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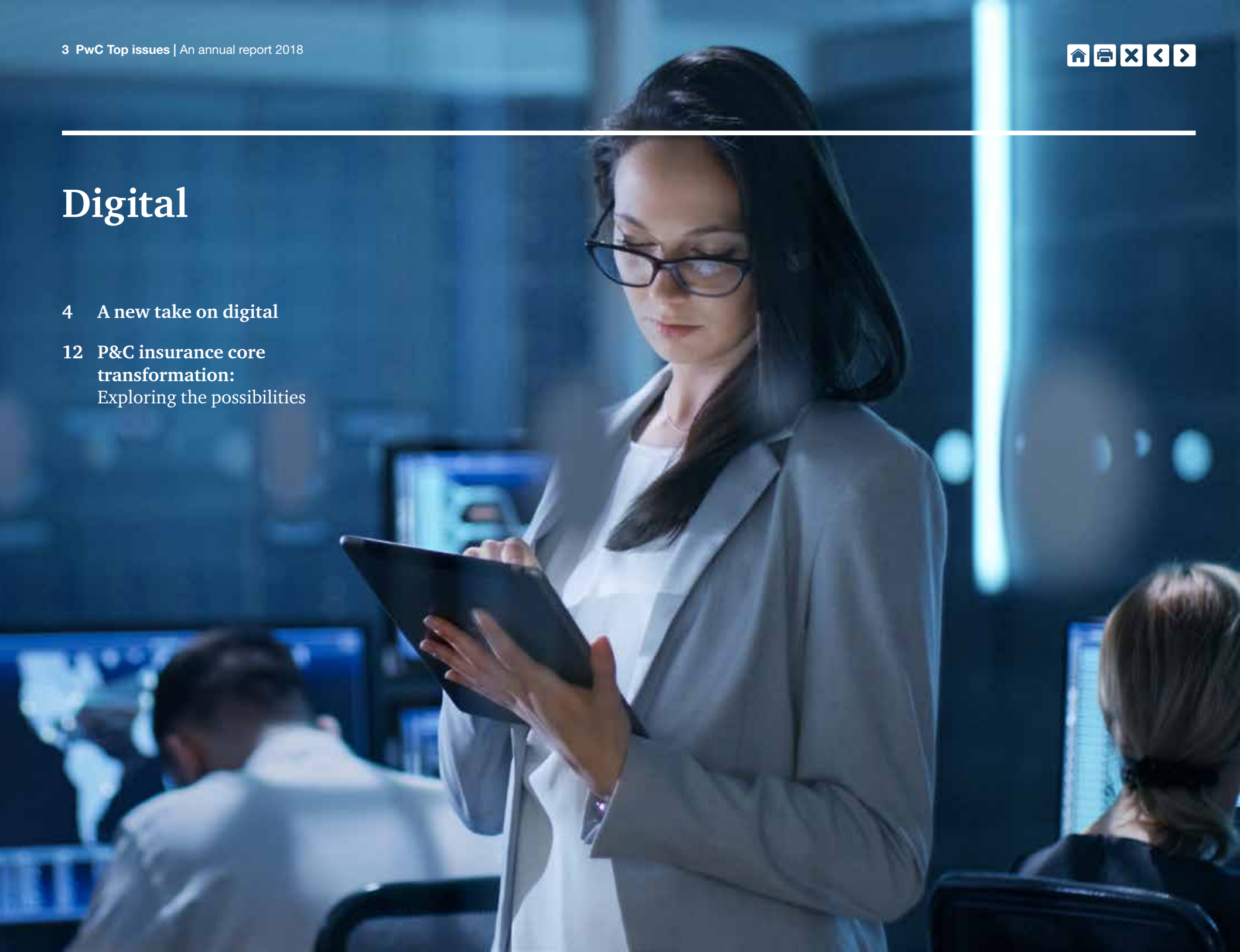

A new take on digital

As consumers, we know that digital has transformed the way we discover, engage and transact with businesses in every industry. From ordering coffee on our mobile devices to running our smart homes on voice-command, we expect all of our experiences to be fast and seamless.

The insurance industry has gone through its own digital transformation over the past five years. With a general acceptance that digital is here to stay, most insurers have incorporated digital into their organizations, implementing ad hoc capabilities to make their business faster and cheaper, creating online tools to further engage their distribution channels, and implementing table stakes technology in areas such as marketing, digital portals, customer self-service capabilities, and automation of some back-end processes.

As we move into 2018, digital is continuing to reshape the way insurers do business. The ecosystem of available capabilities has grown exponentially and industry leaders are starting to leave behind the "fast-follower" mentality, reallocating their investments into core capabilities that give them a more customer-centric view, as well as ways to differentiate themselves in the market.

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From our perspective, insurers will take one of two paths:

1. Continue as followers, investing in only select digital capabilities that support their existing business model. This is a bottom-up, project-driven approach that identifies select digital capabilities within different parts of the value chain.

2. Take a digital-first mindset by better understanding the end-to-end customer experience and how business models need to evolve in order to increase growth and reduce costs. This is a top-down organization transformation with the goal of becoming a digital and data-driven organization which can continuously reassess the business and operating model.

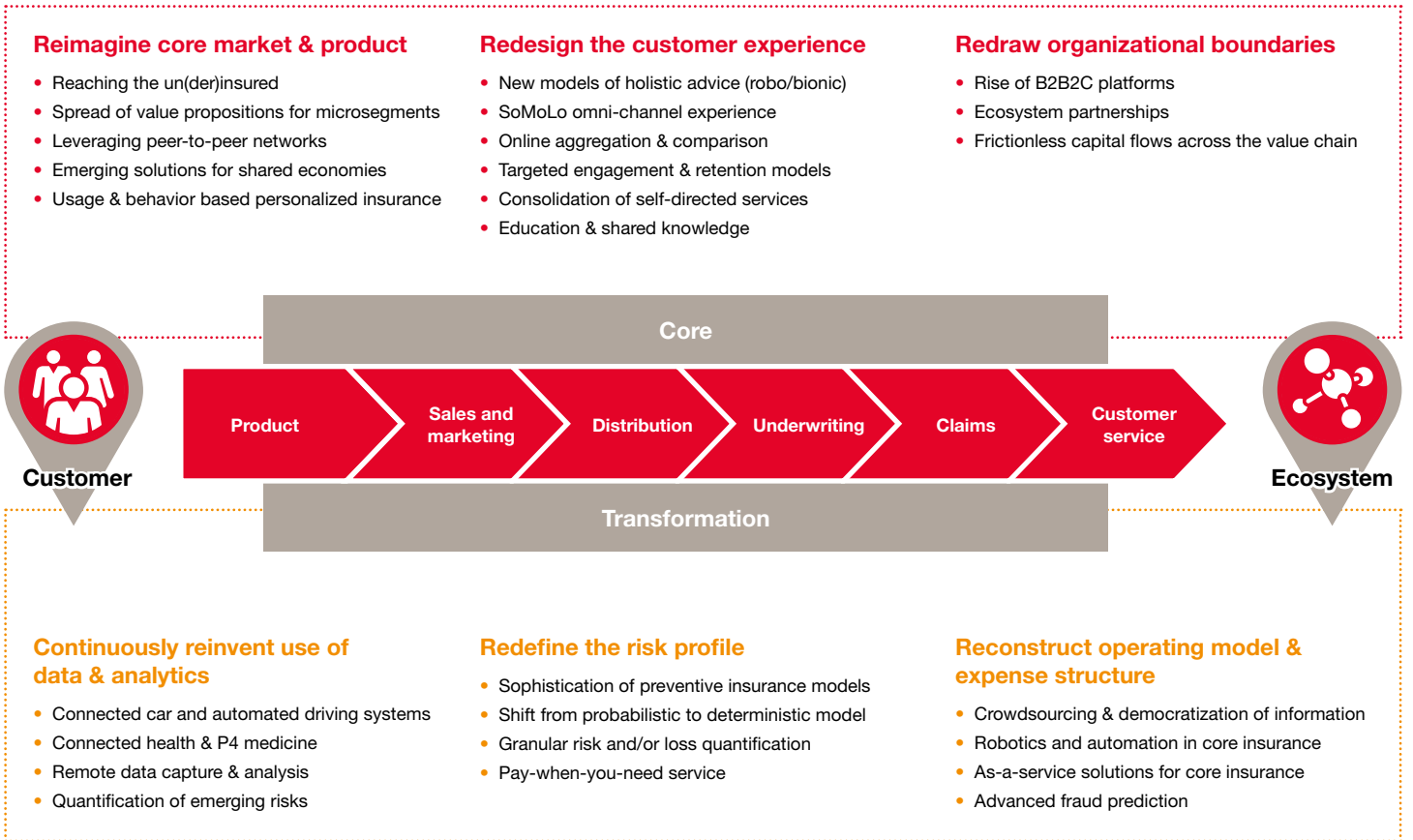
As the graphic opposite illustrates, taking a digital-first approach and synchronizing investments across functions and processes will promote success by enabling a digital strategy that is a "North Star" that guides continuously improvement rather than just a point in time assessment.

The companies that develop a meaningful competitive advantage will design and implement digital platforms that can handle disruption and positively change cost structures. They will:

- Build scalable systems, even for niche offerings,
- Deliver an end-to-end customer experience, and
- Change their business models to foster a test and learn environment that helps them improve how they go to market.

These leaders will be the most likely to quickly adjust and grow as the industry continues to become more digital.

Changing the playing field: The digital agenda



Building a digital platform

Although we tend to understand digital transformation and modernization of technology platforms as sequential, multi-year events with multi-million dollar price tags, finite delivery dates and fixed realization periods, true modernization requires a foundational shift in the organizational culture, operating model, and underlying architecture that enables business flexibility and agility.

Building a digital platform that will take your company into the future – not just respond to current needs – is critical to prolonged success.

Insurers are currently enabling access to data across various domains and dimensions, but the companies going the extra mile to design a futuristic platform architecture are the most likely to benefit in the long term. Future-oriented platform architectures should be able to:

- Enable more granular services,
- Provide flexibility when reacting to traditional demands and responsiveness to disruptive emerging products,
- Support business models and technology needs beyond now standard core platform capabilities (e.g., policy, billing and claims systems).
- Feature consumer-centric architecture built on the core guiding principles of atomic components and services vs. monolithic applications,
- Enable reusability across constituent groups and processes vs. process-centric solutions,
- Assemble best-of-breed technologies, capabilities, and/or service models vs. being just a broker of services.

Enabling your digital platform

Gone are the days of a simple buy/build/rent conversation where companies could seek to house all capabilities within their own walls. Now, everything from InsurTech incubators to white-labelled products are revolutionizing the way insurance is bought and sold. The rise of flexible, digital B2B2C platforms is giving rise to faster, better, and previously unconsidered partnerships across the insurance and retirement spectrum.

Industry leaders are identifying how they can extract value from partnerships in all areas of their organization, whether by providing newer customer engagement models, adding revenue streams, or reducing cost structures, all while building digital ecosystems that can easily integrate with these strategic partners. These partnerships are enabling companies to respond more nimbly to changes in market trends, consumer expectations and nascent technology, creating frictionless capital flows across the value chain.

Better know your customers by serving them better

While many insurers have been actively investing in customer facing digital capabilities for the past several years, the industry as a whole is not yet fully realizing customer and economic value. As insurers continue to respond to constantly evolving customer expectations, a holistic, data-driven approach that drives a detailed understanding of the customer and the contribution of digital initiatives to actual business value will be critical to meaningful ROI.

Developing a detailed understanding of customers and their end-to-end journeys is necessary to improve customer value. Knowing your customers – not just as segments but individuals – will help you pinpoint opportunities and effectively optimize their experience across all channels and throughout their lifetimes. Tying these digital initiatives to measurable business value from the beginning is critical to justifying the case for investment and creating a framework for measuring the effectiveness and impact of various initiatives.

With a strong, flexible framework in place, companies will be able to re-focus time and money into revenue-driving capabilities like external partnerships, invest in data-driven digital capabilities to improve customer value, and build back-end processes to support platform scalability.

Don’t forget about back-end processes

All the recent hype about InsurTech and customer interactions has shifted attention away from digital considerations beyond technology and customer experience. However, leading companies’ back-end processes will support a digital environment. In a rapidly advancing industry, the companies out in front are transforming their processes to automate repetitive, business rule-driven work; this is rapidly reducing costs, improving controls, enhancing quality, enabling scalability, and facilitating effective 24/7 service.

