening market

As the non-life insurance market continues to soften, the need to maintain underwriting discipline could mean that there is less scope for volume-led growth. Insurers may now need to look to those classes of business that are less affected by the insurance cycle, and bolt on acquisitions in order to deliver earnings growth. In particular, it can be difficult to value the earnings stream of an insurance business in a softening market, and if it becomes harder to control the top line then focus will inevitably shift to the control of expenses. A particular focus might be deals capable of delivering expense efficiencies

and synergies along the lines of the Pearl/Resolution and AA/Saga mergers in 2007.

Opportunities in life insurance and pensions

In August 2008, Barclays agreed to sell its life assurance division ('Barclays Life') to Swiss Re.¹³ The business was closed to new customers in 2001. The planned sale is the latest in a growing wave of life insurance buyouts. Although the sale of discontinued business has so far been predominantly confined to the UK, the move to Solvency II could heighten the spotlight on capital-intensive run-off business and prompt more Continental companies to divest.

13. Barclays media release, 05.08.08.

2008 and 2009 are also likely to see a continued increase in pension scheme buyouts. Sales in 2007 included Paternoster's €1 billion acquisition of the pension scheme of P&O. PricewaterhouseCoopers latest pension survey in the UK¹⁴ found that many companies are interested in selling some or all of their pension liabilities, with most citing the volatility of their funding position as the chief reason for their continued interest.

Owning the customer

In the face of funding constraints and an uncertain economic outlook, many insurers may focus more closely on safeguarding existing business and cementing long-term client relationships, rather than new customer acquisition. This is already evident in the purchase of a number of brokers by AXA and other leading groups, as they seek to gain closer control over the customer relationship. It is also likely to frame client retention and

customer management strategies as part of the wider pursuit of organic growth.

Organic growth

A recent PricewaterhouseCoopers survey explored the revenue growth strategies of a number of leading European insurance executives.¹⁵ Four key imperatives emerged from the findings:

Greater focus on technology, especially the internet. Customers are demanding faster response and more choice of access points from their insurers. This ranges from electronic data exchange between brokers and underwriters to the ability to follow up the status of car repairs being carried out in insurers' garage networks.

Joined-up channel strategies, with pricing reflecting the channel cost. The leading European insurers now offer multi-channel services and are developing their understanding of the relationship

between individual customer's channel preferences and profitability.

Enhanced data management, feeding more sophisticated rating engines. The fires and flood losses in Europe in 2007 highlighted the need for underwriters to develop a better understanding of their aggregated risks. The insurers that are improving their data management as a result will be able to enhance risk selection and improve their loss ratios accordingly.

Well-defined market segmentation, identifying the most profitable customers and focusing on the business that will reap the best returns on investment in customer acquisition and retention. In the current market, this may include focusing more closely on the quality of core business and how this compares to peers rather than new markets as they seek to secure greater customer 'ownership'.

Companies will not only need to develop effective customer profiling, but also ensure that staff understand and make best use of the opportunities to provide more responsive products. This can present cultural and change management challenges. 'Established practice is difficult to change', said a survey respondent. 'We have a lack of proper intelligence to accurately segment our chosen market space.'

Another central challenge is how to deliver a more favourable customer experience, while still being able to compete on price. 'Our current tailored approach, which is built around face-to-face relationships, is expensive', said a survey respondent. 'We need to utilise the expediency and reach of web distribution, while still appearing to give a personal service and offer our unique expertise.'



14. 'PricewaterhouseCoopers pensions survey: Tracking the views of key decision-makers', June 2008.

15. Survey conducted by PricewaterhouseCoopers and published at 'The Insurance Network Half Day Workshop', 15.05.08.



SUSTAINING PROFITABLE GROWTH continued

The focus on controlling costs is clearly essential. However, as we outlined in an article in the previous edition of Digest,¹⁶ companies should avoid setting arbitrary cost reduction targets that may prove unsustainable or even commercially disruptive. In particular, it is essential to identify the people and operations needed to compete, grow and deliver strategic objectives. A clear case in point in the current market is the need for people with customer relationship and entrepreneurial skills to spot and realise opportunities in a downturn.

The importance of integrated cost, channel and retention strategies has been brought into sharp focus by the rise of price comparison websites ('aggregators'), a distribution phenomenon that has grown rapidly in the last three years in the UK and may become a major new channel in other European countries. The aggregators offer price quotation comparisons for retail products such as private motor, personal loans and home insurance.

The quotes are binding and in many cases the contract can be executed on the internet there and then. Insurers featured on comparison sites are seeing rapid increases in the use of the internet channel (in the case of one major player a rise from 20% of motor policy sales via the internet in 2005, to 40% in 2007). This suggests that a multi-channel strategy is going to be increasingly critical for personal lines insurers as the aggregators provide instant choice and greater convenience in the buying process, although policy inception and service (including claims) are still largely executed via conventional channels, such as voice and post.

Survival and success

The soft cycle, falling investment returns and uncertain economic outlook are making it harder to sustain profitability and assure capital providers that anticipated returns can be achieved. Success depends on being able to manage the uncertainty ahead.

This challenging environment is likely to accelerate consolidation as insurers pursue scale, synergies, diversification and complementary earnings streams. The difficult climate is also likely to spur further developments in distribution and customer relationship management (CRM) as insurers look to enhance their understanding of their clients and offer more integrated and responsive multi-channel services. From cost control to customer ownership, effective growth strategies cut across acquisition and organic development. The key to success is determining what business fits best with the strengths of the company and developing this through targeted acquisition and customer service investment.

The prospects for growth will be strengthened still further by new opportunities, including the divestment of insurance subsidiaries by banks. As sellers begin to adjust their price expectations, purchasers may be able to secure these deals at

more realistic prices. They might also be able to enhance the value of the transaction by extending investment in more effective distribution and CRM to newly acquired businesses.

While funding is likely to be challenging for some time to come, continuing investment and growth will be critical, both in equipping companies to manage the downturn and in preparing them for the eventual upturn in the economy and insurance cycle. Sustaining profitable growth will clearly be difficult in the tough market conditions ahead. Pressure on margins and investment returns will leave insurers with less room for manoeuvre and turn the spotlight on insurers that may struggle to deliver competitive returns. The key to sustaining profitable growth is decisive strategic evaluation and execution capable of realising the opportunities that are now emerging within these tough market conditions. □

AUTHORS



Damian Guly

Partner, Leader of Transaction Services,
Financial Services Deal Team
PricewaterhouseCoopers (UK)

Tel: 44 20 7804 3494
damian.guly@uk.pwc.com



Simon How

Director, Financial Services, Performance
Improvement Consulting
PricewaterhouseCoopers (UK)

Tel: 44 20 7804 9717
simon.x.how@uk.pwc.com



Steve Osei-Mensah

Partner, Financial Services, Performance
Improvement Consulting
PricewaterhouseCoopers (UK)

Tel: 44 20 7213 1892
steve.s.osei-mensah@uk.pwc.com



Rupert Taylor-Rea

Manager, Transaction Services,
Financial Services Deal Team
PricewaterhouseCoopers (UK)

Tel: 44 20 7804 8737
rupert.taylorrea@uk.pwc.com

16. 'Smart cost management: Making every cent count', European Insurance Digest March 2008 (www.pwc.com/insurance).

Is your ERM delivering?

AUTHORS: ROBERT BORJA, JAN-WILLEM DEURVORST AND MARK TRAIN



A far-reaching new PricewaterhouseCoopers study¹ has found that many European insurers' enterprise risk management (ERM) programmes may be failing to keep pace with mounting risk pressures, escalating commercial challenges and more exacting stakeholder demands. Robert Borja, Jan-Willem Deurvorst and Mark Train look at how making ERM more integral to the business could help to deliver the anticipated benefits of a more informed and assured basis for decision-making and strategic execution.

IS YOUR ERM DELIVERING?

From financial market volatility to climate change and geopolitical instability, insurers are facing an increasingly complex and uncertain risk and commercial environment. The pressure on returns is likely to be heightened still further by capital constraints, the softening of premium rates and the slowdown in the economy.

In the face of these challenges, an increasing number of European insurers are developing a more systematic and holistic, enterprise-wide approach to risk management, aimed at strengthening control and providing a more incisive risk-adjusted basis for strategic evaluation. In today's tough business environment, the potential benefits include reduced losses, more effective use of capital and the ability to identify and swiftly capitalise on what may be limited and hard-to-discern opportunities.

However, ERM programmes cannot work in a vacuum; they need to be relevant to, and integrated into, every aspect of the business to make a difference. The need for effective embedding has been amply demonstrated by banks' recent experience of the credit crisis. It is notable in particular that many institutions

What makes ERM work?

- Effective alignment of strategy and risk appetite;
- Timely, reliable and consistent risk identification, measurement and monitoring;
- Effective communication of risk to decision-makers and appropriate escalation of issues for action;
- Understanding of risk concentrations, correlations and their potential implications, based on effective risk analytics and underpinned by regular validation, calibration and adjustment
- Ability and readiness of senior management to understand and, where necessary, challenge underlying risk assumptions;
- Consistent implementation of risk management practices and standards across businesses and geographies; and
- A culture that builds risk considerations into performance objectives and management in key areas such as business unit targets and individual incentives.

that had developed what they believed were robust and sophisticated ERM capabilities still suffered severe losses. What marked out companies that largely avoided these problems was the timely, rigorous and consistent identification, communication and consideration of risk across the decision-making and risk-taking chain (see box above). For insurers, a similar commitment to

making risk integral to the business is likely to be critical in realising the full commercial value of what for many has been a considerable investment in ERM.

