Looking Back to Better Understand the Future of Insurance

Introduction

Recent years have brought seismic shifts – in geopolitics and financial markets alike – that will likely continue to shape investors' approaches for some time to come.

Russia's invasion of Ukraine has exacerbated the pressure on global supply chains, particularly in the food and energy sectors, leading to inflation rates not seen in some markets for decades. Inflation in some developed economies hit double figures, presenting significant challenges for individuals, companies, and policymakers.

For insurers, on top of these macro challenges have come major natural disasters, such as Hurricane Ian, with the US experiencing more than double its normal level of billion-dollar-plus weather- and climate-related disasters in 2022.[1]

In many countries and regions, the number of people aged over 65 is increasing and is expected to continue to do so for decades. This presents challenges and opportunities for life and health insurers: while their potential customer bases are growing, they must invest in scalable solutions to meet growing demand. For some insurers, this will mean entering new markets, which also requires significant investment.[2]

Meanwhile, in the reinsurance industry, inflation is likely to impact pricing – potentially requiring reinsurers to take on more risk. A recent spike in natural disasters in Europe, such as flooding, is also affecting market capacity, particularly in property reinsurance.[3]

Through this, insurers also faced longer-term sectoral challenges, such as addressing rising costs, diversifying investment portfolios, and responding to client demands relating to sustainability and climate change concerns.

How have the events of 2022 affected some of the long-term themes in the insurance sector? In this report, we will explore the following five themes – portfolio diversification, operating models, data, ESG and industry consolidation – and look at how they have developed over the past year.

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Operating Models

Outsourcing is The Future

For much of the past 20 years, the insurance sector has struggled to generate strong returns above the cost of capital. This is partly because of lower yields on fixed income investments. But it is also because rising costs are putting further strain on balance sheets, especially in areas such as life insurance.[4]

Insurers have turned to private assets and alternatives to drive returns, which is impacting investment operations. Mortgages, collateralized loan obligations, limited partnerships, bank loans, and real estate bring a higher level of complexity, risk, and manual administration. As exposure has grown, insurers' legacy processes have become unsustainable, bringing the need for new expertise, data management, technology enabled scalability and risk mitigation.

At the same time, insurers' finance and investments units are seeking to simplify operations. Companies want to grow their business, scale up their investment capacity and improve their ability to react to market changes – all while creating firm-wide cohesion and reducing overall costs.

In State Street's recent Private Markets study,[5] 62% of insurers said they were spending a "considerable" amount of resources on manual data management processes. Nearly three quarters (72%) said improving these processes would help create a competitive advantage for them. Efficient data processing and distribution will also help meet the evolving expectations of key stakeholders and regulators, and better inform their investment decision making processes.

Addressing these challenges will require significant investment for most insurance companies. Many still rely on outdated systems that struggle to integrate with newer technologies, which carries various risks, information gaps, and the need for manual processes.

Meeting these needs requires innovation and, for many insurers, a complete rethink of investment processes.

Insurance companies should look to embrace new technologies and partnerships to enhance their operations, and the services and support they can provide to their customers and internal business partners.

As insurers work to achieve these goals, outsourcing is becoming increasingly popular as a way of bringing on board specialist capabilities at a manageable and predictable cost. When asked in the Private Markets Study about their technology strategies for 2022, 57% of the respondents said this was a top priority for operational improvement in their organization. Only a minority of respondents (27%) said they were already efficient at integrating technology and data systems.

Outsourcing can help create an integrated approach across the front-, middle- and back-office investment operations functions, improving the flow of information between business units and helping senior leaders get a holistic view of their portfolios and operations. It can also help improve regulatory reporting and risk management, with automation and data analysis tools removing manual processes to give staff more time to focus on value-add activities.

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Diversification

Looking to New Asset Classes

Given the almost two decades of yield challenges with traditional fixed income assets, insurers have continued to diversify into new areas such as private markets, real assets, and other complex asset classes.

Despite rising reinvestment rates, insurance companies have not changed their investment posture towards alternatives. In fact, recent studies indicate that insurance companies intend to increase their allocations to alternatives, within the limits of what is allowed under their jurisdiction's collateral and risk rules and their internal appetite.[6]

Approximately two thirds (64%) of insurer respondents to State Street's recent Private Markets Study said they would continue with their private markets allocation plans. This is despite an unpromising macroeconomic environment, and 72% of respondents citing higher borrowing costs that have made highly leveraged investments less attractive.

Listed fixed income instruments remain a core component of insurers' investment strategies. While it is unclear how long this high inflationary period will last, investment-grade corporate bonds and developed market government bonds are presenting attractive investment opportunities for the first time in several years, due to an increase in base rates across most markets. Nearly half (48%) of insurers said they now find traditional fixed income to be more attractive, relative to private market assets, as yield-generating elements of their portfolios.

Insurers use derivatives to optimize exposure to risks across their portfolios. At the end of 2021, US insurers alone had exposure to $3 trillion of derivatives as measured by notional value, according to the National Association of Insurance Commissioners.[7] Life insurers accounted for 98% of this total.

Diversification is important to investors during periods of uncertainty. Having access to as broad a universe of potential investments as possible will give insurers new opportunities to protect and grow their investment portfolios. To support this, they will need a sophisticated, flexible and scalable technology platform to fully enable them to manage risks and seize opportunities.

BRIAN BUCHINSKI
Head of North American Insurance Segment Sales

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Data

Creating a Single Source of Truth

Underpinning the challenges outlined in this report is the subject of data. Getting the right data – to the right place, and at the right time – is essential to the success of insurance companies, but it is not easy.