Future profitability and ROI hinge on being extremely responsive to business and market conditions and making business processes digital. The market leaders of the future will have fully digitally enabled operating models that feature a low cost profile, increase automation and efficiencies, offer an easy end-user experience. All of this will help them accelerate innovation and invent the future of insurance instead of just reacting to it.

Where we're headed

The world of insurance has already become digital. Whether you are a personal lines insurer assessing digital sales and service platforms or a life insurer trying to understand interactions with your end consumers, most of the industry has adopted digital agendas and many companies are is seriously trying to become digital-first organizations. Current frontrunners are redirecting their roadmaps and investments to high-priority business areas differentiate them in the market.

Over the next five to ten years, all insurers will be able to take advantage of a broader ecosystem of available tools, leveraging test and learn capabilities that promote innovate in an industry that has not been reinvented for quite some time. Anyone still waiting on the sidelines is in jeopardy of falling so far behind recovery will be extremely difficult. Don't blink and miss your chance.

Most of the insurance industry has adopted digital agendas and many companies are seriously trying to become digital-first organizations. If you aren't doing the latter, you risk falling behind; if you haven't done the former, you may never catch up.

Implications

- Industry leaders are starting to leave behind the "follower" mentality, reallocating their investments into core capabilities that give them a more customer-centric view, as well as ways to differentiate themselves in the market. Whether you are a "fast-follower" (as opposed to just a follower) or a market innovator, you are likely to share essentially the same approach to establishing an agile organization.
- The companies that develop a meaningful competitive advantage will design and implement digital platforms that can handle disruption. They will build scalable systems, deliver an end-to-end customer experience, and change their business models to foster a test and learn environment that helps them improve how they go to market. These leaders will be the most likely to quickly adjust and grow as the industry continues to become more digital.
- With a strong, flexible framework in place, companies will be able to re-focus time and money into revenue-driving capabilities like external partnerships, invest in data-driven digital capabilities to improve customer value, and build back-end processes to support platform scalability.

P&C insurance core transformation: Exploring the possibilities

The insurance industry continues to invest heavily in transforming their legacy policy, billing and claims applications. But are carriers actually realizing what was promised to the business? Core transformation can be so much more than a legacy technology replacement.

In our experience, many projects fail to fully realize their potential benefits due to three common oversights:

- Digitization without differentiation – Projects that simply upgrade their core systems but fail to change the customer engagement.
- Limited focus on information data – Too much focus on transactional data elements and not utilizing a comprehensive informational data approach.
- Failure to foster innovation – Modernizing applications but failing to leverage these tools to support continuous improvement and innovation.

In fact, 67% of insurance respondents to PwC's 2017 CEO survey see digitalization and innovation as very important to their organizations. Specific to the insurance industry, CEOs noted that the area they would most like to strengthen in order to capitalize on growth opportunities is digital and technological capabilities, followed by customer experience (reflecting the interconnectedness of the two).

Insurers are looking for more than just modernization of core systems. They expect a successful digital, analytics, and organizational transformation that can enable them to unlock the full potential of a core transformation has provided to them.

Carriers should be asking themselves the following questions to determine if they're achieving the full benefits of expanding beyond core. Is the organization

- Leveraging the new platform to change the customer engagement model?
- Leveraging analytics-based insights with a clear vision and plan to translate that into value based capabilities?
- Promoting ongoing innovation – both internally and to customers?

Key opportunities beyond core

Regardless of where you are on your core transformation journey, there are several opportunities that you can leverage to unlock the full potential of your transformation.

- **Digital differentiation:** Putting the customer at the center of the business is a driving success factor for any core transformation effort. With the maturation of customer portals and digital platforms, insurers can now focus on customizing the digital layer while retaining the back-end core systems as out of the box as possible.
- **Data and analytics:** As the volume of data has grown, insurers have implemented new big data technologies and reporting structures. The challenge remains to translate data into insight, and we have seen an emerging trend of establishing a chief digital officer and corresponding analytics business units that can span across the various data silos and business units.
- **Innovation:** Within the context of innovation, a significant majority of carriers dedicate one to five percent of their IT budgets to research and development (R&D). We believe carriers should pursue to two-pronged approach to innovation that leverages both internally generated innovation as well as strategic partnering with emerging InsurTech companies.
- **InsurTech:** Carriers should think beyond their internal businesses to identify and collaborate with an increasingly robust InsurTech community of start-ups. This will allow carriers to implement innovative technologies through a combination of partnering strategies.

Digital differentiation

We have seen a significant maturation of portal and digital platform offerings in the market in the past two years. This shifts the balance for carriers who now have the ability to leverage commercially available offerings that previously required custom builds in-house or through extension of the core policy, billing, and claims products.

What this means for carriers is that digital strategy can now complement the core transformation journey. Carriers are now pursuing a "digital first" strategy that places the customer value proposition first when prioritizing project work. In this model, the core application's UI / UX is kept nearly out of the box, with the focus of UI / UX customization performed on the digital layer.

We believe this approach results in the best of both worlds, resulting in a highly conforming set of core systems and a carrier-unique digital experience delivered through the custom digital layer. To achieve these goals, projects should:

- Leverage commercially available digital products as the foundation for your digital layer;
- Implement APIs between the back-end core applications and the digital layer;
- Leverage the enterprise digital layer for all external-facing interactions, including intermediaries and customers.

Insurers are placing greater emphasis on their digital offerings as a key customer differentiator, shifting customization from the core applications to the digital layer.

Data & analytics

Big data implementations have hit a critical mass, with nearly all carriers either pursuing a data lake-style implementation or planning one. Carriers who have implemented big data implementations have benefited from faster enterprise-level deployments, but at a cost of re-training the data and analytics business units. In some cases, these projects have shifted the reporting development to the respective business units, which must up-skill to support this previously IT-led work.

We have also observed a growing trend of the Chief Digital Officer (CDO) and the creation of a specific analytics business unit within organizations. This reflects the belief that data is now longer the domain of individual siloed business units, and carriers must now use data cross-business to achieve true customer insights.

Finally, carriers are now looking at new monetization opportunities as a result of their data stewardship. For example, one international carrier is now investigating how to monetize their supply chain data for automobile repair networks. Other possibilities include data provider relationships with original equipment manufacturers and even competitors who may use the carrier's repair cost history to better price risks in the local market.

Trends in data and analytics include the introduction of new Big Data tools and techniques, new business units to leverage data across the enterprise and a renewed focus on monetization of insurer's data.

Innovation

We make a distinction between "invention," which represents the creation of a new capability versus "innovation," which is the application of that invention to the marketplace. For insurers, invention is rare and generally coincides with a change to both the technology and regulatory landscape (e.g., credit scoring).

Insurers should focus on innovation and how to leverage emerging technologies and evolving customer expectations into your business. Insurers who lead in innovation exhibit the following traits:

- A mechanism to capture innovative ideas across the enterprise (e.g. innovation workshops, targeted interviews from front-line employees, etc.);
- A project funding and prioritization structure that links new ideas to internal capital budgeting and executive priorities;
- A willingness to fail early and often. For example, Google X (Google's innovation arm) incentivizes employees to end a project early if it makes sense to do so.

The good news is an emerging InsurTech ecosystem is growing, which allows insurers access to a pool of experimental projects and partners. Insurers should look to implement a two-pronged innovation model that includes internally-derived innovation as well as a partnership model with leading InsurTech vendors.

Insurers should implement a two-pronged innovation model that includes processes and budgeting for internally-derived innovation, as well as an engagement model with leading InsurTech vendors

InsurTech

The exponential growth of InsurTech funding and new company formation reflects the belief that the insurance space is ready for fundamental transformation. Because the InsurTech ecosystem is still evolving, it will remain unclear who will ultimately become leaders within the space. As a result, insurers should look to a combination of partnering models to hedge against an uncertain future.

Some models we have observed include:

- **Joint venture –** In this model, the insurer and InsurTech company form an exclusive joint venture. The insurer provides seed capital and is able to influence the InsurTech more greatly than in other models.
- **Strategic partnership –** In this model, we see the insurer take a leadership role in partnering with the InsurTech, usually at favorable economic terms with the goal of growing the partnership over a longer period of time.
- **Acquisition –** In this model, the insurer makes a strategic acquisition. This is a less common model due to the capital required and concern a merger may have on the acquired company
- **Service provider –** In this model, the InsurTech is considered a provider and works on a pre-defined contract term. This model may be pursued for smaller proofs-of-concept or for new products the insurer is experimenting with

Regardless of the partnering model, we have seen both life and P&C carriers successfully work with emerging InsurTech companies to roll out new and innovative products and features. In the life space, the use of health tracker-style devices, apps and policy discounts have helped transition insurers to a proactive health monitoring and lifestyle advisor.

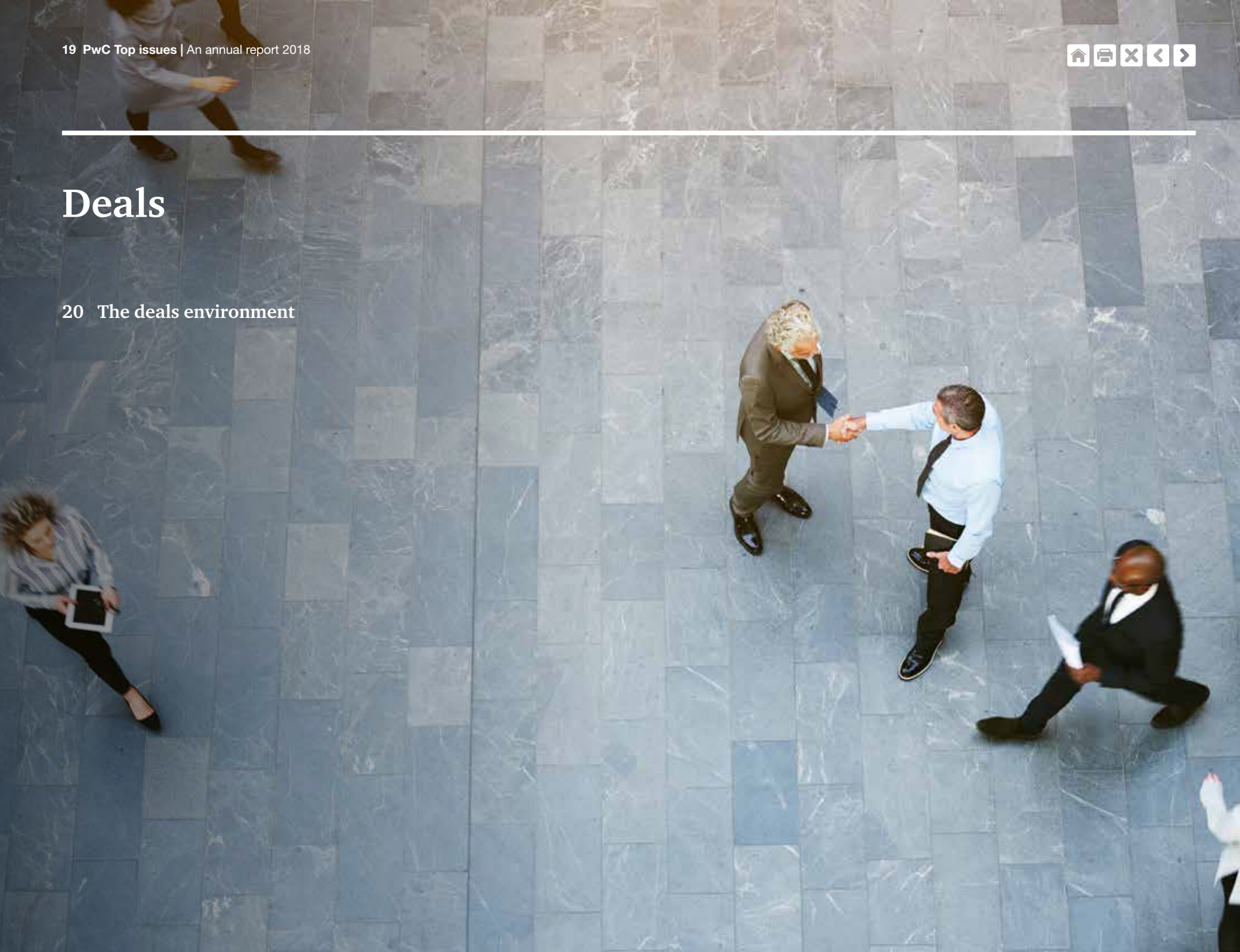
Insurers should look to leverage InsurTech opportunities to continue broaden their customer value proposition, both through increased customer touch points and proactive risk management features.

