

Market Review  
July 13, 2016

**“Mutual insurers have historically proved to be resilient thanks to their solid links with affinity groups and member-based organisations.”**

## Future Proofing European Mutuals

European mutual insurance companies are at an inflection point in which they must embrace change, or risk losing relevance and market share. Faced with pressures that include the increased regulatory requirements under Solvency II and a changing and competitive operating environment in which stock insurance companies have proved quicker to innovate, the suitability of the traditional mutual business model finds itself both challenged and ripe for reinvention.

Having remained largely unchanged for decades, the speed and agility with which European mutuals can react to the dynamically changing market landscape will be essential in determining the sector's future growth and prosperity. Depending on the local market in which they operate, their size and history, mutual companies are adapting to these myriad challenges in a number of different ways.

Strategic considerations faced by European mutuals include consolidation, governance, recognition of the need to innovate, and capital optimisation. In particular, some mutuals are taking advantage of the soft reinsurance market. As European markets become ever more competitive, mutuals are looking at increasing their operating efficiency, emphasising the factors that differentiate them from conventional insurers, such as enhanced loyalty amongst their customer base.

Inevitably however, some mutuals are struggling to adapt. It will be these companies that could begin to demonstrate weaker fundamentals going forward, particularly if the low interest rate environment persists and as anticipated disruptive innovation occurs across the wider insurance space. Examples include the trend towards an “Internet of Things” and the prospect of Big Data within personal lines to offer products that are more tailored to the individual. A.M. Best notes that there is also the prospect of the encroachment into the insurance market of players that offer alternatives to traditional models. These can include large organisations that have accumulated significant customer databases, or the more recently launched peer to peer insurers (for example, Friendsurance in Germany).

The next decade will undoubtedly be a decisive one for mutual insurance companies in Europe. In A.M. Best's view, those most likely to thrive will maintain a close alignment with their policyholders while taking steps to increase efficiencies, improve capital management and make the most of new opportunities.

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### The multi-faceted face of European mutuals

There are material differences between mutual companies operating in Europe, based on size, location and history, often with strong links to professional bodies in France and Spain, or with farming associations in the Netherlands and Finland. Going back to historical roots, ship owners continue to share risk on a mutual basis through protection and indemnity (P&I) clubs, which in 2016 are responsible for insuring around 90% of the world's ocean-going tonnage.

While P&I clubs and other mutual groups have their own distinct and often unique characteristics, they often share certain commonalities. Many have links to affinity groups and member-based organisations, and were created to cover specific categories of policyholders. Mutual companies aim to act in the best interests of their members, through striking a balance between delivering high-quality services at a competitive price, and being profitable to support future development, with profits either retained or distributed back to policyholders, typically in the form of reduced premiums.

Globally, mutuals play a vital role within the insurance market, representing approximately a quarter of the insurance industry. In 2013, European mutuals represented nearly 40% of



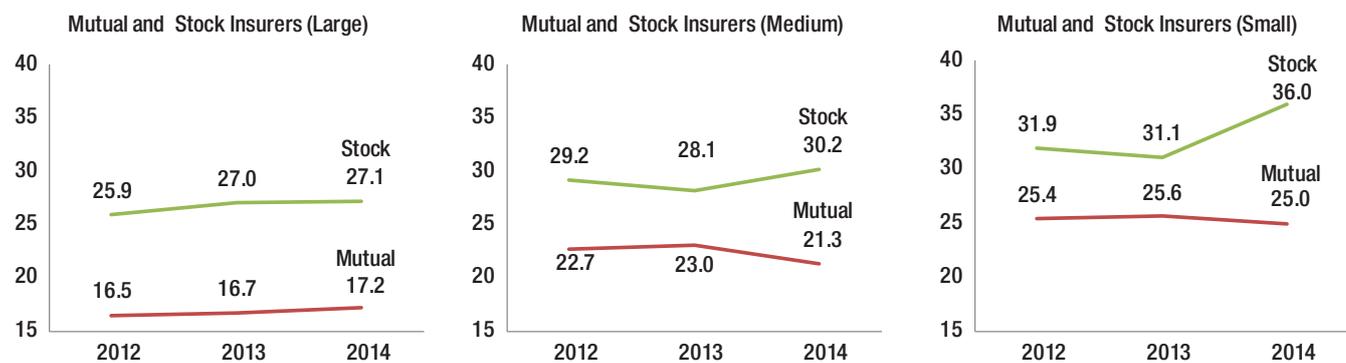
total global mutual business, according to the International Cooperative and Mutual Insurance Federation (ICMIF). France, Germany and the Netherlands recorded the greatest gains in market share over recent years, while the proportion of mutual business in the United Kingdom fell for the third successive year following a period of demutualisation in the market.

