MERCER GUY CARPENTER

ASSESSING INSURERS IN A PERIOD OF RAPID CHANGE

INSURANCE EQUITY ANALYST SURVEY 2016

MARSH & McLENNAN COMPANIES

EXECUTIVE SUMMARY

Insurance companies have been through a period of dramatic change, with increasingly demanding regulatory regimes, a continually challenging investment environment, a flood of external capital into the industry and a need to materially innovate product offerings.

Insurance company boards and senior management have had to make difficult but time-critical decisions to navigate such an environment. However, when making such decisions, it is often a challenge to understand whether the direction chosen is aligned with the needs and objectives of key stakeholders, such as shareholders and policyholders.

To help insurers understand the possible objectives and aspirations of shareholders, Mercer (specializing in the asset side of insurers' balance sheets) and Guy Carpenter (specializing in the liability side) have conducted a survey of sell-side and buy-side equity analysts. Since many investors are directly influenced by the views of insurance equity analysts, understanding equity analyst opinions is a valuable and informative proxy for the preferences of shareholders and potential shareholders. Although analyst calls and similar modes of communication provide a limited forum for this sort of exchange, these interactions would not normally be sufficiently deep or frequent enough to influence detailed policies and strategies. Incorporating or at least considering the views of various stakeholders will be critical for insurers in ensuring that they are moving along the right path, especially in this uncertain environment.

In some areas, the survey revealed surprising results, with some particularly interesting consensus views around areas including:

- **Underwriting exposures:** Analysts typically favor companies that are reducing probable maximum losses (PMLs) in the current rate environment. However, they would generally prefer insurers to reduce these by writing less business rather than with retrocession, although we observe that the latter remains popular with many insurers.
- **Turn of the underwriting cycle:** Reserving deficits are cited as the most likely factor to turn the underwriting cycle and bring an end to the current soft rate environment, although the consensus is that the effects of this will take some time to emerge.
- **Investment risk-taking:** Most insurers have been increasing the level of market risk taken in reaction to the low-yield environment. However, for life companies in particular, many analysts feel insurers have gone too far and are now taking an excessive level of risk.
- **Focus of investment approach:** Analysts express a strong preference for adopting a risk-focused approach to investments — preferably a robust asset liability management (ALM) approach rather than one that focuses on superior return generation.

The analyst survey was split into four key sections. Our main findings in each area are outlined below.

1. Insurance equity valuation and drivers of performance

How do analysts form opinions on insurers, and what features do they like to see when analyzing the company?

- Institutional investment in insurers is typically viewed with a longer-term time frame than the market average.
- Analysts tend to use accounting-based valuations, with book value being viewed as the most important.
- Many analysts view low interest rates as the biggest downside risk for insurers.
- Analysts would like to see management prioritize growth in book value, improved underwriting approach and cost-reduction measures.
- More disclosure around reserves and capital adequacy would be valuable to improve transparency.

2. Underwriting policy

How should insurers evolve their underwriting strategies, and how should the exposures be measured and managed?

- The current level of capital allocated to underwriting risk is viewed as broadly appropriate.
- Analysts find it difficult to benchmark the use and sophistication of predictive analytics due to limited disclosures around this topic.
- Disclosures around catastrophe risk exposure and reinsurance protection are viewed as highly important.
- Analysts typically favor companies that are reducing PMLs in the current rate environment and would prefer them to reduce by writing less rather than with retrocession.
- Reserving deficits is cited as the most likely factor to turn the underwriting cycle.

3. Investment policy and market risk

How should insurers set their overall investment approaches and manage the associated market risks?

- Respondents express a preference for strong investment risk management practices, such as ALM, rather than approaches that focus purely on return generation.
- Analysts generally favor a lower level of investment risk-taking for life insurers, but the consensus is less clear for nonlife (P&C) insurers.
- Most analysts feel shareholder capital should be invested largely in medium- to higher-risk assets with a longer-term time frame.
- Analysts generally feel there is sufficient investment governance and management in place to deal with the asset strategies being implemented.
- There is also support for outsourcing the investment function, particularly for smaller insurers.
- In setting an insurer's investment strategies, most analysts are supportive of diversification and investing in less liquid assets to earn additional yield.
- Analysts prefer a blend between very-low-cost asset strategies and higher-cost but potentially better-rewarded strategies rather than focusing only on one type.
- Although many insurers view environmental, social and governance factors as increasingly important, most analysts do not yet see this as an immediate priority.

4. Mergers and Acquisitions (M&A)

Will the trend of increased M&A in the sector continue, and what are the main value drivers for this?

- Most analysts feel there are potential sustainable cost and/or underwriting benefits from M&A activity.
- Just over half of the analysts surveyed believe M&A activity in the insurance industry is likely to increase over the short term, with less than 10% expecting a fall in M&A levels.

The challenging business environment shows no sign of abating, with increasing geopolitical risks, further pressure on underwriting margins and little value offered by most investment markets. In making decisions around policy and approach, it will therefore be even more important for insurers to engage with different key stakeholders to ensure their needs are appropriately reflected and balanced in the overall business strategy.

1. INSURANCE EQUITY VALUATION AND DRIVERS OF PERFORMANCE

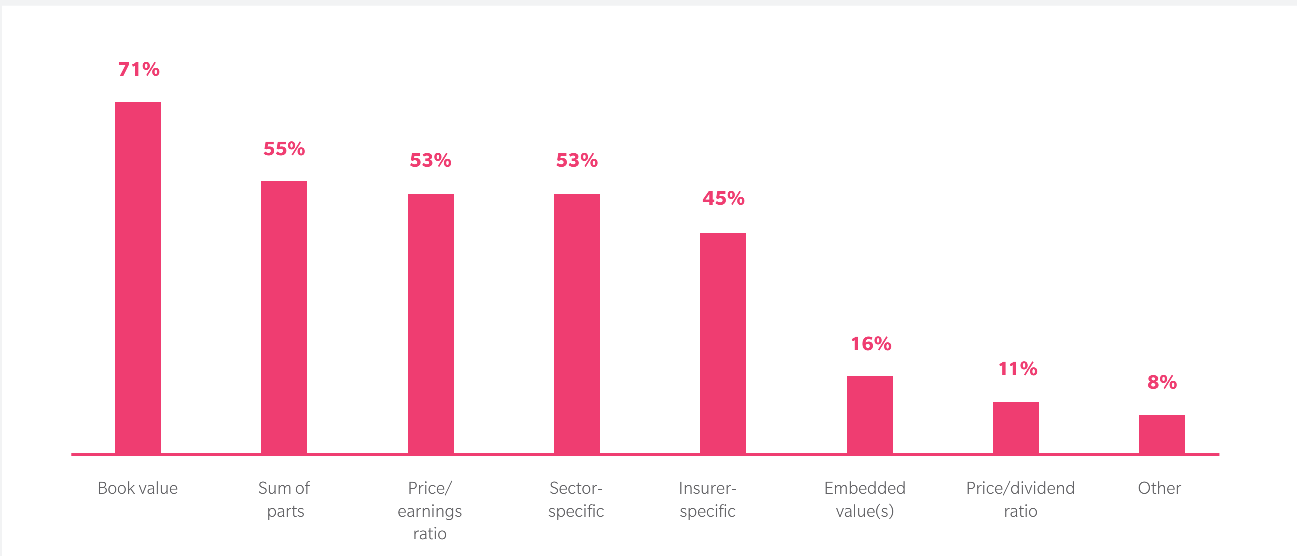
Analysts' recommendations remain unchanged for relatively long periods of time.

