Insurance challenges ahead of the economic recovery

The insurance sector has weathered Spain's economic storm with notable resilience. According to the latest indicators this storm is now abating but nothing will be the same again. The sector therefore faces a complicated period in which it needs to map out an action framework action and strategies to meet these challenges and maximize any opportunities that arise.

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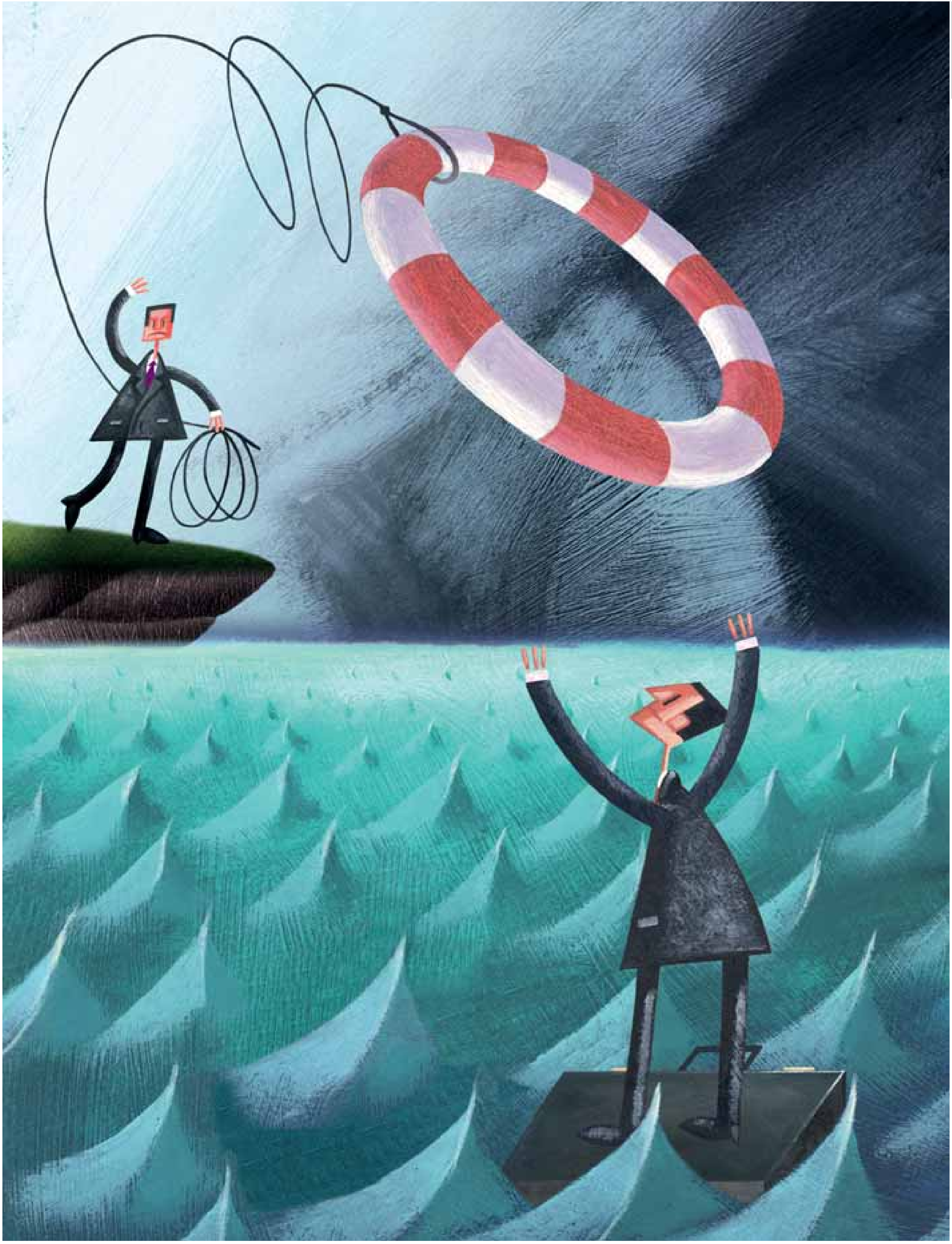
Third quarter economic indicators, recording a slight GDP growth of 0.1%, suggest that the recessive phase of Spain's economy is at last drawing to a close. That said, the figures on household- and company-credit, unemployment and demand augur a slow pick-up from this slump, undoubtedly the worst of recent decades.

The insurance sector, however, has shown great resilience to this recession. Premium revenue may have fallen (non-life by 2.3% from 2007 to 2012), but assets under management (life insurance provisions) have increased by 17%, solvency ratios have come out stronger, results have risen and, most importantly, sector employment levels have held pretty steady, and still with a healthy percentage of indefinite-term contracts (temporary employment contracts lower than 3%).

Nonetheless, overcoming the recession does not mean a return to the previous situation. This slump has been so deep that it is bound to change substantially the business scenario afterwards for all economic stakeholders, including insurance companies.