Implications

- Digital experiences, not the back-end core application, are the true customer differentiator. As a result, insurers should look to establish a customizable digital platform that interacts with a nearly out of the box set of back-end core applications.
- Data and analytics will both increase in volume and frequency, requiring carriers to look across individual business units and data silos to form truly actionable customer insights.
- Innovation will originate internally within the company, but also from an emerging InsurTech ecosystem of companies.
- InsurTech is still evolving and picking winners will be difficult. Insurers should look to a combination of partnering models to ensure the best trade-off of engagement and risk.

Deals

20 The deals environment



The deals environment

The US insurance market in 2017 realized substantial losses from a costly hurricane and wildfire season, saw a glimmer of hope in rising interest rates, and ended the year with the news of a transformative tax reform. These events did not slow the pace of deal activity, and should encourage more transactions in 2018. Emerging trends such as the growth of PE as a player in US insurance and the viability of InsurTech startups should also continue into the new year.

US insurance sector announced deal value reached $9.0 billion in the second half of 2017, as compared to $24.2 billion in the second half of 2016. Activity remains robust in the brokerage sector with 232 announced deals which was three percent higher than the same period in 2016. Among insurers, megadeals have been impacted by uncertainty in terms of the direction of tax and regulatory reforms. Nevertheless, the passing of tax reform at the end of 2017 and postponement of the implementation of the Department of Labor's fiduciary rule until 2019 will likely improve clarity for deal making in 2018.

Trends & highlights

- Insurers are expected to continue to divest capital-intensive or underperforming businesses. Private equity will no doubt continue to pursue US insurance sector assets, which are now more attractive due to a lower corporate tax rate.
- 271 insurance deals were announced for a disclosed $9.0 billion deal value in 2H 2017 (of which 248 deals with undisclosed deal values).
- Insurance broker deals remained the most active, comprising 86 percent of deal volume.
- For insurance underwriter deals, the life and property & casualty sectors each contributed over $4 billion in disclosed deal value while property & casualty led in deal volume.

Insurance sector value by the numbers

$9.0B

63%

Decrease in deal value versus 2H 2016

15%

Decrease in deal value versus 1H 2017

Insurance sector volume by the numbers

271

4%

Increase in deal volume versus 2H 2016

8%

Decrease in deal volume versus 1H 2017

Source: S&P Global Market Intelligence

Robust deal activity in the second half of 2017

There were four announced deals valued in excess of $1 billion, for a total of $6.1 billion, in the second half of 2017.

Month Announced	Target Name	Acquirer Name	Sector	Value ($ in Mn)	% of Total
March	USI Insurance Services*	KKR & Co. and Caisse de Depot et Placement du Quebec	Broker	$4,300	22.1%
November	The Warranty Group, Inc.	Assurant	P&C	$1,906	9.8%
May	Fidelity & Guaranty Life	CF Corporation	Life & Health	$1,842	9.5%
May	OneBeacon Insurance Group, Ltd.	Intact Bermuda Holdings Ltd.	P&C	$1,732	8.9%
December	Hartford Life, Inc.	Investor Group	Life & Health	$1,607	8.3%
October	Aetna's U.S. group life and disability business	Hartford Financial Services Group, Inc.	Life & Health	$1,450	7.4%
December	Voya's closed block variable and fixed annuity business	Investor Group	Life & Health	$1,100	5.6%
November	AmTrust's U.S. fee businesses	Madison Dearborn Partners, LLC	P&C	$950	4.9%
July	State National Companies, Inc.	Markel Corporation	P&C	$923	4.7%
May	OneDigital Health and Benefits	Investor Group	Multiline	$560	2.9%
			Top 10 deal value	**$16,370**	**84.1%**
			Total disclosed deal value	**$19,476**	

Source: S&P Global Market Intelligence, Excludes Managed Care; *Includes USI/ KKR deal which do not meet screening criteria

Key transactions and themes

The Hartford agreed to two major deals in the last quarter of 2017 including an acquisition and divestiture:

- Hartford Financial Services Group Inc. unit Hartford Life and Accident Insurance Co. agreed to acquire Aetna's U.S. group life and disability business for $1.45 billion.
- An investor group, including Pine Brook Partners, LLC, TRB Advisors LP, Atlas Merchant Capital LLC, Cornell Capital LLC, Basel, J. Safra Sarasin Holding AG and Hamilton, Global Atlantic Financial Group and Hopmeadow Holdings GP LLC, agreed to acquire Talcott Resolution, a run-off life and annuity business, from Hartford Financial Services Group Inc. for $1.6 billion.

Private equity consortiums are exhibiting interest in runoff variable annuity platforms as insurers focus on new risks:

- In December, an investor group, including Apollo Global Management LLC, Reverence Capital Partners LP, Crestview Advisors LLC and Pembroke, Bermuda- based Athene Holding Ltd., agreed to acquire the closed block variable annuity and fixed annuities businesses from New York-based Voya Financial Inc. for $1.1 billion.

The other notable deal announced in 2H 2017 over $1 billion in deal value was:

- Assurant Inc.'s November agreement to acquire The Warranty Group Inc. from TPG Capital Management LP for $1.9 billion. The Warranty Group provides underwriting, claims administration, and marketing expertise to manufacturers, distributors, and retailers of consumer goods including automobiles, homes, consumer appliances, electronics, and furniture, as well as specialty insurance products and services for financial institutions.

Top 10 US Insurance and Bermuda Deals Announced in 2017 (by value)*

Month Announced	Target Name	Acquirer Name	Sector	Value ($ in Mn)	% of Total
March	USI Insurance Services*	KKR & Co. and Caisse de Depot et Placement du Quebec	Broker	$4,300	22.1%
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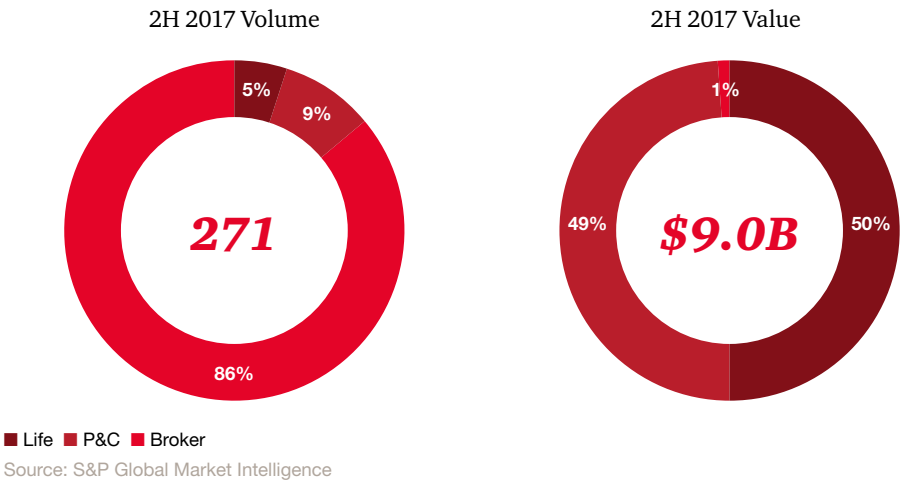
Sub-sector highlights and outlook

- **Life and Annuity –** This sector has been suffering through the persistent low interest rate environment that has weighed on insurers' investment portfolios. Nevertheless, the US Federal Reserve raised the fed funds rate three times in 2017 and there are current expectations of additional hikes in 2018. Opportunities remain for insurers to exit capital-intensive or non-core businesses, with ongoing investor interest in closed blocks and narrow concentrations. In a recent deal, an Apollo-led investor group purchased the closed block variable annuity and fixed annuity businesses of Voya Financial for $1.1 billion. Also, The Hartford agreed to sell its runoff life and annuity business, Talcott Resolution, for $1.6 billion to an investor group led by Cornell Capital LLC, Atlas Merchant Capital LLC, TRB Advisors LP, Global Atlantic Financial Group, Pine Brook and J. Safra Group.
- **Property & Casualty –** Deal activity increased in the sector during the second half of 2017. In addition to traditional M&A, the P&C sector has seen mega insurance legacy transfer transactions, headlined by AIG's $9.8Bn reinsurance, excluding interest, with National Indemnity to take on long-term risks from legacy commercial policies announced in January 2017.
- **Insurance Brokers –** The segment continued to be the most active in terms of deal volume in 2H 2017. The most activity came from several serial acquirers buying regional brokers, further consolidating the market. The five most active acquirers were Acrisure, Hub International, National Senior Insurance, Alera Group, and NFP.

Sub-sector deals by volume and value



Source: S&P Global Market Intelligence

Conclusion & Outlook

Deals in the second half of 2017 ended on a strong note and activity should see further acceleration in 2018 as insurers continue to focus on cutting costs, achieving scale, and enhancing and streamlining or consolidating dated technologies.

- **Macroeconomic environment:** The economic environment improved in the second half of 2017, although persistently low interest rates and geopolitical uncertainty continue to constrain insurers' revenues and profitability. Life insurers have used both divestitures and acquisitions to manage the low-return environment and transform business models.
- **Regulatory environment:** Increased oversight and uncertainty have heavily influenced insurers' business models and strategies, forcing many to exit businesses, often through divestiture. The current presidential administration favors easing regulation, and the US Department of Labor Fiduciary Rule enforcement has been delayed until July 2019, which may mitigate near-term implications for insurers that use exclusive agents.
- **Tax Reform:** The passage of the Tax Cuts and Jobs Act is expected to be a mixed bag for insurers. Changes to the corporate tax rate, special insurance company provisions, and the switch to a territorial system with anti-base erosion provisions significantly impact insurance companies (including reinsurers), both US-based and companies based elsewhere that do business in the US. For some companies, life insurance products and taxation of international transactions changes are costly and outweigh the benefit of reduced tax rates. For other companies (e.g., issuers of short-tail products), changes in the computation of taxable income are more modest. In addition, companies that were chronically subject to AMT under current law may now look forward to an eventual refund of minimum tax credits. The companies that stand to gain the most from reduced tax rates would be US-based multinational companies. See Tax reform insurance alert and Tax reform impact private equity for additional discussion on the impacts from the Tax Cuts and Jobs Act.
- **Technology:** Insurers have been slower than many other industries to adopt new technologies, but they are increasing investment in technology and innovative platforms. According to CB Insights and Willis Towers Watson, InsurTech funding volume increased 38% year over year in 3Q 2017. In a headline grabbing deal, InsurTech start-up Lemonade raised $120 million series C funding round led by SoftBank.
- **Canada interest:** Closer to home, there is evidence of an increasing appetite from Canadian buyers. In the second half of 2017, there were three announced deals in which the acquiring company was Canada-based. The largest deal was Quebec-based Industrial Alliance Insurance agreeing to acquire Columbus, Ohio-based Dealers Assurance Co. and Albuquerque, N.M.-based Southwest Reinsurance Inc. for $135 million. Also, Toronto-based Intact Financial Corp. completed its acquisition of Bermuda-based OneBeacon Insurance Group Ltd. from Hanover, NH-based White Mountains Insurance Group Ltd. for $1.7 billion.
- **Public offerings:** Several major global insurers have responded to the low-growth environment in the US with significant divestitures or restructuring. MetLife successfully completed the spinoff its US retail business, Brighthouse Financial, in August. AXA has also filed preliminary documents for an IPO of its US operations this past November. It seems likely that other large insurance companies will have similar divestiture or restructuring plans.
- **Asian inbound interest:** The past several years have seen Asian firms expand their global footprint in the US insurance market. While Asian investors maintain a global appetite, regulatory and shareholder skepticism remains a hurdle. A bid by Anbang to acquire Fidelity and Guaranty fell through in April. China Oceanwide's acquisition of Genworth has yet to close and is still under CFIUS review.

Fit for Growth

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Are your strategy and structure fit for purpose?

As we've noted previously,[1] balancing growth and profitability is no easy trick as major changes unsettle an industry that has been used to gradual change. "Business as usual" approaches are faltering in the face of generational shifts in customer needs, rising capital requirements, new regulatory burdens, low interest rates, disruptive technology, and new competitors. Many companies aren't getting the results they need from textbook moves, such as fine-tuning marketing programs, updating products, enhancing customer service systems, and beefing up information technology systems.

Strategic success now requires a structural response, and companies can't adapt to current conditions without modernizing often antiquated structures. Before attempting to implement new strategies, companies need to re-evaluate operating model dimensions such as capital deployment, organizational design, tax positioning, and governance.

In a changing insurance industry, strategic execution often requires a new structure.

We recognize this is easier said than done. Structural impediments take many forms. Some companies lack scale to generate profitable growth under new capital requirements. Others with siloed, hierarchical organizations lack the flexibility to respond quickly to market shifts. Poor technological capabilities often hamstring old-line insurers facing newer, more digitally-oriented rivals. And tax reform looms as a potential threat to profitability in certain business lines.

