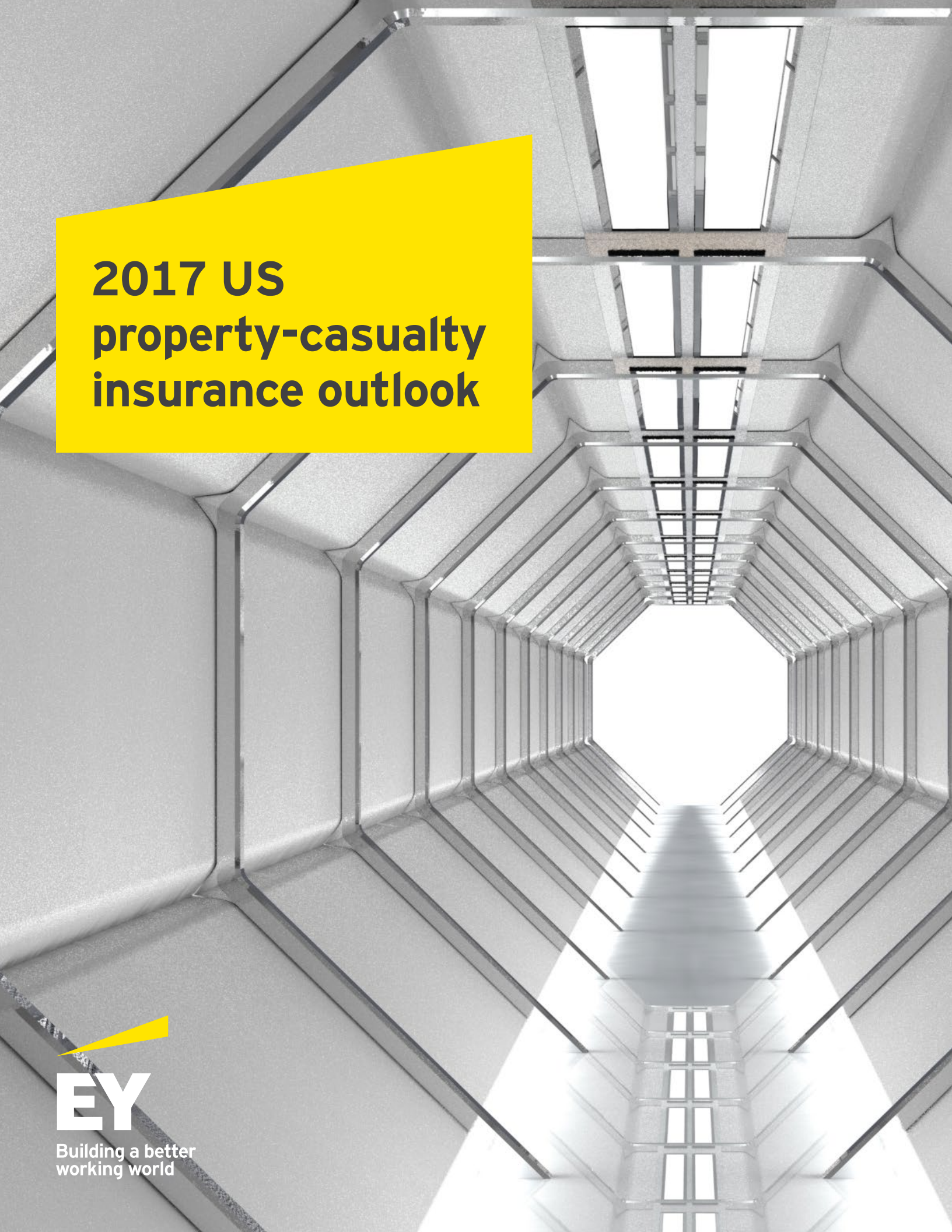
2017 US property-casualty insurance outlook



EY

Building a better working world

2017: a time for reassessment

The US property and casualty (P&C) insurance industry is at an inflection point. The economic engine for growth in America has been sputtering, and it is providing little support for an industry plagued by shrinking investment incomes, escalating claims costs and rising regulations. At the same time, advances in technology and the growth of InsurTech are raising customer expectations for greater innovation and revising traditional P&C insurance models. The Internet of Things, telematics, artificial intelligence, driverless cars and blockchain have the potential to transform industry fundamentals and even redefine the nature of risk. In the future, competing for market share will be increasingly dependent on technology, data and analytics.

