


Strategic business risk 2008

Insurance





It is never the risk
that causes damage or
creates opportunities –
it is how we respond.

About this report

Risks are inherent in every forward-looking business decision, so successful risk management should be an integral part of an organization's strategy and operations – an important dimension of good management practice.

There has been a great deal of work done in the area of risk management in recent years. Ernst & Young has been engaged in significant global activity to clarify stakeholder perspectives, map management activities and identify leading practices from which all can benefit. Likewise, many companies have invested significant resources globally in risk and compliance initiatives.

Financial risk and regulatory risk have been the focus of much of this effort. In both cases, there are externally determined rules and frameworks with which companies need to comply, and emerging best practice guidance on processes and controls that can help. We have worked with many companies who have found that the challenge of compliance can lead to opportunities for performance improvement through improved processes and enhanced communication. Some companies are now looking more closely at their operational risks, prioritizing these and thinking about how they can manage and monitor them in a coordinated way, the result of which can again be opportunities for performance improvement. What is clear is that to gain further business advantage, companies must increasingly look at the extended risk universe, from finance and compliance risk to operational and finally, strategic risk.

A different perspective on strategic risk

Our experience, however, suggests that strategic risk has not necessarily benefited from developments in management practice. Much that has been written about strategic risk seems to be at such a macroeconomic level that the implications for action by the management of a specific company can be lost. More significantly, the different implications for companies operating in different sectors can be blurred. Someone's challenge is frequently someone else's market opportunity.

We decided to explore the area of strategic risk from a different perspective. In collaboration with Oxford Analytica we focused on the strategic risks facing 12 of the world's most important sectors: asset management, automotive, banking and capital markets, biotechnology, consumer products, insurance, media and entertainment, oil and gas, pharmaceuticals, real estate, telecommunications and utilities. These sector studies served as the primary source for the overall comparative report of our findings.

This report was prepared
in collaboration with



**Oxford
Analytica**



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Introduction

Strategic risks arise from trends, conditions and uncertainties within global markets. This report explores the most significant business risks and challenges that the insurance industry will face over the next three to five years.



Peter Porrino
Global Director of
Insurance Industry
Services
Ernst & Young

Strategic risk: a risk that could cause severe financial loss or fundamentally undermine the competitive position of a company.

Understanding how to respond to current trends is paramount for insurance companies as they seek to manage risk, optimize performance, and increase operational effectiveness. To gain further insight into what will drive the fortunes of these firms over the next five years, we have been talking with Ernst & Young global industry leaders and with sector experts from more than 20 disciplines that shape the industry environment. Together, we have identified leading strategic business risks and have rated the severity of the strategic risk management challenge posed by each emerging issue.

In this report, we comment on the top 10 insurance company risks that have emerged from our research, and those currently “below the radar” screen that we believe may top the risk tables in years to come. This is not an exhaustive list, but it is a stepping stone to ongoing dialogue and innovative thinking that is essential within every organization.

I would like to thank all of those who participated for their valuable time and insights. We hope that you enjoy this report and will benefit from the findings.

A handwritten signature in dark ink, reading "Peter R. Porrino". The signature is fluid and cursive, with a large, stylized 'P' and 'R'.

“As the insurance environment becomes more complex, companies need to shift from traditional risk management approaches to integrated processes that add greater value.”



The Ernst & Young strategic business risk radar

A simple and useful risk radar device that Ernst & Young has designed provides a snapshot of the top 10 strategic business risks for a company, a sector or the global economy as a whole.

Risk weighting and risk prioritization

Phase 1:

- ▶ We asked the pool of sector experts to list and to rate (on a scale of 1-10, with one having the most impact), the 10 most significant trends or uncertainties that may impact companies, and to provide commentary on why these are important to their industry.
- ▶ Analysts were then asked to list the five most significant business risks to firms within their industries – that might bring about shifts in the industry or put leading firms in peril of losing their position. A numerical rating was applied from one to five.