It is therefore now necessary to map out, as far as possible, a future action framework, to draw up our strategies and then take the necessary measures to achieve mid- and long-term goals.

Each company will have its own goals in its own particular sphere. MAPFRE's is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to continue trading and developing as a trusted worldwide insurer, constantly improving its service and building up the best possible relationships with our clients, distributors, suppliers, shareholders and society as a whole.

This shapes up as no easy task; the path ahead is strewn with difficulties. Of course, all societies tend to regard the moment it has befallen them to live through as exceptional and gravid with change. In our case, however, I believe there is objective

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evidence for a real watershed moment with few past shibboleths left standing.

So let's now look at these change-inducing factors in our sector and sketch out solutions for the corresponding challenges that are likely to arise in the recovery phase.

1. The first challenge is that posed by the high level of economic uncertainty we are now going to have to cope with, accompanied; as always with the concomitant geopolitical risks. This situation hampers long-term strategies, which are where insurance really comes into its own, prompting both companies and individuals to stick to short-term, less irreversible economic decisions.

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2. In the particular case of the Spanish market we also need to factor in the contagion risk from other financial sectors currently suffering serious problems. The obvious example is the banking sector; this risk needs no spelling out for life insurance, which is largely dominated by the bank-insurance (*bancassurance*) model. It is not only a question of a knock-on effect of failing bank assets on insurers' balance sheets but also the role played by banking networks as a distribution outlet. We believe, however, that in this case the worst is already over; there is still some unfinished business but this is now unlikely to upset the stability of insurance companies as a whole.

A high level of interaction with banks now needs to be kept up – this is inevitable – while throwing off the yoke of excessive dependence. Recent experience shows the importance of a proper diversification of distribution outlets, harnessing suitably in all of them the idiosyncrasies of our business model while prioritising those aspects that favour a direct relationship with our clients. The insurance sector has weathered the worst storms far better than most and we now need to bring this proven efficiency and resilience to much wider notice. This will boost our image and emphasise our sounder bases, compared to other adjacent sectors that have fared worse.

3. In relation to the above, we also need to make due provision for the likely slowness in any credit pickup. In July 2013 mortgages were down by 42% on June 2012, and total loans to the private sector, households and firms, fell by over 10%, the biggest drop in the EU (average fall of 1.9%). This just goes to show how unreasonable the pre-slump levels were.

Raising a loan, with or without a mortgage, is one of the main reasons for taking out a life- or home-insurance policy but it is not the only one. We need to drive the sale of these insurance arrangements in their own right rather than always tying them in with loans. There are powerful arguments to justify this and we have perhaps underplayed them in the past due to the ease of selling this insurance as a mortgage tag-on.

4. The last and perhaps most telling challenge of a macroeconomic character is the likely low level of interest rates into the foreseeable future. I am talking here about low levels in historical terms, whether or not they rise moderately from the current all-time lows. This situation impinges directly on insurers' results and brings up the need to reinforce underwriting policies as well as cost-contention policies. In other words, it is essential to work with combined ratios well below 100% since it will be difficult from now on to offset technical losses against investment profits.

5. In this context it will not be easy to keep up strict compliance with the principle of premium sufficiency, for the following reasons. Firstly, marginal costs are showing an upwards trend as the crisis drives down business volumes and stokes up the unemployment rate to unprecedented levels. Secondly, there is very strong downwards price pressure in lines such as automobiles due again to the ever-fiercer level of competition in our market.

There is therefore no option but to continue cutting all management costs to the bone, trying at the same time to reduce the marketing dependence of the price factor. Aspects that now need to be favoured and stressed are innovation, service quality, solvency and security.

6. Maybe the biggest challenge faced by the insurance sector in coming years is helping to shepherd the country towards a mixed public/private pension scheme and tapping into the business opportunity this represents. There are great expectations to live up to here. Public coverage of retirement and other contingencies now seems bound to dwindle as the population ages and budgets shrink, not only in Spain; this will fuel a demand for complementary private schemes.

We will have to keep up or even double our efforts to boost public conviction in the formulae we are offering, i.e., the pensions schemes and various long-term insurance sa-