A new Trump administration introduces the likelihood of further economic and regulatory change. With the industry in flux, this is the right time for CEOs to think through their future business strategies. What will the change in political direction mean for the insurance industry? Which market segments and business areas should they focus on in the future? How can they use robotics, data analytics and other key technologies to streamline costs and attract new business? How can they build innovative, customer-driven organizations that will enable them to stay relevant in a fast-changing marketplace? And what do they need to do to ensure they have the right talent in place?

Continued economic headwinds

In 2017, the P&C market will face ongoing economic challenges marked by greater uncertainty. US economic growth was expected to rise only moderately from roughly 1.4% in 2016 to about 2.1% in 2017. However, Donald Trump's victory has raised questions about the future of the US economy. Some market analysts believe that Trump's promise of a large tax cut and increased infrastructure spending would boost US growth and drive up long-term interest rates. But others feel Trump's policies, particularly on trade, would have the opposite effect. Bank of America, for example, cut its GDP growth outlook from 2.1% to 1.8% and sees fewer tax hikes ahead.

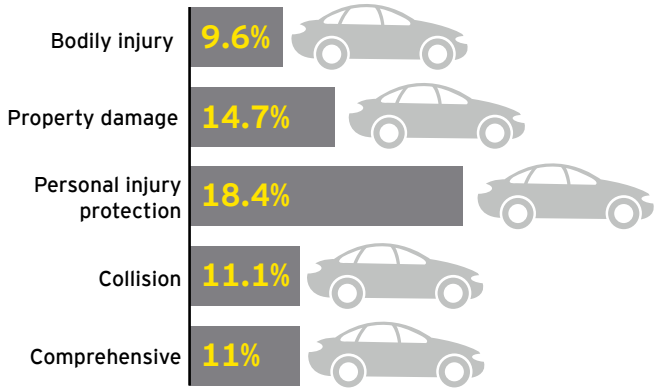
For the P&C sector, sluggish GDP growth and greater uncertainty come with lowered expectations for premium growth in 2017. Munich Re predicts real premium growth in the North American P&C market to decline from roughly 4% in 2015 to just over 1.5% in 2017. However, premium growth will depend on the future direction of US growth and household income under the new administration.

The ongoing low-interest environment in the US resulted in a 16% decline in net investment income for the industry, from US$31.6 billion in the first half of 2015 to US$26.5 billion in the first half of 2016, according to the Insurance Information Institute. For 2017, there's little relief in sight, with portfolio yields hovering at record low levels. Lagging investment income will consequently remain the drag on bottom-line growth for the P&C sector for the foreseeable future.

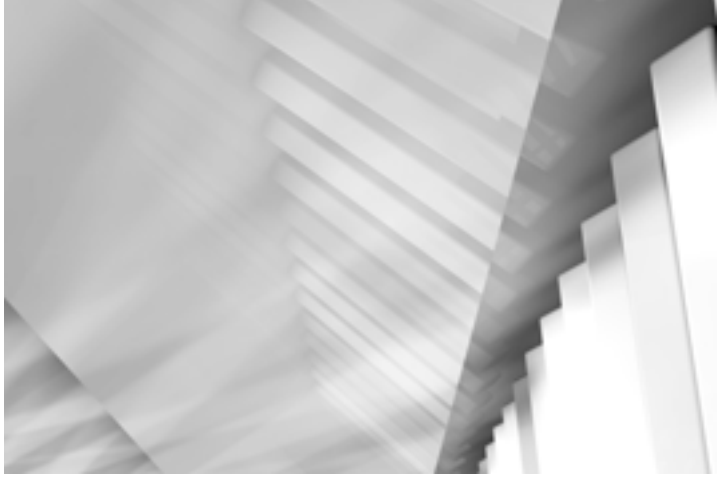
The market had been expecting 10-year bond yields to rise modestly to 2.2% in 2017, with the Federal Reserve (Fed) making two interest rate hikes during the year. But with rising inflation a distinct possibility under a Trump administration, as a recent sell-off in bonds would suggest, long-term interest rates could climb higher, to 2.5% in 2017. However, since P&C insurers' investment portfolios are generally locked in for longer terms, the impact on portfolio yields would be marginal. And if GDP growth slows under Trump, as some economists expect, the Fed's expected rate increases next year may be put on hold.

