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CEE Insurance Banana Skins 2015

A survey of the top risks in the insurance sector in Central and Eastern Europe

In co-operation with

CSFI
Centre for Study of Financial Innovation

pwc

Insurance Banana Skins 2015

Key risks to the insurance sector
(2013 ranking in brackets)

World

1 Regulation (1)
2 Macro-economy (3)
3 Interest rates (n/a)
4 Cyber risk (n/a)
5 Investment performance (2)
6 Change management (15)
7 Guaranteed products (6)
8 Distribution channels (11)
9 Natural catastrophes (5)
10 Quality of risk management (7)
11 Business practices (4)
12 Quality of management (8)
13 Market conditions (n/a)
14 Long tail liabilities (9)
15 Human talent (19)
16 Political interference (10)
17 Product development (20)
18 Reputation (14)
19 Climate change (18)
20 Social change (n/a)
21 Corporate governance (17)
22 Capital availability (16)
23 Terrorism (27)
24 Pollution/contamination (26)
25 Complex instruments (23)

Central and Eastern Europe

1 Macro-economy (3)
2 Interest rates (n/a)
3 Guaranteed products (14)
4 Business practices (2)
5 Regulation (1)
6 Investment performance (5)
7 Cyber risk (n/a)
8 Distribution channels (16)
9 Climate change (22)
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Executive Summary

'Insurance Banana Skins 2015' charts risks in the insurance sector around the world. The survey was conducted by the CSFI (Centre for the Study of Financial Innovation) in association with PwC. This year marks the fifth edition of our biennial survey and the first time we are issuing a separate report on results for Central and Eastern Europe.

What is keeping insurers awake at night?

Not surprisingly, ***macro-economic*** risks have risen to the top of the list as companies in CEE economies are adversely affected by the Eurozone crisis in the west and geopolitical uncertainty in the east.

Similarly to their European colleagues, CEE respondents are also very concerned about low interest rates. This risk is a new entrant in this year's survey and debuted in the number 2 position in CEE. Low ***interest rates*** are also resulting in lower ***investment income***, while making it less sustainable and profitable to cover rates of return on ***guaranteed products***.

Regulation is seen as the top risk globally, and the fifth biggest risk in CEE. Regulation such as Solvency II is creating additional uncertainty in an already difficult market. Companies are struggling with increased demands and costs of compliance. In an attempt to address risks related to business practices, regulators are also introducing consumer protection legislation to provide better oversight over intermediaries and ***distribution channels*** and prevent unethical sales practices.

Cyber risk is a growing concern around the world, and has debuted in seventh place in this year's Banana Skins. After several high-profile security breaches in the US, both customers and insurers are worried about the security of sensitive personal data. National regulators have also taken notice and implementing new legislation to assist insurers in managing and mitigating IT risks.

Over the past two years, there have also been areas where CEE insurance companies have made improvements. For example, they are now more confident in the ***quality of management*** and ***human talent***. They are also less concerned with risks to their ***reputation***.

How does CEE compare to global?

In this year's Banana Skins survey, the findings for CEE have become more similar to the rest of the world, but there continue to be some notable differences between the CEE and global responses:

Higher concerns:

- Climate change
- Corporate governance
- Business practices

Lower concerns:

- Regulation
- Change management
- Human talent
- Political interference

The Banana Skins Indices

Banana Skins Index

2.93
Banana Skins Index

The Banana Skins Index measures the average score given by each country to the 25 risks listed in the questionnaire. The higher the score, the greater is the implied “anxiety level”.

CEE countries scored ***2.93*** on the Banana Skins Index which is well below the global average of 3,21. This difference can be explained by a number of factors.

Firstly, regulations in many CEE countries are less stringent than in more mature markets. Second, the insurance sector in CEE tends to be relatively conservative, so respondents may be less likely to recognise potentially disruptive market forces. Finally, as insurers have made improvements to their governance and controls, they are likely feeling more confident overall.

Preparedness Index

3.18
Preparedness Index

The Preparedness Index measures the average response given to the question: “How well prepared do you think the insurance industry is to handle the risks you identified?” where 1=Poorly and 5=Well. The higher the score, the greater is the implied level of preparedness.