Raising the bar

Further impetus for the development of ERM within the European insurance industry is coming from its growing



...ERM programmes cannot work in a vacuum; they need to be relevant to and integrated into every aspect of the business to make a difference.

¹ 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.

importance within rating agency financial strength evaluations and the approaching move to risk-based prudential regulation under Solvency II. Analysts and investors are also taking an ever-keener interest in the risks insurers are running and the risk-based measures that indicate how effectively these risks are being managed and translated into rewards.

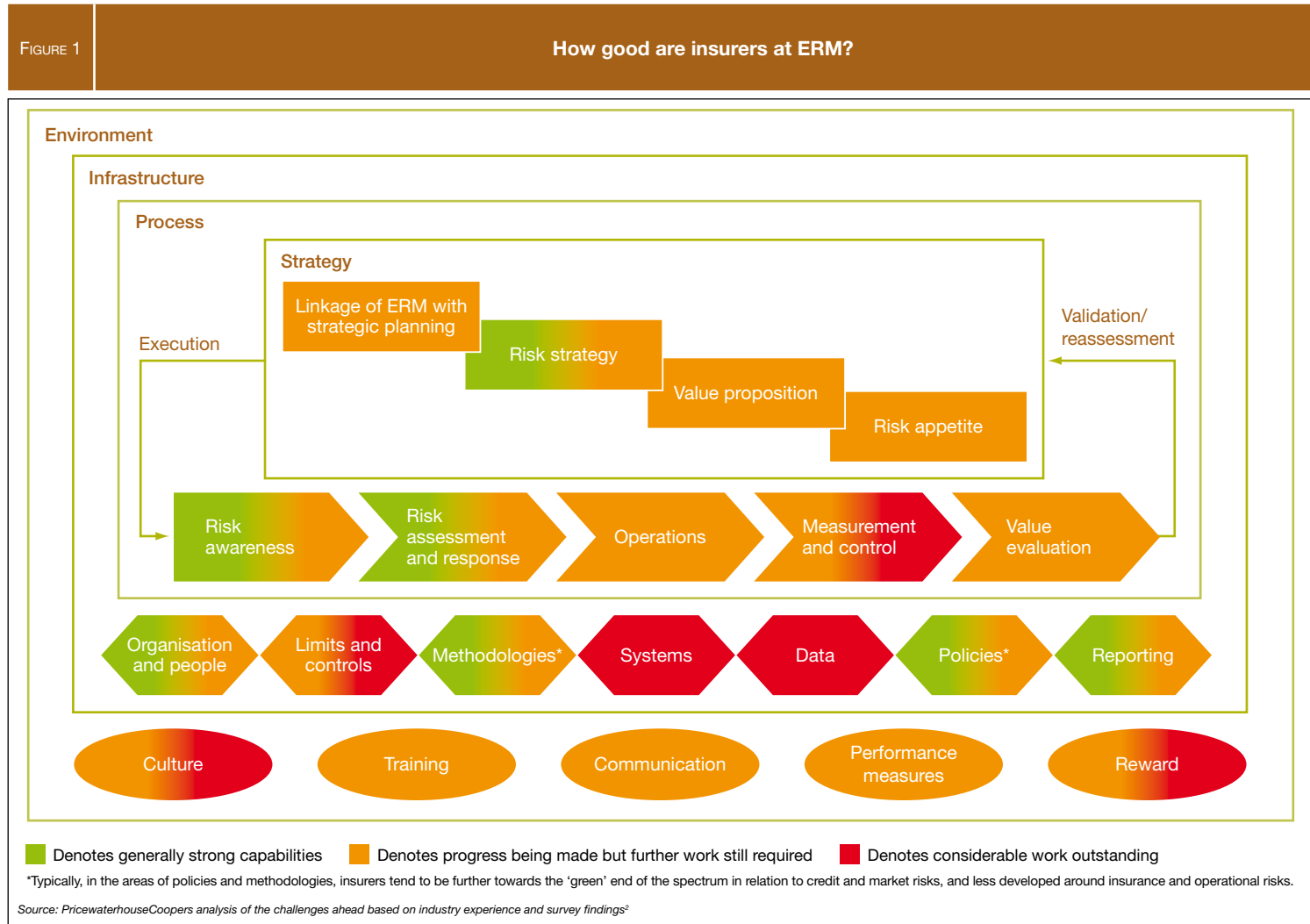
Alongside the demands of a rapidly evolving risk and commercial environment, these more exacting stakeholder expectations are raising the bar for ERM, including the depth of risk understanding, rigour of control and extent to which risk considerations are embedded into business planning and capital allocation.

Fit for purpose?

To help judge how effectively insurers' ERM programmes have developed and judge where further work may be required to meet this rising bar, PricewaterhouseCoopers recently carried out one of the most detailed studies of ERM ever carried out in the insurance industry. The follow-up to an

earlier report, published in 2004, the latest study draws on an in-depth survey of more than 50 insurers, more than half of whom are major international groups with annual revenue of more than €3 billion.

Half of the respondents have operations in Europe and one-third are based in the European Union (EU). The sample



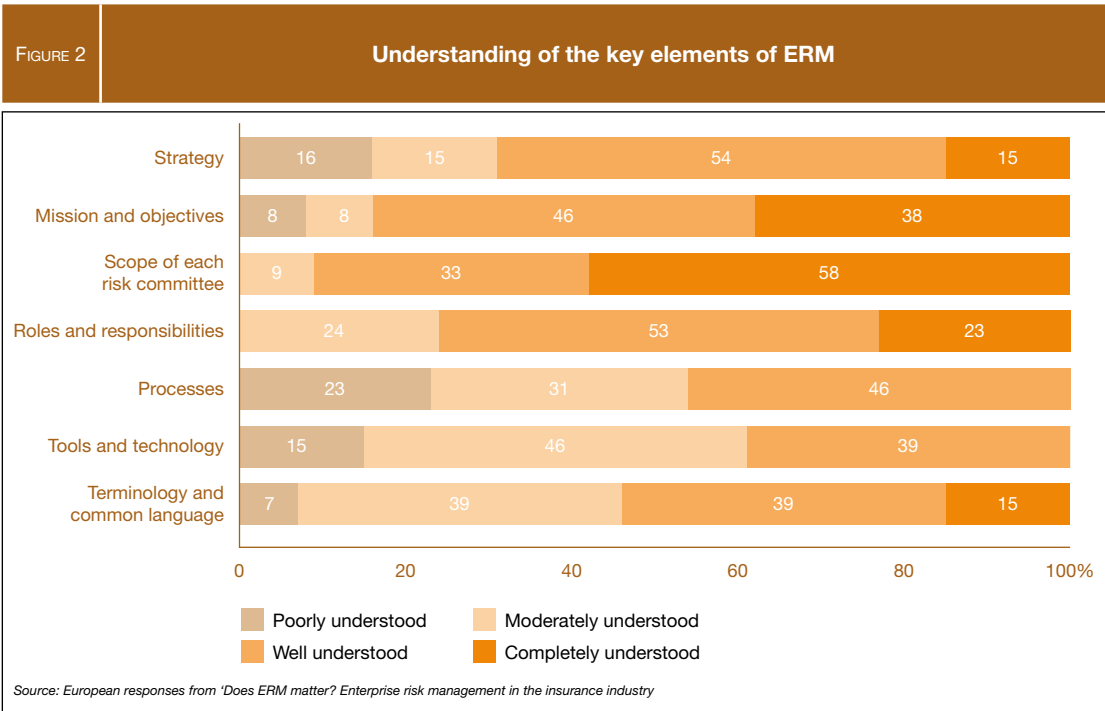
2 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008.



brought together a balance of life, non-life and composite companies, along with a selection of reinsurers. What emerges from the findings is that while ERM is an increasing board-level priority and insurers have generally made valuable progress since 2004, further development is likely to be required in a number of significant areas (see Figure 1).

Most notably, the extent to which ERM is integrated into frontline decision-making is often limited. Nearly half of European participants report that risk considerations are not fully integrated into strategic planning. There also appears to be a surprising lack of alignment between the corporate risk appetite and risk-taking on the ground. The articulation and application of the risk appetite are critical in defining and enforcing the amount of risk a business is willing to accept in the pursuit of value and are therefore key cornerstones of the effective embedding of ERM. However, nearly half of European participants do not align changes in strategic direction with their risk appetite. Moreover, business units within more than 80% of European respondents do not base their risk tolerances on the broad risk appetite and tolerance levels set by senior management.

The operational application of ERM also demands that limits and controls are rigorously monitored and enforced. However, most European respondents do not have procedures for limit



monitoring and exception approval and nearly 70% accept that the enforcement of limit thresholds is not operating effectively. The communication, escalation and risk-learning procedures for breaches in limits may also be insufficiently proactive and systematic. Only around 30% of European participants have early-warning systems to detect when volumes are approaching the maximum threshold and less than 40% have processes for identifying and analysing why limits are breached.