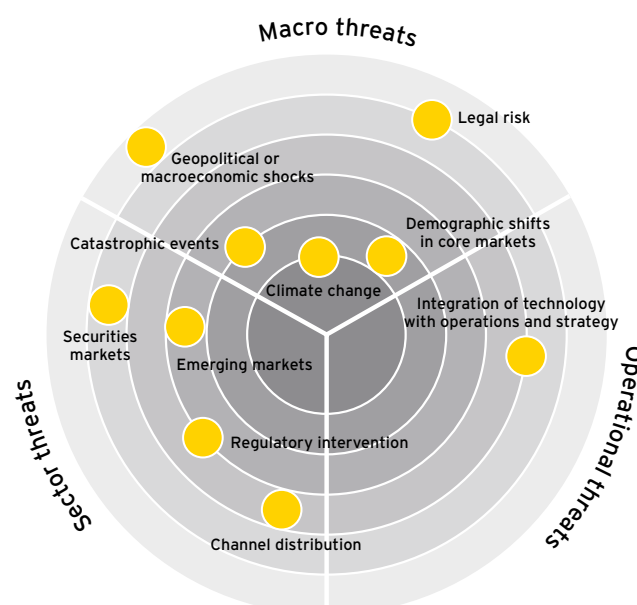
Phase 2:

- ▶ In order to prioritize the top risks for each sector, sector experts – including journalists, researchers, advisors and our own industry leaders – rated the severity of each of the risks for the sector concerned. They were asked to assign a numerical severity rating, from one to five, based on the likelihood that a risk issue would lead either to severe financial impact or undermine the competitive standing of the leading firms in their sector. Ratings were averaged to build the lists of top risks by sector.

The risks at the center of the radar are those that are expected to pose the greatest business challenges in 2008. Those on the outer edge – and still within the top 10 – are considered less of a priority.

It is clear that not all strategic business risks are equal. Therefore, the radar is divided into three sections: (1) **macro threats** that emerge from the general geopolitical and macroeconomic environment; (2) **sector threats** that emerge from trends or uncertainties reshaping the industry; and (3) **operational threats** that have become so intense that they may impact the strategic performance of leading firms. While not exclusive, these categories include the strategic risks that industry leaders must manage if they are to maintain dominant competitive positions.

Ernst & Young worked with Oxford Analytica to interview more than 70 industry analysts from around the world and representatives from over 20 disciplines that shape the business environment, including law, finance, the sciences, business strategy, geopolitics, regulation, medicine, economics and demographics. The purpose was to identify the emerging trends and uncertainties that will drive the fortunes of leading global businesses over the next five years. Here are the findings, as they relate to the insurance sector.



Executive summary



Top 10 strategic risks

- 1 Climate change
- 2 Demographic shifts in core markets
- 3 Catastrophic events
- 4 Emerging markets
- 5 Regulatory intervention
- 6 Channel distribution
- 7 Integration of technology with operations and strategy
- 8 Securities markets
- 9 Legal risk
- 10 Geopolitical or macroeconomic shocks

The top strategic risks to emerge for insurance are far-reaching social and environmental trends - climate change, demographic shifts, and catastrophic events. These present complex ramifications for the insurance industry because companies underwrite such a wide range of risks. Insurers are developing new solutions to address these issues, but many are only in the early stages of the process.

Second-tier risks that are reshaping the industry include: penetrating new markets, regulatory intervention, channel distribution, technology and pressures from securities markets. While competition has a strong influence on these challenges, the solutions are clearer and more developed compared with the top three.

The last two are traditional risks - legal risk and geopolitical or macroeconomic shocks - which are changing so rapidly that they have the potential to have a serious impact on the industry and result in losses for individual firms.

Change is constant in the market, so risks - and perceptions - will change over time. If this exercise had been completed 10 years ago, it is fair to question whether climate change would have scaled the list.

The hypothesis for this research was based on the fact that strategic business risks will vary for each company within a sector. While some of the risks and rankings may be surprising, they highlight the importance of a risk management process that delivers value and continually evolves to meet competitive challenges and ongoing trends. It is never the risk that causes damage or creates opportunity - it is the response.

1 Climate change

The top insurance risk in 2008 is climate change. This threat is typically viewed as a long-term issue with broad-reaching implications that will significantly impact the industry.



2 Demographic shifts in core markets

As the post WWII baby boomer market reaches retirement age, its financial needs will change. This demographic shift is creating new demands that insurers are well placed to satisfy. The possibility of the insurance market losing out to other sectors in core markets will be a key challenge.

3 Catastrophic events

Changing weather patterns, terrorist attacks and pandemics were cited as contributors to the third significant risk – the rising cost of catastrophic events and the potential impact on insurers' earnings and capital.

4 Emerging markets

Penetration of the emerging markets represents both a risk and an opportunity for insurers. Success in these markets is by no means assured. There is also concern about competitive threats, which could result in a number of today's leading global players being displaced.