Meanwhile, in response to low yields, insurers will continue to look for higher-yielding investment opportunities that may expose them to greater investment risk. With investment returns likely to stay weak for some time, insurers will need to continue to focus on earning profits through underwriting. On the plus side, improvements in the wage and employment situation in the US, along with potential increases in disposable income, could boost top-line growth.

Rise of personal automobile insurance loss costs from Q1 2014 to Q1 2016

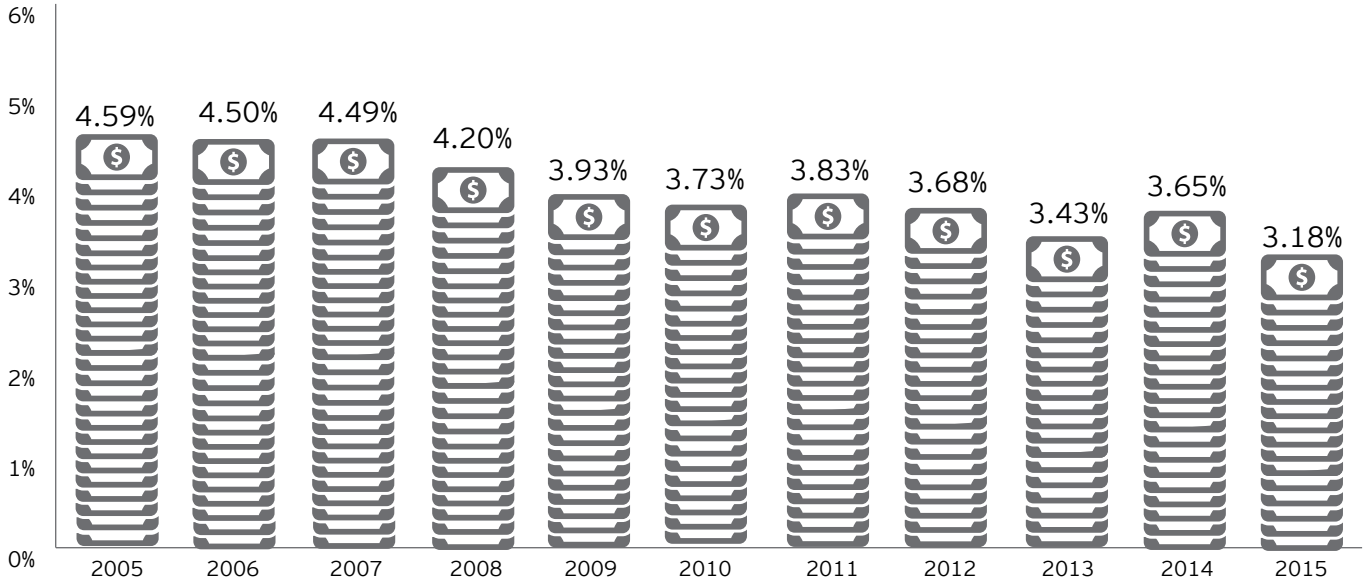


Source: Fast Track Monitoring System



An additional problem for the auto insurance industry is the sharp rise in both the frequency and severity of claims. Over the last two years, the aggregate cost of accidents rose in the double digits. With low gas prices likely to encourage driving in 2017 and the cost of car repairs staying high, this trend is expected to continue. To compensate for escalating losses, insurers will again raise premiums for personal and commercial auto clients in 2017. Telematics and improved monitoring systems, auto-safety technology and increasing automation have the potential to improve loss rates going forward, but it is unclear when that will begin to affect claims.

P&C insurer portfolio yields, 2005–15



P&C carrier yields have been falling for over a decade, reflecting the long downtrend in prevailing interest rates. Even if prevailing rates rise in the next few years, portfolio yields are unlikely to rise quickly, since low yields of recent years are "baked in" to future returns.