There have been few mutual start-ups in the last decade, although China’s high-profile efforts to support the establishment of new mutuals has been viewed positively (see A.M. Best’s briefing, “Mutual – A New Insurance Organizational Structure in China”, published May 24, 2016), and has culminated in the June 2016 announcement by the China Insurance Regulatory Commission (CIRC) that it has approved the establishment of three mutual insurance associations. In the United Kingdom, efforts to allow mutuals to access more capital without undermining their mutual principles led to the passing into law of the Mutuals’ Deferred Shares Bill in March, 2015. Further work is required, in both legislative terms and with the UK regulatory authorities, culminating in mutuals seeking the approval of their members before they can begin to issue these shares (currently expected some time in 2017).

### Exhibit 1

#### European Mutuals - Expense Ratios (Mutual and Stock Insurers) (2012-14)

(%)



Notes:  
 Data includes all European affiliated and unaffiliated singles with gross written premium in excess of zero in 2014.  
 Company size by gross written premium:  
 Small = Less Than GBP 50m  
 Medium = GBP 50-1,000m  
 Large = Greater Than GBP 1,000m

Source: Best’s Statement File - Global, A.M. Best data and research

According to A.M. Best’s statistics, large and medium-sized European mutuals have reported significantly higher loss ratios than their stock counterparts, but much lower expense ratios (see **Exhibit 1**), resulting in three-year average combined ratios that are marginally higher than that of stock insurers (see **Exhibit 2**). This reflects the ethos of mutual insurers, which aims to offer protection to their members at competitive prices, in comparison to stock insurance companies with

their greater pressure to produce profits and pay dividends to shareholders.

There is significantly less pressure to report a high net income to members for mutuals, whose underwriting performance can be hindered by a conservative reserving philosophy.

On the other hand, mutuals may also share profits among their members by offering reduced premiums in subsequent years, an indirect mechanism of returning excess surpluses to

### Exhibit 2

#### European Mutuals – Three-Year Combined Ratios (Mutual and Stock Insurers)(2012-14)

Organisation Type	Large	Medium	Small
Mutual	98.4%	97.7%	95.0%
Stock	95.4%	95.0%	96.7%

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Source: Best’s Statement File - Global, A.M. Best data and research

policyholders that can be utilised as an advantageous tactic in a competitive environment. This has been evident over recent years in French motor business where some mutuals, in an effort to gain market share, have fuelled competition by freezing tariffs despite a deteriorating claims environment.

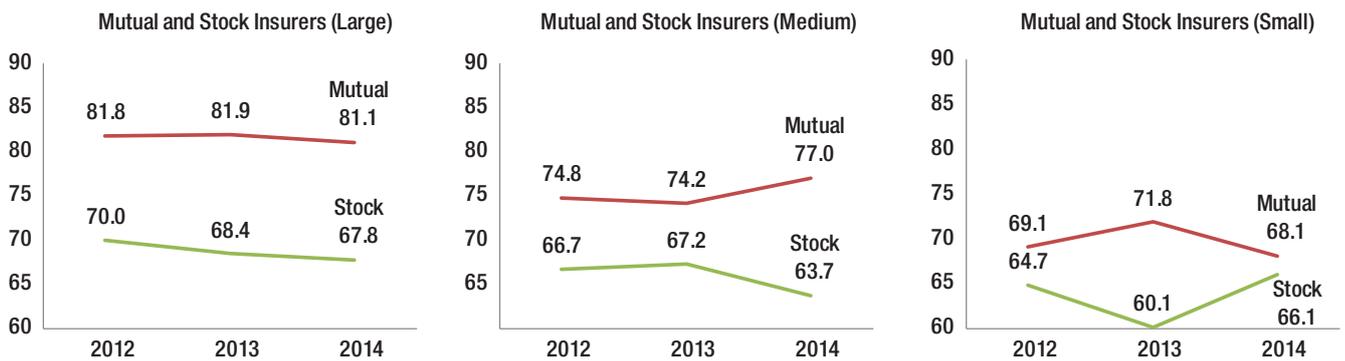
Because they have historically enjoyed higher levels of loyalty and retention from their customer base than stock insurance companies, most small and mid-sized mutuals have conventionally spent less on advertising and marketing campaigns as they have relied on business being directed towards them rather than having to compete for customers in the marketplace. In these instances, mutuals have been able to reduce their acquisition costs in comparison to their stock peers.

There is however an argument that some mutual insurers could benefit in the future by allocating more resources to attracting and retaining customers than was previously necessary. In a competitive and rapidly evolving insurance landscape, in which new entrants are seeking to disrupt traditional distribution models to access new clients, investments in developing their business profile offers mutuals the opportunity to communicate their ethical/cooperative credentials and offer a range of expanded and evolving product lines.