We've seen three common industry responses to these pressures:

- Anticipation of the effects of marketplace trends and make appropriate structural adjustments, clearing the way to profitable growth. For example, life insurer Metlife avoided costly regulatory mandates by selling registered broker distribution to MassMutual and spinning off its Brighthouse retail operations. Other companies, including Manulife and SunLife, have made substantive acquisitions to consolidate scale positions.
- Recognition of the need for structural change, but have yet to carry it out. Some companies have plans in the works, or are debating their merits, opportunistically waiting for the right deal to come along.
- Hunkering down behind existing structures, making only minor tweaks, and hoping to emerge from the storm without too much damage. For some this is rational because they are constrained. For other companies with more viable options, company culture may be removing certain options from consideration too quickly.

Companies in the first two groups are giving themselves a chance to compete and ideally prosper. But the third group is not making strategy equal structure.

1 Please see last year's Fit for Growth insurance survey report and 2016 Top Insurance Industry Issues.

A time for structural change

Most insurers work diligently to improve their businesses across several dimensions. They seek more insight into consumer needs and behaviors, nurture unique capabilities to differentiate themselves from competitors, modernize products and distribution strategies, and embrace digitization. These are all sound approaches, but are inadequate to address the uncertainties facing insurers today. The familiar "good to great" rallying cry assumes a certain stability in underlying economic and market conditions that hasn't been the case since the financial collapse of nearly a decade ago.

The crash and its aftermath undermined pillars of many insurance business models. We've seen years' worth of modest industry growth – just over three percent for P&C companies, and barely over one percent for life insurance companies.

This long stretch of sluggish global growth has pressured revenues and forced insurers to compete harder on price. Persistent near-zero interest rates are squeezing profit margins, especially in life insurance. Moreover, tougher accounting rules are driving up costs while heavier capital requirements weigh down balance sheets and dilute returns. Compounding these challenges are potentially destabilizing effects of recent US tax legislation on earnings and growth. Taxes may rise for some insurers, an unexpected outcome that could force them to raise prices or find other ways to protect shareholder returns. Substantive impacts may result from falling corporate tax rates, offset by the limiting of deductions for affiliate premiums, limits to the deductibility of life reserves, accelerated earnings recognition and a slowing-down of deferred acquisition cost deductions.

Competitive dynamics also are shifting as expanding "pure play" asset managers such as Vanguard and Fidelity block growth avenues for insurers. Other companies and some new entrants are innovating and experimenting with strategies to disrupt distribution. Still others, including private equity firms, are looking at ways to change the cost-curve through aggressive acquisition and sourcing strategies

To be sure, some long-term trends could benefit selected insurers or at very least shift the risks. Longer life spans and the shift of responsibility for retirement funding to individuals may drive demand for annuities and other retirement products.

Many companies are as unprepared to capitalize on new opportunities as they are to meet long-term challenges.

However, many companies are as unprepared to capitalize on these opportunities as they are to meet long-term challenges. Often the problem comes down to scale. Some insurers lack the resources to build new distribution platforms and customer service capabilities in growing markets like group insurance, ancillary benefits and retirement plans. While markets for individual products may be easier for new entrants, establishing expensive platforms for asset management, retirement, and group are more difficult – driving a desire for scale and putting more pressure on sub-scale competitors.

Sometimes the issue isn't scale but a failure to respond quickly enough as conditions change. Buying habits are changing, notably through online channels (though our research indicates that for bigger and more complex transactions, most people still want help of some sort of "human" interaction before actually buying). It takes investment and experimentation for companies to try and then refine new models. Some companies haven't built needed assets and capabilities or adjusted to evolving distribution patterns and consumer buying habits.

The ideal response to each challenge and opportunity will vary for each company, depending on its unique characteristics and circumstances. Few companies have the scale to fix all of their problems on their own. In virtually every case, the right solution will involve structural change.

Structural change drives strategic execution

The link between strategy and structure has become apparent to many management teams, particularly in life insurance. Major life insurers are taking dramatic steps to add scale, open new distribution channels, augment capabilities, drive down costs and rev up growth and, where regulation is burdensome or profit-prospects dim, exit geographies and business-lines. Recent transactions in the sector show the range of structural options to advance strategic goals in a changing marketplace.

As companies recognize that traditional approaches to annual planning, project funding approvals, and technology architecture may be getting in the way of innovation and their ability to respond to changing market conditions in real time, they are rethinking and redesigning core processes to help the company change.

Traditional approaches may be getting in the way of innovation and the ability to respond to changing market conditions in real time.

Sometimes, the best choice is to move out of harm's way. Companies can preserve margins by exiting businesses targeted for higher capital requirements or costly new accounting standards. For example, Metlife's 2017 Brighthouse spinoff bolstered its case for relief from designation as a SIFI (systematically important financial institution) and associated capital requirements. Exiting US retail life insurance markets also enabled Metlife to focus on faster-growing businesses that are less vulnerable to rock-bottom interest rates. As another example, The Hartford recently announced the sale of Talcott Resolution to a group of investors, completing its exit from the life and annuity business.

When scale is an issue, the solution may lie outside the company or in new structural approaches:

- Some insurers form partnerships to expand distribution, diversify product portfolios or bolster capabilities. Companies also adjust their scale and capital structures through mergers, acquisitions and divestitures. Sun Life paid nearly $1 billion in 2016 for Assurant's employee benefits business, filling gaps in its product portfolio and gaining scale to compete with larger rivals. MassMutual's purchase of MetLife's broker/dealer network in 2016 enlarged the MassMutual brokerage force by 70%, and freed Metlife to pursue new distribution channels.
- New product lines offer another path to faster growth or fatter profit margins. Several insurers have moved into expanding markets with lower capital requirements, such as asset management. Voya, Sun Life, and Mass Mutual have acquired or established third-party asset management units to capitalize on investment expertise they developed managing internal portfolios.
- The Hartford recently announced an agreement to acquire Aetna's U.S. group life and disability business, deepening and enhancing its group benefits distribution capabilities and accelerating the company's digital technology plans.
- We also see companies establishing technology-focused subsidiaries, like Reinsurance Group of America's (RGA) RGAx and AIG's Blackboard.

Still other companies have moved aggressively to improve their cost structures:

- Insurers seeking greater financial flexibility have divested assets that require significant capital reserves.
- An insurer that offloads its own defined-benefit plan to another via pension risk transfer (PRT) frees up capital and eliminates ongoing pension funding requirements. Other cost-saving moves focus on workforce expenses. In addition to reducing staff, such measures include relocating workers to low-cost areas or jurisdictions offering significant tax incentives.

Structural change requires cultural change (or vice-versa)

Companies that launch ambitious structural initiatives may under-appreciate the role of culture in making new structures work. Culture is a set of norms, mindsets and behaviors that have developed around existing organizational structures. The two are tightly linked, and one can't change without the other changing, too. Structural change will force changes to operating models and cultural change may be necessary to drive it.

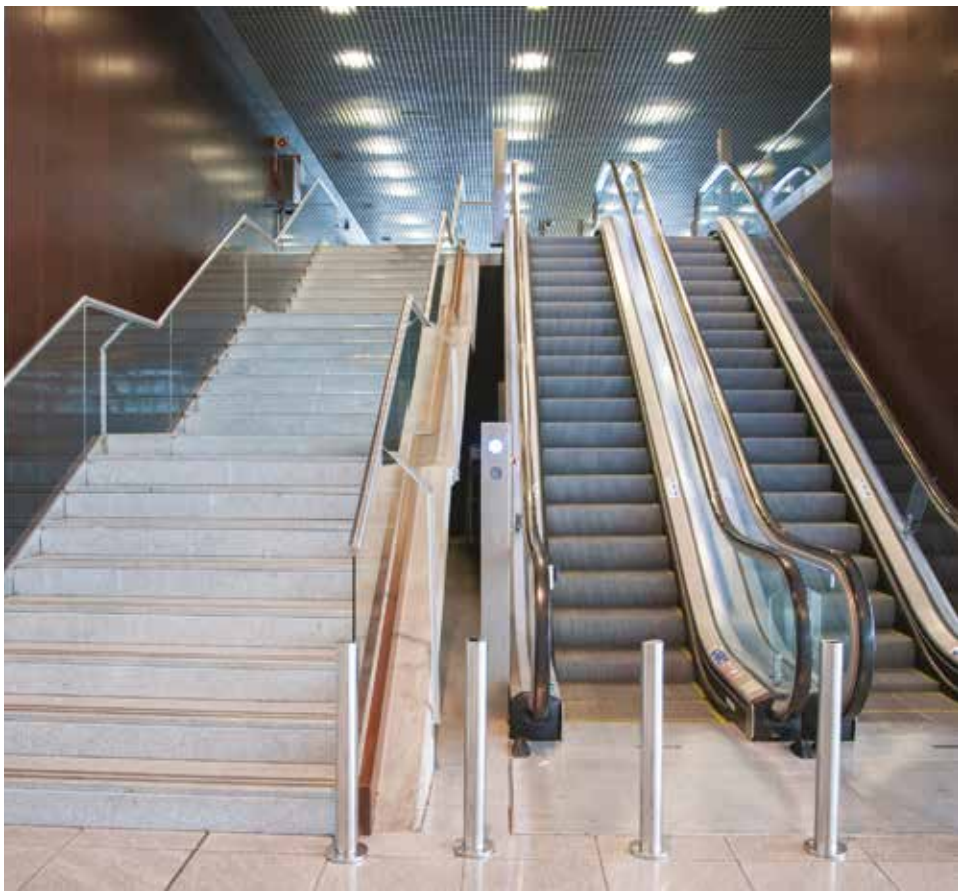
A new structure without corresponding changes in culture amounts to little more than a redesigned table of organization. Culture makes or breaks the new structure, influencing everything from resource allocation to governance and even profit formulas. It's not uncommon for a company to expend tremendous effort and resources on a complete structural overhaul, only to see incompatible cultural norms thwart strategic execution. For example, a new, streamlined operating model intended to accelerate decision-making and foster cross-functional collaboration won't take root in a culture that exalts hierarchy and encourages employees to focus on narrow functional priorities.

A new structure without corresponding changes in culture amounts to little more than a redesigned table of organization.

Culture also influences a company's willingness to make the deep structural changes in time to avert a crisis. Those who wait until changing market conditions have undermined their operating models put themselves at a disadvantage. Nevertheless, few companies attempt structural change in "peacetime."

Absent a crisis, directors usually provide guidance and perspective and monitor indicators such as growth and profitability, while management takes responsibility for achieving specific strategic objectives. Successful companies, by contrast, continually reassess their structures in light of evolving market conditions. They understand that organizational structures aren't permanent fixtures, but strategic choices they need to reconsider as circumstances and objectives change.

Implications: Is your culture ready for structural change?



Amid the constant drumbeat of change in today's insurance industry, successful companies are meeting structural challenges with structural solutions. Approaches vary from company to company. Some add scale or enhance capabilities, while others streamline cost structures or exit lagging business lines. With the right cultural support, these structural responses position a company to capitalize on industry changes that confound competitors.

Based on our experience, companies that adjust their structures ahead of a crisis exhibit three distinctive cultural traits:

- Directors track management's allocation of resources against key strategic priorities.
- Directors and managers make clear to everyone throughout the company that "the truth" is not only welcome, but expected.
- Directors make sure the company's talent, capabilities and know-how align with its goals.

Complacent organizations that don't make structural changes until a crisis hits also have three distinguishing characteristics:

- They over-emphasize "cascaded objectives" that often conflict.
- They rely excessively on "can-do spirit" as a plan of action.
- They exhibit unwarranted confidence in their own prescience and planning capabilities.

Which scenario typifies your organization? Are you confident your structure and culture are fit for purpose?

Financial challenges are clear but financial wellness is elusive

In recent years, insurers have understood that many Americans face real financial challenges – whether saving for retirement or making ends meet on a monthly basis. Yet, in spite of this, no single company has differentiated itself in serving customer needs. Many companies that have a stated goal of improving financial wellness have focused instead on improving financial literacy.

As a result, they haven't seen as many improved outcomes as they'd hoped. Others, who have tried to take the positive step of removing customer barriers to action, have found that their efforts sometimes lead to unintended consequences (e.g., auto enroll and auto increase leading to increased hardship loans because of inattention to underlying cash management issues). In addition, those competing for share of wallet in the financial wellness space have traditionally taken an "inside-out" view, highlighting their own product features but leaving customers to sort out which types of products they can piece together to meet their varied needs.