CEE scored ***3.18*** on the Preparedness Index which is close to the global average. This is a significant jump from our last survey in 2013, when CEE scored 2.92 on the Preparedness Index. This is an indication that over the last 2 years, CEE insurance companies have focused on improving risk management and management policies to better respond to perceived risks.

Banana Skins Index

Turkey	3.52
South Korea	3.52
Portugal	3.48
USA	3.44
Cyprus	3.31
Bermuda	3.31
Belgium	3.28
Australia	3.26
Switzerland	3.24
UK	3.24
Ireland	3.22
India	3.22
Brazil	3.21
GLOBAL	***3.21***
Mexico	3.17
New Zealand	3.17
Greece	3.15
Spain	3.13
Italy	3.11
South Africa	3.11
Singapore	3.10
Netherlands	3.08
Luxembourg	3.06
Denmark	3.03
Argentina	3.03
Canada	3.01
Peru	2.96
CEE	***2.93***
Finland	2.89
Czech Republic	2.59

Preparedness Index

Spain	3.74
Czech Republic	3.50
Denmark	3.47
Peru	3.40
Finland	3.37
South Africa	3.33
Luxembourg	3.32
Turkey	3.31
Ireland	3.27
India	3.27
Switzerland	3.25
Canada	3.24
Australia	3.23
Brazil	3.20
Mexico	3.20
Singapore	3.20
GLOBAL	***3.20***
CEE	***3.18***
Bermuda	3.18
New Zealand	3.17
Portugal	3.13
Netherlands	3.12
UK	3.10
Greece	3.00
Cyprus	3.00
Belgium	2.96
South Korea	2.96
Italy	2.90
Argentina	2.90
USA	2.82

Avoiding the banana skins

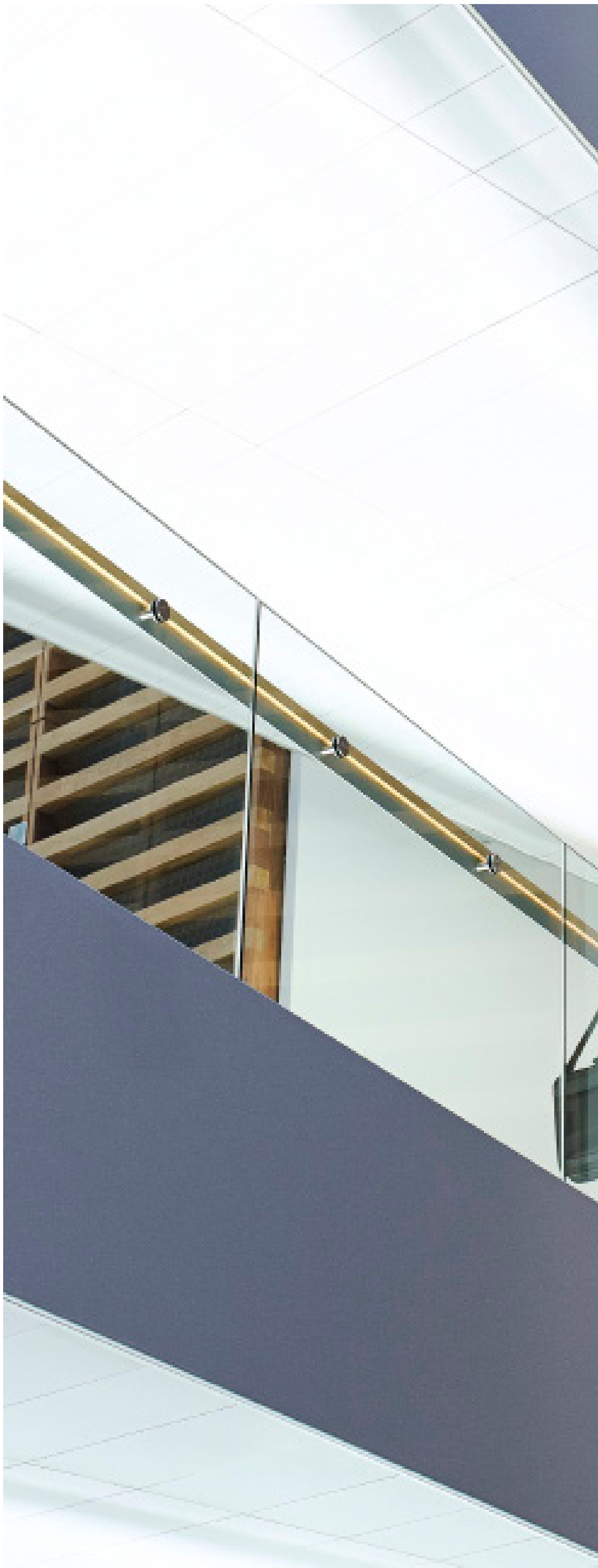
Despite the escalating economic, regulatory and industry pressures, insurers in Central and Eastern Europe feel more confident in their ability to respond to business risks than they did two years ago. This improvement is a clear indication that insurers in Central and Eastern Europe are making strides in preparing for current and future risks.