### Exhibit 3

#### European Mutuals - Claims Ratios (Mutual and Stock Insurers) (2012-14)

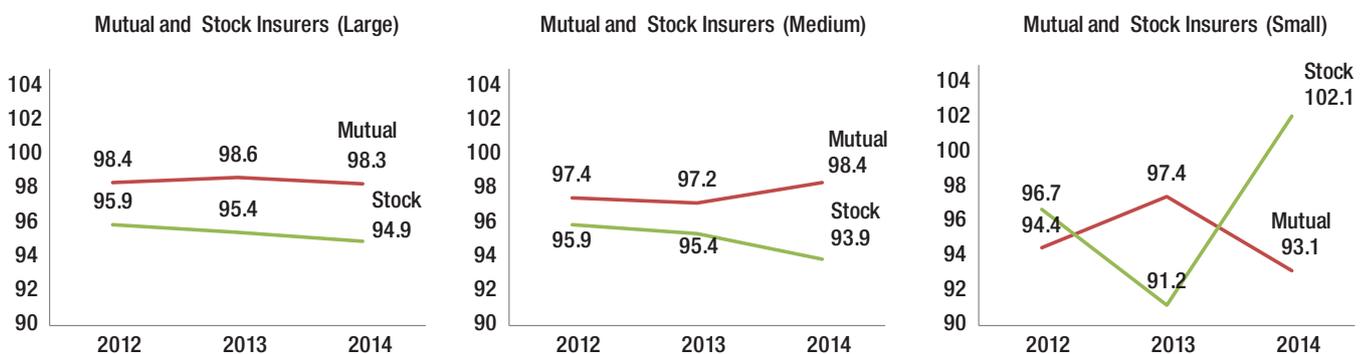
(%)



### Exhibit 4

#### European Mutuals - Combined Ratios (Mutual and Stock Insurers) (2012-14)

(%)



Notes:

Data includes all European affiliated and unaffiliated singles with gross written premium in excess of zero in 2014.

Company size by gross written premium:

Small = Less Than GBP 50m

Medium = GBP 50-1,000m

Large = Greater Than GBP 1,000m

Source: Best's Statement File - Global, A.M. Best data and research

## Looking to the future

### *Regulation and consolidation: an unfolding drama not without its pitfalls*

One of the factors continuing to challenge European mutuals is the increased regulatory and capital burden under Solvency II. For smaller monoline mutual companies in particular, Solvency II's standard formula has, in many cases, significantly increased the amount of capital such mutuals are required to hold, whilst the new regulatory framework has also enhanced reporting and governance requirements, with attendant cost increases.

The result in recent years has been a push for consolidation among smaller, regional players seeking the benefits and efficiencies expected with enhanced scale and diversification. Regulatory changes have assisted mutual partnerships in many European countries with, for instance, the Building Societies (Funding) & Mutual Societies (Transfers) Act 2008 paving the way for mergers between insurance mutuals in the United Kingdom.

The need for mutuals to be able to get together and cooperate has given rise to new legal consolidation tools. In France, the legal vehicle of société de groupe d'assurance mutuelle (SGAM) has, since 2001, been offering mutuals a method of forming groups using an umbrella entity, without the need to demutualise, while maintaining their own brand, management team and independence as SGAM members define together their degree of integration. Similar networks in existence in other countries include LocalTapiola in Finland and Unive in The Netherlands.

France in particular has seen significant consolidation within its mutual sector over the past decade, with the number of mutual companies halving during that time. However, the story has been far from a simple one and the recent breakdown of anticipated partnerships has highlighted some of the difficulties faced by mutuals undergoing this process, with parties in many cases unable to reach agreement over the terms of the transaction.

After several years of discussion, French mutual insurance companies Macif and Matmut recently announced their decision not to pursue their original plan to structure their partnership in a "SGAM of SGAM", though they have announced they remain open to future cooperation opportunities.

In A.M. Best's opinion, finding an agreement in terms of governance between mutuals seeking to operate as a prudential group may be one factor making such unions more of a hurdle under Solvency II.

In addition, the United Kingdom's Senior Insurance Manager Regime (SIMR), which came into effect in March 2016, may conflict with mutuals' principles of democratic election to their boards, further complicating concentration within the sector. The SIMR applies to the most senior executive management and directors subject to regulatory approval. It places a requirement on their firms to allocate prescribed responsibilities across their senior managers, setting out their duties, and to seek Prudential Regulation Authority and Financial Conduct Authority approval prior to their performance of PRA-designated Senior Insurance Management Functions.

### *Making the most of a soft reinsurance market*

The historically low interest rate environment is an additional burden for mutuals alongside Solvency II's often higher capital requirements. The actions taken by the central banks since the 2008 global financial crisis, in an effort to boost the economy and restore market confidence, have flooded the markets with liquidity and exercised significant pressure on interest rates, squeezing investment income, which has been a key source of profitability in the mutual world.