Interestingly, the equity analysts surveyed indicate that they maintain the same recommendations for insurance equity for relatively long periods of time (90% tend to hold for more than one year). Given that the average holding period for the S&P 500 is less than 12 months, this is unusual and likely shows that many of the analysts select insurance equities based on fundamentals as opposed to momentum or other factors, such as macro trends. When asking specifically about the valuation frameworks used, we received a wide array of responses but accounting values seem to be most popular.

Accounting-based valuations tend to be used for insurers, with book value prioritized.

Perhaps surprisingly, analysts ascribe a relatively low value to dividends, as these are usually aligned to economic value and what many investors are focused on in a low-growth environment. The majority of analysts believe earnings and book value growth are the most important drivers for insurance sector valuations, which makes sense given the valuation frameworks most often used. Whether analysts look deeply into what drives earnings and book value growth (for example, growth in distributable reserves) or take them at face value is unclear. In Europe, there has been increasing focus on Solvency II capital generation as a critical component of economic value growth, and it will be interesting to see whether this view gains popularity in North America and other regions.

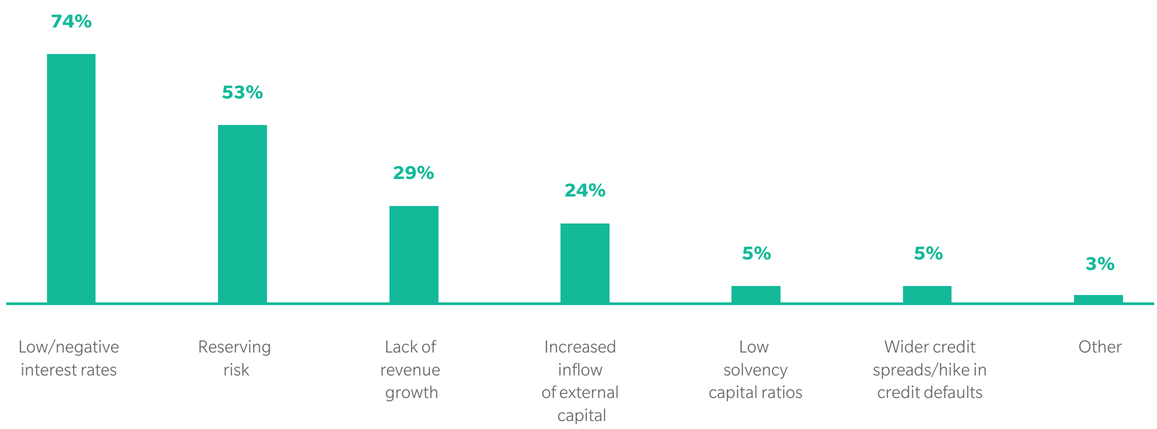
Figure 1. What is your valuation framework for insurers?



Low interest rates are viewed as the biggest downside risk for insurers.

Low interest rates are the biggest concern for analysts. With some central banks likely to raise interest rates over the next couple of years, this implies a potential upside for the industry (even though lower bond values may hit book value). There may be subtle differences between regions, with credit spreads perhaps being more important in Europe than in other regions, as they have the highest sensitivity to Solvency II — an example of how disclosure can skew the debate. Concern over low interest rates has likely informed analysts' views on performance across insurance sectors. Almost twice as many analysts believe the nonlife (P&C) sector will outperform compared to the life sector over the next year. Going forward, this may shift, as the macroeconomic outlook suggests rising interest rates and stronger earnings growth, which will improve conditions for life companies relatively more than for nonlife. To some extent, this is already taking place.

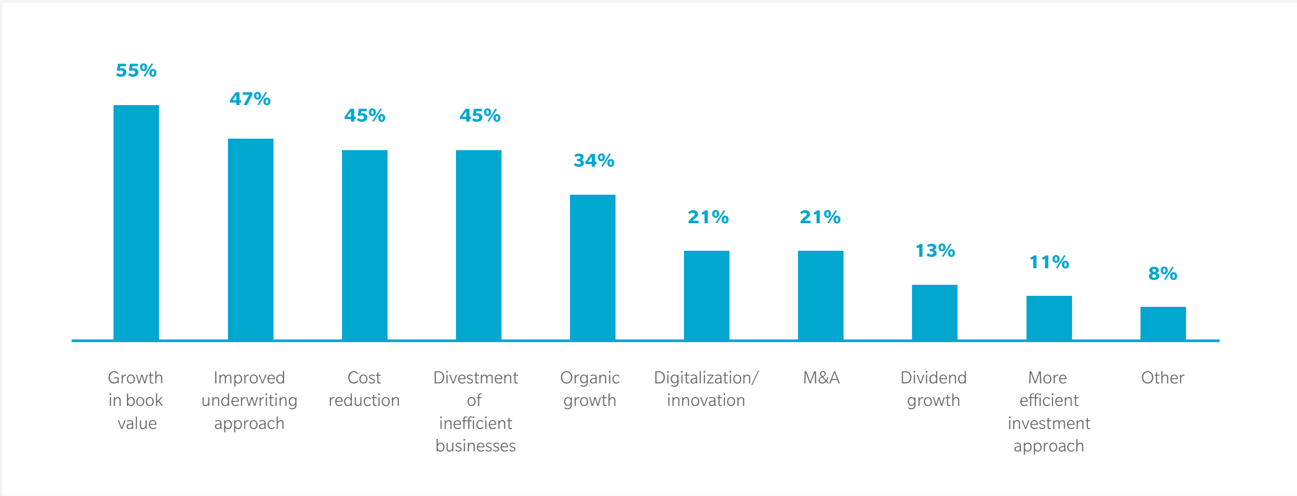
Figure 2. What are the two biggest downside risks for insurers on a two- to three-year view?



Analysts would like to see management prioritize growth in book value, improving underwriting approach and cost reduction over the next two to three years.

Overall, it appears that equity analysts across the board are cautious about the growth prospects for the industry and would like underwriting and investment policies to reflect this. Many equity analysts would like to see management prioritizing measures around cost reduction, divestment of inefficient businesses and organic growth over M&A. Furthermore, it appears that analysts believe there is more opportunity for improvement in underwriting in comparison to investments. There are clearly many views on the subject, and these will continue to change over time.

