Shrinking Investment Return Increasing Focus on Underwriting Profitability

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Overview

In today's business environment, insurance companies cannot only rely upon investment income to improve their operating ratios. Previously, property and casualty (P&C) insurers' return on investment (ROI) was primarily dependent on investment income, while underwriting profit was secondary. Now, since investment returns are shrinking, insurance CIOs must turn their focus to underwriting profitability. But in order to ensure a more predictable return on investment in underwriting risk selection and work management, processes must be state of the art. Insurers need precision and granularity in their business rules, processes, and in the information they collect. Along the way, insurance underwriters face significant challenges in selecting and classifying risk exposures as well as appropriately matching price to the exposure.

While identifying and classifying risk exposure is the first step in the underwriting process, evaluating risk exposure is where the real difficulties arise. Insurance companies, large and mid-sized, need to deploy various tools and platforms to improve underwriting discipline.

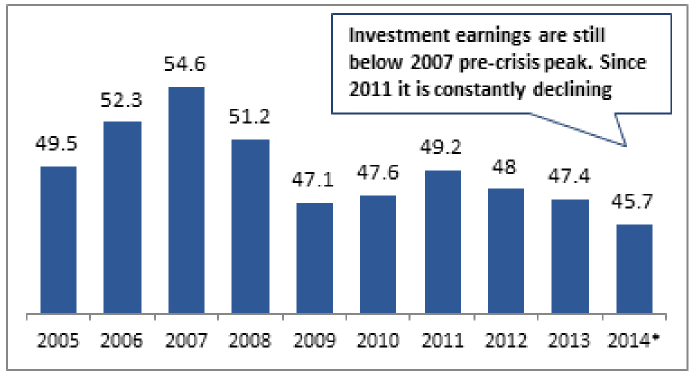
In the past, the majority of P&C insurance companies generated nearly 75% of their return on equity (ROE) goal from their investment portfolio. For example, if a company's ROE goal is 15%, then 11.25% would be produced from investments and 3.75% from underwriting operations. To generate a 3.75% underwriting return, a company could write a 98-100 combined ratio; depending on its operating and investment leverage. In today's environment of low interest rates, a company will need its underwriting operation to produce approximately 50% of its ROE goal - which translates into a 90-92 combined ratio.

Insurance companies are under increasing pressure as investment income shrinks.

Decline in Investment Income

U.S. P&C Insurance Industry Investment Income Trend ($ Bn)

The insurance industry's net investment income has decreased from 2012-2014, amid low interest rates prevailing in the market. As long-term high-yield investments begin to mature and insurers reinvest at a lower rate, investment income may sink more in the near future.



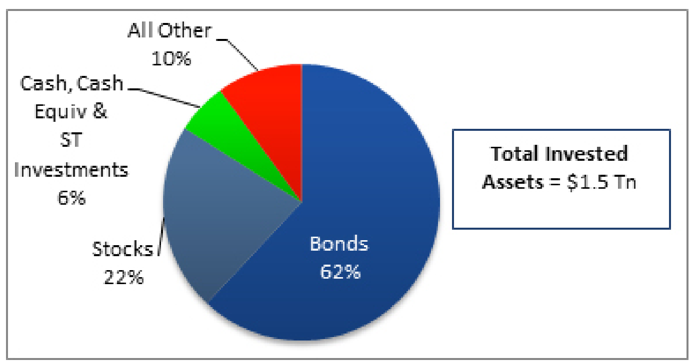
** 2014 figure is estimated based on annualized data through Q3*
Source: ISO; Insurance Information Institute.

CIOs' Outlook on Investment Opportunities in 2015

Asset Distribution: U.S P&C Insurance Industry, 2013

A large portion of the investment income comes from the industry's bond investments, which are mainly high-quality corporate and municipal bonds. While this asset class provides certainty of returns to an insurer, the yield obtained is much lower than those of other classes of assets.