Source: National Association of Insurance Commissioners (NAIC), via SNL Financial Insurance Information Institute

> "In a more fragmented market, where performance among insurers can vary widely and disruptive change is growing, insurers will need to reassess their strategic positioning."
>
> Thomas Holzheu, Chief Economist, Americas, Swiss Re Sigma

Adapting to market shifts

To meet rising customer expectations for digital access and new business models, companies will do more in 2017 to develop a culture of innovation. "Innovation incubators" are now common in most P&C companies, and many are partnering with InsurTech start-ups or working with internal business teams to incorporate the latest customer-centric strategies and cross-channel technologies into their operations.

With more than 1,000 InsurTech start-ups in operation, many well funded, the pace of P&C innovation will speed up next year. For example, in 2017, InsurTech start-up Trov plans to roll out on-demand insurance that will enable customers to use their smart phones to turn coverage for personal belongings on and off. The first US on-demand insurance provider of its kind, Trov is an example of how product innovation directed toward Millennials could disrupt the P&C insurance model. Incumbents will be watching this space closely, creating venture funding groups that are actively monitoring and investing in InsurTech initiatives. The most agile will put what they learn into practice in other parts of their business.

Insurers will take digital transformation to the next level in 2017. They will expand their use of robotics and advanced analytics across most aspects of their business — from claims handling and underwriting to customer relationship management (CRM) systems and risk management. Forward-looking firms will continue to embrace innovative technologies, such as artificial intelligence, the Internet of Things, telematics and blockchain. The focus on innovation will widen beyond doing things better to doing "better things" as insurers pursue new business models, such as pay-as-you-go pricing and peer-to-peer insurance.

These shifts will redefine the competitive environment in 2017, particularly as insurers step back to reconsider their core markets, key strengths and longer-term strategic positions. According to Thomas Holzheu, Americas Chief Economist for Swiss Re Sigma, "Weak organic growth, profitability pressures and favorable market multiples will make conditions ripe for consolidation in 2017." M&A is likely to come from different directions, from smaller players looking to build scale to insurers from Asia seeking to penetrate the lucrative US market.

A changing regulatory landscape

A new US political landscape in 2017 will increase the likelihood of greater regulatory change at the state, federal and international levels. With Republicans about to be in control of the White House and both chambers of Congress, some experts foresee fewer legislative logjams and reduced federal oversight. For P&C insurers, the political shift in Washington could lead to more favorable regulations on a number of issues, from Dodd-Frank and national flood insurance programs to regulations on cybersecurity and self-driving cars. Insurance firms, like other businesses, may also benefit from a lowering of effective corporate taxes on worldwide income beyond the current US Treasury target of 23%. But some industry experts question just how much regulatory reform can be achieved, particularly over the shorter term.

In the meantime, regulatory trends already in motion may gain momentum in 2017. Over the past few years, regulatory pressures have slowly adjusted the financial positions of insurance companies in the US and around the world. For the P&C insurer, capital requirements will increasingly vary across product lines and be driven primarily by underwriting risk. Evaluating risk-based capital (RBC) will continue to demand improvements in enterprise risk management (ERM) systems.

US insurers, along with other financial institutions, are likely to see further regulations on cybersecurity, which has risen as a national security issue. The Fed, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation have issued an advance notice of proposed regulations covering five categories of cybersecurity: cyber risk governance; cyber risk management; internal dependency management; external dependency management; and incident response, cyber resilience and situational awareness. In addition, the New York State Department of Financial Services recently issued regulations that will ensure that financial institutions maintain programs to protect consumers from cyber risks. Other states may follow suit.

Addressing cyber risks

With cyber attacks rising sharply and creating greater operational and reputational risks, cybersecurity is becoming an imperative both within insurance companies and across their commercial client base. Cyber insurance is already a multibillion-dollar business for the P&C sector in the US, with more than 60 carriers now offering it. The US market is worth more than US$3.25 billion in gross written premiums, with the potential to grow to US$7.5 billion over the next few years, according to the Insurance Information Institute.