Figure 3. What would you like to see management prioritize over the next two to three years?



Analysts would like to see more disclosure around reserves and capital adequacy.

The majority of analysts would like to see more disclosure around reserves and capital adequacy. Many companies are still coming to grips with additional disclosures for analysts and investors, and we can expect this to evolve over the next few years. This subject is coming to the fore in Europe with Solvency II. In the US, there has been disclosure on reserves and investments for a long time, but the capital adequacy rules and disclosure requirements are less comprehensive than under the Solvency II regime. For European insurers, most analysts deem a Solvency II ratio below 160% to be insufficient. This is surprising, considering that a 100% ratio is broadly equivalent to a BBB level of capital and 160% is a comfortable A-rating level, but this result only highlights the importance currently placed on adequate capitalization.

2. UNDERWRITING POLICY

Underwriting continues to be at the heart of the insurance business, and many insurers are looking to transform this central function with large-scale investments in technology. As such, it will be useful for insurers to understand how equity analysts evaluate underwriting policies and performance. Many insurers are improving underwriting with increased automation and use of analytics, but, for the most part, investors have limited insight into the strength and sophistication of an insurer's underwriting processes. We asked analysts where they would like to see more disclosure and what they looked for when evaluating insurers' underwriting practices.

Most analysts believe the current level of capital allocated to underwriting risk is about right.

Risk-based capital regimes, such as Solvency II, have helped to improve disclosure on how companies allocate their capital. So far, this has typically been restricted to the larger companies, which have provided an analysis of their solvency capital requirement (SCR) by market, credit, insurance and operational risks. Some split the underwriting risk capital further into nonlife (P&C) and life. For the overwhelming majority of companies, though, there is a lower capital allocation to underwriting risk than the aggregate of other risk categories. More than two-thirds of respondents consider the current level of capital allocated to underwriting risk to be about right. The consensus around the status quo is against a background of a lower-investment-yield environment, suggesting, perhaps, that analysts do not believe underwriting can offer superior relative returns and therefore the potential for higher earnings or book value growth.

In the coming years, as Solvency II and other regulatory changes are more firmly embedded and public filings become available, we would also expect more detailed disclosures to emerge, particularly around capital generation. As investors become more familiar with the new disclosures, it would be interesting to revisit this question and think about whether insurers are positioned to achieve optimal returns for their allocated capital and risk appetites.

Analysts find it difficult to benchmark the use and sophistication of predictive analytics due to limited disclosures around this topic.

We asked whether analysts benchmarked the use and sophistication of insurers' predictive analytics capabilities. Most analysts responded that, due to little to no disclosures around this topic, it is very difficult for them to evaluate the appropriateness of these tools and the extent of their use. For similar reasons, it is rarely possible to determine their direct impact on the business and benchmark their performance — other than on a post-event basis or considering historical results more generally, which some may not consider adequate.

One analyst's response showcases a pragmatic approach: "Scale is part of the answer, as larger insurers have more fixed R&D to allocate across more units of risk. Looking at an insurer's analytical successes and failures relative to their prior guidance provides information content. All companies provide sensitivities in advance of events; we review actual losses in relation to those sensitivities."

Analysts are split on the significance of annual actuarial review results.

Opinion is equally divided on the weight put on annual actuarial review results. Some analysts are inclined to view assumptions as being too optimistic in the current climate and prefer to rely on their own analyses. The results and comments, though, are broadly consistent with the responses provided to earlier questions, which cite the desire for more disclosure on "reserves and capital adequacy," a majority view that some companies are now under-reserved and that "reserving risk" is the second biggest downside risk on a two- to three-year view. Our takeaway, therefore, is that respondents consider reserves to be a very opaque area yet one that is fundamentally important to the performance of the sector. However, they are wary of trusting actuarial reviews — either the company's internal reviews or those procured from third parties.

The majority of analysts consider disclosure around catastrophe risk exposure and reinsurance protection to be highly important.

In contrast to actuarial reviews, a majority of respondents (55%) consider disclosures on catastrophe risk exposures to be "very important" and another 36% "somewhat important." This is not surprising when large natural or man-made catastrophes seen in recent years, such as Hurricane Katrina or the Thai Floods, have the potential to wreak havoc on earnings and balance sheets in a spectacularly short space of time.

Similarly, respondents treat disclosures on reinsurance protection very seriously. Almost two-thirds responded that it is "very important" and another third say it is "somewhat important." One analyst commented that reinsurance protection disclosures "help us to understand what the likely limits are to the downside for the insurer during major cat events, which is important to help frame the risk profile of the insurer and how we rate [the] company relative to the market." Another said that the "key is counterparty risk evaluation." Taken together, the responses to these two questions show that the investment community places a high importance on this area of risk management, both in terms of assessing exposures and for comparing risk appetites.

Analysts favor companies that are reducing PMLs in the current rate environment and would prefer them to reduce by writing less rather than with retrocession.

Respondents almost unanimously prefer companies that are reducing probable maximum losses (PMLs) in the current rate environment, with 78% in favor. This is a simple question but a complex underlying topic, as rate adequacy and expected returns can vary materially across layers depending on inter alia available capacity and risk appetite.

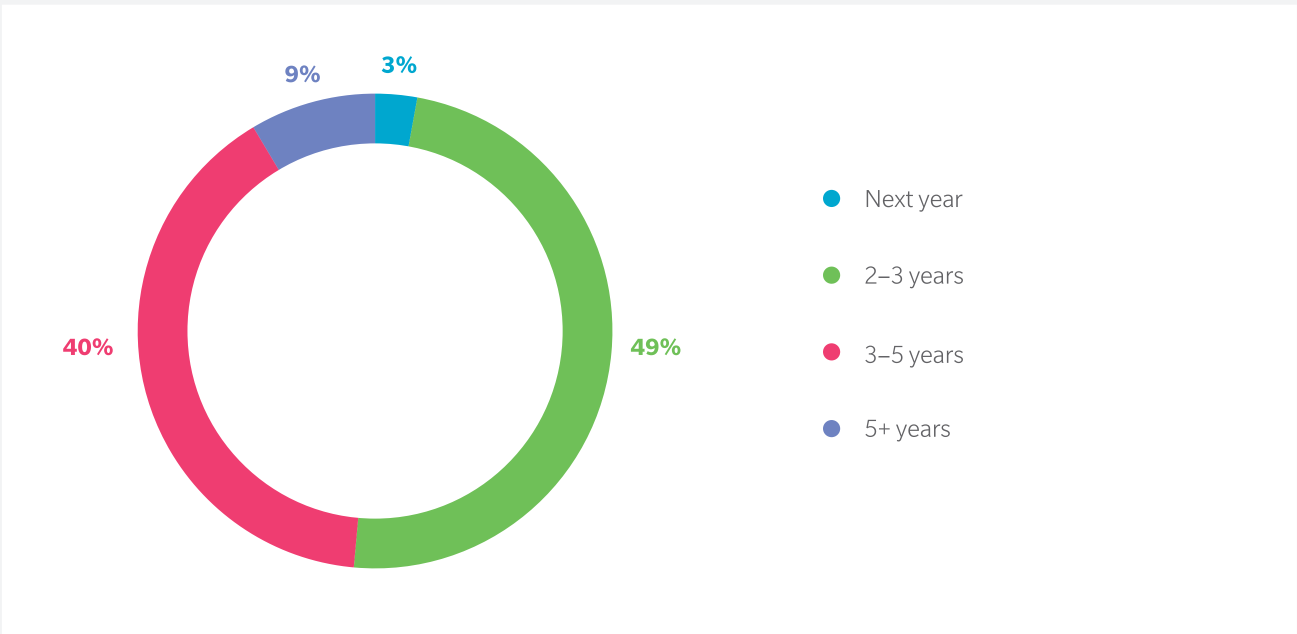
By and large, analysts would also prefer insurers to reduce their net PMLs by writing less (61%) than by reducing them with retrocession. The comments from respondents, though, give a more nuanced picture, recognizing that it depends on other factors and that it is more about "which is priced better and provides a better return" as well as the quality of the retrocession counterparties.