Underlying difficulties often include a lack of clarity about how ERM should be structured and governed. Ideally, business units should assume primary

responsibility for the risks they take in line with the overall risk appetite and standards set by the ERM team. As Figure 2 highlights, however, the mission, terminology and roles and responsibilities are not clearly understood within many organisations.

Clearer definition and establishment of roles and responsibilities and closer interaction between risk and business teams could help to make better use of the risk management activities that are already in operation across the business. However, less than half of participants report a high level of interaction between risk and business teams in the definition and monitoring of key risk and

performance indicators and the aggregation of risk across different categories.

In addition, there appears to be insufficient interaction in how risk limits and objectives are set and enforced. Poor collaboration between risk and its partners in the business can create confusion about who 'owns' risk and how it should be managed. More broadly, it may mean that risk management is seen as someone else's job and that ERM is not really relevant to them.

Further problems stem from the often poor quality and reliability of risk information and analysis. Less than 30% of European respondents believe that their risk

data and systems are good or excellent. Nearly half recognise that their risk information does not adequately support their risk objectives and less than 10% believe that the communication and escalation of risk information across the organisation is very effective.

The general lack of confidence in model outputs is especially noticeable. Barely a quarter of European respondents discern that their economic capital modelling provides substantial value in defining their risk appetite, setting risk limits or improving strategic planning. Nearly three-quarters do not believe that their economic model output has gained full acceptance from business units or influences day-to-day decision-making. This is especially surprising as this buy-in will be critical in meeting rating agency

expectations and securing accreditation for the use of internal models under Solvency II.

Building confidence in the model analysis requires credible data and a reliable infrastructure of governance, operation and validation. However, more than 60% of European respondents believe that the control environment surrounding data input and the use of their models is no more than moderate or weak. Again, the rigour of model governance is a key regulatory and rating agency evaluation criterion.

As discussed in the article on pages 22-26, bringing risk considerations into the forefront of business planning and performance management would also ideally require integrated measures ('common language') that bridge risk and finance; yet most participants accept that the alignment of risk and financial metrics is limited at best.

In today's risk environment, there is clearly a danger that poor information or 'blind reliance' on complex models could generate false confidence and encourage a company to accept too much risk. Equally, limited risk insight could lead to an overcautious approach in which an insurer assumes too little risk or ties up capital that could be better invested elsewhere. The key tests of an organisation's ability to deal with these challenges would include the quality, timeliness and reliability of its risk assessment, the effectiveness of aggregation monitoring and its confidence in its ability to use its risk analysis to identify commercial opportunities. Our survey highlights that further work may be required across all these areas.

As Figure 3 highlights, less than 50% of European respondents report that consistent criteria are in place to assess identified risks. The development of a coherent

portfolio view of the threats and opportunities facing the business is likely to be difficult without such assessment. Moreover, while more than half of European respondents now have a process to identify emerging risks, less than 40% are quite confident and none fully satisfied that it is operating effectively. The ability of respondents to identify and respond to emerging opportunities is called into question by the fact that only around a half use risk/reward considerations in making decisions about whether to seize opportunities. Less than 20% have a process to align their assessment of emerging opportunities with their risk appetite.

The way forward

Naturally, we would not expect to see fully mature ERM programmes at this stage. ERM is still a relatively young management discipline and key components

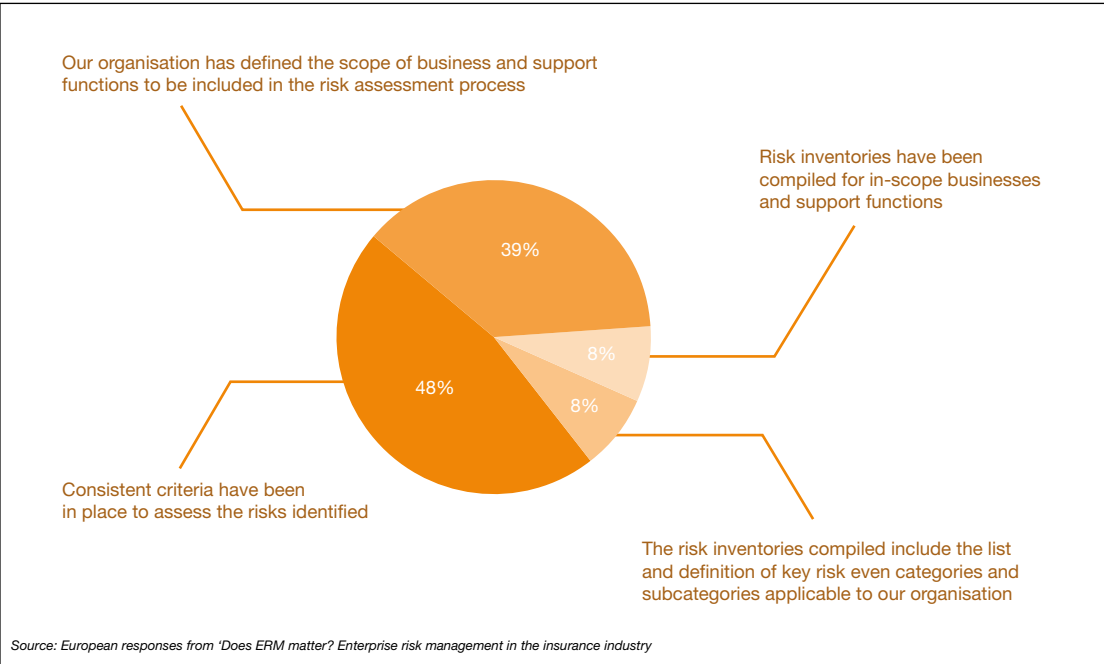




ranging from risk modelling to risk-adjusted performance management present challenging new frontiers for many organisations. It is therefore notable that our survey reveals a strong commitment among respondents to further progress in their ERM programmes and confidence in its ability to enhance value in the future. For example, most European participants expect to achieve better allocation of capital and changes in strategic direction as a result of implementing economic capital modelling and aligning it more closely with decision-making, if indeed they have not done so already.

However, risk pressures, commercial challenges and stakeholder demands will continue to escalate. As our survey underlines, ERM needs to be embraced by risk-takers rather than just risk professionals, if it is to equip insurers to meet this rising bar and deliver the payback. Embedding ERM into day-to-day decision-making and risk-taking activities is likely to be

FIGURE 3 Level of risk assessment



a tough challenge for many companies, demanding important changes in the way they formulate their strategy and judge, reward and communicate their

performance. While the tone from the top is critical, effective ERM cannot be imposed by the board or senior management. Business teams need to be convinced that

it can help them to make more informed decisions and enhance their ability to create value if it is to be relevant to them. □

AUTHORS



Robert Borja
Partner, Systems and Process
Assurance Leader, Insurance
PricewaterhouseCoopers (Switzerland)
Tel: 41 58 792 2956
robert.borja@ch.pwc.com



Jan-Willem Deurvorst
Senior Manager, Assurance
PricewaterhouseCoopers (France)
Tel: 33 1 56 57 83 11
jan-willem.deurvorst@fr.pwc.com



Mark Train
Partner, Actuarial and Insurance
Management Solutions
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 6279
mark.train@uk.pwc.com

Bridging risk and reward: Closer alignment between risk and finance

AUTHORS: RANJIT JASWAL, JAMES SMITH AND DAVID WONG



Bringing risk and finance closer together could enhance decision-making and provide a valuable foundation for the implementation of Solvency II and IFRS Phase II. However, full integration may be a mistake as it would blur the fundamental differences between the risk and finance functions and miss the complementary roles they play in the business. Ranjit Jaswal, James Smith and David Wong look at how to harness the benefits of closer alignment between risk and finance, while preserving their distinctive roles, perspectives and skills sets.

BRIDGING RISK AND REWARD: CLOSER ALIGNMENT BETWEEN RISK AND FINANCE

One of the earliest records of risk management dates back to around 1700 BC, when the Hammurabi Code was developed to help govern the vast Babylonian empire. Several of the laws deal specifically with the risk of default. This includes empowering a creditor to take a debtor's family into slavery to work off an unpaid loan. Some time later, medieval Florentine merchants marked the origins of modern financial management through the first use of double-entry bookkeeping.

Although risk management and financial management have come a long way since these historical beginnings, they have in many respects remained two quite distinct disciplines. In particular, finance tends to focus on the losses or profitability of the business at a specific point in time. Risk tends to be more forward-looking, exploring a range of possible options, outcomes and their implications for the business. This cultural diversity leads to different languages, ways of working, systems, data and processes. Today, however, both internal and external drivers are bringing these functions closer together.

More informed decisions

As the article on enterprise risk management (see pages 16-21) outlines, many European insurers are looking at ways to make risk a more visible and telling element of strategic evaluation, capital allocation and performance management.