5 Regulatory intervention

New regulatory developments and increased scrutiny could lead to changes in operations and underwriting practices within organizations. Interventions driven by political factors could become a serious risk. Incidents where insurance companies receive unfavorable press coverage can impact the perceived trustworthiness of the industry as a whole.

6 Channel distribution

Technology has changed the way insurance services are sold and Internet disintermediation has become a major risk for insurers. Companies with multi-channel access for sales and information may have a competitive advantage.

7 Integration of technology with operations and strategy

A further technology-related risk is the lack of integration at a strategic business level. Technology has opened new distribution channels, allowed more sophisticated and accurate underwriting and reduced unit policy processing costs. Insurers need to view technology as an enabler to keep pace with the competition.

8 Securities market

Increasing pressures from securities markets could have serious consequences if not monitored closely. New players are entering the market and blended products are challenging the position of traditional insurance companies.

9 Legal risk

Our ninth strategic business risk involves legal uncertainties over liability, tort reform and other similar issues that could threaten a company's standing or result in financial loss.

10 Geopolitical or macroeconomic shocks

A major industry risk is the potential for geopolitical or macroeconomic shocks. While many disagree on their likely cause, there is general concern about the threat of a financial meltdown resulting from derivatives and hedge funds.

While these “below the radar” risks were not rated in the top 10, they have the potential to emerge onto the list within the next five years.

- Over-reliance on model-based risk management
- Threats to the reputation of the industry
- Losing the war for talent
- Increasing corporate exposure to global regulatory heterogeneity
- Possible emergence of entirely new risks

See page 15 for more detail on “below the radar” risks.

The top 10 risks for the insurance industry



1 Climate change

It is surprising that this risk, which is typically viewed as a long-term issue, would be identified as the greatest strategic threat for the insurance industry in 2008.

Recent events are manifestations of climate change. For example, changing weather patterns as a consequence of global warming will bring about a fundamental shift in the underlying probability of insured loss (e.g., by windstorm or flood) and require insurers to scrutinize their insurability criteria for certain risks (i.e., Florida households). Climate change also can affect insurance company pricing structures and reserving policies, as well as solvency and corporate viability.

In addition to windstorms, flood and heat waves, climate change can lead to broader and more gradual consequences including: increases in mortality and health problems, the spread of environmentally related litigation, political risk linked to conflicts for control of resources, and effects on capital markets. These implications could result in correlations across geographies and insurance classes - perhaps sooner than expected.

2 Demographic shifts in core markets

The baby boomer generation is causing a demographic shift that has huge ramifications for the insurance industry. The population over age 60 is expected to increase from 20% in 2005 to 33% in 2050. As this group reaches retirement age, their financial needs will change and they will look for products to fill the gap. Current generations may not have sufficient funds to sustain their lifestyle or provide the income stream for post-retirement that they anticipated in their financial planning.

In responding to this opportunity, insurers are stepping into a role that has, for a generation at least, been played by governments. This is a significant risk. As private provision becomes a pillar of the social welfare system, insurers are starting to face intense political pressure in cases of failure, intensified public scrutiny, and greater regulatory pressures.



Chris Raham
Ernst & Young

Winning the battle for the savings market

Changing financial needs

The baby boomer generation is retiring just as employers and governments are progressively disengaging from pension provision. As a result, the financial needs of individuals are changing dramatically. The central financial challenge for these retiring baby boomers is how to transform the wealth they have accumulated in their pension accounts into a steady income stream. To a large extent this is a decision that they will have to face alone.

The vast majority of baby boomers have only three assets: house, occupational plans and social security. With the exception of the high-net-worth segment, the value of additional savings is minimal. These trends will transform the savings products industry, which so far has been accumulation-oriented. The business challenge over the next 15-20 years will be to create products for the pay-out phase.

The strategic risk for insurers is their inability to adjust, develop products for new needs, and compete against other sectors of the financial services industry.

How can insurers capitalize on new opportunities?

Occupational pension/cash-balance plans, and individuals in the mass market offer the most significant opportunities. Successful ventures here will benefit the largest segment of the population - those without sufficient wealth to attract the assistance of wire houses, retail advisors or independent financial planners. Only a handful of

competitors are offering well-planned, valuable services to these segments, although most major financial institutions are circling the opportunity.

In the defined contribution market, insurers should offer employers products that combine the accumulation and pay-out phase. These products transfer most of the risk from the individual to the insurance company. Combining the two phases can represent a competitive advantage. At present, the asset management industry has the capability to offer only investment products.