Insurers need access to timely, accurate and consistent data to help manage liabilities, monitor capital risk, access investment opportunities, and report to clients, regulators, and other stakeholders. State Street's Growth Readiness Study[8] shows that insurers are focused on improving data management capabilities across their portfolios; a third (33%) cite data management across geographies as a top-three priority. Similar proportions cited data management for complex or esoteric investments (32%) or across asset classes (30%) as a top-three priority.

Data security is also paramount. Cloud-based data solutions can meet the needs of insurers and enhance the quality and quantity of data available, but it must come together with robust security protocols to ensure that clients' information is always protected.

As insurers diversify their investment portfolios, accessing consistent and high-quality data is becoming more of a challenge. Private markets reporting is less standardized than in public markets, meaning it is essential that insurance companies can access as wide a range of data sources as possible. As they add more investment managers across private market asset classes, insurers must also have strong data capabilities to analyze exposures and ultimately improve portfolio returns.

Similarly, with the rising importance of environmental, social and governance (ESG) themes, investors require data from less traditional sources, and in new or unusual formats.

Collecting, auditing, analyzing, and distributing this information accurately – to the benefit of insurers and their clients – requires a powerful centralized data management system. It must embrace automation and cloud technology to provide scalability and flexibility – and ensure it can become the single source of truth for all operations.

As outlined above, insurers are increasingly turning to outsourced service providers for these solutions. This can be a cost-effective way to bring in specialist expertise while also ensuring full compatibility with internal systems and external partners.

There is no denying that data is crucial to everything insurance companies do. Insurers need to better manage and analyze increasing amounts of data in order to act upon it. We are constantly speaking with insurers regarding opportunities to use best-in-class technology and services that will help them identify opportunities quicker so they can build lasting competitive advantages.”

VERONICA LEE
Global Head of Accounting & Insurance Segment Product

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ESG

Sustainability Takes Center Stage

ESG themes are now central to many investment strategies. Increasingly, clients expect issues, such as sustainability and climate change, to be addressed within investment portfolios – and regulators are starting to do the same.

The momentum of ESG investing is unlikely to change. This increased scrutiny will serve to raise the bar for all market participants.

Many insurance companies are still only part of the way along this journey. Better understanding of their ESG exposure is a top organizational priority for 69% of insurer respondents to the Private Markets Study, but only 38% rated their abilities in the area as well developed.

ESG integration will continue to be a priority for insurance companies in the years ahead, especially as regulations evolve, and political and industry leaders set targets in areas such as emissions reduction or human rights.

One of the biggest challenges in addressing ESG risks is obtaining high quality, consistent data. Many metrics used for ESG analysis are non-financial and there is less standardization in reporting.

A robust, centralized data solution (as outlined above) will go a long way to solving these issues. A "single source of truth" approach can enhance insurers' ability to access, analyze and act upon all kinds of data.

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The violent climate events we have seen across the world during 2022 are a reminder of the importance of managing climate risks. There are many aspects to ESG risk beyond climate sustainability. This requires insurers to be cognizant of their exposures and approaches to themes such as human rights, diversity and inclusion. There are opportunities across all of these areas, therefore, having the right platform can play an important role in positioning insurers to gain a competitive advantage and have a positive impact on their investments and society.

SARAH NELSON

North America Head of Insurance
Relationship Management

Consolidation

An Opportunity not to be Missed

The effects of rising inflation and interest rates are expected to significantly dampen merger and acquisition (M&A) activity in the sector, with Deloitte recording a 30% drop in the number of deals completed in the first half of 2022, compared with the same period in 2021.[9] This trend continued in the second half of the year.[10]

However, there remains a significant amount of investor capital available, and private equity interest in the insurance sector is strong.[11] As companies seek to streamline their operations, divestments and consolidation will remain a priority for some.

Major corporate events present challenges and opportunities for management teams that need to integrate different teams and operating systems. This can be difficult, particularly if one or more parties has legacy technology that requires upgrading. Often, M&A transactions can be the ideal time to upgrade technology and operating systems to make the business 'futureproof'.

Combining two companies' systems into one flexible technology platform is an investment that would pay dividends in the future through enhanced capabilities, a cohesive data strategy, and the ability to respond quickly to client needs and market changes.

Conclusion

The insurance sector has successfully navigated many varied challenges over the past few years, including geopolitical conflicts and a global pandemic.

The industry will not stand still and will undergo further consolidation. There is a vast amount of capital in the hands of private equity investors, and this will be a driving force in the industry, commanding more efficiency and creating better operating models as a result. The industry's ability to remain robust and continue to serve its clients will depend on how well it can adapt to an increasingly rapid pace of change.

Collaborations with outsourcing partners will play an increasingly important role as insurance companies seek to streamline their operations, improve operating margins, and gain new capabilities. This will help insurers identify and work closely with data and investment specialists to diversify their portfolios and get the best out of the huge amounts of data and information available.

With sustainability taking center stage, more and varying datasets will also need to be analyzed and put to use, requiring more expertise and specific investment capabilities.

Underpinning it all will be technology. Investment functionality, customer service, data management, ESG analysis, and all other front-, middle- and back-office operations rely on having the best technology available. Now, perhaps more than ever, insurance companies need to ensure they have the best systems and processes in place to position themselves not just to survive the challenges ahead, but also to thrive and grow to the benefit of their customers and other stakeholders.

Throughout the turmoil of 2022, at State Street, our focus has been on making sure our insurance clients have the best solutions to service their customers and strengthen their businesses. Whatever 2023 and the years ahead have in store, we will remain focused on these challenges to help your business continue to operate efficiently, focus on value-add activities and continue to grow.

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