Exploring the insurance industry's top risks

A New Zealand perspective

This biennial report is a supplement to the PwC Banana Skins series, a global series that measures risks in financial services

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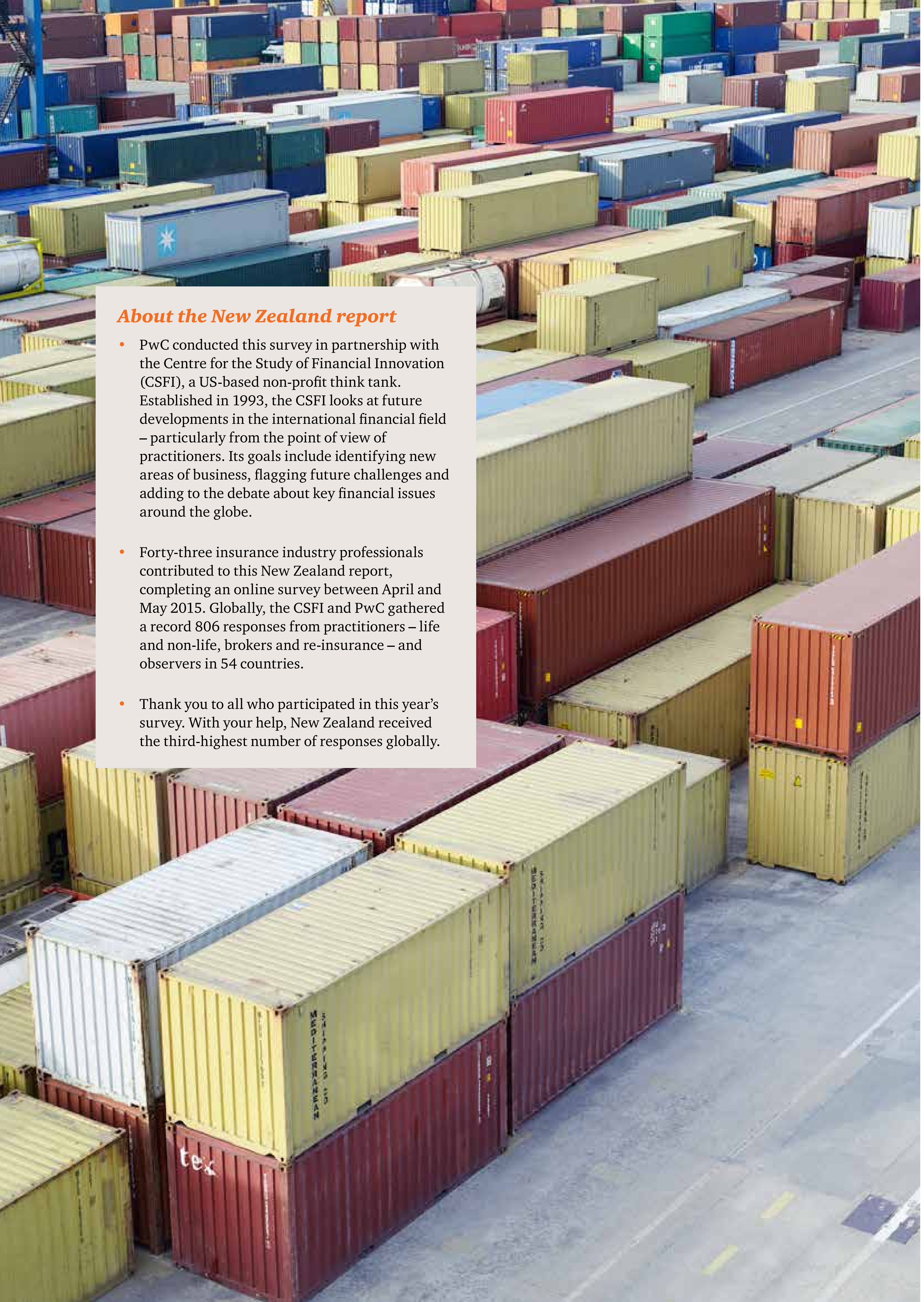


About the New Zealand report

- PwC conducted this survey in partnership with the Centre for the Study of Financial Innovation (CSFI), a US-based non-profit think tank. Established in 1993, the CSFI looks at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging future challenges and adding to the debate about key financial issues around the globe.
- Forty-three insurance industry professionals contributed to this New Zealand report, completing an online survey between April and May 2015. Globally, the CSFI and PwC gathered a record 806 responses from practitioners – life and non-life, brokers and re-insurance – and observers in 54 countries.
- Thank you to all who participated in this year's survey. With your help, New Zealand received the third-highest number of responses globally.