The majority of analysts believe that reserving deficits will be the most likely factor to turn the underwriting cycle but don't believe this will occur for two to five years.

Reserving deficits was selected as the most likely factor to turn the underwriting cycle, with support from 54% of respondents compared to just 20% favoring large catastrophes and none for reinsurer default. The remainder of respondents selected other factors, which include "anything that destroys capital fast," persistently low interest rates and low operating cash flow. In the comments, inflation is not explicitly mentioned, presumably as it's considered within reserving risks, but it could also have an adverse effect on bonds and equities, which would materially dent balance sheets as well.

Although respondents may be confident in the factors most likely to turn the cycle, they still don't expect the turn to be imminent. The most popular choice was two to three years away, but almost 90% expect it to occur in the next two to five years. In providing further comments for this question, one analyst does emphatically cite inflation, saying it "depends on inflation — no inflation, no turn." Another analyst says, "We are not in the business of predicting the shape of the cycle as much as taking advantage of unexpected activity," neatly summing up where most of the investment community likely stands on this issue.

Figure 4. When do you expect the underwriting cycle to turn?



The vast majority of analysts evaluate the underwriting team's talent and structure.

Three-quarters of respondents say they evaluate the underwriting team's talent and structure. This is not surprising, but the comments received make plain that this is not easy to do from the outside, and many have to rely on "experience and time [to tell] whether a team is good."

3. INVESTMENT POLICY AND MARKET RISK

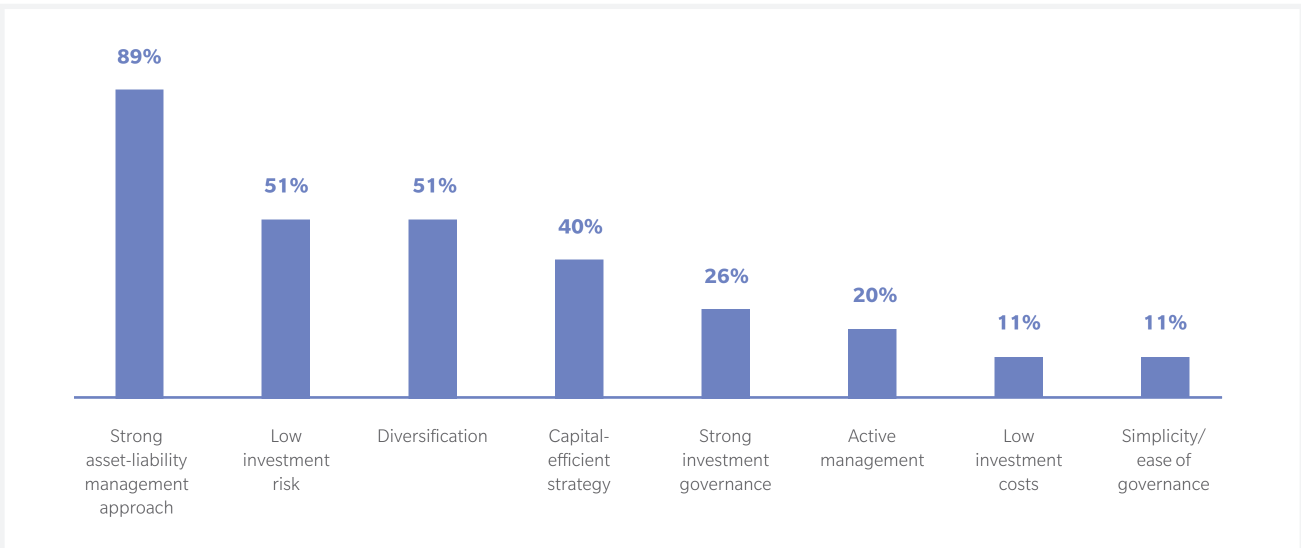
This has been a rapidly developing area for insurers over recent years, with the ongoing low-yield environment and changes in regulatory regimes driving often significant changes in investment strategy and approach. However, a key question is the extent to which equity analysts have been supportive of these changes — notably, the higher level of investment risk-taking and the increased sophistication of investment policies.

Analysts prefer to see strong investment risk management practices, such as ALM, rather than an approach that focuses purely on return generation.

The majority of respondents favor a strong asset liability management (ALM) approach, with around 90% choosing it as an attractive attribute of an insurer's investment policy. The other popular areas are low investment risk, diversification of investment risks and having a capital-efficient asset strategy.

Consistent with the above preference for strong ALM, the main concern expressed by the participants is around any material mismatches between assets and liabilities. We note that, given the increased volatility in bond yields and currency rates due to recent economic and geopolitical events, insurers have, in general, been paying ever-closer attention to minimizing any unintended ALM mismatches.

Figure 5. What are the most attractive attributes of an insurer's investment portfolio?



For nonlife (P&C) insurers, the participants are evenly divided between those who favor greater investment risk-taking versus those who prefer some de-risking. For life insurers, the majority favor a lower level of investment risk-taking than currently.

Given that many nonlife (P&C) insurers in particular have already increased the level of investment risk in investment portfolios to react to the low-yield environment, we can infer that most equity analysts are supportive of this. However, the support for further increases in risk-taking seems mixed. For life insurers, the survey appears to indicate that most analysts feel they have gone too far in reacting to the economic environment.

Some of the rationale expressed for greater risk-taking for nonlife (P&C) insurers was that investment risk-taking can represent an efficient use of capital (especially given the diversification with underwriting risks), and some riskier assets, such as equities, can provide an inflation hedge. However, other analysts are more cautious, citing concerns around the current value in investment markets.