The rapid growth of cybersecurity insurance will continue in 2017 in the commercial segment, particularly among small businesses. Research has shown that most small businesses still do not have cyber attack response plans, although many have been victims of an attack. As cybersecurity insurance grows and evolves, insurers will do more to improve the product offering, as well as establish greater consistency in underwriting and pricing models.

However, just how far the private insurance industry is able and willing to provide cybersecurity coverage is an open question. As with flood insurance, a government solution may be necessary.

To establish themselves as cybersecurity leaders, insurers themselves will be under pressure to create robust security systems to protect against cyber attacks within their own enterprises. Hiring cyber risk experts or partnering with other organizations to manage internal systems better, and building that expertise into client value propositions for clients, will become increasingly important.

What P&C CROs say about cyber risk

Most executives participating in the *EY 2016 North American Insurance Chief Risk Officer (CRO) survey* reported that their companies faced a real risk of suffering a serious cyber attack or data breach. The survey revealed a second type of cyber risk involving insurance liabilities, especially casualty lines. Many survey participants observed that casualty providers were underwriting cyber risks either consciously or unwittingly. Some P&C CROs reported that they are involved in reviewing existing contract language to assess whether and which types of cyber risks have already been underwritten (knowingly or otherwise). P&C CROs spoke of seeking the right balance between seizing the profit potential of those risks and exposing their companies to an unacceptable level of risk.

Closing the talent gap

With insurance professionals retiring and digital transformation accelerating, P&C insurers will be looking to Millennials to fill a widening talent gap in 2017. Insurance providers will actively seek specialized skills in the latest technologies, such as artificial intelligence, social media and blockchain, as well as a variety of other competencies, from digital sales and marketing to risk modeling and big data analytics. Tighter immigration policies and changing attitudes under a Trump presidency could tighten the talent pool.

It is estimated that the insurance industry will need to replace 70,000 people who will be retiring next year. To compete with other industries recruiting fresh talent, insurers will need to develop more proactive programs to attract Millennials and build awareness of exciting future trends in the insurance industry. Without the right people, driving the next stage of innovation and transformation for P&C insurers will be impossible.

David Hollander, Americas Insurance Leader for EY, sees this as an ideal time to make plans that take into account the future nature of work. "Insurers now have the opportunity to introduce new technology, such as robotics, and more effective workforce management activities," he says. "By taking out repetitive tasks, they can produce an even more productive and stimulating work environment for people."

Impact of external factors on the P&C market in 2017

(1 = low impact, 10 = high impact)

9	**Technology**	Advances in technology are enabling insurers to improve efficiencies across their operations, from underwriting and policy administration to claims and risk management. New smart technologies, such as artificial intelligence, telematics, driverless cars and blockchain, will be game changers.
8	**Customer expectations**	Insurers will need to keep up with rapidly changing customer expectations for 24/7 digital access, greater transparency and self-directed customer experiences. At the same time, price sensitivity will drive comparison shopping through emerging online and mobile platforms.
8	**Cyber risks**	With digital attacks on the rise, cyber risk insurance will grow fast as a commercial line of business in 2017. To maintain their leadership role, insurers themselves will be under pressure to create robust cybersecurity systems within their own enterprises.
7	**Competition and M&A**	With sagging growth and falling profits, the industry is likely to see greater consolidation, including within the specialty insurance market. Insurers will continue to explore InsurTech opportunities through partnerships, acquisitions and venture capital investments.
7	**Talent**	With 70,000 insurance professionals retiring in 2017, insurers will need to attract Millennials to fill the gaps. Insurers will need to attract data scientists, cyber risk specialists, digital marketers and others to capture their future. A tougher US stance on immigration could hinder efforts to recruit talent.
6	**Economy**	Low interest rates combined with mediocre growth will continue to impact the P&C industry in 2017, putting pressure on profits and reserves. Expected shifts in growth, trade and tax policies under a Trump administration add to a high level of economic uncertainty.

Strategic priorities for 2017

For US P&C insurers, 2017 will bring new strategic challenges to an industry in flux. Technological and regulatory shifts are changing customer expectations and market dynamics in the personal property and auto insurance space, and creating demand for new products and services, such as cyber risk insurance. The investment required to drive future innovation is competing with the need to find efficiencies and comply with growing regulations. Against this backdrop, the fiscal realities of compressed margins and declining investment revenues in the sector are making investment choices increasingly difficult. Technology will need to be used to cut costs to free up funds for strategic investments.