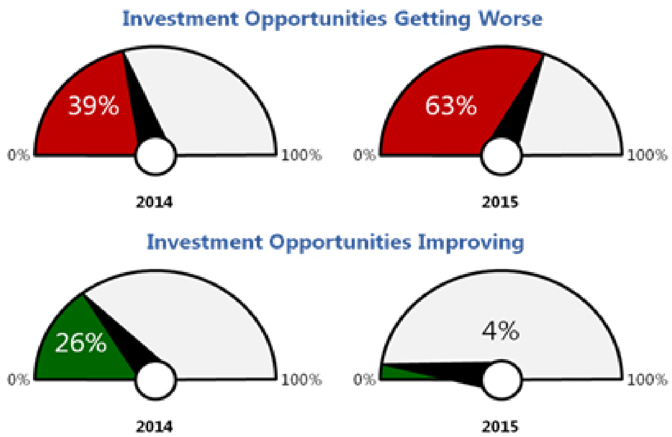
According to the Annual Goldman Sachs Asset Management



Source: Insurance Information Institute Fact Book 2015, A.M. Best.

Insurance Survey 2015, insurance companies are more pessimistic about investment opportunities in 2015 than they were three to five years ago. The gloomy view of CIOs towards investment opportunities is mainly due to the global monetary policies pushing yields to ultra-low or even negative levels.

The below chart shows the Annual Goldman Sachs Asset Management Insurance Survey, 2015:



"It's not that insurers think markets are too volatile; it's that yields are too low, credit spreads are too tight and equity prices are too high." "There's a concern about getting adequate returns on investing."

– Michael H. Siegel, Managing Director, Global Head of GSAM Insurance Business

Underwriting Initiatives Needed

Amid a low interest rate environment, P&C insurance companies are facing mounting pressure to generate robust margins from their underwriting operations. Inability to generate a decent return from the capital markets has put stress on the insurers to make meticulous choices on the risks they take and on the prices they charge companies for assuming those risks.

"If you made an underwriting mistake in 1990, you had a lot of help from investment income to cover that up and still end up with an acceptable ROE. But if an insurer makes underwriting mistake today, you're not going to get a whole lot of help from investment income. And you better work hard to make sure that you're making the best underwriting decisions."

– Robert S. Schimek, SVP and Chief Executive Officer Americas, AIG

Underwriting performance is the most volatile and influential determinant of profitability for P&C insurers. Results are influenced by variability in competitive forces that influence premium rates, losses from catastrophic events (i.e., natural disasters) and volatility in loss cost trends.

Improving underwriting profitability refers to ongoing efforts to improve business performance by assessing and pricing risk more accurately and efficiently.

Realizing Improvements in Underwriting

Availability of Sufficient Data such as Prior Loss History to Make Informed Decisions

Insurance companies work in silos and have huge quantities of scattered data. Chief Technology Officers always stumble over how to integrate such large volumes of historic data into a single source of truth and develop a mechanism to collect and record data in a standardized manner.

Data alone is insignificant as it is the insights derived from the data that matter most. The analytics team and underwriters need to work collaboratively to withdraw meaningful insights from large volumes of data. This will be possible with the help of a powerful communication tool that can create a partnership of exploration between the two parties.

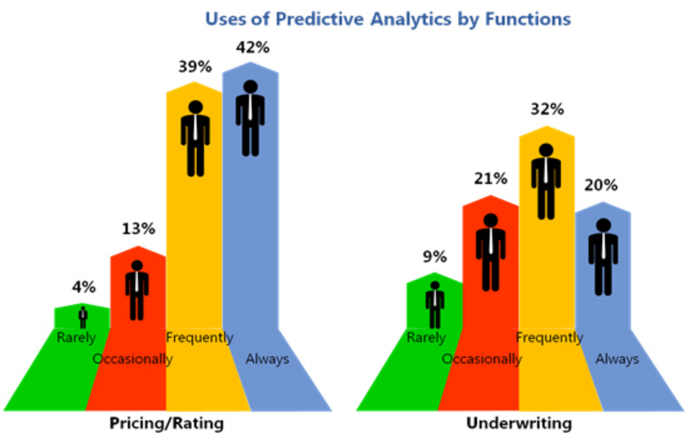
To integrate various tools and platforms, insurance companies need structured as well as standardized data.

Blend of Competent Underwriting Skills and Tools to Precisely Assess Data Available

With underwriting remaining one of the top challenges, many insurance companies are making investments in underwriting technology and underwriter training. A perfect balance of competent underwriting tools and platforms along with skilled talent to assess available data is expected to deliver measurable results for these companies.

In case of commercial insurance, especially the specialty insurance business line, as the complexity of the risk (and the size of the premium) increases, skilled underwriters who can complete a more thorough and accurate assessment of the risk gain. These underwriters require a dedicated underwriting workstation that provides access to key data and tools within a consistent process.