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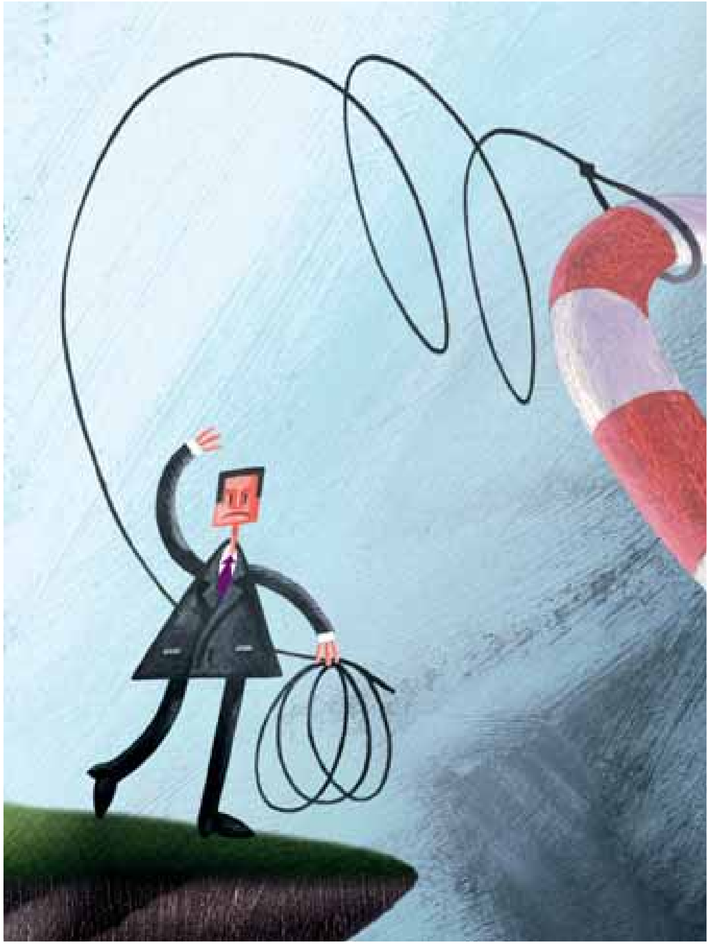
ving schemes like Social Welfare Insurance Plans (*Planes de Previsión Asegurados: PPAs*), Systematic Individualised Saving Plans (*Planes Individuales de Ahorro Sistemático: PIAS*) and Life Insurance Capitalisation Policies (*Seguros de Vida Ahorro*). This will best be done by fine-tuning and honing the information given to participants and insureds and also improving the level of consultancy and advice when the policies are taken out to ensure that clients understand the guarantee and security levels associated with each product. This will help them to find the ideal combination from among all the different options. This would also be a good chance to stress the advantages of insurance-based saving vehicles when it comes to topping up long-term public pensions.

7. One line of action that should now be vigorously advocated not only to the sector itself but also and above all to the legislative and administrative authorities is the channelling of the vast pool of savings tied up in property, encouraging its conversion into life annuity insurance. This would help to flesh out complementary saving for retirement, which might otherwise be a sluggish business. The necessary tax incentives would need to be phased in plus other administrative measures to encourage the taking out of these policies and increase their legal security.

8. In addition, in relation to all the above, there is another big challenge we need to face up to: the suitable management of longevity risk. Here, the sector needs to be extremely nimble, skirting the peril of excessive commitments that might exact too heavy a toll in the long term. This is a contingency that has to be



provided for in the policies issued right now to cover survival risk.

9. Going back to the abovementioned challenge of filling the gap opening up in the public pension system, doing so in a solvent and efficient way, we need to think beyond the retirement factor and take in other contingencies too, like death and invalidity, where, we insist, the sector has not done everything it could have in the past, probably lulled into a false sense of security by the easy option of mortgage-linked insurance.

Along the same lines, health insurance could offer new opportunities, in view of the public authorities' increasing difficulties in providing a totally free service with universal coverage while costs are soaring.

Here too we could talk of long-term-care insurance, which will one day have to pick up on the objectives laid down by the still valid Personal Autonomy and Dependency Law (*Ley de Autonomía Personal y Dependencia*).

10. And the last challenge I wish to mention has to do with regulation.
Regulatory pressure has now become one of the most worrying and time-consuming concerns for companies, forcing them to eat up a growing percentage of resources on other activities outside their core business, namely, the design, launch and marketing of products and the management of client relationships.

We are speaking here, among other things, of the challenge of bringing information-giving procedures and sales processes into line with the new regulatory requirements (Marketing in Financial Instruments Directive, MIFID; Directive on Packaged Retail Investment Products, PRIPs; Insurance Mediation Directive, IMD). But above all we are talking about the Solvency II project, which received a definitive leg-up last 13 November with the Omnibus II agreement reached between the European Parliament, the Council and Commission. Its requirements in terms of the governance model (risk control, internal control, actuarial function) and its risk-based capital model now pose a sterling challenge for insurers.

Much is at stake here in terms of the treatment of long-term guarantees in life insurance. Fortunately, the final wording seems to us to field all the minimum quantitative objectives defended by the industry, especially the Spanish one, though the enforcement measures still need to be properly spelled out.

As a sector we need to make sure that the chance to fill the long-term gap in demand left by the public pension systems is not missed. This would be a real danger if the stipulations of the Solvency II Directive are not brought into line with market reality in terms of interest rates, equity eligibility requisites and the calculation of life insurance provisions.

In short, we need to convince the regulators that the new capital requirements should not upset the current balance between yield and risk, prompting an investor drain from the insurance industry. Like any other, this industry needs financial resources to develop and overcome all the abovementioned challenges, including this one; i.e., to meet all the sector objectives, which are none other than to increase the insurance sector's economic gravitas while also upping our involvement and profile in society.

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