The global context

As the Canterbury earthquake events reach their five-year anniversary, New Zealand's list of top risks still differs from that of global concerns.

In our last survey in 2013, New Zealand shared three top-10 risks with global rankings: natural catastrophes, quality of management and business practices. This year, New Zealand shares half: natural catastrophes, change management, distribution channels, quality of risk management and cyber risk.

Globally, the entire industry points to regulation as the top risk, while New Zealand insurers, intermediaries and industry observers still point to natural catastrophes as the main concern. In addition to natural catastrophes, the biggest concerns in New Zealand are around how the industry manages change: commoditisation of the personal insurance environment and the disintermediation of traditional distribution models.

Cyber risk is the number one 'banana skin' for non-life insurers globally. It's new to the survey this year and it's not only debuted as a top 10 risk for New Zealand, but it's the top concern among respondents in Australia, UK and the US. In these markets, the chief concern is the vast quantity of data held in the cloud. Major breaches are perhaps inevitable, with the aftermath expected to cause both financial and reputational damage. One consultant in the UK said, "There are two types of companies – those hacked and those that will be hacked. There is no amount of security in place that prevents attacks 100 per cent." Additionally, underwriting of cyber risk has yet to be fully scoped.

For life insurers globally, the leading challenges ahead are interest rates and the macro-economy. Low interest rates are making it difficult to generate competitive returns for policy holders. This is impacting a range of savings products (such as guaranteed annuities) and investment returns. Higher capital charges for guaranteed products could drive up costs still further and erode returns in many markets. With regulation the third-highest concern for life insurers globally, this focus is on issues such as reform of pensions and health care.

For brokers and intermediaries across the globe, changes to the structure of the industry – particularly the client interface – are clearly top of mind. Change management, quality of management and distribution channels top the list of potential risks for this subgroup. Brokers are less affected than primary insurers by macro-economic issues such as interest rates, though they share the industry's broader concern with the quantity of new regulation, particularly in the area of business conduct.

Insurers view rich data held in cloud-based storage systems as their main concern around cyber risk.

Top risks: New Zealand and abroad

2015	World	Aus
1. Natural catastrophes	9	15
2. Change management	6	6
3. Distribution channels	8	3
4. Cyber risk	4	1
5. Reputation	18	10
6. Human talent	15	8
7. Product development	17	7
8. Long tail liabilities	14	9
9. Quality of risk management	10	18
10. Social change	20	13

2013	World	Aus
1. Natural catastrophes	5	11
2. Reputation	14	14
3. Distribution channels	11	3
4. Innovation	13	10
5. Human resources	19	21
6. Reinsurance	24	16
7. Quality of management	8	17
8. Climate change	18	19
9. Social media	21	12
10. Business practice	4	9

2011	World	Aus
1. Macro-economic trend	3	7
2. Regulation	1	2
3. Natural catastrophes	5	3
4. Capital	2	1
5. Distribution channels	9	9
6. Managing costs	13	12
7. Talent	6	5
8. Reinsurance	21	13
9. Reputation	16	6
10. Management quality	14	8

The view from New Zealand

Natural catastrophes risk again topped the list for New Zealand participants, as it did two years ago. Nearly five years on from the Canterbury earthquakes the emphasis has shifted more to reputational damage. With several respondents voicing a view that the industry's reputation has been damaged by its response to the earthquakes, it's no surprise that reputation risk continues to feature in the top 10. One New Zealand respondent stated, "People in Christchurch do not trust the general insurance industry."

Change management has made a big jump and is now the second-highest risk in New Zealand, up from number 18 two years ago. Concerns are around commoditisation of the personal insurance environment and the disintermediation of traditional distribution models. A non-life respondent said, "Insurers appear to be slow in adopting web-based technologies to meet customer needs. Intermediaries jealously guarding their customer data may be partly to blame." Many thought non-traditional entrants could shake up the industry as "new competitors with different approaches will provide what the customer requires if existing insurers ignore the changing marketplace" but the danger is that "competitive forces that will affect the profitability of the industry and leave it open to upheaval in the event of another Nat Cat event."