To sell against investment-only solutions, insurers should have the ability to provide key constituents with clear information about product benefits and competitive advantages from the employee's perspective. Such assessments will help employers and their benefit consultants understand the value of the product. Insurers may also support the plan sponsor by providing financial advice to employees.

In the retail market, insurers should take steps to leverage their ability to write contracts that will provide more dollars of lifetime income per dollar of investment. A retirement program that combines decisions around the timing of social security elections, the use of home equity, and the disposition of cash balance plans into an easy-to-use, cost-efficient menu approach, will be effective in the mass market.

Barriers to success - the threat of competition

To be successful, insurers should change their approach to the competition and take a broader view of the market. For years, they have been focusing on competition among themselves. In the US, for example, insurance companies have only a small share of the US savings market. Their true

competition is represented by other providers of savings products, in particular, mutual fund entities. Insurers should become as aggressive as other institutions competing for the same dollar.

As the only writers of pay-out annuity products, insurers should be well positioned to take advantage of the shift from accumulation to pay-out. However, they face three significant obstacles:

- ▶ Most of the retirement wallet is now in the hands of other asset managers, who are in a strong position to retain customers.
- ▶ Even though pay-out annuities provide the most income for a given investment, individuals dislike the idea of suddenly transferring all of their assets to the insurance company. They feel that they are losing control over their wealth and they would prefer to keep the money with their insurance industry's competitors.
- ▶ Some sales practices related to deferred annuities have created negative sentiments that have been actively expressed in popular media and by regulators.

Twenty-five years ago, insurance companies were strongly positioned against asset managers to dominate the savings industry. Mutual funds were vulnerable and their market share was relatively small. However, there was a risk of complacency and some insurers lost the battle for individual retirement assets. The demographic shift is creating new demands that insurers are well placed to satisfy. Making the most of this opportunity to recapture lost territory should be high on the agenda.

- ▶ **Chris Raham is a Senior Advisor in Ernst & Young's Insurance and Actuarial Advisory Services**

“If weather patterns are changing as a consequence of global warming, this will bring out a fundamental shift in the underlying probability of insured loss.”

Ernst & Young



3 Catastrophic events

Floods, hurricanes, earthquakes, terrorist attacks and pandemics are well-publicized catastrophic events. These trends have far-reaching implications for insurers who are paying the price for escalating costs. Catastrophic events may have an immediate impact on insurers' ability to pay high claims, impacting profitability, reinsurance recoveries and ultimately, overall solvency. In the longer term, underwriting against the backdrop of an increased likelihood of catastrophic events will impact pricing and drive tighter contract wordings. This may result in a strengthening of reserves and the need to review reinsurance strategies. Insuring extreme events poses significant challenges for the industry including: pricing (the risk characteristics of catastrophic events require different models from those used for most other insurance businesses), contract structure (definition of the loss events can be difficult, in particular for terrorism) and financing.

4 Emerging markets

Many companies' growth are essentially emerging market strategies. Consumer insurance purchases generally lag behind economic growth in these markets, representing opportunities for the industry to develop new products, increase customer base, and develop better infrastructure. In China, for example, only a third of the urban population has basic medical insurance, with coverage even lower in rural areas.

Success in these markets is by no means assured, and today's leading global players could be displaced. There is also a competitive threat from other Western insurers with good emerging market strategies.

Insurers face severe challenges in developing cultural knowledge (for product design and sales) and effective distribution channels. Local insurers in countries such as Russia, China and India are often the main beneficiaries of market growth. The rapid growth in thinly regulated markets can lead to financial instability, regulatory backlash, poor business practices (e.g., difficult compensation processes and tax avoidance), and the threat that politicization of issues such as premium growth will generate reputation, regulatory and political risks.



5 Regulatory intervention

Increased regulatory scrutiny, complexity of rules, and sophistication of underlying methods are pressuring the industry. Regulatory developments include: International Financial Reporting Standards, Sarbanes-Oxley, Solvency II in the European Union, and Principles-Based Reserves in the US. While the shift from rules-based to principles-based regulation is, in theory, more flexible and comprehensive, it is also more complex and subjective.

The threat of major regulatory intervention is driven by political factors and could result in changes in underwriting practices and selection criteria. Incidents where insurers receive unfavorable press coverage can seriously impact the perceived trustworthiness of the industry (i.e., misrepresenting life insurance policies, refusal to provide homeowners coverage in certain geographic areas, perception of unfair commission structures). Increased regulatory compliance costs, largely driven by government policy in supervising financial firms, can be unpredictable, especially if there is a change in political control or public sentiment.