Through the development and application of common metrics (common language) that bridge risk and reward, closer alignment between risk and finance is the key foundation of this risk-adjusted view of the business. In turn, the development of quantitative metrics for operational and strategic risks mean that measures that align risk and finance such as risk-adjusted return on capital (RAROC) can now provide much more coherent and comparable insights into the trade-off between risk and reward. The potential benefits of these measures include:

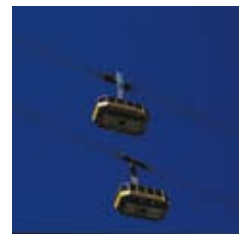
- Greater application of risk disciplines in key business processes such as strategy, planning and valuation;
- More robust financial plans and projections (for example by challenging management to consider ranges of upside and downside outcomes it requires

them to better define their appetite for risk and earnings volatility);

- A more coherent and consistent view of the business from risk and finance; and
- Better, faster and more robust decisions based on common data.

From a business perspective, aligning risk and finance would enable insurers to bring together disparate bases of management information into a 'single version of the truth'. The result would be a more precise and reliable foundation for risk selection, pricing, reserving and reinsurance strategies.

At a time when margins are coming under increasing pressure and the economic slowdown is limiting business opportunities, a more insightful risk-adjusted view could also help companies to pinpoint openings that may be missed by their competitors and target investment where it can earn its best return. For example, as insurers scale back writing amid the softening of rates, risk-adjusted measures would enable them to judge how the capital released could best be redeployed, be this through investment, underwriting other classes of business or return to shareholders. Just as crucially,



From a business perspective, aligning risk and finance would enable insurers to bring together disparate bases of management information into a 'single version of the truth'.

such analysis would enable companies to demonstrate the rationale of their choice to shareholders.

However, while greater alignment of risk and finance metrics can be helpful, full operational integration would in our opinion be a mistake. Effective strategic evaluation requires the ability to formulate and challenge prospective decisions from a range of different

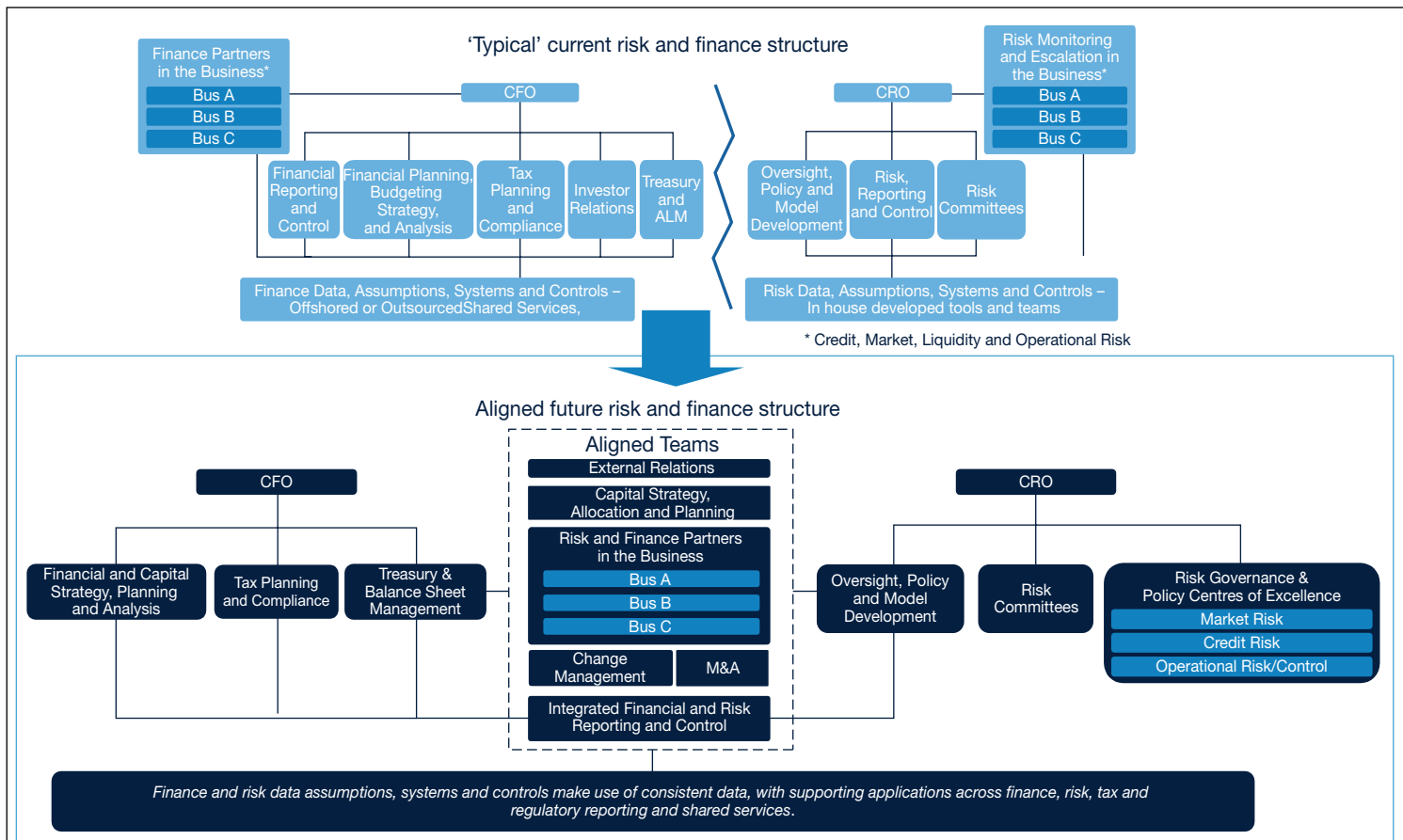
perspectives, which may be blurred within a fully integrated approach to risk and finance. It is also important to preserve the distinctive roles and skill sets of the risk and finance functions – financial management in areas such as tax planning, capital raising and financial engineering, and risk management in areas such as pricing, process improvement and the application of limits and controls.

Meeting reporting requirements

A series of new reporting developments is providing a further catalyst for closer alignment between risk and finance. Risk is already an important element of financial reporting. Under IFRS 7 ‘financial instrument disclosure’, for example, insurers must now present a management’s ‘eye view’ of the risks they run and

their potential impact on the business. In June 2008, the European CFO Forum¹ launched its Market-Consistent Embedded value (MCEV) principles, which are likely to set the standard for embedded value disclosure across the industry. In seeking to convey the prospective value of cash flows on a risk-adjusted and market-consistent ‘economic’ basis, MCEV is paving the way for

FIGURE 1 Example of future state with alignment of risk and finance



Source: PricewaterhouseCoopers

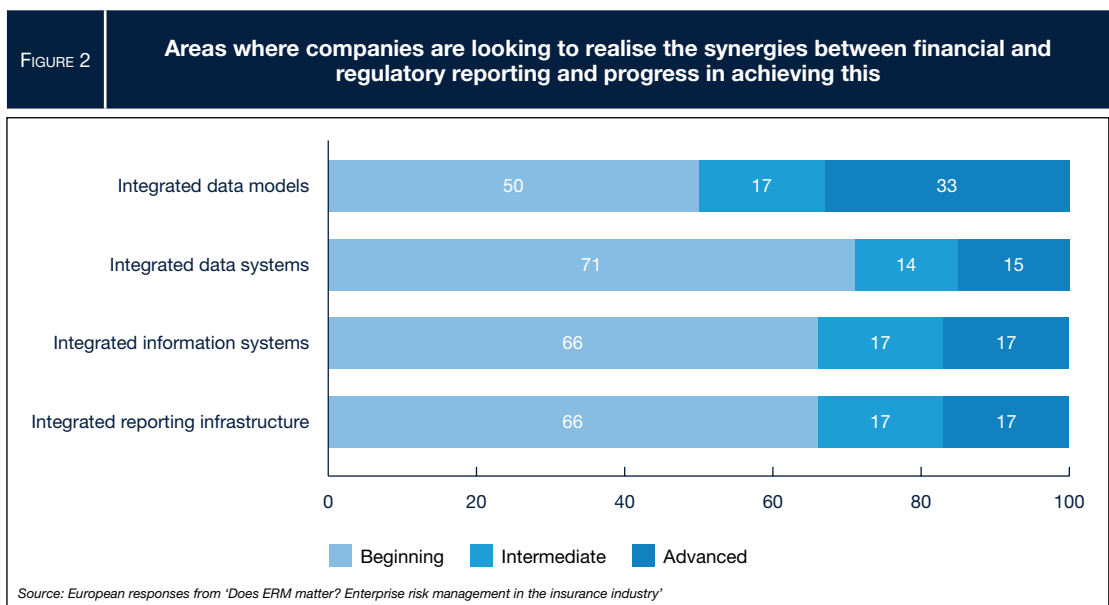
1. The CFO Forum is a high-level discussion group that brings together CFOs from leading European insurance companies (www.cfoforum.nl).



comparable approaches within the planned EU Solvency II and IFRS Phase II.

These reporting developments present considerable implementation challenges, including reconciling risk and financial data as part of the market-consistent approach to liability measurement. Under Solvency II, insurers will need to demonstrate that they use the resulting risk and capital analysis in the direction of their business (the 'use test'). Greater transparency about risk and its implications could also have critical implications for share values and the cost of capital at a time when analysts, investors and rating agencies are taking an ever-keener interest in how effectively risk is managed and integrated into decision-making. Most rating agencies now employ a similar use test to Solvency II as part of their financial strength evaluations. In turn, most leading insurers now present some form of RAROC measure in their annual reports to aid comparison with their peers and other financial institutions.