Distribution channels remains in third place. Concern is high that insurers are not making the best of new distribution channels to reach clients and a repeated point that traditional intermediary channels are standing in the way of change. "The digital revolution has the potential to change the framework for doing business," said one respondent. New distribution channels alongside increased regulatory focus will inevitably change the traditional intermediary channel.

Cyber risk is a striking new entrant to the list (featuring fourth in New Zealand and globally). There is clearly a high level of anxiety about cyber risk. The main concern is the security of the volumes of data in particular those held in cloud-based storage systems with the view that insurers are a prime target given the 'richness of data' held. One Australian respondent said cyber risk was a major threat, "We repel more than 20 serious attacks every day. Half of these we suspect are state-sponsored attacks." Urgent concerns about cyber risk could be found in every region and sector that was surveyed. Also highlighted was a broader point on the underwriting risk. One respondent stated, "Cyber insurance is such an unknown and many insurers may be opening themselves up to potentially horrific losses."

Human talent remains in the top 10, with the challenge for New Zealand's insurance industry continuing to be higher than the rest of the world. Attracting talent to our corner of the world and retaining that talent has always been difficult. There is still a feeling that insurance is seen as banking's unglamorous cousin – particularly in New Zealand where employment levels are rising and graduates can afford to be more choosy. This, interplaying with changing customer make up and requirements, creates further challenges to the industry to attract and retain talent. Respondents noted concerns over "ensuring we secure key talent and leadership that represents the diversity of our customer base and skills required in the future. In New Zealand, the demographics are changing significantly on an ethnic basis."

What New Zealand respondents had to say...

Higher concerns

- ***Reputation:***
  "Social media coupled with increasing premiums across the country will spread [distrust] and make the industry more despised."
- ***Social change:***
  "There are significant risks for life insurers associated with demographic changes – including new causes for some diseases."
- ***Human talent:***
  "Talent has lots of options – many more exciting than insurance."

Lower concerns

- ***Macro-economy, interest rates:***
  "New Zealand's economy is in reasonable shape at present."
- ***Regulation:***
  "Industry regulation is light and, as a result, there is insufficient transparency for customers."
- ***Guaranteed products:***
  "Risk has reduced in recent years after strong investment market returns."

If existing insurers ignore the changing marketplace, new competitors with different approaches will provide what the customer requires

There are a number of new entrants into the top 10 for New Zealand.

Product development seems to have a higher sense of urgency in New Zealand than the world. The typical concern is that markets are changing and insurers are not adapting fast enough. Respondents saw focus was required on, "responding to the needs of customers so they still see value in their insurance spend. Keeping up with emerging risks, in particular, cyber, geopolitical/ terrorism, spread of diseases (ebola for example) and supply chain."

The concerns about long tail liabilities are easing internationally but this has made it to the top 10 in New Zealand. This remains a difficult area marked by uncertainty about claims and litigations, as well as the complexities of accounting and legislation. One New Zealand respondent commented on the legal uncertainty arising from the 2014 Sentencing Amendment Act in New Zealand which has extended the ability of the New Zealand courts to award compensation for losses suffered as a result of personal injury.

Quality of risk management now features in the top 10 as opposed to quality of management, reflective of the increased focus on risk. This has largely arisen from increased regulation coupled with new risks such as cyber. One respondent stated there "is a lack of in-depth understanding in the risks we carry," while another said future risks will be fuelled by ongoing catastrophes, "weather events, and associated reinsurance and reputation risk."

Social change ranks well above the global ranking, not surprisingly given the demographical and ethnic shift in New Zealand, particularly seen in Auckland. This creates both challenges and opportunities for New Zealand insurers – having the right sales force and distribution channels, understanding the needs of customers and tapping into new demographics.