Moreover, many traditional financial wealth advisors have focused on the narrow, super-affluent customer segment, whereas a broad swath of customers who desire advice and guidance remain effectively un(der) served. According to a 2017 PwC Financial Wellness survey, 53% of respondents who are currently employed felt stress dealing with their personal financial situation, and 46% of respondents indicating that financial stress was their primary stressor.[1]

A broad swath of customers who desire financial advice and guidance remain effectively unserved. Traditional advisor approaches have focused primarily on a small segment of the market at the expense of a greater portion of it.[1]

As of now, recent advances in technology and analytics, including in robo-assisted advice (made possible by artificial intelligence and advanced analytics), are dramatically reducing the cost of providing financial advisory services, creating a sizable market opportunity as competitors can develop sustainable business models to target a much wider range of customers. At the same time, advances in digital experiences available to consumers have started to heighten customer expectations about the transparency, accessibility, and personalization of financial advisory solutions for anyone serving this space, including insurers. Finally, technology advances and transformative portal and services architectures are paving the way for platform economies that allow connectivity across multiple providers.

1 PwC Special Report: Financial Stress and the Bottom Line, September 2017, p. 3.

Delivering integrated financial wellness solutions

In order to win these customers, insurers must understand what customers want, rather than focus simply on what their own products can do. In the short-term, this means addressing the need most customers have to maximize their monthly budgets. In the longer term, customers want to prepare for retirement, potential emergencies, health care needs, college expenses, and transferring wealth to younger generations.

In order to win customers who seek financial wellness solutions, insurers must understand what these customers want, rather than focus simply on what their own products can do.

While customer needs may seem simple and straightforward, providing advice about them is anything but, given the complex and changing economic and financial conditions facing younger workers in particular. On average, Millennials are saddled with almost 300% more student debt than their parents, and are earning 2.9% in average annual returns on 401(k) plans, compared to 6.3% returns for Baby Boomers. Many younger workers will need to work longer; in fact, federal data suggests that the average Millennial will need to work until age 75.[2]

Helping customers understand and manage their financial wellness suggests a need for a broad solution centered on them (not a basket of off-the-shelf products). This includes:

- Personalized financial information accessible via a digital platform that takes into account personal circumstances and changing lifetime needs,
- Access to an advisor/coach/counselor who offers tailored guidance, actionable solutions, and answers to specific questions on a range of topics (e.g., health, wellness, finances, insurance benefits, legal services), as well as
- Access to a wide range of customizable financial products and solutions (e.g., 401K/403B accounts, life insurance, auto/home insurance, and college saving plans).

2 Millennials' troubling financial future, by the numbers, AXIOS, December 17, 2017, https://www.axios.com/millennials-troubling-financial-future-by-the-numbers-2518149166.html.

Competing with others for integrated financial wellness

While retail banks, wealth managers, and financial planners are typically viewed as being the best equipped to help individuals achieve their financial goals, many of them have focused primarily on helping wealthy customers accelerate their wealth accumulation and secure access to credit, rather than the protection aspects of wellness. More recently, they have started to consider the implications of a broader definition of financial wellness; in contrast, employers have been concerned about their employees' holistic financial wellness and how it affects their productivity for years.

Millennials are expected to make up 50% of the workforce by 2020 and 75% by 2025,[3] and the extent of their financial stress is particularly concerning for employers. An alarming 47% of those who feel financial stress say that they're either missing work occasionally or their productivity at work has been impacted by financial worries, and even more of them – 50% – said that they're spending three or more hours each week at work dealing with personal financial issues.[4]

Millennials' financial stress is particularly concerning for employers because it has a real effect on employee productivity and emotional well-being.

Employers will continue to be a critical touchpoint for insurers because they serve as an effective point of access to deliver financial wellness programs to employees, and have access to a significant amount of employees' personal financial information. Employees tend to view employers as an objective party that seeks to protect their financial well-being rather than profit from them, and employer effectiveness in delivering financial wellness solutions can improve employees' perception of and satisfaction with their compensation (which in turn has a real impact on a company's performance).

3 2011 PwC study, "Millennials at Work: Reshaping the Workplace." Forbes, "Millennials are the True Entrepreneur Generation."

4 PwC Special Report: Financial Stress and the Bottom Line, September 2017, p. 5.

The competitive landscape

Considering customers' holistic needs, the size of the financial wellness market, and employer motivation to provide employees financial wellness programs, the fundamental question is how insurers can capture the market before competitors do.

It won't be easy. The financial wellness marketplace is crowded. It ranges from traditional, established players like financial advisors at financial institutions, retirement providers, individual and group insurers all the way to consulting firms, health insurers, and emerging InsurTech companies. This competitive landscape is especially complex because these institutions' capabilities are fluid, not static; many of them form partnerships and make acquisitions to obtain leading-edge capabilities and frequently revise their business models to incorporate emerging forms of innovation.

As in the market as a whole, seamless and personalized digital delivery remains vital to provide customers a worthwhile, user-friendly experience, as well as generate actionable insights insurers can use to tailor and enhance their financial wellness offerings.

We believe that whoever gains a meaningful share of the financial wellness market will:

- Focus on understanding and addressing customers' holistic financial protection needs, rather than use the traditional "inside-out" orientation just to sell products and services.
- Offer personalized, actionable, and digitally-enabled financial wellness solutions that include financial products, advisory services, and educational resources that continually promote improved outcomes.
- Effectively target specific customer segments.
- Develop ways to drive ongoing engagement with consumers through an advanced digital platform with real "human" support at critical moments of truth.
- Demonstrate positive ROI to employers.
- Derive the rich, data-driven insights into customers that enable continued improvement of financial wellness offerings.

Implications

In order to compete effectively, insurers will need to determine a distinct basis for differentiation, and focus investment in those capabilities that are key to strengthening their way to play in the market.

Potential ways to play include, but are not limited to:

- Analytical segment specialist – Defined by the proactive use of data-driven insights to better understand customers and provide tailored solutions to effectively meet their employees' needs.
- Consumer experience expert – Defined by the provision of seamless end-to-end customer experiences, primarily through digital or mobile channels, to deepen relationships with both the employer and employee.
- One-stop-shop provider – Defined by providing employers and employees the ability to access and purchase all desired products or solutions in a single place using an ecosystem approach.

Real opportunity exists for insurers in the financial wellness space as the market's current business model strains under changing socioeconomic conditions and a challenging investment environment. While the financial wellness niche was siloed in the past, forward-looking insurers must strengthen their market strategy, offerings, and capabilities to gain market share in this highly crowded, competitive, and converging marketplace.

Shifting cost curves to stay in the commercial insurance race

Despite ongoing efforts to cut costs, US commercial lines loss adjusted expense and underwriting expense ratios have not improved over the last 20 years. Over two-fifths of every dollar of U.S. commercial lines premium collected is used not to pay claims but to fund loss adjustment, commissions and brokerage, and underwriting expenses (source: S&P Global Market Intelligence data and PwC Analysis). New regulatory burdens and requirements for better service, among other factors, have negated any efficiency gains from technology investments. However, we expect that today's market environment is forcing a shift, and that a more strategic approach to cost management will become an imperative for growth in 2018 and beyond.

It's becoming harder and harder to sustain the same returns as in the past. Insurers are facing pressure on both sides of the balance sheet. Coming off multiple years of soft market pricing and a string of catastrophes in 2017, underwriting margins are being squeezed and reserves depleted. Looking forward, any market hardening is likely to be moderate and short-lived, given advancements in data and analytics and flow of capital toward industry opportunities. At the same time, investment returns are at historic lows. Accordingly, a fresh look at costs is an obvious path to improve returns.

Although a cost advantage has not driven commercial lines performance to date, times have changed.

Technology has now advanced enough that significant productivity gains can result from digitizing and leveraging information assets. Over the past year, enabling technologies such as cloud, artificial intelligence, and robotics have continued to mature. They are no longer "innovative," but tested and proven mechanisms. These technologies help attack the expense problem much more efficiently and at a lower cost than five years ago, and with the help of InsurTech firms that offer point solutions, they no longer depend on core transformation and in-house development to yield results.

With companies already feeling pressure to shift cost curves, **tax reform** further increases the impetus and opportunity to think differently about operating models. In particular, companies will have to make key decisions on existing and new businesses, reinsurance arrangements, investment opportunities, products and services, systems and technology, and employee compensation considering the tax implications. For example, companies will want to evaluate operations in US states and non-domestic jurisdictions to determine strategy for where employees are located, where revenue is accrued, and from where items are sourced. Multinational insurance companies may have significantly more earnings onshore given the US mandatory tax on foreign earnings, and a lower corporate tax rate will make domestic investment more attractive. Additionally, with more cash onshore and the lower tax rate, companies may want to look at how **acquisitions** can advance their strategies. Tax reform also may drive changes to structure, valuation, and timing of acquisitions, dispositions, and alliances. Given the level of change, tax implications can both spur action and uncover cost-saving opportunities.

Challenges vary by segment

At the highest level, the commercial lines market consists of 1) small to mid-sized companies needing standard products (e.g., property, auto, general liability, workers' compensation), 2) large companies with more complex needs and program structures (e.g., self-insured retentions, captives, reinsurance), and 3) companies with high-hazard/specialty risks with customized product needs. Commercial insurers face different challenges to remain profitable and grow in each of these segments, and expense management tactics vary accordingly.

In the personal lines market, an expense ratio advantage typically provides a sustainable competitive advantage (i.e., those with the lowest expense ratios grow the fastest). The small to mid-sized standard market is increasingly going the way of personal lines. A heightened demand for a streamlined agent and customer experience coupled with a larger focus on price means insurers have to focus on efficiency and simplification to remain competitive. Those that do this well will more easily steal share.

On the other end of the spectrum, clients with large or high-hazard/specialized risks continue to demand high touch service and customized underwriting and claims solutions to meet their needs. Insurers in these markets must balance efficiency improvements to reduce cost to serve against the need to deliver the "last mile of service" to a specific location, whether a handshake at New York headquarters or a truckload of generators and plywood to keep operations going after a storm in Oklahoma. Larger clients also may demand higher touch on financial analysis to support their own reserving and reinsurance needs.

Insurers in multiple segments must consider the intricacies of each business segment while leveraging scale and national presence across all of them. This makes cost optimization more complex than it first appears. To add to the complexity, the demand for simplicity and efficiency is increasingly moving up-market while the demand for customized service is moving down-market, blurring the lines between segment needs.

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Strategic Cost Management Tactics

Cost management is not a new phenomenon. Our research shows that 75 percent of insurers have undertaken cost cutting programs in the last three years[1] and 61 percent of insurance CEO's plan to launch cost reduction initiatives this year alone[2]. However, while many insurers have cost management on their agendas, few are achieving sustainable cost savings. While most have tackled the basics when it comes to process design and efficiency, business complexity (often driven by a desire to be infinitely flexible and meet a wide range of needs) and fragmented technology environments can get in the way. Furthermore, when cost cutting efforts do not tackle strategic and structural issues or address required cultural changes within the company, costs tend to creep back up as focus fades.

What should commercial lines insurers do?

1. Don't try to shrink your way to greatness.

Driving toward the lowest possible expense ratio is not the key to long-term success. Underwriting is still king and likely always will be; you cannot sacrifice your underwriting prowess in favor of stringent cost reduction tactics or policies. Acquiring and developing strong underwriting talent and having appropriate data, analytics, and governance to guide decision-making are fundamental to strong performance. Investments in these areas may be necessary to keep pace: if they stall for the sake of cost management, there could be bigger profitability challenges down the road. For example, no-touch underwriting and processing in the small to middle market space requires appropriate a) data quality, accessibility, and monitoring mechanisms to govern what is on the books and b) speed-to-market (in terms of decision-making and system change processes) to adjust to market changes. In the large commercial and specialty segments, careful operating model design is essential to align proper expertise to relevant risks at the right time.

That said, costs can be shifted from fixed to variable in order to a) align more closely with the size of the business and b) provide necessary market agility. Partnerships with MGAs can enable quick stand-up of new underwriting operations (with appropriate underwriting expertise) without having to build them from the ground up. This also allows for a quick exit if the new endeavor isn't profitable. In addition, shifting low-value work to lower cost resources (e.g., from underwriting experts to processing centers) makes it easier to hire and train for these activities when scaling up for growth in a given area or repurposing FTEs to other areas when exiting.

You cannot sacrifice your underwriting prowess in favor of stringent cost reduction tactics or policies.