Artur Pikula, Insurance Leader for PwC in Central and Eastern Europe comments:

"In the 2013 Insurance Banana Skins survey, regulation was considered the highest risk in CEE, mainly due to uncertainty about Solvency II readiness and the related cost/benefit ratio. Since then, we have observed a greater emphasis on managing risk and compliance among insurance companies in CEE. Insurers are investing in good governance, tighter controls, and more secure IT systems. In particular, we have seen concerted efforts in preparing for the 2016 deadline for Solvency II implementation. We are very encouraged by the progress made so far, but there is still much to be done. The regulation itself, if taken as more than just a compliance exercise, can help insurers with faster identification and assessment of risks and better risk management. We encourage insurers to take that extra step in the process to get the most out of it.

The top risks in CEE in this year's survey are interrelated. The adverse economic conditions and low interest rates have brewed a 'perfect storm' which threatens the investment income which is vital to all insurance businesses, while creating challenges with respect to guaranteed products in life businesses. In combination, these risks threaten to squeeze long-term profit margins. In my view, this is the main reason they have risen to such a prevalent position this year. To ensure sustainable success in this low interest rate environment, insurers need to review their products and investment strategies in terms of both ROI and matching maturities to insurance liabilities. Product innovation will be key to maintaining competitiveness and profitability."

Top 10 risks in CEE: A closer look



1. Macro-economy (3)

Not surprisingly, given the debt crisis in the Eurozone and the geo-political issues in Russia and Ukraine, the macro-economic situation has moved into the top place as the biggest risk to insurance businesses in Central and Eastern Europe. (This echoes the findings of PwC's 2015 Global CEO Survey, which found that CEOs in CEE were the least confident about the economic outlook of any region around the world.)

Martin Hrdy, Senior Manager at PwC Czech Republic explains: "The macro-economic environment has a major impact on the demand for insurance products and their profitability. Furthermore, strong competitive pressures are squeezing margins due to declining insurance rates. Insurers are reacting to the difficult situation by reducing operating costs and focusing on profitability, which in the past were often neglected in the battle for new business."

2. Interest rates (new entrant)

The persistently low interest rate environment was seen as a more severe threat in Europe than any other region. The Eurozone is setting low interest rates to help the banking sector and governments keep the costs of borrowing under control and ensure available liquidity. However, this presents a big risk to the insurance sector, which relies heavily on investment income and is now seeing lower returns on their investments. It also makes products with guaranteed rates of return less profitable and sustainable, as discussed in detail in the following section.

3. Guaranteed products (14)

Closely related to the issue of low interest rates is a growing concern about guaranteed products. Insurance companies which offered savings products with guaranteed returns when interest rates were high back in the 1990's are now facing losses because insurers cannot earn high enough investment returns to fund the liability. **Eva Hupková, Director at PwC Slovakia** explains: "If interest rates stay at the current level over the next several years, life insurers will struggle to meet their promises to policy holders leading to lower results in the medium term."

Fortunately, such guaranteed products are not as common in many parts of Central and Eastern Europe as in more developed markets, so this issue affects a small portion of insurers' portfolios.

4. Business practices (2)

The issue of business ethics is very much on the mind of insurers, particularly in relation to fraudulent practices in the sale of life insurance products (see more below under “distribution channels”).