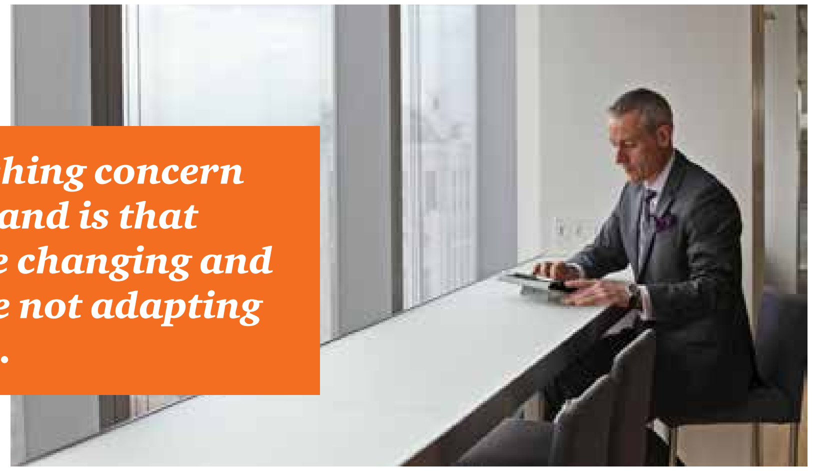
In New Zealand regulation continues to sit outside the top 10, where globally it continues to rank at the top.

One respondent said, "In New Zealand's case, the strengthening of solvency and prudential supervision of insurers has been a positive." It was noted, however, there were a number of comments provided by New Zealand respondents about regulation. Concerns were raised over, "compliance issues associated with ever increasing regulations." Additionally, another respondent noted, "regulatory change will affect the industry in a number of ways. Increased capital will need to be retained for solvency purposes, potentially stifling investment. I foresee major changes from the [Financial Markets Authority] into how independent financial advisers can be remunerated." Another respondent noted that regulators should ensure that "regulation continues to be balanced in protecting policy holders but not adding cost burdens that will push the cost of insurance to a level that forces people to drop out of having adequate coverage."

While New Zealand has seen greater regulation over the past five years with the introduction of the Insurance (Prudential Supervision) Act 2010, regulators have started to invest significantly in enhancing their supervision through increased data collection. The cost of this regulatory compliance could be felt in New Zealand as much as it has been in other parts of the world. On a global stage, the regulatory concern interestingly was highest amongst respondents who were not direct practitioners in the industry (for life/non-life insurers regulation ranked at number three).

In conclusion, insurers in New Zealand are operating within a complicated matrix.

This matrix encompasses an unpredictable natural environment, changing consumer behaviours and disruptions from technology. If new regulation adds costs for the end customer, many fear policy holders will simply cancel their insurance. As one New Zealand respondent stated, "we run the risk that regulation impacts adversely on costs with unintended consequences such as higher levels of under-insurance."



The overarching concern in New Zealand is that markets are changing and insurers are not adapting fast enough.

Change management and distribution channels: a response to technology

Disruption has become the new normal with technological advances and changing customer behaviours, and it has hit the insurance industry — hard. In this year's PwC Global CEO Survey, insurance industry leaders across the world told us (more than any other commercial sector) that their businesses were facing disruption. These challenges are reflected in the top 10 New Zealand risks in the areas of change management, distribution channels, cyber risk, human talent and social change.

From the recent PwC publication *Insurance 2020 and beyond: Necessity is the mother of reinvention,* it was noted insurance is an industry at the tipping point as it grapples with the impact of new technology, new distribution models, changing customer behaviour and more exacting local and global regulations. For some businesses, these developments are a potential source of disruption. Yet for others, change offers competitive advantage.

Technology is one of the driving forces behind competitive advantage for new and non-traditional entrants, enabling their ability to quickly respond to customer demands.

The insurance marketplace is becoming increasingly fragmented, with an ageing population at one end of the spectrum and a less loyal and often hard to engage millennial generation at the other. As the nature of the marketplace changes so do customer expectations. Customers want insurers to offer them the same kind of accessibility, understanding of their needs, and products that fit their requirements that they've become accustomed to from online retailers and other highly customer-centric sectors. Digital developments offer part of the answer by enabling insurers to deliver anytime, anywhere convenience; streamline operations; and reach untapped segments.

The need for insurers to respond to change is nothing new in New Zealand, but the struggle has always been with speed of change. Legacy systems, the significant amount of customer details required to appropriately price risk, and significant levels of data required for financial reporting, are the contributing factors to the challenges facing New Zealand insurers to move quickly and effectively. The risk is far too high to take shortcuts.

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Why cyber risk is a strategic challenge – and shouldn't be defined as an IT problem

It is not surprising that cyber risk features in the top 10 for both New Zealand and the world. This risk has been present since computers and the internet were invented. However, according to recent PwC surveys* the impact on organisations is growing. This is why it is a new entrant to the Banana Skins questionnaire.