1 https://www.pwc.com/us/en/insurance/publications/assets/pwc-fit-for-growth-insurance-survey.pdf

2 https://www.pwc.com/gx/en/ceo-survey/2017/industries/pwc-ceo-20th-survey-report-2017-insurance.pdf

2. Manage costs for the enterprise, not one function

Insurers should approach cost management at the enterprise level, setting targets for the organization and challenging the business units and functions to work together to identify opportunities to hit them. When tackled function by function, cuts may be made at the expense of other functions, thereby cutting capabilities others need to perform well (e.g., eliminating required fields at the first notice of loss may impact the granularity and timeliness of underwriting analysis), or simply shifting costs from one area to another (e.g., eliminating information gathering in the underwriting process means processing will have to do it, likely resulting in inefficient back-and-forth when gathering information). Additionally, changes in one area may be justified by cost savings in others (e.g., removing a coverage option simplifies both the billing and claims handling). Lastly, success in one area has potential benefit elsewhere in the organization (e.g., RPA in processing also could apply to claims). Fostering collaboration across the enterprise (and even incorporating feedback from distributors and customers) can uncover new insights and opportunities, as well as promote the cultural shift that sustains a cost-focused mindset.

3. Cut features and services, not just costs

Choosing where not to invest can be difficult; defining a strategic "way-to-play" is the first step to understand which products, services, channels, and/or capabilities can be eliminated to better manage costs. For example, continuing to support legacy products and features (e.g., pay plans) can add significant complexity to an insurer's operating environment, which adds cost and can stall efforts to upgrade platforms or add new features for future products. Choosing to transition existing customers to the latest products and features (or even exit certain markets) can be difficult, but it can be the right move to unlock growth, profitability, and cost savings across the rest of the portfolio.

Customer segmentation also can help insurers determine where to invest and what to cut. Not all customers require the same level of risk analysis and customer service and identifying which segments are currently overserved can help align cost with customer value. For example, underwriting reviews could be triggered by changes in risk exposure rather than annual or once-every-three year reviews. Loss control visits could vary by industry, size, and length of relationship. Distributor service levels (e.g., turn-around times, quote negotiations) could be tailored to the value of the relationship. Taking a closer look at customer and distributor needs and value can help cut costs without sacrificing revenue or profitability.

4. Put new technologies front and center

When it comes to cost cutting, the traditional levers have not changed. Commissions, headcount, and IT remain significant areas of spend for insurance companies. However, there are innovative ways to reduce these costs. Offering certain value-added services to agents (e.g., taking on servicing) can indirectly bring down commission expense, artificial intelligence and robotics offer new ways to reduce headcount, and the cloud lowers IT costs and enables a more variable "pay-as-you-go" model.

Too often, cost management efforts that focus on immediate savings put new technologies in a "parking lot," treating them as a future-state opportunity that will take significant up-front investment for questionable down-the-road benefits. However, immediate benefits are now readily available. Many insurers are partnering with InsurTech companies to quickly enhance their capabilities and realize long term savings. Moreover, new technological capabilities are leading insurers to rethink their broader business models.

When it comes to cost cutting, the traditional levers have not changed. Commissions, headcount, and IT remain significant areas of spend.

Implications

- Although a cost advantage has not driven commercial lines performance to date, times have changed.
- In the short-term, cutting costs will help insurers fund strategic initiatives that better position them for growth and profitability in their target markets.
- In the mid-to-long term, insurers with a sustainable cost advantage empowered by efficient operations and a flexible cost structure will be able to compete more aggressively on both price and service and have the flexibility to allocate capital to the most promising market opportunities.

The three C's:
How consolidation, customization and collaboration will continue to impact commercial brokers in 2018

As we first noted in our 2014 publication, Broking 2020: Leading from the front in a new era of risk[1], trends reflecting larger macroeconomic forces have been fuelling a contentious debate between brokers and underwriters on compensation, leading to a "war of words" in 2017 that saw leading players on both sides to invest to reinforce their market positions. The same trends are also driving increased customization of products, increasing reliance on direct-to-consumer models, and greater economies of scale for an increasingly large number of market participants. Collectively, we categorize these trends into the "three C's" of consolidation, customization and collaboration.

Consolidation: We continue to see overall consolidation of the brokerage market; Conning tracked over 450 transactions through October 2017. This activity compares favorably to 537 transactions in 2016 and a longer term annual average of 414 transactions from 2011 to 2015. Looking forward, the factors that are driving consolidation and greater levels of operational efficiency include a low interest rate environment, the presence of alternative capital providers, and ongoing demand for expanded broker capabilities.

Customization: Overall, the desire for more localized market knowledge and custom products is a strong and recurring trend, with historically strong insurance hubs such as Lloyd's recognizing the increasing need to meet local demands. For brokers, the need is clear: provide local knowledge coupled with global scale to rapidly place risks across geographies.

Collaboration: Technologies such as Blockchain have the potential to fundamentally transform insurance processes providing both efficiency savings and greater levels of information to both brokers and their customers. Depending on its ultimate implementation, it is possible that brokers could operate within a fully

1 Available at http://read.pwc.com/i/391105-broking-2020-leading-from-the-front-in-a-new-era-of-risk.

electronic process or be innovated out of it (i.e., be replaced by electronic platforms and algorithms for many categories of risks). Ultimately, the broker's place in the insurance lifecycle likely will remain despite increasing automation, but for those risks from which an intermediary can be removed, disintermediation will occur. For example, we have seen innovative carriers such as Hiscox offer a direct to consumer model for small commercial risks.

Trends that impacted the personal lines market in prior years are beginning to impact commercial lines, with risk managers looking for more customized products and technology-driven innovations for even the most specific product classes.

Consolidation – The commercial brokerage market has experienced continued consolidation, with the top ten brokers generating 2.5 times more revenue than the next 90 brokers in the market (Conning Insurance Segment Report: Property – Casualty Distribution, p. 2). We believe that three trends are driving this M&A wave:

1. **Alternative capital –** Alternative capital providers (e.g., hedge funds, private equity) have continued to play a role in accelerating consolidation, lured by consistent revenue streams (many brokers have renewal rates in the 80%- 90% range), as well a systemic diversification outside of the debt and equity markets. With ongoing low investment yields, the presence of alternative capital is expected to continue influencing the market. Their "hunt for yield" has raised broker multiples, and created a feedback loop of higher valuations and higher deal volumes.

2. **Stagnant Revenue –** Despite some short-term hardening as a response to catastrophic events in the second half of 2017, we believe generally favorable loss experience and historically high policyholder surplus will continue to pressure pricing for the foreseeable future. As a result, premium pricing could remain soft across most commercial classes, thereby restricting both premium and commission growth.

   This ceiling on commission growth will challenge brokers of all sizes to improve their internal cost structures, particularly for back-office processing, which can represent well over half of their operating costs. They are increasingly able to do this through technology initiatives that automate standard and/or low-value processes, as well as introducing better analytics and sales tools to increase

3. **Demand for Local Market Presence –** As risk managers struggle with increasingly complex risk exposures, they are looking for brokers to provide enhanced services across their enterprises. While this would seem to benefit the largest brokers, we believe there is a growing appetite for a seemingly contradictory skill-set: a global footprint with enhanced local knowledge – which puts pressure on brokers to expand their footprint in new or existing locations.

   For brokers whose operating model is "hub and spoke" with branch offices remitting central placement to a global office, we believe smaller specialist firms that can provide immediate service on the spot will continue to compete strongly against brokers that are unable to provide comparable, enhanced local support. In fact, this expectation goes beyond the brokerage side of the value chain to insurers and even placement markets such as Lloyd's, which are increasingly challenged to provide more efficient and localized service.

In either model, Blockchain has the potential to transform the (re)insurance value chain, including:

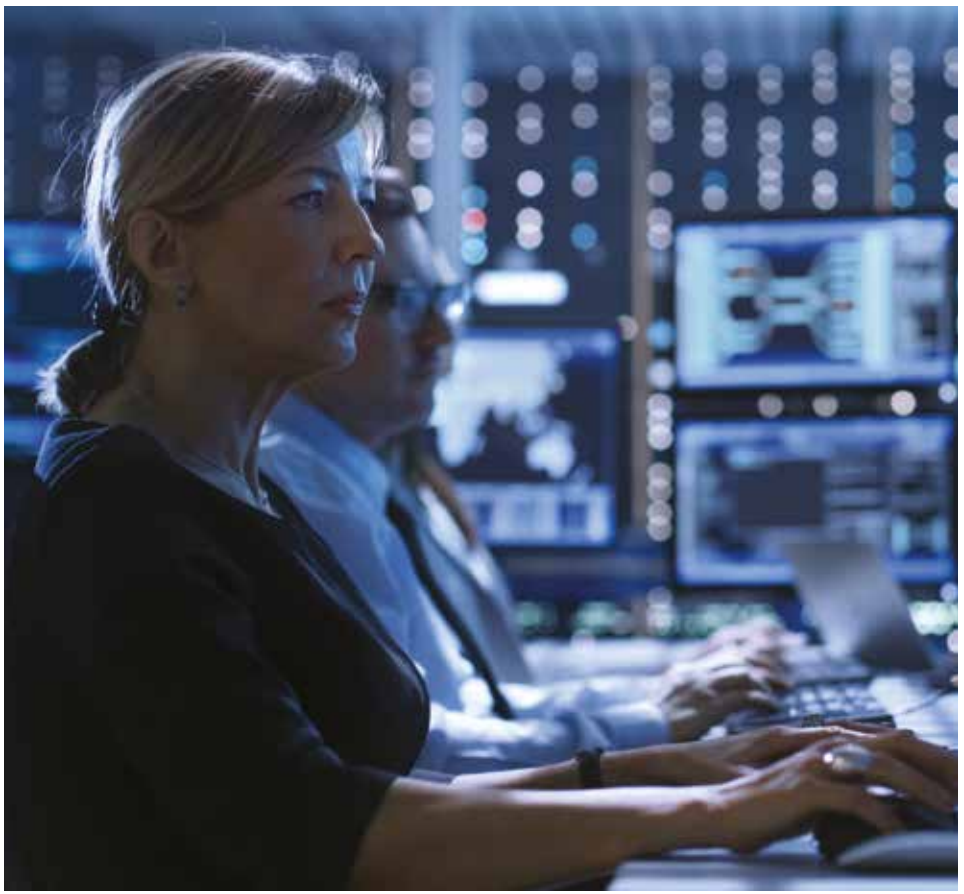
- **Risk Management –** Blockchain could be combined with other Internet of Things products (such as RIFD) to track the transport of high value goods.
- **Policy Validation –** Blockchain implementation could support policy validation in real-time, minimizing coverage validation and improving subrogation/recovery capabilities. Steps to create insurer-to-insurer (I2I) communications have already begun, with the carrier-led "B3i" initiative between Aegon, Munich Re, Zurich, SwissRe, and Allianz to link the numerous insurer-specific use cases for Blockchain.
- **Reinsurance –** Complex, multi-layer reinsurance contracts could be managed on a common Blockchain, allowing participants to automatically track and managed ceded/assumed premiums and losses.

In addition, as we noted in Broking 2o2o, one way brokers can create value in this environment is to become risk facilitation leaders. This role would connect various industry leaders, (re)insurance leaders, and governmental officials on select risks (e.g., cyber) to discuss holistic risk management solutions. Brokers seem ideally placed to facilitate such discussions, which would provide them an opportunity to move beyond risk transfer and become a collaborative partner in their clients' operational success.

PwC's 2014 Risk Buyer Survey supports this idea: 67 percent of risk managers considered their brokerage firm a "trusted advisor," versus 46 percent who simply viewed themselves as a "placer of coverage" (Note: respondents were able to select multiple choices, resulting in values greater than 100 percent).

New technologies such as Blockchain could provide the insurance industry a unique opportunity to collaborate. How these technologies will impact the industry remain to be seen, but forward-thinking (re)insurers are already establishing collaborative initiatives to establish proofs of concept.

Implications



- Faced with the “three c’s” of consolidation, customization and collaboration, we believe brokers have an opportunity to implement proactive changes before these trends cause even more disruptive change(s). Changing buyer demands will require brokerages to reassess their operating models in order to confirm they provide the correct balance of enhanced local market knowledge and scale efficiencies.
- Industry consolidation will further concentrate market power. Smaller brokerages need to determine the appropriate business strategy for a market where the top ten brokerages produce 2.5 times revenue as the next 90 firms.
- Brokers could position themselves to compete in price-sensitive “insurance as a product” markets and/or establish risk management/advisory offerings to serve “insurance as a service” buyers.
- Emerging technologies such as Blockchain have the potential to disrupt insurance placement and policy management processes. Brokers should establish a plan to leverage these emerging technologies to manage or avoid disruption from new market entrants.