A strategic road map to drive profitable growth

1. Focus on customer-driven innovation
2. Use technology to drive top- and bottom-line performance
3. Put cyber risk high on the corporate agenda
4. Rethink strategies to attract, develop and retain talent

1 Focus on customer-driven innovation

Accelerate the development of new products and business models. 2016 saw a proliferation of new P&C products and business models offered by InsurTechs: Metromile's pay-per-mile insurance model, Trov's on-demand insurance for belongings and Bought by Many's peer-to-peer insurance, to name a few. According to Hollander, insurance product innovation will kick into high gear in 2017. "The nature and range of insurance products are new and evolving fast," he says, "and insurers need to act now to develop a next generation of products to meet the changing needs of companies and individuals." These needs, in Hollander's view, represent a broad spectrum, from short-term house and car usage to a shareable work environment for small business. "The insurers that are most nimble in defining these new customer demands and getting these products out to market first will be the winners."

Stay customer-centric. To adapt to a fast-moving marketplace and differentiate themselves from competitors, insurers must stay laser-focused on the customer and adapt their go-to-market strategies to meet their ever-changing needs. For 2017, insurers will want to develop a Millennial-minded strategy that highlights 24/7 digital access, personalization, self-directed functionality and a seamless customer experience. The strategic importance of Millennials is becoming clear to both personal and commercial insurers. Millennials are now the largest generation in the US; their wealth is growing faster than other age groups and, according to a recent BNP Paribas study, "Millennipreneurs" have started twice as many businesses as baby boomers. Insurers should continue to focus on the needs of core customers, such as large companies that are increasingly expecting carriers to provide value-added services, such as insights from claims and expert risk advice.

Nurture a culture of innovation. For the insurance industry, "innovation is no longer an option, it is absolutely key for success," says Swiss Re Sigma's Thomas Holzheu. "The price of not keeping up with innovation to cutting costs and move with demographic trends will show up not just as weaker growth but also eventually in rising claims." For a conservative business such as insurance, building a culture of innovation can be challenging. It requires embracing change at the top, staying focused on evolving customer needs, and taking a test-and-learn approach that accepts occasional failure. The most successful insurers now have chief innovation officers and innovation labs that work together with business heads to drive change throughout the organization. Tying up with InsurTech start-ups and external innovation incubators and think tanks can be powerful ways to transfer new ideas.

2 Use technology to improve top- and bottom-line performance

Drive cost savings by drawing on robotics to automate insurance processes. In the face of shrinking returns, the first strategic line of defense for P&C companies is to use robotics to automate business processes and streamline back-office operations. Digitizing routine processes can deliver significant near-term gains in the form of reduced costs, lower error rates and increased customer satisfaction for carriers across business lines. "Every client we are talking with is looking at deploying robotics to automate processes to cut costs," says Hollander. "That's something every carrier should just do. It doesn't need a lot of evaluation. Just pick your vendor and figure out the process to target." Once the first wave of automation is in place, insurance carriers will create smart automation that will incorporate artificial intelligence, predictive analytics and other advanced technologies.

Apply advanced analytics systematically across the value chain. According to David Bassi, Executive Director at EY, "Over the next year and into 2018, analytics will become a ubiquitous utility within insurance companies." Bassi sees the use of analytics spreading across the enterprise, from decision-making to operations. "Some companies had their first beachhead using predictive analytics for pricing. Others started in claims management or underwriting. As people get early wins in one place, they start seeing potential in other areas." One natural progression, according to Bassi, is building on the trends in automation and behavioral analytics that create smart automation that responds to customer behaviors to deliver tailored solutions.

Build InsurTech and smart technologies into your future plans. In 2016, there was a growing push among large insurers to link up with InsurTechs actively through partnerships, acquisitions and VC investments. This approach not only helps incumbents get a toehold in a fast-emerging market, it provides them with insights that they can apply to other parts of their business. Next year, established carriers will closely monitor progress among the more than 1,000 new InsurTech entrants to determine which business models will succeed and where to place their future strategic bets. 2017 will also be the year for building core digital technologies, such as cloud, mobility and social media, into business processes. At the same time, forward-looking insurers will experiment with new emerging technologies, from sensors, wearables, shareables and real-time data to telematics and blockchain.