Cyber risk can be both an internal risk and an underwriting risk. For insurers in New Zealand, the challenges faced in the speed of adapting will provide similar challenges to addressing cyber risk.

Ultimately, cyber risk is not just a technology problem. It is a strategy problem, a human problem and a process problem. After all, organisations are not being attacked by computers, but by people attempting to exploit human frailty, as much as technical vulnerability. As such, this is a problem that requires a response grounded in strategy and judgement about business process, access, authority, delegation, supervision and awareness – not merely tools and technologies.

While one-quarter of respondents in our most recent *Global Economic Crime Survey* reported that they have suffered a cybercrime, we must also consider that a significant percentage of those who did not report cybercrime may also have suffered an event – and just did not know about it. This underscores the challenge of the threat. Many entities do not have clear insight into whether their networks and the data contained therein have been breached, and they don't know what has been lost – or its value. Further, even when it is detected, cybercrime often goes unreported. Often there may be compelling competitive reasons for organisations to keep such losses confidential.

Organisations must ask themselves whether they are adequately defending themselves against cybercrime breaches, and if they were discovered, how would they value the loss? Much of the damage caused by these kinds of incidents are not disclosed, either because it is not known, because it is difficult to quantify or because it is not shared.

In response to this complex risk environment, the market for insurance products is evolving as companies seek new opportunities to gain insight into, and better manage, cyber risk. The insurance industry is expanding into new cyber risk areas, such as first-party policies to cover the value of lost intellectual property, reputation and brand, as well as products to cover cyber-related infrastructure failures. Further, there are policies available for coverage of damages and defence costs suffered by a company's customers in connection with a breach of third-party intellectual property.

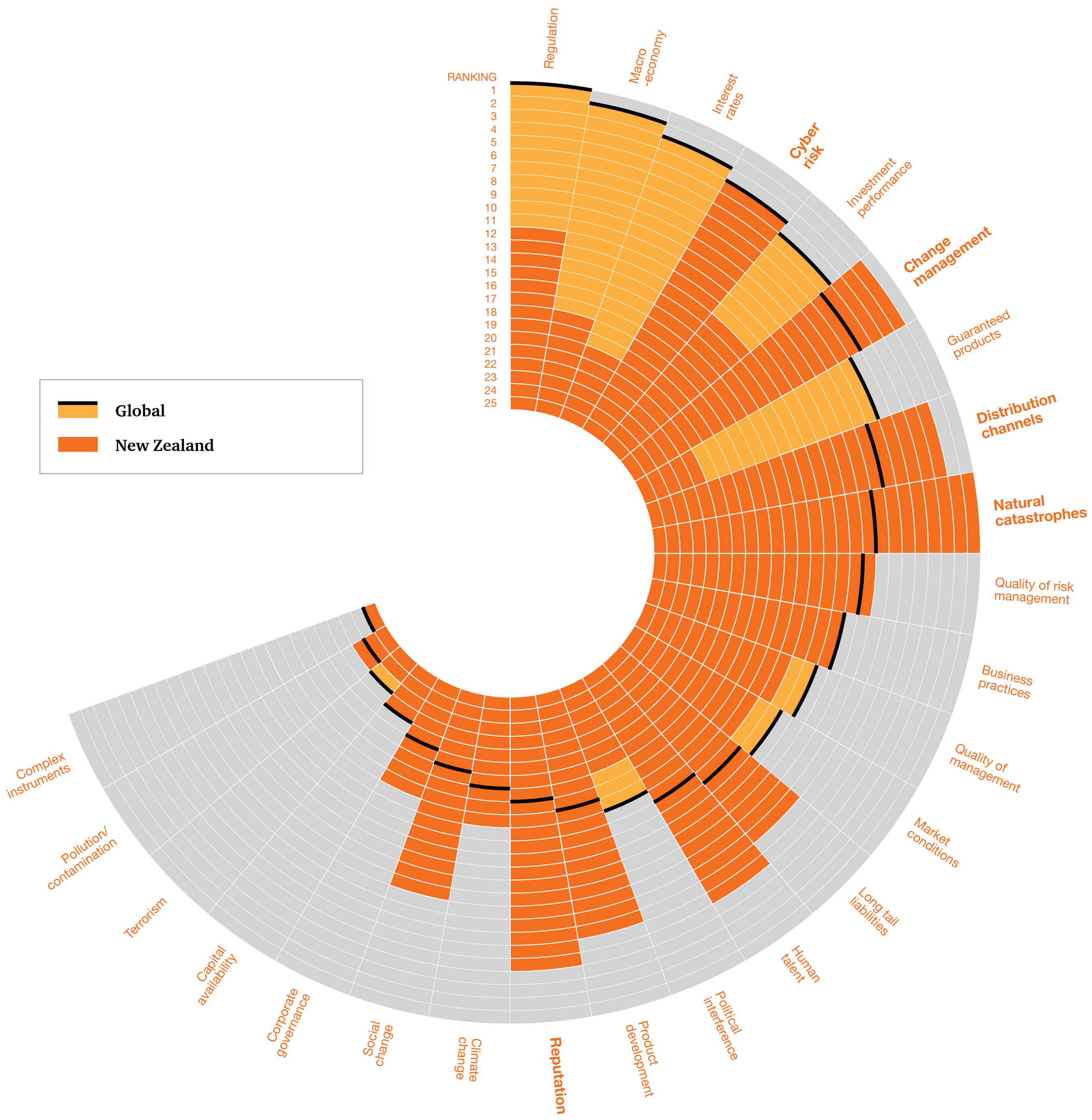
There are currently only a handful of insurance providers in New Zealand who offer cyber insurance. We expect that more insurers will include a cyber policy in response to this growing threat, and to ensure they do not lose a customer's wider insurance portfolio to competitors who offer such policies.