The good news is that the parallels in the timings and bases for disclosure in Solvency II and IFRS Phase II could open up cost-saving synergies in common areas of risk and finance such as data, assumption setting, modelling and reconciliation. Exploiting the synergies would allow insurers to avoid some of the costs, duplication and potential disruption of applying and managing the frameworks separately. By streamlining and improving the efficiency of the reporting process, closer



alignment could help to reduce the burden of meeting compliance obligations and hence enable risk and finance teams to devote more time to providing input into business decisions. In turn, regulatory and financial reporting harmonisation could enhance market credibility by enabling insurers to convey a single view of their business as outlined earlier, which more closely reflects the way they are run internally.

Making it happen

Closer alignment between risk and finance functions rests on standardisation and simplification of the reporting, control, modelling, transactional and data elements of risk and finance. There may also be further opportunities to leverage predictive analytics, such as stress testing risk and reward scenarios as part of the budgeting and planning process.

Figure 1 outlines how this alignment of risk and finance might be structured in practice.

While prudential and financial data requirements may differ, there is sufficient common ground for companies to consider the establishment of data warehouses or shared service centres to source and reconcile information. Data coming from around the organisation needs to be consistent. Risk and economic capital analytical systems also need to be appropriately controlled as part of bringing them up to an auditable standard.

Training, secondment and cross-functional career development could help to lay the foundations for a common understanding – finance teams need to be able to understand risk terms and issues, while risk teams should be familiar with

accounting requirements. As the operational manifestation of a risk-adjusted approach to management, effective ERM will also be critical in developing consistent firm-wide procedures for risk identification, measurement and monitoring ('informing the input'), and ensuring that risk limits and controls reflect the risk appetite and overall strategic objectives of the business ('enforcing economic behaviour').

More broadly, embedding risk-adjusted measures into the business may require significant changes in the way performance and related bonuses are judged.

In many companies this will require a shift away from targets based on short-term top-line results towards risk-adjusted criteria and long-term growth in shareholder value. It will also require risk teams to be involved

in decisions from the outset and the tone from the top needed to ensure that risk is a priority.

How aligned are risk and finance?

Alignment can be demonstrated in a number of ways, but one of the key barometers is the consistency of the metrics between risk and finance.

It is therefore notable that PricewaterhouseCoopers recent survey of ERM in the insurance industry found that only around one-quarter of respondents are confident that they have an efficient basis to link risk with other financial information.²

Greater alignment does appear to be moving up the agenda, however. Most European respondents expect to realise

synergies between financial and regulatory reporting as part of the move to Solvency II and IFRS Phase II. Nonetheless, most are only just beginning to realise these anticipated synergies (see Figure 2).

Risk and finance may already work closely together in companies that have moved to an economic basis of management reporting such as economic capital or embedded value.

The challenge ahead is how to bring the 'black box' risk and analysis up to an auditable standard for external disclosure. Insurers also need to ensure that the model outputs are understandable and credible enough to be used in the direction of the business as part of the rating agency and Solvency II use test. It is therefore significant that the recent ERM

survey found that only a quarter of respondents believe that the output from their economic capital model has gained full acceptance from business units or influences day-to-day decision-making.³

Converging destinies

Risk may be from Babylon and finance from Florence, but the demands of a fast-shifting commercial and regulatory environment are bringing the twin disciplines closer together. Although alignment of risk and finance can provide valuable operational synergies as insurers move to Solvency II and IFRS Phase, the most important advantages relate to the current business climate.

Boards and business teams need to understand risk and build it into their decisions,

not only to identify threats and weaknesses, but also to pinpoint valuable opportunities that may be missed by overly cautious or less well-informed competitors.

As available capital becomes scarcer and insurers come under increasing pressure to deliver more favourable and sustainable returns across the cycle, risk-adjusted economic measures are likely to prove evermore critical in judging opportunities, instilling risk considerations into the organisation and demonstrating the strength and potential of the business. Nonetheless, some distinction is necessary in ensuring that insurers continue to benefit from cross-challenge and complementary professional perspectives of the Babylonians and the Florentines. □

AUTHORS



Ranjit Jaswal

Associate Director, Actuarial and Insurance Management Solutions
PricewaterhouseCoopers (UK)

Tel: 44 20 7212 1197

ranjit.s.jaswal@uk.pwc.com



James Smith

Director, Financial Services, Performance Improvement Consulting
PricewaterhouseCoopers (UK)

Tel: 44 11 7928 1233

james.t.smith@uk.pwc.com



David Wong

Director, Actuarial and Insurance Management Solutions
PricewaterhouseCoopers (UK)

Tel: 44 20 7804 3587

david.l.wong@uk.pwc.com

2. 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance.
3. 'Does ERM matter? Enterprise risk management in the insurance industry', a study published by PricewaterhouseCoopers in June 2008. To download or order a free copy, please visit www.pwc.com/insurance



BRIDGING RISK AND REWARD: CLOSER ALIGNMENT BETWEEN RISK AND FINANCE continued



Is this a good bet? Driving value amid uncertainty

AUTHORS: ALBERTHA CHARLES AND HSIU MIN LIM



From emerging market entry to the development of new product platforms, life insurers are taking ‘big bets’ to improve business growth and enhance shareholder value. Yet, difficulties in predicting customer reaction and inadequate understanding of the uncertainty and risks of the target market could mean that strategic evaluations may not provide a sufficient basis to convince analysts of the merits of the investment. Albertha Charles and Hsiu Min Lim examine the potential flaws in traditional evaluation techniques and explain how a more insightful approach that combines conjoint analysis to model customer preferences and dynamic financial analysis (DFA) to incorporate a structured view of uncertainty, could provide a more reliable measure of value.

IS THIS A GOOD BET? DRIVING VALUE AMID UNCERTAINTY

European life insurers face three continual challenges: how to create, sustain and explain value. Economic slowdown, ever-higher customer turnover and the growing maturity of their home markets have led companies to seek fresh sources of growth in areas such as emerging markets or the development of more sophisticated product offerings.

Life insurers recognise that being able to understand the value likely to be generated from a management decision or ‘big bet’ is critical to explaining the overall potential to analysts and investors. However, shortcomings in traditional research techniques and risk assessment tools can often limit their ability to do so.

As we outline in this article, innovative customer research methods, such as conjoint analysis, can be fused with dynamic or stochastic modelling to take account of uncertainties, to provide a more granular, transparent and robust evaluation of the balance between risk and reward. This article specifically focuses on the use of such techniques to evaluate emerging market entry strategies, though other areas such as M&A and distribution strategy could equally apply.

Emerging market growth

The prospect of higher growth rates for future new business has led many life insurers to step up investment in emerging markets. Analysis that matches rapidly rising incomes with the present low rates of insurance penetration and product sophistication would certainly suggest that many emerging markets are likely to grow far faster than their Western European counterparts. This basic macroeconomic analysis underpinned much of the first wave of international expansion by insurers into emerging markets in the 1990s.

However, the fact that few emerging markets have subsequently achieved the insurance growth and take-up rates that would be expected under this broad brush macroeconomic analysis would indicate that such projections provide an insufficient guide when used in isolation.

As Figure 1 highlights, there is indeed an evident correlation between GDP per capita and insurance penetration; increasing wealth leads to growth in demand for long-term savings products. However, the most striking feature of the penetration/GDP per capita

analysis is the diversity of patterns of market development. This would suggest that opportunities and growth may also be driven by a range of often more complex structural and cultural ‘micro-factors’, many of them specific to the particular country in question.

For individual countries, the relationship between economic growth and insurance penetration is far from clear. Indeed, some countries experience declining penetration rates at the same time as economic growth. Market specific factors are often more influential than the macroeconomics in determining market development, in particular:

- Regulation and tax incentives/ tax structure;
- Government pension and welfare policies;
- Stock market performance;
- Infrastructure and distribution networks, particularly bancassurance channels;
- Demographic factors; and
- Customer preference and socioeconomic factors.



...innovative customer research methods, such as conjoint analysis, can be fused with dynamic or stochastic modelling to take account of uncertainties, to provide a more granular, transparent and robust evaluation of the balance between risk and reward.

The importance of these micro-factors can be seen in the contrast between the life market developments in Russia and India. Russian life premiums declined by 43% in 2006, largely as a result of the continued impact of 2002 tax legislation.¹ Conversely, India has experienced dramatic growth in premiums in recent years, due to changes in the competitive and regulatory environment. In short, there is no one-size-fits-all economic model that captures the diversity of risks, rewards and uncertainties across emerging markets.

Most structural and regulatory risk factors can be addressed through tools such as commercial, financial and regulatory due diligence. However, these tools are unlikely to provide the necessary insights into customer preferences and behaviour, along with an understanding of the nuances of culture, demand and distribution, which are needed to develop and execute a viable market entry strategy in highly uncertain markets. This is particularly important where significant variations in customer experience and product use exist. Indeed, products that are the core of a life insurer's business in Western Europe may not be suited to particular overseas markets or may simply not be permitted. Developing a good understanding of customer attitudes towards particular product features and how these may vary across markets or customer segments is fundamental to success.