US insurers have come under attack for their practices in broker compensation and underwriting. Following the 2003 investigation by then New York State Attorney General Eliot Spitzer on conflicts of interest in broker compensation, regulators and the industry have moved towards increased transparency and compensation disclosure.

6 Channel distribution

Technology has changed the way personal lines are sold, as traditional agent-based distribution models are under pressure from technologies that allow companies to reach clients directly, via telephone or the Internet. For example, agents in the UK represent a small proportion of property and casualty sales (notably automobile), but they account for the majority of contracts in life and personal pensions. In the US, agent sales still account for a higher proportion of personal property and casualty business.

Although there are many dimensions to the distribution system, insurance brokers and intermediaries are the key channels for selling commercial lines of insurance and complex products. This creates a scenario where insurance brokers are viewing an increasing share of business in many markets at the expense of tiered agents and direct sales forces.

The marketing of simple, low-cost products and complex, higher-cost products is diverging. Businesses that do not have multi-channel access for sales and information may fall behind those that understand the important role of the Internet. The relationship between goods producers/services providers and customers is increasingly intermediated via peer-to-peer advice and ad hoc communities of practice.

“Risk management can be turned into a competitive advantage if it is embedded in the strategy and operations of the firm – beyond its original role as a simple tool for regulatory compliance.”

Chris Karow, Ernst & Young



Chris Karow
Ernst & Young

Making risk management a competitive advantage

Long-term trends, such as globalization and financial innovation, are creating a financial environment in which risks are increasingly interconnected across assets, geographies and classes.

Accordingly, risk management is becoming an integral part of business strategy. Risk management can be turned into a competitive advantage if it is embedded in the strategy and operations of the firm – beyond its original role as a simple tool for regulatory compliance.

In particular, risk management should be integrated into the financial planning process. Setting financial objectives without a coherent risk framework can lead to two strategic pitfalls and destroy value:

- ▶ Perverse incentives – many organizations establish financial goals “to exceed the returns of our peers” or achieve a given return on equity, without a formal consideration of what this means from a risk perspective. However, to budget only for return and not risk may create perverse incentives for line management to take ever increasing levels of risk. It is unlikely the markets would favorably view goals such as “take more risk than all our peers” or “increase risk to achieve returns in excess of what our mature product line generates.” Therefore financial goals must be linked to risk strategies and risk management processes.

- ▶ Time inconsistency – in order to achieve static financial targets, businesses are incentivized to take more risk in times of falling returns and less risk in times of rising returns. Strategic business management would dictate the opposite: taking more risk when risk-adjusted returns are high and taking less risk in times when compensation for risk is inadequate.

The goal of enterprise risk management (ERM) is to develop an integrated framework for risk, finance and strategy to guide decision-making across the business. As a result, ERM can be a source of competitive advantage through improved risk/return decision-making and optimized use of capital. At an operational level, ERM includes a range of tools for improved enterprise-wide identification, measurement and modeling of all classes of risk.

At a strategic level, the crucial aspects of ERM are the holistic assessment of risks and the explicit definition of a “risk appetite”:

- ▶ Holistic risk assessment – ERM breaks down the barriers between risk “silos” within the business. Insurers have developed a range of tools to assess underwriting, investment, operational and other types of risks. These provide a picture of risk at operational but not at strategic level – in particular, the linkage of different risks remains untested. ERM integrates the different tools into a single, consistent framework approach that highlights the linkage between different risk types and allows a holistic view of risk.



7 Integration of technology with operations and strategy

Technology has opened new distribution channels, allowed for more sophisticated underwriting and reduced unit policy processing costs. In an environment with pressures on growth and margins, it can also reduce time to market and improve service quality. Insurers need to integrate technology into their strategic plan if they are to achieve success and keep pace with their competitors. Those who fail to make an investment in this area are likely to be left behind.

With significant insurance business online and outsourced operations across continents achieved through the Internet, new risks have emerged. The risk of cyber-terrorism highlights how vulnerable the environment is to attack and the potential threat for one person or a small group to wreak havoc on others.

As insurers increasingly rely on external service providers, seamless data exchange with customers and providers becomes crucial. As outsourcing becomes a key tool in the search for competitive advantage through cost reduction, there is the risk of over-dependence on outsourcing partners. For example, the value of insurance outsourcing to India was US\$690 million in 2006 and is expected to reach US\$2 billion by 2010. Insurers need to find a balance.