The influx of capital into the reinsurance industry in recent years and a period of relatively benign catastrophe losses have resulted in excess capacity and downward pressure on rates. Multi-year deals are increasingly available for more influential buyers and broader terms and conditions are also on offer in addition to discounted rates. As reinsurance became a buyers' market, cedants, including mutuals, took the opportunity to revisit their protection strategies.

Buying reinsurance remains a key feature of the mutual industry in a move that increases security and enables the release and deployment of capital. Whilst some mutuals have taken advantage of the soft reinsurance market to increase their cover, using risk transfer as a form of contingent capital, quite a few have preferred to benefit from cash savings and reduce their expense base to ease pressure on performance.

### *Push for innovation*

Competition for quicker profit gains for shareholders has placed stock companies ahead of the curve in embracing new technologies and developing products that cater to new and emerging risks. On the other hand, mutual insurers have been perceived as slower to adapt, though there is a recognition this now needs to change.

From a competitive standpoint, mutuals cannot afford to fall behind the curve on innovation at a time when the industry is facing high levels of competition and the risk of disruption from external sources. The sharing economy is one example where brands such as Wiki, Uber, Etsy and Airbnb have applied mutual-like principles to change how consumers share, collaborate and unlock the value of under-utilised assets.

The benefits on the demand side is the ability to source goods and services in a more efficient way where buyers are paying for access as opposed to ownership. Guevara and Friendsurance are two examples of start-up peer-to-peer insurers which have leveraged the mutual and cooperative concept for the age of the sharing economy, rewarding policyholders for a claims-free year by paying them back a proportion of their premium.

Like all insurers, mutuals are therefore under pressure to demonstrate they can remain relevant to their members by adapting existing product and service offerings while exploring new opportunities. If a growing number of stock companies have been looking at the prospects of "innovative technological utilities", offering products such as telematics in motor, these concepts have started to be focused on by mutuals only more recently.

However, there are glimpses of what the future could look like with some of the largest mutual insurers offering new products that cater for emerging risks, such as cyber liability, or else broadening the wordings around traditional covers to reflect new realities. Medium-sized and smaller mutuals, which have a solid understanding of their members, could make use of these opportunities to become more agile and adapt products to better fit the changing needs of their policyholders.

### **A.M. Best's outlook for European mutuals**

Mutual insurers have historically proved to be resilient thanks to their solid links with affinity groups and member-based organisations. These durable bonds and the ethos to operate in the best interests of their policyholders have rewarded them with strong loyalty among their members and in most instances, a high degree of customer satisfaction.

It is therefore not surprising that some of the world's oldest insurance companies are mutuals or cooperatives, and their longevity has helped build and sustain reputations of solidarity, strong ethics and reliability. A study of A.M. Best's Financial Strength Ratings (FSRs) (see Best's

Review, “Standing the Test of Time”, July 2016) shows that mutuals have comprised at least 25% of those insurers rated “A” or higher for 75 years. The European mutual insurance industry has also largely performed well, reporting strong results through the global financial crisis and over the past few years.

A.M. Best expects mutuals to continue to report relatively higher loss ratios than stock insurance companies, in many instances reflecting their conservative approach to reserving, partially compensated for by lower expense ratios. This conservatism, together with the ethos of putting their members’ interests at the heart of their business models, generally imply a solid balance sheet strength for mutuals.

However, while the fundamentals of mutual insurance remain strong and attractive to the 409 million policyholders that ICMIF estimates were served by European mutuals and cooperatives in 2014, this does not present a case for complacency but rather an opportunity. The wider insurance industry is on the cusp of significant change and the ongoing operating pressures, including a historically low interest rate environment, are unlikely to change in the immediate future. This is in addition to the more stringent regulatory capital, governance and reporting requirements many mutuals across Europe face under the Solvency II regime.

Inevitably, larger more diversified mutual insurers will be better placed to navigate these multiple challenges by virtue of their economies of scale, access to different markets and influence. Smaller, more niche players are likely to find themselves in an increasingly difficult situation and A.M. Best would anticipate consolidation to remain a feature of the European mutual landscape for quite some time.

## Tackling the protection gap

The May 2015 Group of Seven (G7) initiative on climate change insurance set out to provide climate risk insurance to populations in emerging countries who are particularly at risk from extreme weather events. The goal of the initiative was to deal with the risks rather than providing disaster management, and so reduce the protection gap. At the time of the announcement, it was estimated that only about 100 million people in emerging countries and economies were covered by climate risk insurance. The initiative is expected to bring new coverage to 400 million people insured for disaster risk and resilience by 2020.

Mutual insurers can take a pivotal role in this initiative, building resilience through innovation while also providing stability in communities and helping businesses develop. Representatives from mutual insurers are already participating in the Insurance Development Forum’s working groups, with the aim to improve on the ways insurance market techniques are brought into government disaster risk reduction and resilience frameworks.

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