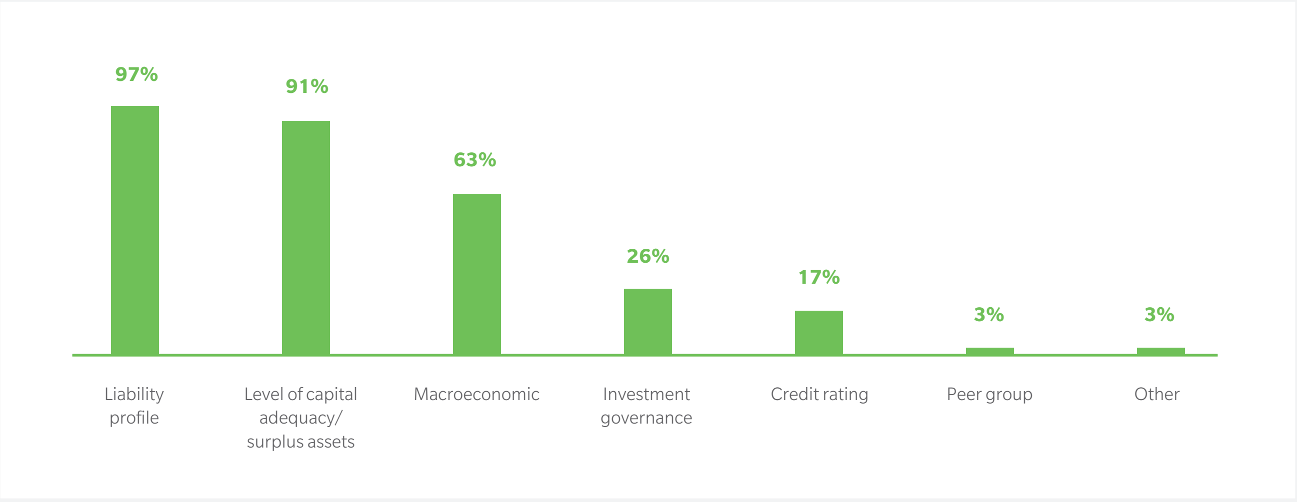
There are three main factors that analysts feel should drive the level of investment risk:

1. The liability profile, consistent with the previous responses around asset-liability management being a key area of focus

2. The level of capital adequacy and surplus assets

3. The overall macroeconomic environment, with some analysts suggesting the level of investment risk-taking should be more dynamic, reacting to factors such as asset valuations and the level of credit spreads

Figure 6. What are the main factors that should determine the appropriate level of investment risk?



The majority of analysts feel that shareholder capital should be invested largely in medium- to higher-risk assets, with a longer-term time frame.

Eighty percent of the survey participants are supportive of a reasonable degree of investment risk-taking with shareholder assets, perhaps recognizing factors such as the very low level of yield available from low-risk assets and the need to provide shareholders with an overall acceptable level of return. Only around 10% of the respondents want to invest this in low-risk, highly liquid assets.

The majority support a medium-to-long time horizon for investing the shareholder capital. This could be because they recognize that a longer-term perspective can add value — in particular, many riskier assets that could be held in shareholder funds do need a longer time horizon to withstand shorter-term volatility.

Figure 7. What's your view on how shareholder capital should be invested?

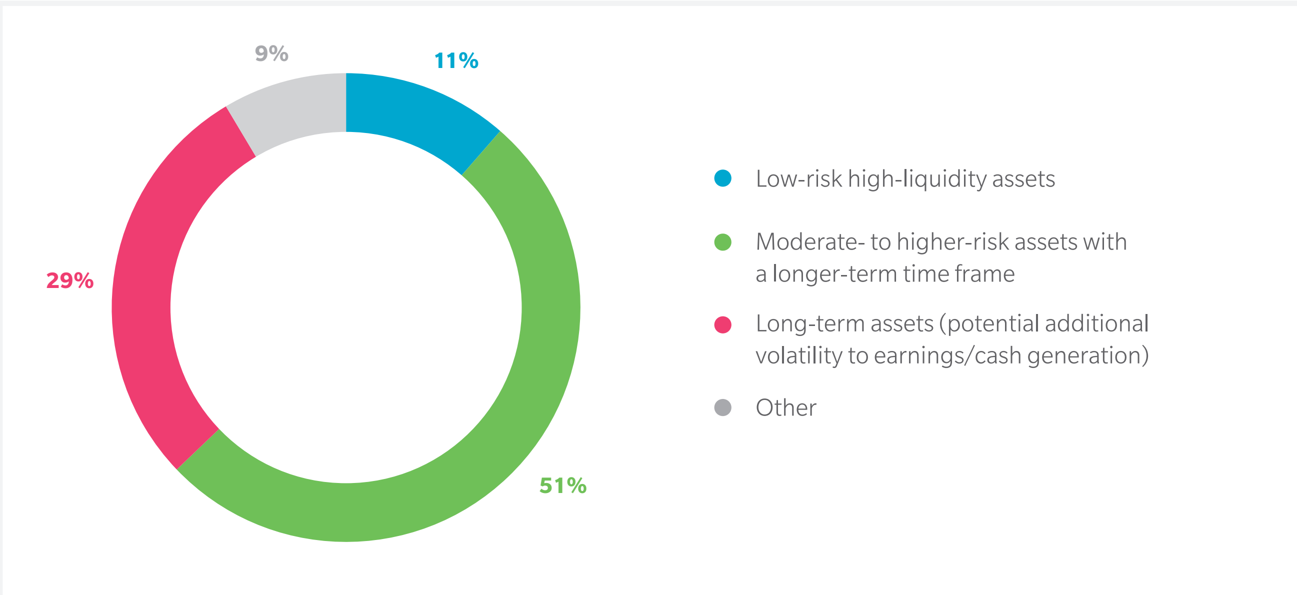
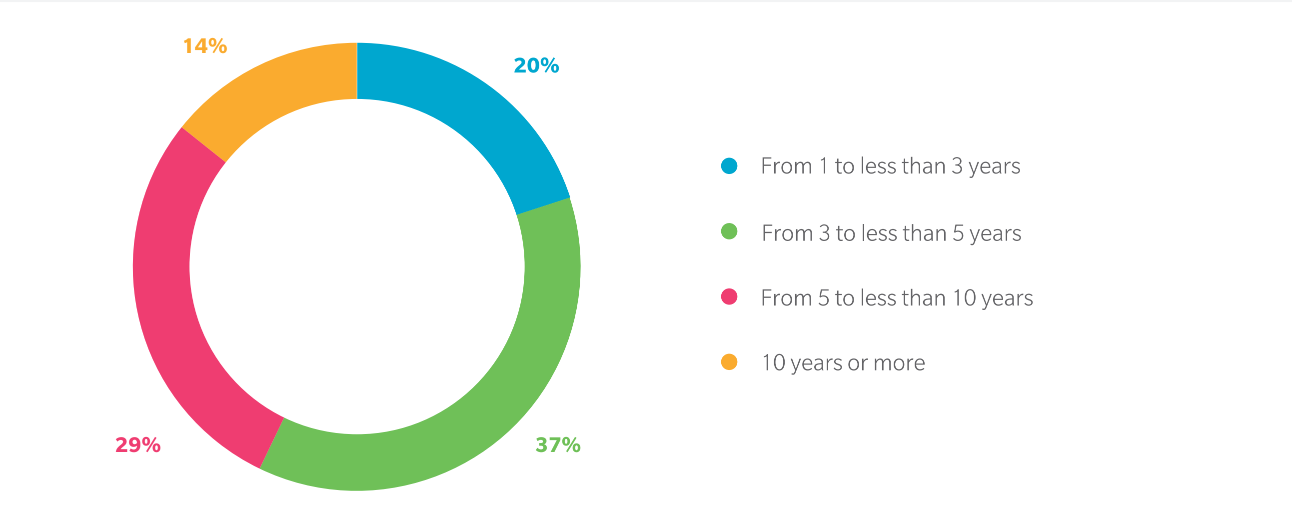