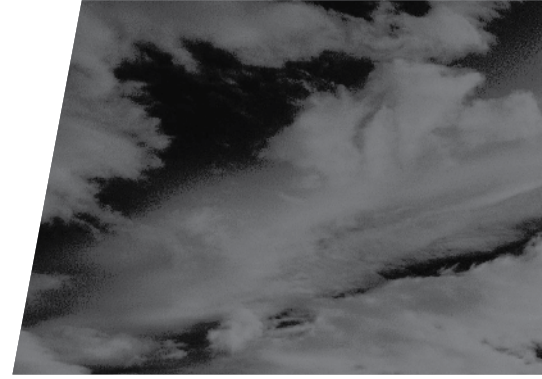
8 Securities market

Innovation in finance – just as in technology – has the potential to transform the sector and introduce new sources of competition. For example, the barriers are lifting between insurance companies and other financial institutions (i.e., securities firms and banks). New players are entering the market and blended products, such as securitizations, insurance derivatives and life settlements, are challenging the position of traditional insurance companies.

This is an emerging trend that needs to be closely monitored. Increasingly, new sources of capital (hedge funds and private equity) are investing in insurance start-ups, seeking to make significant returns in specific opportunities. This process will greatly disadvantage the long-standing insurers who will not be as nimble or have the ability to exit the market opportunistically. In a similar vein, the US has seen how the creation of life settlements is affecting today's underwriting and reserving policies. Securitizations are also significantly impacting the reinsurance sector.

“... many insurance companies have shrugged off the competitive threat from securities markets. However, growth is picking up and financial institutions may be skimming some of the best business.”

Richard de Haan, Ernst & Young



Richard de Haan
Ernst & Young

Keeping an eye on the securities market

The insurance sector has traditionally been dominated by integrated insurance companies, which acted as intermediaries between policyholders and capital markets. New players in capital markets, such as private equity and hedge funds, until recently have been unwilling to get directly involved in the industry. This is beginning to change.

In the US, capital markets participants are showing an increasing appetite for taking on risks that have traditionally been left to insurers. Financial innovation - by isolating and repackaging specific risks - has allowed investors to select specific aspects of the insurance value chain, rather than taking an integrated approach to the insurance business. Examples are the development of life settlements in the life insurance market, the use of securitizations as an alternative to reinsurance, and the start-up of, or investment in, property and casualty (P&C) businesses by private equity funds.

Life settlements: In the US life insurance market, hedge funds have been a key provider of capital for the development of life settlement transactions. Life settlements effectively represent a second-hand market for life policies. Policyholders can sell their contracts for more than the cash surrender value and unlock the value of policies that they no longer need. As a recent Ernst & Young study points out, life settlements create a challenge for the business model of life insurers, exposing the lack of flexibility of life contracts and the conservative approach to actuarial estimates. This has created an opening for capital markets players willing to seek out arbitrage opportunities.

Use of securitizations: Another innovation in the life insurance market has been the growth of securitizations. These securitizations, which differ in terms of objectives and structures, represent an alternative source of capital to traditional sources of equity or debt financing. For example, securitizations have allowed insurers to limit the impact of regulatory requirements (known as Regulations XXX and AXXX) on their capital structure. In the process, insurers have been able to transfer risks to the capital markets and found risk solutions without the involvement of traditional reinsurers.

Acquisition of portfolios: In the P&C market, private equity firms have teamed up with existing insurers to finance new start-ups focused on specific risk segments. Through this, private equity firms have been able to benefit from the increase in premiums following 9/11 and Hurricane Katrina, without being exposed to historical losses.

In most cases, it has been innovation in risk analysis and structuring that has allowed new players to unbundle complex risks and select their exposure to specific aspects.

As transaction volumes are still small relative to the overall insurance markets, many insurance companies have shrugged off the competitive threat from these capital markets players. However, growth is picking up and financial innovation may be taking some of the best business, leaving traditional insurers with a portfolio of increasingly 'poor' risks.

► Richard de Haan is a leader in Ernst & Young's Insurance and Actuarial Advisory Services, with emphasis on Capital Markets activity.



9 Legal risk

Significant and unexpected change in the legal environment has a critical impact on the insurance business. Such change can come about either through government legislation or case law decisions.