Insurers are also under pressure from market and competitive trends in the sector. For example motor third party liability (MTPL) insurance comprises a significant portion of the insurance market in CEE, but premiums in this segment are declining. This has already had an adverse effect on industry profitability and it might further damage the solvency of some insurers. **Damir Radmilovic, Senior Manager at PwC Croatia** comments, “MTPL insurance represents 41% of the total market non-life insurance revenue in Croatia. Last year the average MTPL insurance premium decreased by 30% with a continuing decreasing trend. It is expected that only bigger insurers, with recognised and more dispersed product portfolios will survive this market pressure.”

5. Regulation (1)

Achieving compliance with Solvency II by the 2016 deadline is one of the key challenges on the agenda for insurers. Not only is the Solvency II framework difficult to implement, but insurers are also facing high implementation costs and uncertainty of acceptance by the regulator.

Piotr Bednarski, Senior Manager and Senior Regulatory Advisor at **PwC Poland** elaborates: “Solvency II implementation will put a great deal of pressure on insurance companies in the EU over the next few years. They will need to address growing regulatory requirements for risk model governance – including data quality, validation, stress tests, models monitoring and change management. They are also facing increasing scrutiny of their insurance sales practices, such as bankassurance and structured products, from both regulators and customers. Data-hungry and security-sensitive regulators will expect more data and higher IT governance standards. We can expect a shift from a purely actuarial focus towards a broader risk governance framework. There is currently a hot debate between the US/Canada and the EU over Solvency II application of mark-to-market valuation and the viability of the insurance asset-liability matching model (e.g. discount rate choices and the resulting potential volatility of reported results for long term life insurance products). These different approaches combined with the differences between IFRS and US GAAP, might lead to possible issues for EU insurance companies and could trigger a further evolution of Solvency II.”

EU and national regulators in CEE are also increasing regulation and oversight of other aspects of the insurance sector, such as information security (see Cyber risks below) and consumer protection.

Ģirts Kronbergs, Senior Manager at **PwC Latvia** comments: "Regulators have set high expectations in terms of consumer protection. We are seeing a gradual shift towards better oversight and governance of insurance products and commission payments. This will likely involve changes to insurance products, as well as to sales and control processes."

6. Investment performance (5)

In the low interest rate environment, insurance companies are struggling with the lower rates of returns on their investments. This is adversely affecting overall financial performance, and creates a challenge in being able to fulfil promises to life policy holders in the long term. **Maria Mihaljevic, Senior Manager** at **PwC Croatia** comments, "Insurance companies will have to reassess not only their investment strategy but also the structure and benefits of their life portfolios, their risk management and accounting practices. They need to maximise the spread between the revenue and cost of operations while reducing overall costs per policy unit."

7. Cyber risk (new entrant)

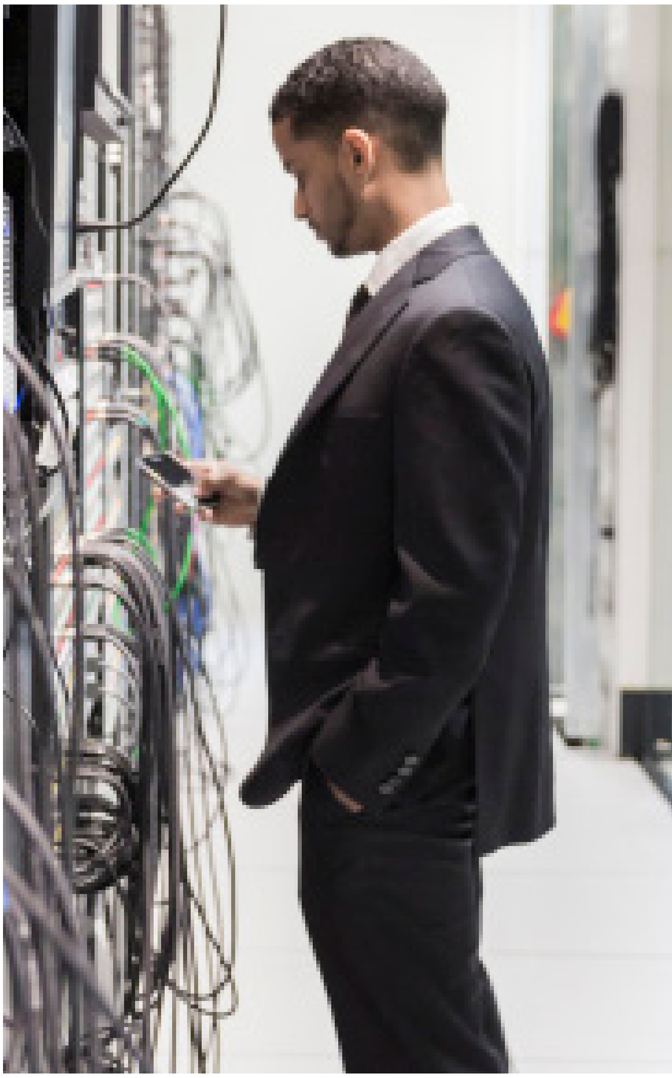
Recent hacking incidents in US-based health insurance companies have compromised the personal data of tens of millions of customers. These high-profile cases highlight the massive financial and reputational risks to insurance companies in the case of an information security breach. To manage these risks and protect customer data, insurers need to invest into consistent and reliable information security systems and processes. **Girts Kronbergs, PwC Latvia** explains: "Many insurance companies are still using a combination of new systems and 15-20 year old legacy systems, which are not always able to provide the same level of security. Tightening security across different platforms is high on the agenda for management."