Figure 8. What should be the investment time horizon of shareholder capital?



The majority of respondents feel there is, on average, sufficient investment governance and management in place to deal with the asset strategies being implemented. However, there is also support for outsourcing the investment function, particularly for smaller insurers.

With the increased complexity of investment approaches being adopted, many insurers have been looking to outsource all or part of their investment functions to external partners. Most analysts in the survey are supportive of this move, particularly where there is a lack of internal expertise or for smaller insurers where it is not economical to develop internal capabilities.

In setting an insurer's investment strategies, most analysts are supportive of diversification and investing in less - liquid assets to earn additional yield. However, support for investing in real assets to provide an inflation hedge is more mixed.

Nearly all respondents (all but one) feel that insurers already have well-diversified investment portfolios, recognizing that many insurers have moved away from plain vanilla equity/cash/fixed-income portfolios into alternative assets and different types of fixed income. However, when comparing insurers against other types of institutional investors, we would observe there is still material scope for further diversification in most insurance investment portfolios.

Opinion is split on whether insurers should be concerned about hedging claims inflation. Around half of the responses are in favor of this, which could be achieved in practical terms either by investing in assets with inflationary characteristics, such as certain forms of real estate and infrastructure, or with more explicit inflation linkage through inflation derivatives and inflation-linked bonds.

The majority of respondents (71%) are supportive of insurers investing in less-liquid assets to take advantage of an illiquidity premium to earn additional yield. However, some of the responses come with the caveat that sufficient liquidity should be retained to meet cash-flow requirements. One analyst also feels this strategy is appropriate for life insurers but not nonlife (P&C) insurers, presumably reflecting the higher liquidity requirement of nonlife

(P&C) insurers' more uncertain liabilities.

Most of the respondents prefer a blend between very-low-cost asset strategies and higher-cost but potentially better-rewarded strategies rather than focusing only on one type.

A fundamental decision for any investor is how much to allocate to very-low-cost passive strategies (for example, indexation approaches and exchange-traded funds) to minimize costs and how much to higher-cost strategies where there may be the expectation of a higher net return (for example, actively managed strategies and alternative assets).

The majority of respondents feel that a balance between these two approaches is best. This can be reconciled by focusing on the lower-cost approach, where there is less demonstrable value in using active management (for example, treasury bonds), and paying a higher fee when there is a stronger case for it (for example, emerging market equities). Only a small proportion of respondents favor a fully passive/cost-minimization approach.

Although many insurers view environmental, social and governance (ESG) factors as increasingly important, most analysts do not yet see this as a high priority.

Many insurers have been at the forefront of developing a robust ESG approach, driven by various external stimuli (for example, the United Nations' Principles for Responsible Investment) as well as a belief that this can add value over the longer term. However, although there is support from around one-quarter of respondents for formally incorporating this in portfolios, the majority feel this is less of a current priority.

We note that there is typically a longer time horizon considered for ESG approaches, which is at odds with the shorter-term focus of equity analysts for insurance stocks (as discussed previously). This perhaps reconciles why there is less support than might be expected for an ESG approach, given the wider popularity in the marketplace.

4. MERGERS AND ACQUISITIONS (M&A)

The last section of the survey considered analysts' views on M&A activity between insurance companies, including what value has been produced from these transactions. The ongoing low-yield environment and the flood of external capital into the insurance industry have depressed and are expected to continue to depress profitability, putting pressure on insurers to find other means to extract value. A key focus of this is often exploring cost synergies by achieving greater scale of the business through M&A. In addition, this increased scale can permit a more sophisticated approach to extracting value from the investments and insurance portfolios.

Other key drivers for this increased activity include:

- The increased regulatory and compliance burden being placed on insurers
- An increased focus on technical and digital innovation to deliver value, which requires increased investment and scale
- A desire to sell legacy insurance books and unlock capital from operations that are no longer core to the business
- An increased focus on geographical and product diversification by buying complementary books of business
- New entrants to the market looking to buy share (for example, from Asia Pacific countries such as China), a strategy to reinvigorate growth, particularly among companies with a focus on lower-growth, mature markets

The majority of the respondents feel that there are potential sustainable cost and/or underwriting benefits from M&A activity, although some respondents are not convinced of the merits.

The typical justification provided for a belief in these sustainable benefits is around cost savings, with less conviction in the benefits of M&A for underwriting returns. The main additional reason to support this is the perceived lack of opportunities for growing the business organically.

For those less convinced of the merits, there is concern around the benefits from M&A not often being received by the shareholders in practice and a preference for the insurers to focus more on growing the business organically.

Just over half of the analysts surveyed believe M&A activity in the insurance industry is likely to increase over the short term, with less than 10% expecting a fall in M&A levels.

The justifications provided for this continuing increase in M&A activity include the ongoing pressure on profitability (low premium growth and low yields) and the lack of organic revenue growth opportunities available.

CONCLUSIONS

The survey provides valuable input into how equity analysts evaluate insurance companies across all aspects of their business. Even if the analyst preferences are not incorporated in the actual practices adopted by an individual insurer, it is still useful to understand and reconcile any differences.

Analysts evaluate insurers primarily based on earnings and book value growth, although there is a whole assortment of approaches. Most analysts believe that low interest rates and reserving risks are the biggest downsides in the next two to three years and that reserving deficits may be the most likely factor to turn the underwriting cycle in a similar time period.

Many equity analysts think management should be defensive in the current environment and prioritize measures such as cost reduction and divestment. They would welcome more disclosures around reserves and capital adequacy, predictive analytics and catastrophe modeling capabilities, and reinsurance protection. Furthermore, they would like to see insurers reducing PMLs, primarily by writing less.