Applying smarter technologies to claims management

Savvy CIOs are holding out hope that machine learning and blockchain will transform claims management. For example, according to a survey conducted by FICO, a US-based data analytics software company, fraud accounts for 5% to 10% of claims costs for US insurers. Worse, 57% of insurers predicted an increase in personal property fraud by policyholders, and roughly 58% predicted the same for personal auto insurance. Blockchain may help reduce fraud claims, thanks to independent validation by multiple parties. Similarly, insurers can use machine learning to replicate the claims approval process used by insurance agents.

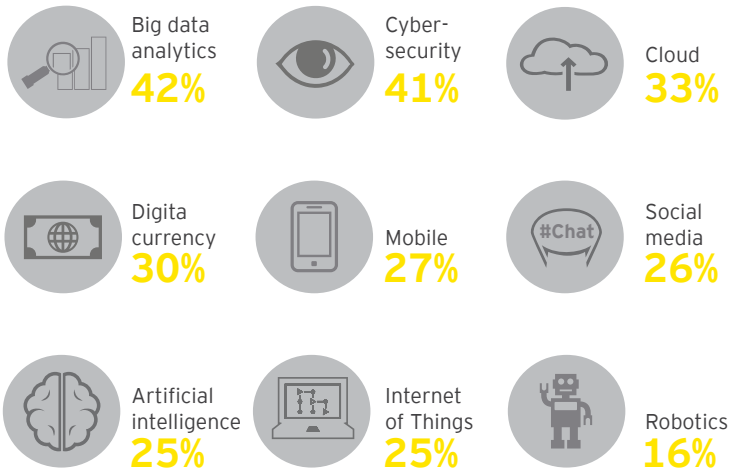
3 Put cyber risk high on the business agenda

Prepare for the next stage of cyber risk. In 2017, cyber risks will increase exponentially as digital technology becomes more pervasive and cyber attackers more sophisticated. According to Jay Votta, Principal in EY Insurance and Actuarial Advisory Services, cyber risk will not only rise, it will also evolve: "Cyber threat will move from the digital to the physical world. When there are more and more interconnected devices and machines, cyber attackers can hack into infrastructure. Send trains into each other. People now are most afraid of losing credit card information, but they will wake up to these enormous physical risks in 2017." Adding to the challenge, managing cybersecurity risk can be a moving target, as cyber hackers get smarter and switch tactics.

Implement an active defense system to protect against cyber risk. As P&C insurers strive to protect their systems, and federal and state authorities introduce cybersecurity regulations, building a comprehensive cyber risk management strategy will be essential for large and small providers alike. EY recommends an active defense program that relies on four key stages:

- Identify critical assets, such as sensitive customer insurance data, sought by hackers
- Develop a model for normal behavior on the network so that it can easily detect unusual activities
- Identify likely cyber attackers
- Conduct active defense measures – from third-party audits to war gaming – to enable cybersecurity effectiveness