Insurance companies are widely adopting predictive analytics as a core business strategy to improve pricing precision, underwriting consistency, and customer segmentation. In a recent survey by the Insurance Information Institute, underwriting and pricing rating were identified as the major functions to employ predictive analytics.



Adoption of Automated Underwriting Based on the Type of Risk, Products, Markets and Maturity of End Users

Instead of analyzing risks, underwriters spend an inordinate amount of time dealing with process and system deficiencies such as unclear workflows, lack of relevant information, multiple systems that require rekeying of massive amounts of data and, most important, lack of powerful tools which are needed to make impactful decisions.

Automated underwriting takes much of the work done in the manual process today into a "no touch" low-cost environment. Typical manual tasks include quoting, policy issuance, policy modification, document management, reporting, message notifications, inquiry, filing, mailing, and cancellation.

> Increased automation benefits customers, brokers, insurers, and reinsurers. Not only will the delivery of insurance products be real-time fast, but the cost benefits to all will be greatly enhanced.

Insurers should take advantage of innovative technology such as automation to enhance processes and create efficiencies. Automation can remove redundancies by focusing on repetitive behind-the-scenes tasks, and enabling the shift of headcount to client-facing tasks.

Underwriting of high-volume, low-premium, and low-risk policies can be supported by automated underwriting solutions such as policy management modules with embedded rating, business rules, integration with key data sources and STP to underwrite a significant percentage of applications without manual intervention.

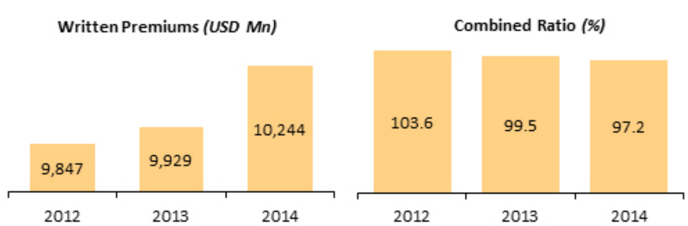
Case Study on the Hartford Financial Services Group

The Hartford Financial Services Group, Inc., known as The Hartford, is a U.S.-based investment and insurance company catering to individual and business customers.

The P&C insurance division is the most important business for The Hartford, accounting for nearly 80% of the company's operational core earnings. It includes commercial and personal lines of insurance; commercial insurance is the biggest segment accounting for 62.3% of the total net written premium in 2014.

The Hartford's workers' compensation business line accounts for an estimated half of its commercial premiums with a market share of 5.9% and is the second largest insurer in the U.S.

In 2012, The Hartford completed an evaluation of its strategy and business portfolio with a focus on property and casualty insurance. With realignment of its strategy, The Hartford managed to improve the P&C business line combined ratio by 6.4 points from 2012 to 2014. This was achieved as the company focused on rate increases and the underwriting discipline.



Additionally, the company also further reduced its operating costs and other expenses by 23% during this period. The company is expected to see better results in the coming years as it establishes its market position in the U.S. and continues to focus on underwriting profits. The Hartford also

> Realignment positions The Hartford for higher ROE, reduced sensitivity to capital markets, a lower cost of capital, and increased financial flexibility.

plans to invest in strengthening its underwriting and claims management system to boost its profitability. In 2014, The Hartford partnered with an insurance platform provider to integrate a new underwriting and policy administration platform to replace multiple legacy systems.

> "We are investing in technology as part of The Hartford's strategy to profitably grow its businesses and become more efficient. This investment will enhance crucial policy management processes and systems, helping our employees work better while making it easier for our partners to do business with us."
>
> – Doug Elliot, President, The Hartford Financial Services

Future Outlook

Underwriting profitability is one of the top priorities of CIOs in the insurance industry. Decline in investment income and increase in claims frequency across several lines of business are putting pressure on the underwriting discipline. To improve underwriting profitability, insurance companies need to deploy various tools and platforms. Moreover, the companies need to adopt a more holistic approach to their core system and business transformation, which explicitly focuses on establishing cross-functional linkages to enable more informed and efficient underwriting.

For more information on Sutherland Global Services' insurance process management capabilities, visit www.sutherlandglobal.com/insurance. For detailed inquiries or to schedule an exploratory discussion, email us at SGS.Insurance@sutherlandglobal.com or call 1-800-388-4557 ext. 6123.