When it comes to investment practices, analysts prefer to see ALM strategies as opposed to those that focus on return generation. There are mixed views on whether nonlife (P&C) insurers should take on more or less investment risk, but there is a majority view that life insurers should now be taking less investment risk. Most believe a mix of lower-cost, index-based strategies and higher-cost active management strategies should be utilized. The equity analysts surveyed say that most insurers have sufficient investment governance and management but believe that some, including smaller ones, should consider outsourcing all or part of their investment functions.

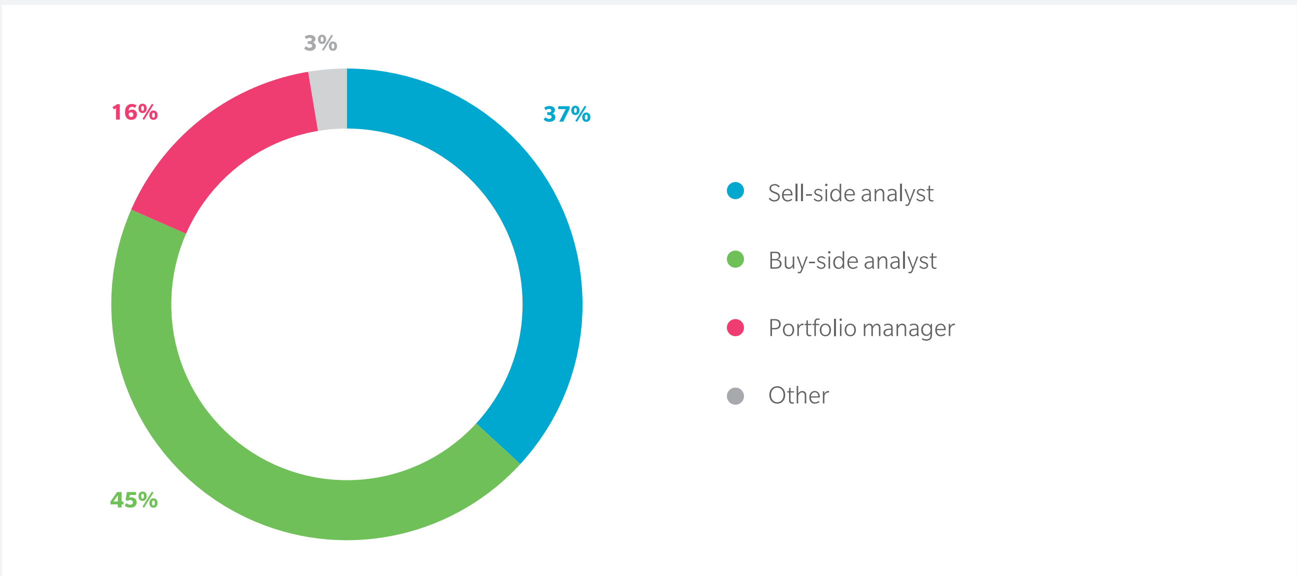
Analysts hold varying views on the benefits of M&A, but of those that think the benefits are substantial, most say these will manifest themselves through cost reductions rather than underwriting improvements. Many analysts think M&A activity will continue to rise, at least in the short term.

Unfortunately for insurance companies, the challenging business environment shows no sign of abating, with increasing geopolitical risks, further pressure on underwriting margins and little value offered by most investment markets. In making decisions around policy and approach, it will therefore be even more important for insurers to engage as far as is practicable with the different key stakeholders to ensure their needs are appropriately reflected and balanced in the overall business strategy.

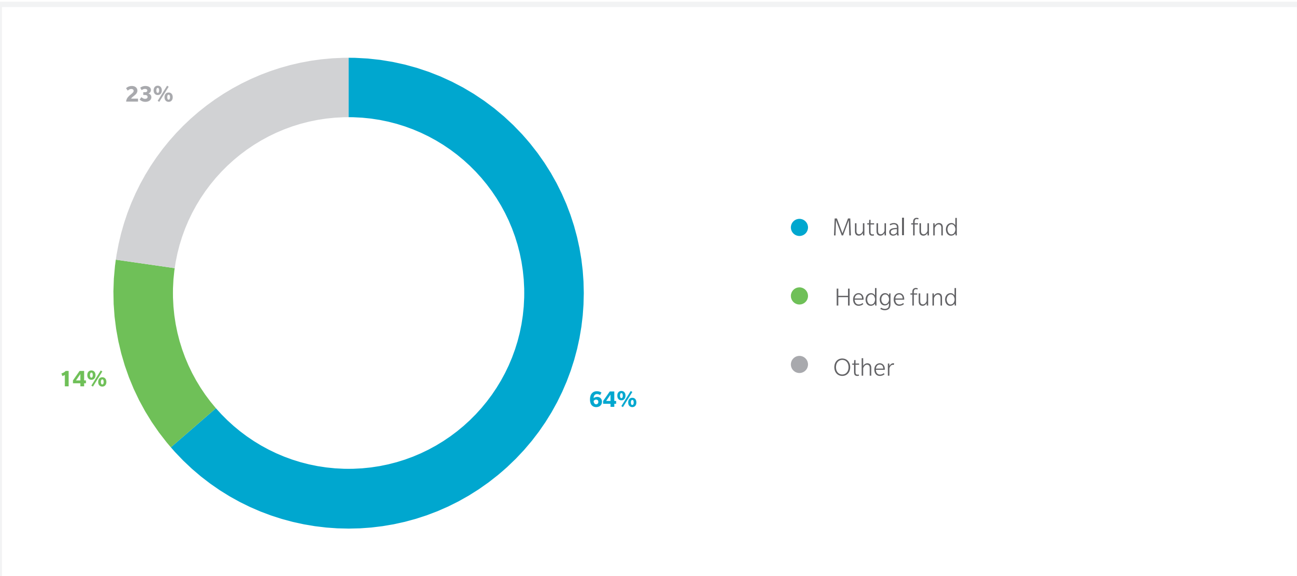
PARTICIPANT PROFILE

There were 38 participants in this survey.