Expanding into small commercial

Small commercial remains a fundamentally attractive sub-segment of commercial insurance. It is intrinsically a large and underserved market; while many small businesses are confident about their business needs, they are often unknowingly underinsured. For example, according to our recent global survey of small business owners[1], nearly two-thirds of US small businesses do not have business interruption coverage and 53 percent lack indemnity coverage. Additionally, once small business owners have a policy in place, they are generally less prone to shopping and switching carriers than larger customers. Their agents also have limited incentives to facilitate this process given lower levels of commission. This has traditionally helped well-established small commercial players better navigate the ebbs and flows of the underwriting cycle, with more than decent levels of profitability for those who can navigate the more sophisticated pricing environment and agency consolidation trends.

1 https://www.pwc.co.uk/industries/insurance/insights/global-digital-small-business-insurance-survey.html

A market primed for significant disruption

Most traditional small commercial players, who rely primarily on agency distribution, have operated the same way for decades and are now saddled with inefficient operations and bloated cost structures. While some of them have made sensible strategic moves (e.g., expanding their underwriting appetite by acquiring or building excess and surplus lines capabilities), none of them has demonstrated a "silver bullet" solution that puts them safely ahead of the pack or better positioned to deter new entrants. In a challenge to incumbents, technology (e.g., advances in automation transforming underwriting and servicing) is increasingly lowering barriers to entry.

Additionally, there is unmet demand among small business owners for digital insurance offerings due to a shift in purchasing preferences. Nearly 90 percent of small commercial purchasing decisions are made by business owners, many of whom have been conditioned by their personal shopping experiences (e.g., 77 percent of customers who purchase personal insurance online prefer purchasing commercial insurance online as well). This has had a major impact on their attitudes for other insurance products, as 33 percent of US small businesses would prefer purchasing commercial insurance online. For millennial small business owners, that number climbs to 75 percent. Despite this rise in demand, only about one percent of commercial insurance policies are currently sold without any intermediaries, compared to around ten percent of homeowners policies and 30 percent of personal auto policies.

Though it has yet to happen, small commercial is ripe for disruption.

This confluence of factors may convince a number of players that entering or further breaking into small commercial and successfully underpricing incumbents should be a relatively straightforward exercise. However, we have yet to see even early disruption of this sub-segment, even though it has grabbed recent headlines and many players have increased their focus and investments in the space (either as new entrants or incumbents who have not traditionally prioritized their small commercial business). While incumbents have generally maintained their dominant position, small commercial outsiders, including 1) predominantly middle market carriers moving downmarket, 2) personal lines carriers moving upmarket, and 3) startups, have found the market challenging. We explain below why this is has been the case.

A) Middle market and super-regional commercial carriers – The lower end of the small business market can constitute a logical growth opportunity for middle market and super-regional commercial carriers, especially as their producers avoid small and micro risks. For carriers, these risks are attractive because they are generally less price-sensitive and easier to underwrite than the more complex business they typically handle.

Channel conflicts. One key challenge is managing channel conflict with their existing agency force. Generally, entering small commercial requires them to expand their agency network. In addition to committing the time and resources necessary for expansion, they also need to be extremely careful and subtle in how they assuage the concerns of their existing agency force, many of whom may view the shift downmarket as a "decommitment" by the carrier to its existing larger accounts and loyal agents. Because smaller risks can be costly for agents to acquire and service relative to commission, many carriers going after small commercial have to regularly emphasize to their top producers that they are pursuing business producers don't want. Others look to collaborate with their mid-market agents by providing incentive compensation for referring micro accounts.

Operational efficiency. Another key challenge is operational efficiency. Given the risks these carriers traditionally underwrite and process, many of them have grown comfortable with manually-intensive processes. Succeeding in small commercial requires low-to-no touch processes that support the speed and scalability required to handle a high

transaction volume. Straight-through processing has become table stakes to acquire and service a greater number of customers at a lower cost, as has utilizing tools to monitor the performance of the book in real-time to avoid adverse selection.

Succeeding in small commercial requires low-to-no touch processes that support the speed and scalability required to handle a high volume of transactions.

B) Personal lines carriers – For predominantly personal lines carriers, diversifying away from increasingly commoditized business and moving upmarket can also constitute the next logical growth opportunity. In fact, several leading personal lines players, including Allstate, Berkshire Hathaway through biBERK, and Progressive, have clearly announced and/or demonstrated over the last few years they are making small commercial a higher priority.

Advertising. A key challenge for these carriers as they move upmarket is generating awareness of their offerings. While spending billions of dollars annually on mass advertising may work in personal lines, small commercial requires a different marketing approach. They need to consider alternative means of getting small business owners' attention, such as building affinity partnerships that can help funnel traffic in preferred customer segments, or deploying targeted advertisements on social media.

Distribution. Another top challenge is picking the right distribution channel(s). Building a brand new network of small commercial agents can be an expensive enough proposition for middle market carriers, but with personal lines carriers that rely on independent agents the cost can be even higher as there is usually less overlap with their current agency force. As such, sticking with an agency distribution channel may be a significant barrier to entry for some players. Building strong digital customer-facing quote, bind, and service capabilities can be a way around that. In addition to aligning with trends in small business owner expectations, personal lines carriers that choose to go direct can potentially take advantage of a lower expense base from not having to pay commission and redirect that to price savings. But it makes the advertising challenge even more significant.

While spending billions of dollars annually on mass advertising may gain awareness in personal lines, small commercial requires a different approach.

C) Startups – Even though a non-traditional player has yet to make a significant dent into the market, a variety of tailored solutions continue to emerge. Newer entrants like Bunker and Founder Shield have focused on specific underserved customer segments. Others have attempted to innovate by providing purely direct-to-customer offerings for commercial lines (e.g., Pie Insurance for workers' compensation).

Insurance knowledge. Many insurance startups owe more to their marketing ideas and technology-savvy staff than to their founders' understanding of the industry, which can leave some significant blind spots. Incumbents often are able to rely on extensive, high-quality experience datasets to distinguish good risks from bad ones and appropriately price them. Startups usually lack this fundamental information.

Foundational insurance infrastructure. A slick front-end website has limited benefits if it's not backed by essential middle- and back-office functions like risk management, policy endorsements processing, and other post-bind servicing (e.g., annual premium audits). Many startups have to stand up these functions and don't have the expertise to effectively navigate and operate in different state regulatory environments. For startups looking to grow fast, building these capabilities from scratch can seem prohibitively expensive and time-consuming. However, there are plenty of partnership opportunities that can expedite this process, as well as options for renting solutions as opposed to buying them (e.g., licensed producers, cloud-based platforms).

A slick front-end website has limited benefits if it's not backed by essential middle- and back-office functions.

The digital opportunity

In addition to anticipating and preparing for the challenges above, small commercial outsiders need to consider how they are going to provide a digital end-to-end experience along the entire customer journey to meet small business owner needs. This requires a clearly defined digital small commercial go-to-market strategy that addresses customers, products and services, pricing, channels, and brand. Indeed, many current small commercial players have already recognized this shift, and are investing in enhancing their existing digital capabilities, including via strategic partnerships (e.g., with FinTechs). These players are looking to create true omni-channel offerings and increase the loyalty of their existing customers.

Other players are pursuing small commercial opportunities by building differentiating business models. These "digital attackers" are creating new, purely digital offerings that emphasize speed and ease-of-use while avoiding the constraints of legacy systems. New aggregators are occupying the client interface and consolidating different product providers (e.g., Simply Business). Other integrators are starting to build new business models for the customer journey (e.g., Flock). And various segment-specific digital direct-to-customer and B2B2C models are emerging (e.g., Cake). Given the relatively large opportunity in the space (particularly the micro space), these options are worth considering for small commercial outsiders.

The outsiders that will be best set up for success in small commercial are those that can both strategically plan for the risks that have tripped up similar players in the past while finding opportunities to inject digital capabilities into their operations. They will be able to hit the ground running and differentiate themselves from both incumbents and other new entrants. Furthermore, they will be better positioned to meet the changing and currently unmet preferences of small business owners.

Digital solutions can improve not just the customer experience, but also operational efficiencies and cost structures.

Implications

- Small commercial has changed very little over the years. We believe the market is ripe disruption although there have been no major changes to date.
- Small commercial generally has been a profitable line that has weathered underwriting cycles well, but it does suffer from inefficient operations and bloated cost structures. Lowering costs of entry into the market are putting pressure on incumbents to improve their business operations.
- As in personal lines, there is increasing desire among small commercial customers for a digital purchasing process. As of yet, customer expectations have gone largely unfulfilled, which provides a real opportunity for whoever can meet them.
- Digital solutions – often from InsurTechs – offer promise to improve not just the customer experience, but also operational efficiencies and cost structures.
- Though nascent, aggregators are consolidating different product providers, integrators are starting to build new business models for the customer journey, and various segment-specific digital direct-to-customer and B2B2C models are emerging.

Group insurance:
No longer an overlooked market

Group insurance is an approximately $65B market.[1] While growth has been consistent but moderate at 3.5% to 4% per year over the last six years, changes in the employee-employer dynamic are reshaping group benefit needs and making investments and growth prospects in the sector more attractive.

Drivers influencing the employee-employer dynamic

Employee value proposition

Employers are responding to the war for talent by looking for innovative ways to **differentiate their benefit solutions and overall value proposition** (e.g. career mobility stretch opportunities, etc.) as a lever to recruit and retain top talent in the marketplace

Generational expectations

Employers are faced with a balancing act to **offer relevant solutions** in order to meet the **expectations of a modern** workforce (e.g. millenials vs. baby boomers)

Income diversity

Employers are considering ways to provide solutions that are **tailored to the diverse range of income and educational background** of the workforce

Work-life integration

Employers are searching for ways to **enrich employee experiences that extend beyond the workplace** and into their daily lives (e.g. well-being rewards, flex-work, contingent workforce)

Self-direction

Employers are looking for ways to provide **self-directed tools and advice** that allow employees to manage their overall well-being

Holistic experiences

Employers are recognizing the **seamlessness of the human experience** and are taking into consideration **holistic well-being across wealth, health and career**

Technology enablement *Technology support and/or enables these drivers*

1 Group Insurance includes employer paid and voluntary Group Life, Disability (Short term and long term) Dental, Supplemental insurance like Cancer Insurance Critical Illness, Long term Care. Source for market size is SNL Financial and PwC Analysis.

Carriers' initial response has been to drive profitable growth by streamlining their operating models and making incremental investments in technology to upgrade their capabilities. However, employer and employee needs and expectations continue to rise.

Employers are using innovative benefit solutions to differentiate themselves when recruiting and retaining top talent. Employers recognize that employees no longer have the patience or time for benefit plans that are cumbersome to enroll in and manage. They're looking for holistic solutions that employees themselves can direct. In addition, employees have different needs based on income diversity and – more so than in recent memory – generational circumstances. Consequently, they're looking to employers to offer customizable solutions that help them meet their unique needs in a user-friendly fashion, 24/7.

Moving forward, five trends will continue to shape the group insurance market and influence carriers to move beyond incremental investment to fundamentally reposition their business and operating models. These trends will motivate group insurers to provide more measurable value for employers, employees and intermediaries by delivering more integrated products and services and better customer experiences. We also expect to see a) More and more players in adjacent markets such as health, workforce management and wealth to expand into market niches that overlap with group insurance; and b) More venture capital to flow to InsurTech solutions that meet the group space's evolving needs.

Group insurer solutions will take advantage of the convergence of health-wealth-career management

Consumers are increasingly managing their health, wealth and career decisions in a coordinated way because they all affect the same wallet.

Decisions about health range from ways to maintain fitness to ensure their quality of life (and thus ability earn an income) to selecting the right combination of benefit products to reduce the key risks that could knock them and their families off track for an extended period of time. As people at the higher end of the socioeconomic scale live longer and healthier lives, they're looking to manage their personal wealth to support their and their families' financial positions for longer periods of time.

Moreover, as employers compete for top talent, they are increasingly providing benefits and programs that address the concerns their employees have about their and their families' physical, mental and financial health. Employers are focusing on a) health and return to work programs that contribute to worker productivity and performance, and b) employee development programs.

The confluence of these factors is creating opportunities for group insurers to provide employers with solutions that help them improve their employees' health, wealth and professional satisfaction. Some carriers are responding by offering more holistic solutions, either by expanding their own product offerings or through partnerships with others in which they can white label products. Other carriers have decided not to expand their own product offerings, but instead focus more on the wealth/retirement or health. In either case, they're trying to make their products and services fit with the other benefits employers' chosen platforms offer.