Several analytical methods have traditionally been used to assess customer appetite for new products including:

- Surveys;
- 'Hypothecation' based on the performance of similar products in other markets; and
- Small-scale trials employed to gain insight into customer preferences.

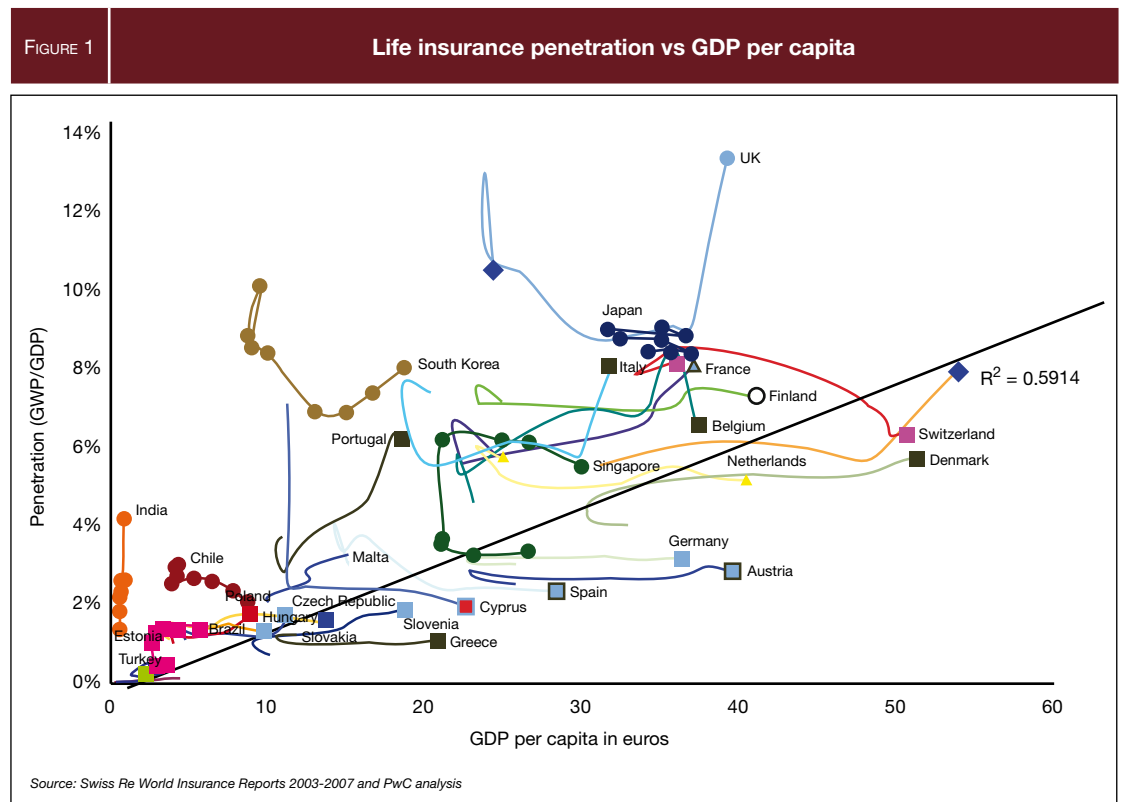
All three of these techniques have inherent weaknesses. Traditional customer surveys can often identify a range of wishes and aspirations, but by questioning respondents

directly may not realistically gauge what people are prepared to pay or their order of preference when subject to real-life constraints. Respondents may also be tempted to say what 'seems' right or tell interviewers what they think they want to hear. Similarly, comparison with a neighbouring market is not always a sure guide to the actual market in question, while even small-scale product trials can often be highly expensive.

Innovative techniques can enhance value

Conjoint surveys use enhanced analytical techniques to provide a more robust measurement of the

value that respondents place on the particular features and benefits of a product or service. Conjoint questions require respondents to make 'trade-offs' between different combinations of product or service characteristics. The responses to these questions can be analysed to provide more detailed insights into the key features and benefits driving customer preference and demand. (For example, it is possible to estimate the value that customers place on one feature compared to another.) These insights can then be used to model customers' purchasing choices, leading to a range of outputs including



1 Swiss Re World Insurance 2007.



willingness-to-pay and market share forecasts under a variety of 'what if' scenarios.

The conjoint model can simulate customer choice behaviour for any combination of the product features tested, even if not currently on the market. It thus provides the flexibility to model both present and future scenarios – very useful in situations where transaction data is limited or, as with new markets, the product is not yet available.

Conjoint analysis is more reliable than traditional survey techniques because it generates data from trade-off questions that replicate the actual experience of customers when making purchasing choices. Furthermore, by modelling preference-based choice behaviour, conjoint is more rigorous and flexible than hypothecation, while being quicker and cheaper than sample product launches. Ultimately, the

robustness of this approach should mean that strategic decisions can be evaluated more effectively before significant investment is made. It can also provide valuable insights into how to maximise the investment, once made, by tailoring outputs to local customer demand or more profitable target segments.

Combining DFA and conjoint analysis

Traditionally, insurers have provided embedded value (EV) results from which analysts have determined an appraisal value that uses high-level multiples to gauge the contribution from future business. While the principles of EV-based methods still hold in emerging markets, determining the multiples requires a number of implicit assumptions about the growth potential and risk-reward metrics across different markets. Stochastic modelling techniques make these assumptions explicit

by taking into account a range of possible outcomes under different assumptions.

Conjoint analysis fits well as an input to effective stochastic modelling. The conjoint approach models the different priorities that govern customer behaviour to forecast demand levels under a range of assumptions. These projections can be incorporated into a stochastic modelling framework so that the two approaches combined deliver more robust and informed results.

As Figure 2 highlights, stochastic modelling techniques used in conjunction with conjoint survey results can provide a more dynamic view of value that incorporates and quantifies the high levels of uncertainty and complexity involved in emerging market investments. This dynamic value framework can be used to address the following questions:

- Will we generate value from this investment and what are the probabilities of achieving certain values?
- What risk-mitigating strategies should we implement to minimise potential downside value?
- How can we maximise the value potential?
- What are the value implications of different strategic options?

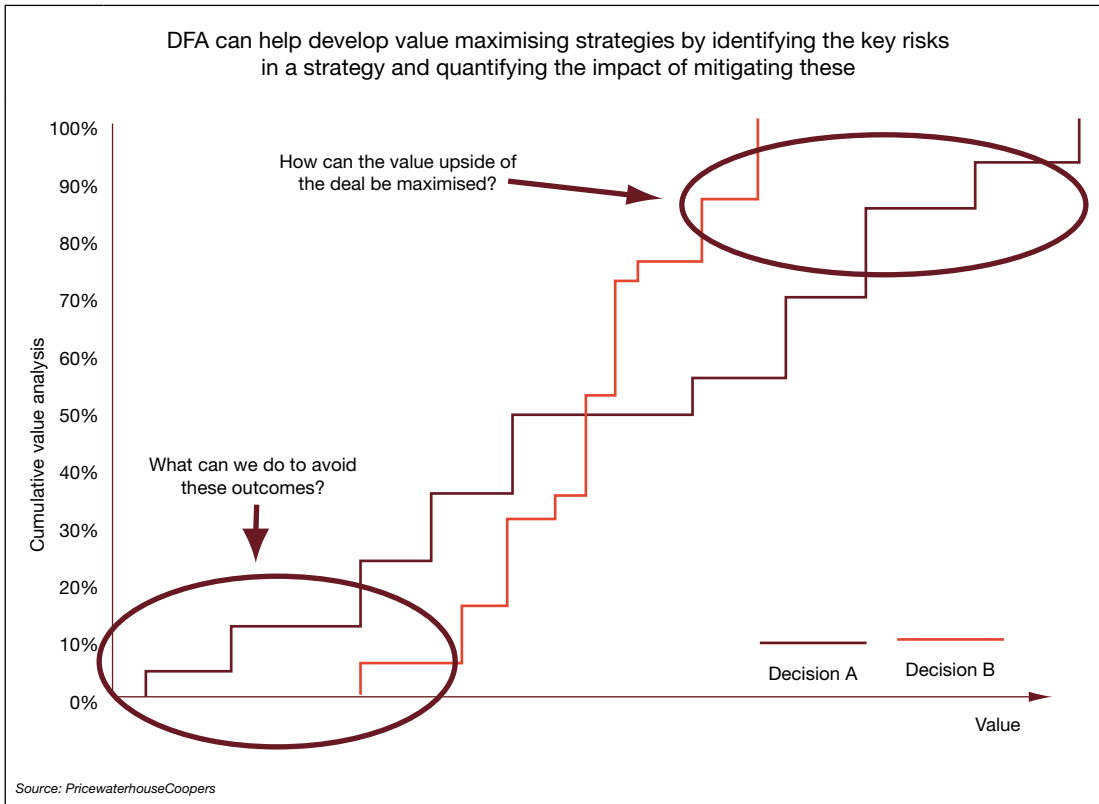
Cumulative value analysis

DFA can help develop value maximising strategies by identifying the key risks in a strategy and quantifying the impact of mitigating these.

Furthermore, conventional EV approaches do not necessarily capture the specific risks within different countries. To understand the real economic value of investments in particular

FIGURE 2

Cumulative value analysis



Convincing case

The life insurance industry will continue to face tough challenges as it strives to maximise value for a given level of risk within a market marked by capital constraints and tough investor demands.