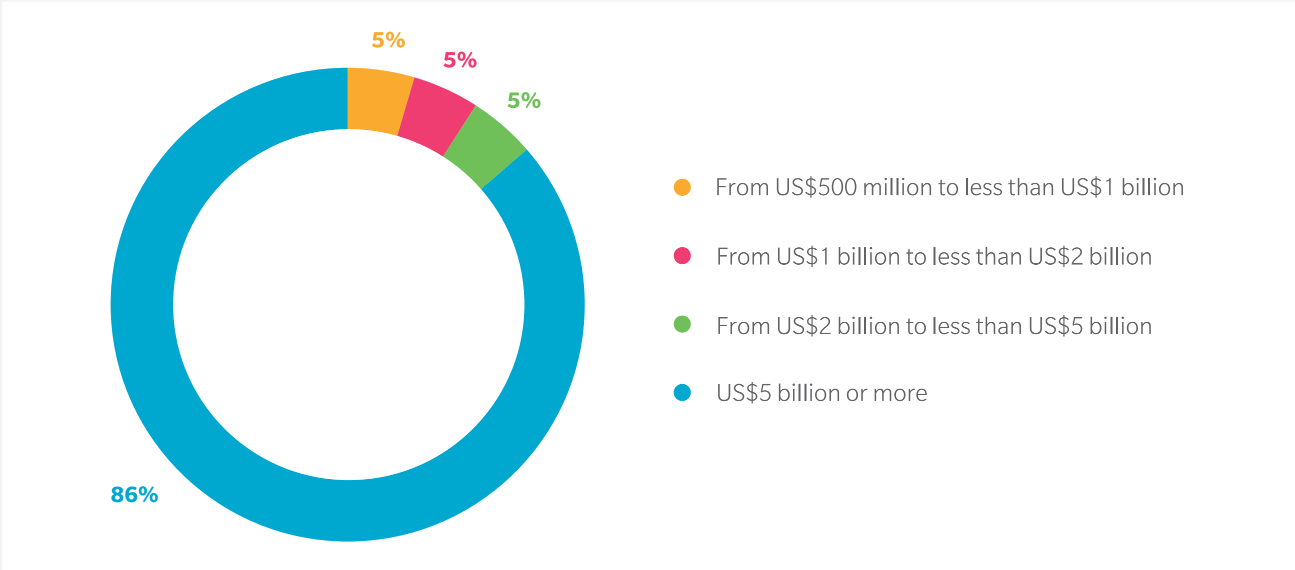
Job types represented:



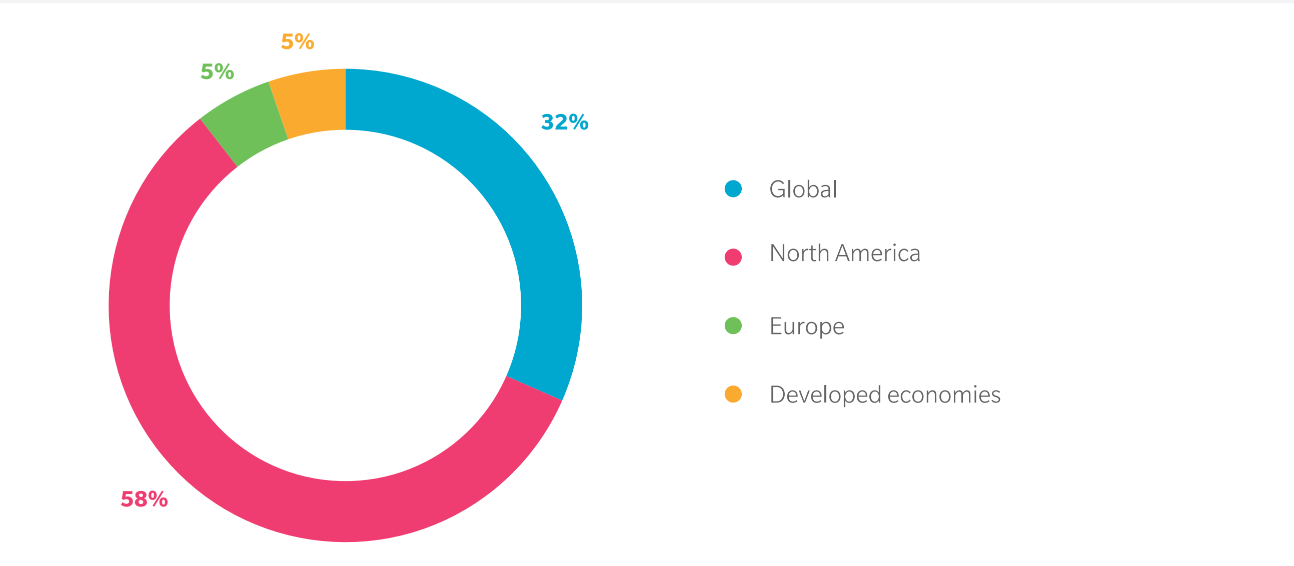
Fund types represented:



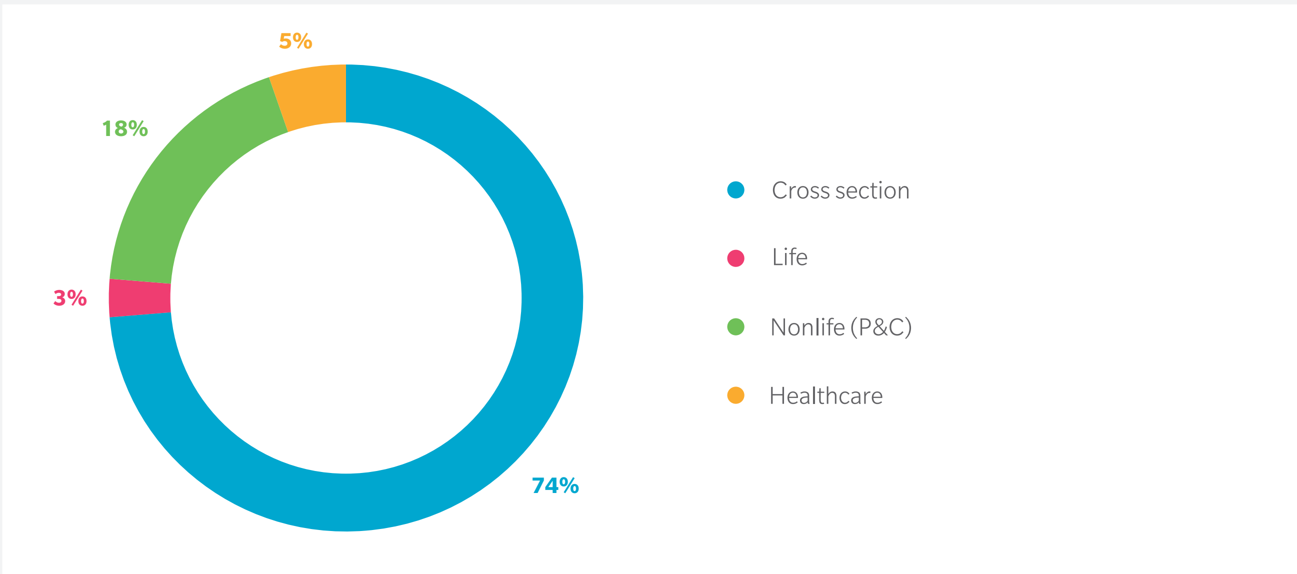
Fund sizes represented:



Coverage by geography:



Coverage by sector:



The survey was completed in October 2016.

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IMPORTANT NOTICES

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