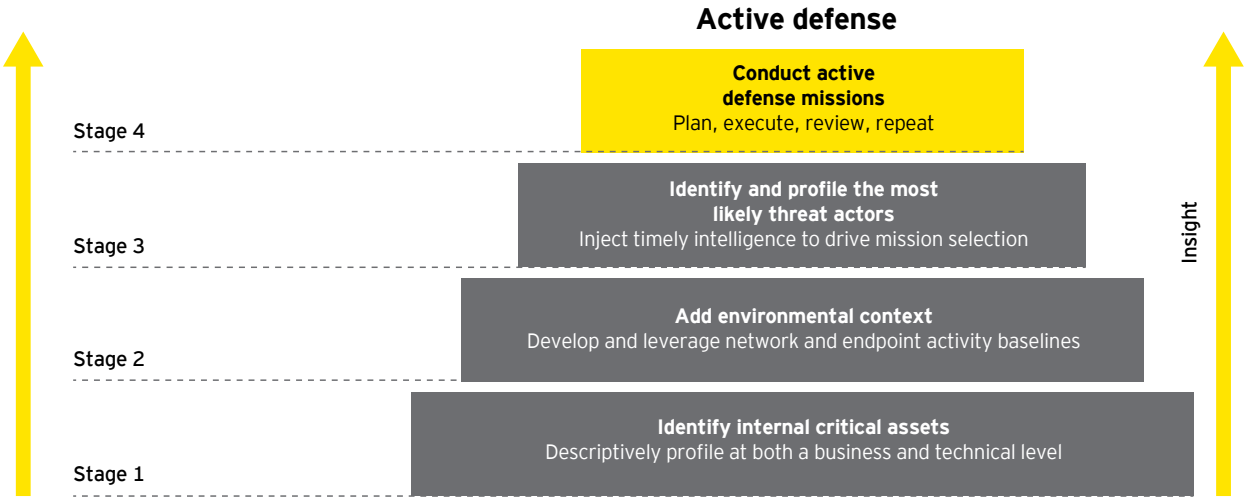
Technologies that will have the biggest impact on insurers over the next three years



Source: Cognizant and Roubini ThoughtLab survey

Hiring cybersecurity internal or external experts, providing cyber risk training to staff and having CROs working more closely with IT teams are all critical for an active defense.

Turn cyber risk into an opportunity for building business. A recent survey conducted by the Risk and Insurance Management Society found that 80% of companies bought a stand-alone cybersecurity policy in 2016. As these policies become the norm for large companies and more popular among smaller businesses, insurers will need to develop products and services, and pricing methods, to meet escalating market demand. To be prepared, insurers need to identify potential cyber risks that are embedded in their standard policies, according to EY's Bassi: "We are now talking to insurers about developing a loss control product around cyber, since they are going to be exposed on the general liability policies. They need to look at the cost-benefits of being very proactive in helping companies develop cybersecurity programs."



4 Rethink strategies to attract, develop and retain talent

Have a clear view of the future of work. With a large percentage of the workforce retiring in the years ahead, and digital transformation accelerating, 2017 will be a good time to take a hard look of future work needs. According to EY's Hollander, insurers should ask themselves key questions, such as: "What work will need to be conducted by people? Which repetitive tasks can be handled through robotics? What are the strategic, interpersonal and analytical tasks that we will need a human brain to do?" As they plan ahead, insurers will also need to identify the digital expertise they will need in the future, from artificial intelligence, social media and blockchain specialists to digital marketing and customer care executives. EY's Hollander believes that insurers should prioritize hiring risk experts next year, particularly in the cyber area, because that knowledge will be needed for internal operations and for providing advice to commercial clients.

Understand the Millennial mindset. Forecasts suggest that, by 2020, Millennials will make up 46% of the workforce in the US. Unfortunately, according to the *Insurance Journal,* more than half of Millennials (53%) perceive the industry as not being innovative and 65% say it has a bad image. "The industry needs to do a better job of helping incoming talent to understand how exciting the business is becoming," says Hollander. One way to do this, for example, is stressing the rise of digital transformation and challenges of cybersecurity. Insurers will be increasing the use of technology, such as social media, to attract Millennials, and targeting messages to their concerns, such as social responsibility, career advancement, entrepreneurial rewards, teamwork and flexible hours. Building a collaborative culture that encourages a free transfer of knowledge between incoming talent and seasoned professionals will be critical for success.

> "Most cyber terrorist attacks will be only partially insured. And the social policy debate for who bears the costs of such attacks will become a much bigger consideration in the years ahead. Just like a flood, except put on steroids times 10."
>
> David Hollander, Principal, Ernst & Young LLP

Contacts

David Hollander
EY Global Insurance Advisory Leader
+1 215 448 5756
david.hollander@ey.com

David Bassi
+1 617 565 0141
david.bassi@ey.com

Jay Votta
+1 212 773 3000
jay.votta@ey.com

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

© 2016 EYGM Limited.
All Rights Reserved.

EYG no: 04118-164GBL

1611-2105114
ED 1117

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, or other professional advice. Please refer to your advisors for specific advice.

ey.com