Achieving transparent, risk-adjusted value analyses is the key to the effective communication of overall value to financial market stakeholders, especially in relation to uncertain investments such as new markets.

Using DFA modelling techniques with conjoint analysis will enable insurers to clarify the balance between risk and reward within competing investment options.

In addition to aiding strategic decisions, this combined approach can greatly enhance a company's ability to convincingly demonstrate the value potential and map out a customer-driven strategy to successfully realise that value. □

countries, insurers should ideally use country risk premiums to derive country-specific discount rates. Applying country-adjusted discount rates

based on both stock market and macroeconomic analysis allows insurers to reflect the risk of particular investments more accurately. Country-

adjusted discount rates are therefore more appropriate for use within the stochastic modelling framework.

AUTHORS



Albertha Charles

Director, Financial Services, Market and Value Advisory
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 5469
albertha.charles@uk.pwc.com

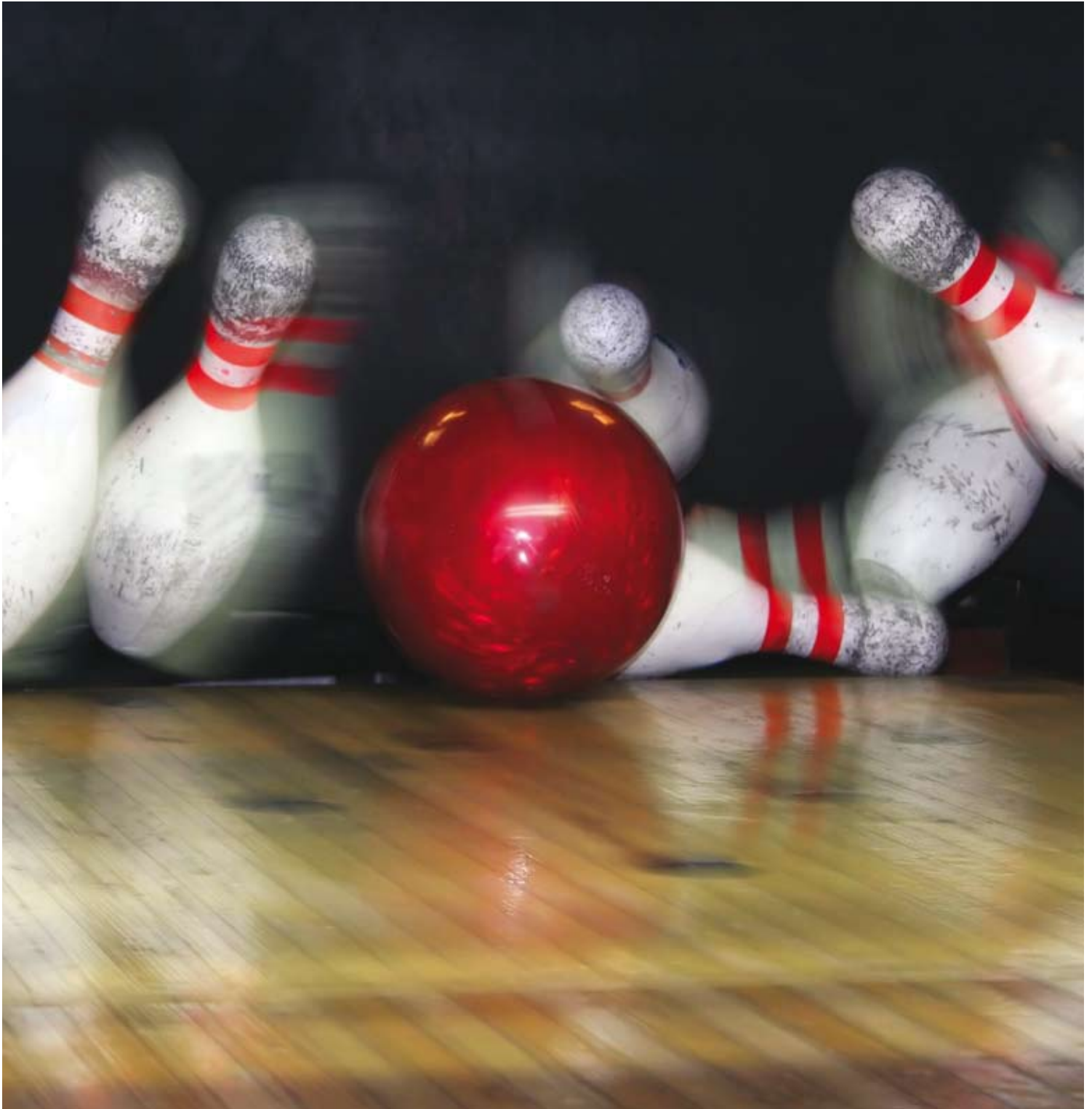


Hsiu Min Lim

Assistant Director, Financial Services, Market and Value Advisory
PricewaterhouseCoopers (UK)
Tel: 44 20 7804 6882
hsiu.min.lim@uk.pwc.com



IS THIS A GOOD BET? DRIVING VALUE AMID UNCERTAINTY continued



Confronting the down cycle: Seeking opportunity in uncertain times

AUTHORS: CAROLINE FOULGER, COLM HOMAN AND ARTHUR WIGHTMAN



Managing the underwriting cycle in a sustained soft market, as well as the challenges of the financial markets, are some of the top issues facing Bermuda CEOs as the results of a new PricewaterhouseCoopers survey shows. While keeping these issues front and centre, however, Bermuda CEOs are similarly focused on growing their franchises as they look beyond their current businesses to find ways of sustaining and increasing shareholder value.

CONFRONTING THE DOWN CYCLE: SEEKING OPPORTUNITY IN UNCERTAIN TIMES

It was only a question of time and seasoned Bermuda CEOs knew it. As the global insurance industry basked in the warm glow of bumper returns from 2007, the noise they could hear in the background was the sound of the underwriting cycle turning.

The signs of a softening market were already apparent in some areas in mid-2007. As the January 2008 renewal season played out, however, CEOs watched as premium rates drifted down across the property-casualty spectrum.

Buyers were changing their behaviour. Renewals were placed relatively late in many markets; cedants were starting to retain more risk despite more attractive rates and competition was growing across the wholesale market, including from certain nontraditional quarters, namely the capital markets.

It was against this background that PricewaterhouseCoopers polled a cross-section of insurance and reinsurance CEOs, of both Bermuda domiciled companies as well as the Bermuda subsidiaries of international groups.¹

So how are they reacting to the changing market conditions? Bermuda's reinsurers are well provisioned in terms of capital, but CEOs are looking at leaner and more uncertain times ahead. What do they perceive as their most important operational challenges and how are they going to tackle them?

Most Bermuda insurers and reinsurers, and specifically the classes of 1993, 2001 and 2005, were each created by a market correction. They were forged in hard market conditions and their CEOs always knew that their above-average returns would ultimately diminish.

In the past, when that turning point arrived, they changed their modus operandi. It is no different this time. In 2008, with 2009 renewals already in their sights, CEOs are refocusing. Last year, Bermuda reinsurers were out to achieve top-line growth; this year the emphasis is on avoiding technically inadequate business.

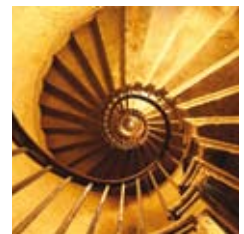
Our survey reveals that CEOs have tightened their focus on underwriting performance, not surprisingly emphasising cycle management and exposure monitoring (see Figure 1 on page 37).

Uncertainty is a key concern. Although CEOs see premium rates continuing to fall through 2010, they do not know how long the down cycle will last. In the poll, many identify this lack of clarity as a major barrier to managing effectively the cycle within their own organisations.

As a result of uncertainty, CEOs place rate monitoring as their highest priority in managing the cycle downturn. Monitoring rates, however, is one thing: in a globally competitive environment, will Bermuda companies and their global competitors be disciplined enough to walk away from technically inadequate risks and leave business on the table?

CEOs themselves expressed some doubt. Number three in the list of perceived barriers to managing the downturn was 'difficulties in ensuring that underwriters adhere to and deliver the underwriting cycle management strategy'. That doubt could potentially turn into a self-fulfilling prophecy for some.

Of course, Bermuda companies can't hope to keep investors who have become accustomed to outsize returns over the past two years on message by being seen



Last year, Bermuda reinsurers were out to achieve top line growth; this year the emphasis is on avoiding technically inadequate business.

¹ Confronting the down cycle: Seeking opportunity in uncertain times – Bermuda market survey 2008, published by PricewaterhouseCoopers in July 2008.

to turn away business. If the rates are inadequate in their current business lines, CEOs have to look elsewhere for growth.

The survey shows that CEOs are seeking to broaden their companies' horizons, exploring new geographical markets and diversifying into different lines of business.

The penetration of new business classes has moved strongly up the ranking of CEOs' top business issues, compared to the last Bermuda survey carried out two

years ago. It is a process borne out of immediate necessity for all the companies involved. So far, as the class of 2005 is concerned, it is a natural evolution as these 'start-ups' metamorphose into fully fledged, diversified insurance and reinsurance groups.