It is very hard to avoid exposure to unexpected shifts in liability risks. An insurance law analyst said, "The liability lines are notorious for their volatility. The mispricing and/or injudicious underwriting of liability risks has been at the root of several of the insurance industry's greatest disaster stories, including the 1984-86 US 'liability insurance crisis'."

There are three main areas of serious risk where liability law is concerned. First, there is environmental liability, where concern about climate change may lead to stricter legal regimes affecting both alleged polluters and agencies charged with predicting or monitoring environmental damage.

The second area is 'managerial' liability, where a raised consciousness of the power of major corporations is leading to much tighter regimes of corporate control in which it is increasingly easy for aggrieved stakeholders to hold corporate directors personally liable for failings in the enterprises they steer.

The third involves moving into new markets where liability law is undeveloped and where there appear to be excellent opportunities for insurers. In these markets, political instability or faltering economic growth could lead to a potentially hostile legal environment in which the protection of insurers' funds comes very low on the list of legislative and judicial priorities.

10 Geopolitical or macroeconomic shocks

There are different views on the most likely causes of geopolitical or macroeconomic shocks. Political global economic threats could include: a financial meltdown emerging from derivatives and hedge funds, fuel prices, weapons of mass destruction (WMD) terror, a messy unwinding of global imbalances, and a setback in Chinese growth.

Credit disintermediation has replaced international banking as a finance source with a range of specialized credit instruments with risk exposures that regulators find difficult to assess. There is concern about the impact on markets. Buoyant capital market conditions have contributed to industry performance since 2002. Systemic risks in finance have increased dramatically and it would be prudent to expect greater international economic volatility. Since there is no comprehensive global regulator for financial issues, the ability to monitor and oversee systemic risks that arise from leverage (either at the entity or investment level) is limited.

“Private equity investors are highly selective and well-researched when making the decision to buy a business, and have the ability to drive real efficiencies through the business plan under their ownership.”

Simon Perry, Ernst & Young



Simon Perry
Ernst & Young

Growth continues

The annual Ernst & Young study *How do Private Equity Investors Create Value?* revealed how the private equity (PE) industry is consistently able to grow and strengthen the companies under its ownership. By focusing on the business performance and strategies of PE firms across the largest deals exited throughout 2006, the study confirmed that the annual rate of growth in enterprise value (EV) achieved last year by the largest private equity-backed businesses significantly outperformed equivalent public companies in the same country, industry sector and timeframe. Average annual EV growth rates were 33% in the US and 23% in Europe, compared with public company equivalents of 11% and 15% respectively, with over 80% growth in total enterprise value.

Private equity ownership creates value from sustainable improvements in performance and business growth. Two-thirds of the earnings growth in PE-owned companies comes from business expansion, with increases in organic revenue being the most significant element. This includes the benefits of investment in sales and marketing, new product launches, acquisitions, investment into attractive industry sectors in the US, and expansion into new geographies in Europe. Cost reduction, including operational efficiencies, is also a very important element of earnings growth in both

The importance of private equity

the US and Europe, accounting for 23% and 31% respectively of the total growth in earnings.

What are the secrets of private equity's success?

The study showed that private equity investors are highly selective and well researched when making the decision to buy a business, and have the ability to drive real efficiencies through the business plan under their ownership. This finding was true across deals in the US and all main European countries. Three-quarters of investments resulted from proactive deal origination strategies, including company or sector tracking, building relationships with management, or introductions from established contacts. Across almost all deals and ownership strategies, private equity investors were actively involved in the business after acquisition, making rapid decisions alongside management, challenging progress and making available specialist expertise. The intensity of engagement between private equity investors and management was often stronger than under the previous owners.

This rapid growth in the scale and success of private equity has brought with it increased scrutiny: politicians in many countries are reviewing whether and how to regulate and tax the industry; corporates are considering how to compete with and learn from the different business model; concerns are being raised about the security of jobs and employment benefits. Despite those concerns, the clear advantages of the private equity model are likely to result in continuing investment and growth.

The credit crunch – implications for private equity

Recent developments in the credit markets may have caused concern. The credit crunch has meant that the debt markets are more or less closed for new large leveraged buy-out (LBO) deals resulting in a significant slowdown in transactions. Market participants view this as a short-term dip in activity prior to returning to a more rational climate in 2008. There is a long-term belief in the PE model by the market and the long-term fundamentals remain strong. The recent events may well prompt a more conservative approach by banks when doing deals. This could result in an increasing need for due diligence at acquisition.