In several CEE countries, national regulators are implementing recommendations and guidelines to protect insurance companies and their customers from cyber threats. **Piotr Urban, Cyber Security Leader** at **PwC Poland** comments: "The Polish Financial Supervision Authority published 'Guidelines for the management of information technology and security of IT environment in the insurance and reinsurance companies' with the deadline for implementation by the end of 2016. Setting cybersecurity as a priority will allow insurance companies to prepare for the upcoming changes. Insurance companies can draw on the experience of the banking sector, which has already tightened information security regulations."

8. Distribution channels (16)

Insurers in Central and Eastern Europe are facing ongoing risks related to fraud in sales and distribution channels, especially in the area of life insurance. In an effort to maximise commission income, many sales intermediaries engage in unethical business practices such as selling non-existent policies or renegotiating a policy with a different insurer every few years (even though there is no real benefit to the client) just to get the commission. This creates problems for both insurers and their customers.

EU and national regulators in CEE are attempting to address these issues through increased oversight and regulation, leading to concerns from insurers about the added uncertainty and compliance burden. According to one respondent from the Czech Republic: "A new act on insurance intermediaries has too many changes which will impact insurance companies and insurance intermediaries. Nobody really knows what will happen. The development is subject to various lobby groups and change may be significant."



9. Climate change (22)

Concern over climate change has increased significantly, moving up from 22nd place in 2013 to 9th place in 2015. This could be attributed in part to a greater social awareness of environmental and climate issues within CEE. More importantly, insurers in Central and Eastern have experienced first-hand the impact of climate change on their business. Major floods in Central Europe in 2013, in Serbia, Bosnia, Croatia and Romania in 2014, and in Georgia in 2015 have cost insurers and governments billions of Euros. As global warming continues, insurers can expect more frequent and larger claims due to climate-related natural disasters.

10. Change management (17)

With the combination of regulatory pressures, economic issues, changing customer demands and technological advances, insurance companies are facing unprecedented changes to their business environment. To stay competitive and relevant, insurers need to accelerate the transformation of their businesses. However, within CEE, there is still a relatively conservative mindset and some may underestimate the pace of change. As one respondent described, “Traditional structures prevail”. Furthermore, the rule ‘business comes first’ is still very much present and insurers tend to be more focused on day-to-day operations than on change management efforts.

Methodology

The global Insurance Banana Skins 2015 survey was conducted via an online survey in March and April 2015 and is based on 806 responses from 54 countries.

There were 34 responses from CEE countries, as follows :

Czech Rep.	10
Slovakia	6
Latvia	6
Hungary	5
Croatia	4
Poland	2
Russia	1

The breakdown by type was as follows:

Broking	1
Life	6
Non-life	14
Reinsurance	0
Observers	13

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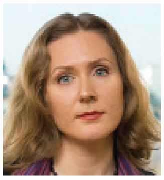

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