The trend for increasing diversification is also reflected in CEOs pushing new geographical markets, as well as new products, higher up the agenda. Bermuda companies have entered established markets in the US and Europe and also emerging

markets in Asia and Latin America as they look for growth in a softening rate environment.

They are expanding their franchises by either acquiring incumbent companies or setting up local representative offices. Forming new units in reinsurance hubs, such as London (including Lloyd's), Dublin, Zurich and Dubai, is another common approach.

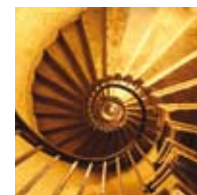
Buying into Lloyd's, which brings with it the corporation's global licence, is a passport into new

markets with the immediate acceptance of a recognised brand. With this in mind, Ariel acquired Atrium, Validus acquired Talbot and Montpelier established syndicate 5151 at Lloyd's – all in 2007.

The addition of new underwriting units and a more diversified portfolio brings with it internal risk management challenges. CEOs' expressed concerns reveal renewed concentration on exposure aggregation, capital management and risk transfer.



1 Swiss Re World Insurance 2007.

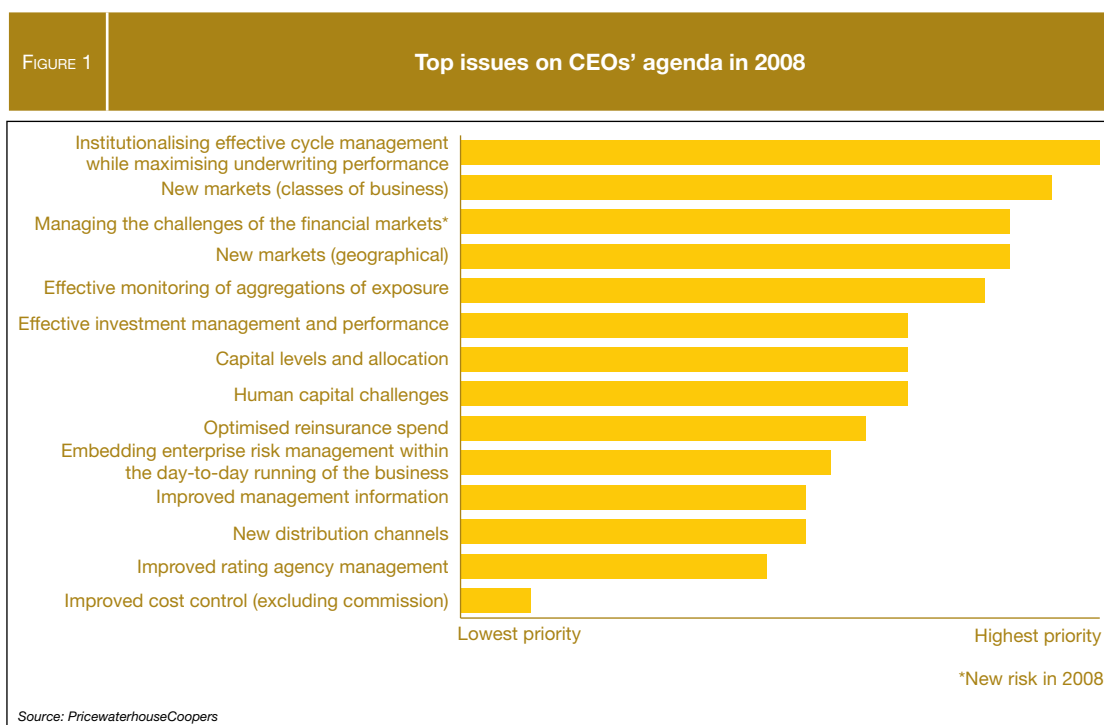


In line with global reinsurers everywhere, Bermuda companies have revised their underwriting models to take account of the industry's loss experience from hurricanes Katrina, Rita and Wilma in 2005. There has also been a discernible 'ramping-up' of in-house exposure management expertise among Bermuda companies.

But it remains to be seen whether the improvements and investments made in exposure management techniques have been effective in view of the absence of significant loss activity since 2005 to test them.

Capital management goes hand in hand with risk management. It is a delicate balancing act. CEOs have to weigh the constraints placed on them by rating agencies and regulators with continuing to deliver solid shareholder value. As attention turns towards the potential for a destructive wind season following 2007's big capital returns, many companies may decide to hold on to surplus capital for the medium term.

One finding related to capital management that stood out was how many CEOs are happy with their progress in embedding enterprise risk management (ERM) practices into the day-to-day running of their businesses. CEOs' improving confidence compared to the last biennial survey is somewhat surprising, in particular, given the difficulties currently being experienced by other financial institutions. It may suggest that



with the increased focus from rating agencies on ERM in their assessments, companies believe that they are responding and investing in their ERM practices.

Asked about their continuing relationship with the capital markets, over half of respondents said they will consider using them for risk transfer, though there are changes there too. Significantly, many now see a reduced role for so-called sidecars, the special purpose vehicles that were formed to provide extra capacity through quota share and other agreements in the aftermath of KRW. They gave investors the ability to enter – and exit – a profitable reinsurance market, easily and quickly.

Soft market conditions mean that sidecars lose their attraction and many of those that were formed post-2005 have since been mutually uncoupled. In line with this trend, insurance-linked securities, industry loss warranties and swaps have moved up the risk transfer/financing agenda.

A counterpoint to this trend is that some Bermuda CEOs – most likely the 'traditionalists' – perceive hedge funds and other capital market institutions as competitors, encroaching on their business.

The financial markets pose another, growing threat to Bermuda companies, linked to the fallout from the sub-prime crisis. The credit crunch was

gathering momentum just as CEOs began to respond to the survey.

As a result, number three of the top five issues on CEOs' agendas was managing the effects of turbulence in the financial markets.

The unprecedented and ongoing events surrounding bank failures, coupled with the ensuing credit crunch, has clearly rattled CEOs.

Few insurance and reinsurance companies have escaped the sub-prime crisis totally unscathed, but the relatively conservative investment policy of most Bermuda companies means asset-side losses are minimal.

FIGURE 2

How the top ranked issues for CEOs have changed since 2007

	2008	Movement since 2007
Institutionalising effective cycle management while maximising underwriting performance	1	= (1)
New markets (classes of business)	2	▲ (7)
Managing the challenges of the financial markets*	3	(NA)
New markets (geographical)	4	▲ (6)
Effective monitoring of aggregations of exposure	5	▼ (2)
Effective investment management and performance	6	▲ (8)
Capital levels and allocation	7	▼ (4)
Human capital challenges	8	▲ (10)
Optimised reinsurance spend	9	▼ (2)
Embedding enterprise risk management within the day-to-day running of the business	10	▲ (11)
Improved management information	11	▲ (14)
New distribution channels	12	▼ (5)
Improved rating agency management	13	▲ (15)
Improved cost control (excluding commission)	14	▼ (12)

*New risk in 2008

Source: PricewaterhouseCoopers

On the underwriting side, it is too early to tell fully. For some companies, a question mark hangs over how many, and how badly, they will be hit by professional liability and directors' and officers' (D&O) claims as the fallout spreads. This survey did not specifically poll financial guarantors, who clearly have additional exposures in this space.

So much for the top five agenda items. Bermuda CEOs' survey responses show they have plenty more on their plate. Effective investment management and performance in the current difficult conditions arguably gains in importance as underwriting returns recede (see Figure 2).

As well as a soft market, Bermuda companies, along with their global competitors, now have to contend with investment market turbulence, the weak dollar, rising oil prices and a continuing decline in interest rates. The corresponding decline in investment returns, based on bond portfolios, will ensure that monitoring investment performance remains high on the chart.

Finally, it is worth noting that if the survey identifies those issues that are most prominent on CEOs' radars, it also flags a potential blind spot. 'More effective management of the regulatory burden' has dropped out of the chart. It is possible that respondents feel they have successfully embedded Sarbanes-Oxley.

Indeed, it could be, that in view of all the complex business challenges Bermuda companies are now facing, it is relatively unimportant. With the onset of Solvency II and IFRS, as well as the changing Bermuda environment, however, regulation perhaps ought to be moving up the agenda and not down.

Bermuda companies have an enviable reputation for adapting to change in uncertain times and, as this PricewaterhouseCoopers survey highlights, a difficult road lies ahead. The ability to seek out and capitalise upon opportunity in these uncertain times will clearly differentiate some of these companies from their global competitors. □

AUTHORS



Caroline Foulger

Partner, Commercial Insurance Group
PricewaterhouseCoopers (Bermuda)
Tel: 1 441 299 7103
caroline.j.foulger@bm.pwc.com



Colm Homan

Partner, Commercial Insurance Group
PricewaterhouseCoopers (Bermuda)
Tel: 1 441 299 7116
colm.homan@bm.pwc.com



Arthur Wightman

Senior Manager, Commercial Insurance Group
PricewaterhouseCoopers (Bermuda)
Tel: 1 441 299 7127
arthur.wightman@bm.pwc.com



CONFRONTING THE DOWN CYCLE: SEEKING OPPORTUNITY IN UNCERTAIN TIMES continued



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