Finally, we recommend that New Zealand organisations keep abreast of pending potential changes to the Privacy Act 1993. Amongst others, these changes would likely oblige businesses to notify its customers if their personal information has been breached, or face hefty fines.

This is a problem that requires a response grounded in strategy and judgement about business process, access, authority, delegation, supervision and awareness – not merely tools and technologies.

* Global CEO Survey, Global Economic Crime Survey and Global State of Information Security Survey.

How New Zealand compares to the rest of the world



New Zealand ranking		*Change from 2013*
1.	Natural catastrophes	NO CHANGE
2.	Change management	16▲
3.	Distribution channels	NO CHANGE
4.	Cyber risk	NEW
5.	Reputation	3 ▼
6.	Human talent	1 ▼
7.	Product development	16 ▲
8.	Long tail liabilities	5 ▲
9.	Quality of risk management	6 ▲
10.	Social change	NEW
11.	Business practices	1 ▼
12.	Regulation	NO CHANGE
13.	Investment performance	1 ▲
14.	Quality of management	1 ▲
15.	Market conditions	NEW
16.	Climate change	7 ▼
17.	Corporate governace	4 ▲
18.	Macro-economy	2 ▲
19.	Political interference	5 ▲
20.	Interest rates	NEW
21.	Guaranteed products	1 ▼
22.	Capital availability	8 ▼
23.	Pollution/contamination	2 ▲
24.	Terrorism	3 ▲
25.	Complex instruments	1 ▲

Canterbury earthquakes

The Canterbury earthquake events that began in September 2010 not only changed the landscape of the community, but transformed the New Zealand insurance industry. In 2013, the time of our last publication, the focus was still on disaster response and initial policy changes by insurers and the Government. Today, the focus for insurers is to reflect on lessons learned and how this translates to future disaster recoveries, as well as customer perception and retention.

Last year, 2014 saw the biggest recovery efforts to date with claims continuing settlement and building permits issued. According to the Insurance Council of New Zealand, an industry trade group representing insurers, settlements ran at $10 million a day on average.

In May 2015, the Council announced that private insurers had paid out almost $15 billion to settle commercial and residential claims since the earthquakes began in 2010, of which over $6 billion was for domestic claims. Additionally, private insurers had settled almost 15,000 over cap residential Canterbury earthquake claims, including 1,100 in the quarter to 31 March 2015, or equivalent to 12 properties per day.

An 'over cap' claim is where the cost of repairing or replacing a home is above the maximum amount that the Earthquake Commission (EQC) will pay. For most people, the EQC cap is $100,000 per natural disaster event. Homeowners whose damage is over this amount work with their private insurers.

As insurers continue to wrap up their claims in Canterbury, they will continue to examine how they can make the recovery from natural disasters faster and more assured.

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