Although the credit squeeze may reduce the benefits from leverage and enhance the importance of underlying profit growth, private equity will continue to be an important factor in the world's financial markets.

What are the implications of the continued growth of private equity for corporates? Every company needs to develop a strategy for engaging with private equity, whether partnering with, buying from, selling to or competing with them.

► **Simon Perry is the Global Leader of Private Equity at Ernst & Young.**



Below the radar

These risks did not make it into the top 10, but have the potential to be “above the radar” within the next five years.

- ▶ Over-reliance on model-based risk management
- ▶ Threats to the reputation of the industry
- ▶ Losing the war for talent
- ▶ Increasing corporate exposure to global regulatory heterogeneity
- ▶ Possible emergence of entirely new risks

Over-reliance on model-based risk management is a major threat to the industry. As the current discussion of “black swans” (extreme events) suggests, these techniques may have limitations in dealing with extreme volatility, and have limited accuracy in periods of stress.

Threats to the reputation of the industry ties into the growing social welfare role of insurers. As more responsibility is placed on insurers, public scrutiny on business practices will only increase. In this environment, governance failures could lead to a fierce political and public opinion backlash against the industry. An “Enron” scenario in the insurance sector remains a distinct possibility. Good governance and internal controls are crucial.

Losing the war for talent could already be in the top 10 risks for many insurance companies. Competition with other financial services sectors for the best people is especially difficult in the current environment, where lucrative posts await in other areas such as hedge funds. History suggests that failure in the insurance sector is as likely to result from poor-quality human resources as from exogenous factors. As risks and the environment become more complex, the industry is struggling to attract personnel of the necessary caliber and, in many markets, has low levels of technical skill and managerial competence and probity.

Increasing corporate exposure to global regulatory heterogeneity is emerging as companies enter new frontiers and expand their operations. Managing regulations in 10 jurisdictions is one thing. What happens when a firm has significant markets in 30-40 countries at varying levels of development and with very different regulatory traditions? Corporate exposure to existing heterogeneity is increasing due to the globalization of markets and the value chain.

Possible emergence of entirely new risks is our final “below the radar” risk. It is inevitable that new risks will emerge that insurers have failed to predict or price accurately. These may be risks affecting human life or health (including new industrial diseases), pandemics or, possibly, risks that will affect property insurance portfolios (i.e., new and unexpected forms of pollution damage).



Conclusion

This study was not a random selection exercise, but rather a structured consultation with industry leaders and subject matter experts from around the world. They have identified trends and uncertainties, and assessed risks and their impact both on individuals and markets.

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In rating the top 10 strategic business risks for the insurance industry, there is tremendous variation in the selection and relative importance. This report illustrates a wide range of risks that companies need to understand and address over the next five years.

Approached properly, the process of risk management can add value even if the event never occurs. Working through scenarios and impact studies can result in opportunities to tighten processes and controls, leading to dialogue and action plans that deliver value.

Ernst & Young's work with companies around the world suggests that there is a body of leading risk management practice emerging, but that companies are doing too little in this area. Many global organizations recognize that they have gaps in their risk coverage, with most in business and operational areas rather than financial. There are steps that company leadership can take to address these issues:

- ▶ **Keep an open mind about where risks can come from.** This is an increasingly interdependent global economy and risks that can damage a business can initiate in any market or sector. High-risk mortgage lending in the US to people with limited or no creditworthiness can hurt the pension funds of the most cautious saver.
- ▶ **Conduct an annual risk assessment** that defines key risks and weights probability and impact on business drivers. Many companies do some form of risk assessment, but experience suggests that too many do not do so on a frequent basis.
- ▶ **Risk assessment needs to go beyond financial and regulatory risk** to consider the wider environment of the organization and the full extent of its operations. This would include effective controls for M&A, IT implementation, business continuity planning, and expansion into new international markets.
- ▶ **Conduct scenario planning for major risks** and develop a number of operational responses. This can be a useful part of the planning cycle and help to encourage innovative thinking.
- ▶ **Evaluate the organization's ability to manage the identified risks** - in particular, ensure that risk management processes are linked to the risks that the business actually faces. While a risk function may bring great value in focus and expertise, companies must avoid the danger that some central function thinks it can or should have responsibility for risk management.
- ▶ **Effective monitoring and control processes** can provide both earlier warning and improved ability to respond. There can be value from much of the compliance activity required by regulators, but it has to be exploited.

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