Employee pressure points

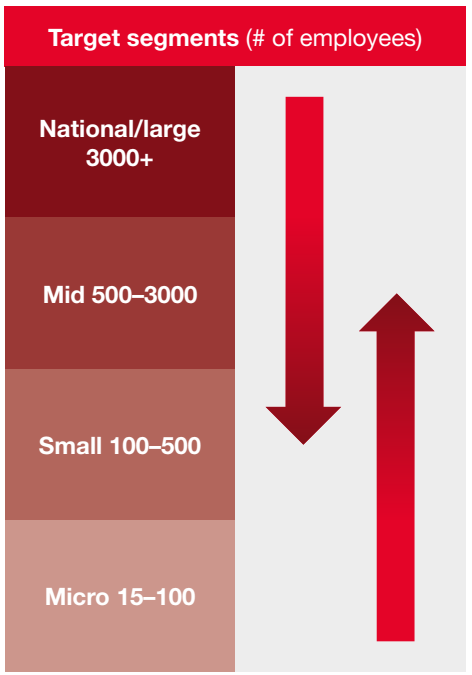
Group insurers will look to serve more market segments

Many group insurers have long focused on certain market segments. For example, some have been dominant in the national account or large case segments and others in the small or mid-case account segments.

Each market segment requires different operating model strengths. But, as employer and employee needs increasingly change, the traditional lines between small, mid, and large account segments are starting to blur.

Group carriers are now rebuilding core capabilities and introducing new ones in order to more profitably serve a broader range of employer segments. Recent M&A activity has resulted in significant new capabilities. For example, the Hartford, which acquired Aetna's group life and disability business, and Lincoln Financial Group, which acquired Liberty Life, are examples of the priority group players are placing on adding or enhancing capabilities (such as integrated absence management) to serve broader segments of the market.

These moves indicate that the carriers which traditionally have been stronger in the small and mid-markets are building new capabilities and transforming their target operating models in order to serve the unique needs of larger account segments. Moreover, large account carriers are building new capabilities and changing their target operating models in order to standardize and automate their solutions to more profitably serve smaller market segments.



Group insurers will increasingly respond to increased absence management needs, even for down market clients

Absence and leave management services are a core service in the disability market and demand is growing.

There has been a spike in requests by employers for absence and leave services as a result of:

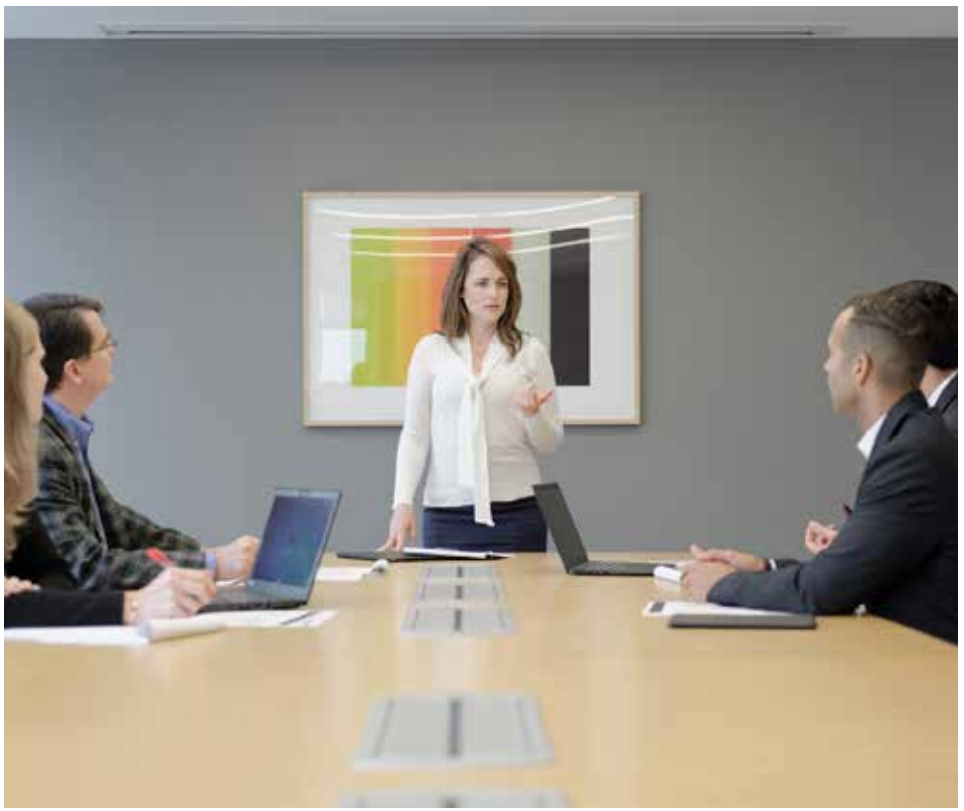
a) The January 1, 2018 New York Paid Family Leave Law, which is the most significant paid leave program in the US;

b) Recent localized laws, such as the Paid Sick Leave Ordinance (PSLO) and Paid Parental Leave Ordinance, have increased the local complexity of employer leave and absence tracking; and

c) Increased cross-selling of disability, FMLA, and voluntary products makes the need for claims/absence integrated services more relevant.

In response to these changes, carriers are increasingly adding absence services and platforms to their repertoire. For those familiar with disability, FMLA, and other products, absence is not new. For those who aren't, tracking the high number of federal, state, and local laws is a tremendous value-add to their client base. In order to improve customer service, carriers are integrating claims and absence into an "event" experience to radically reduce the burden of correspondence that explains payments and absence rights.

M&A activity and InsurTech investment will continue to shape in the group market



Moving upstream and downstream among employer segments requires new capabilities.

The traditional way of doing business will not meet changing employer and employee expectations. As a result, M&A, InsurTech investment, and maturing group technology solutions will continue to influence the group market in three ways:

a) In addition to the M&A activity we previously noted, there have been other transactions in the group space, including Meiji's acquisition of Stancorp and Sumitomo Life's acquisition of Symetra. Acquisitions like these potentially provide much needed capital investment for group players looking to take advantage of the convergence in the space and the opportunity to profitably expand across traditional market segments. This in turn could raise the bar for existing players, especially in areas where they need i) broker or consultant customers to recommend their products, and ii) to address employer needs to respond the changing employer- employee dynamic.

b) There also have been deals adjacent to group benefits, such as CVS's acquisition of Aetna and the Amazon, Berkshire and JP Morgan joint venture. These developments may impact more than product solutions, pricing and omni-channel distribution and service; they also could significantly reshape the employer and employee customer experience.

c) Group carriers traditionally have often been reluctant to make significant investments in technology and when they have, they've attempted to build new technology solutions in-house. However, with the exponential growth of InsurTech and the maturation of group-focused core technology, some carriers are finding it both necessary and easier to acquire new solutions rather than build them. Consequently, group insurers are accelerating their investment in core areas, including enrollment, policy administration, and claims, thereby allowing them to improve in a number of areas from quote to close ratios, and from employee program participation to claims management.

Group insurers will continue to build digital & data architecture and expand analytic capabilities

Artificial intelligence, predictive analytics, behavioral economics, machine learning, robotic process automation, among other technological developments, represent opportunities for group insurers to better understand, acquire, serve and retain customers in new and more cost effective ways.

Carriers are choosing to invest in new digital capabilities to improve customer and channel segmentation and experience, as well as enhance their ability to acquire and retain the right customers. This helps carriers anticipate employer needs and enables solutions to change as employers do. It also promotes better carrier understand of employees' broader needs beyond the employer relationship.

Also of note, group insurers have long had a significant amount of data and in recent years have taken advantage of advances in big data, reduced cost of computing power, and commoditized analytic techniques to increase their use of data for decision-making and insight generation. However, many of the advances in data have still not translated to improvements in employee level data across the value chain.

New investments in data will help group carriers 1) Improve the data architecture that is critical to improving workflow and customer experiences, 2) Focus on employee level data to better meet the needs of employees – especially in the areas of portability, and 3) Incorporate third-party and unstructured data with employee level data, which will help them be more consultative with employers about the design of responses to employee needs.

Implications

- Group insurance will be increasingly important as a business platform for addressing employee health, wealth and career needs, as well as employer needs to offer their employees differentiated solutions.
- Existing players cannot stand still because they face converging forces that are fundamentally transforming group business and operating models. Carriers that are business units of larger insurers which have underinvested in group capabilities (even if the group business unit has been consistently profitable) need to be particularly attuned to these developments.
- New group players, including those resulting from M&A, should do more than just make the mergers "look good on paper" but sincerely focus on designing new customer-centric operating models that leverage new business and technology architectures to create excellent B2B2C experiences.

Risk & Regulatory

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Cognitive dissonance and the CRO

Could F. Scott Fitzgerald have had Chief Risk Officers (CROs) in mind when he wrote, "The test of a first rate intelligence is the ability to hold two opposed views in the mind at the same time and still retain the ability to function"?

Probably not. But, based on recent discussions with some leading insurance CROs and my own experience in the industry, there are a surprising number of circumstances where a CRO needs to accommodate two opposing views. Exploring these circumstances can shed some interesting light on how the CRO role has evolved over the last several years and where it may be heading in the future.

CROs' early focus was on the development and implementation of economic capital and a concerted effort to meet enhanced regulatory expectations. It is now more nuanced

Economic capital: A rule that needs to be followed and a model that needs to be questioned

The development and utilization of economic capital (EC) is a good starting point to explore the CRO's cognitive dissonance. Economic capital is a powerful and indispensable concept; arguably the most powerful weapon in the CRO's arsenal. It allows insurer's to quantify many of their most important risks in precise monetary terms that can be translated into precise actions. Like, "add this much to the product price to accommodate its risks" or "buy this asset not that asset because it has a better risk-adjusted return".

In order for economic capital to do its work, it needs to be a rule that is followed. From its most comprehensive manifestation – the expected level of capital that the insurer should hold – to the tolerances and limits that inform pricing decisions and individual asset transactions, insurers need to build economic capital values into their decision making fabric.

At the same time, the CRO recognizes that the economic capital values are model output. They depend on a lot of assumptions. And the underlying methodology, that risk is best quantified as the upper bound of a high confidence interval such as 99% or 99.5%, is only one of many meaningful options. The CRO should develop insight into how other assumptions and methodologies would impact business decision making. Furthermore, risk managers also need to employ other, completely different tools, like stress testing. And these could lead to new and conflicting insights that the CRO needs to reconcile with economic capital's definitive outcomes.

The dissonance engendered by economic capital presents a particular challenge for CROs with long experience in insurance ERM. More than any other development, economic capital was the progenitor of enterprise risk management (ERM). Before economic capital, ERM consisted primarily of risk lists and heat maps. Economic capital provided a solid foundation to decision making, particularly related to credit and market risks in the period leading up to and during the last recession. But, as the industry evolves, and credit and market risk taking has stabilized and often declined, new risk and new ways of managing risk need more attention. CROs who grew up with economic capital as the defining feature of their job may need to exert special effort to champion non-EC tools' decision making potential.

CROs who grew up with economic capital as the defining feature of their job may need to exert special effort to champion non-EC tools' decision making potential.

As Isaiah Berlin noted in The Fox and the Hedgehog, "A fox knows many things but a hedgehog one important thing." Considering the importance of EC in the emergence of ERM, it is reasonable to think of the risk function as a very quant-oriented one. Calculating EC is a complex undertaking requiring a high level of mathematical and financial acumen. Certainly it is a great example of "one important thing."[1]

However, other, equally important aspects of the CRO role need a much broader vision. In keeping an eye out for emerging sources of risk and new challenges it would be good to know "many things." We have noticed that successful operational risk management efforts feature a multifaceted mindset when helping businesses recognize and manage these risks. Contrast this with model risk management where a more singled minded focus is required.

Even within the narrow world of some traditional risk thinking, taking a broader view could yield innovative and profitable outcomes. For example, mortality and longevity risk is almost universally viewed one way: from a retrospective experience perspective, with mortality rates varying by age and gender. Risk values are generated by shocking these rates; upwards for mortality (representing the impact of a pandemic) and downward for longevity (representing significant medical advances in treating deadly diseases). But broader, informed thinking by someone or a group could find an alternative, likely one that looks at underlying fundamentals and utilizes advanced analytics to develop better and more actionable insight.

As ERM continues to develop, both hedgehogs and foxes are necessary. And the CRO needs to be able to effectively communicate with and manage both..

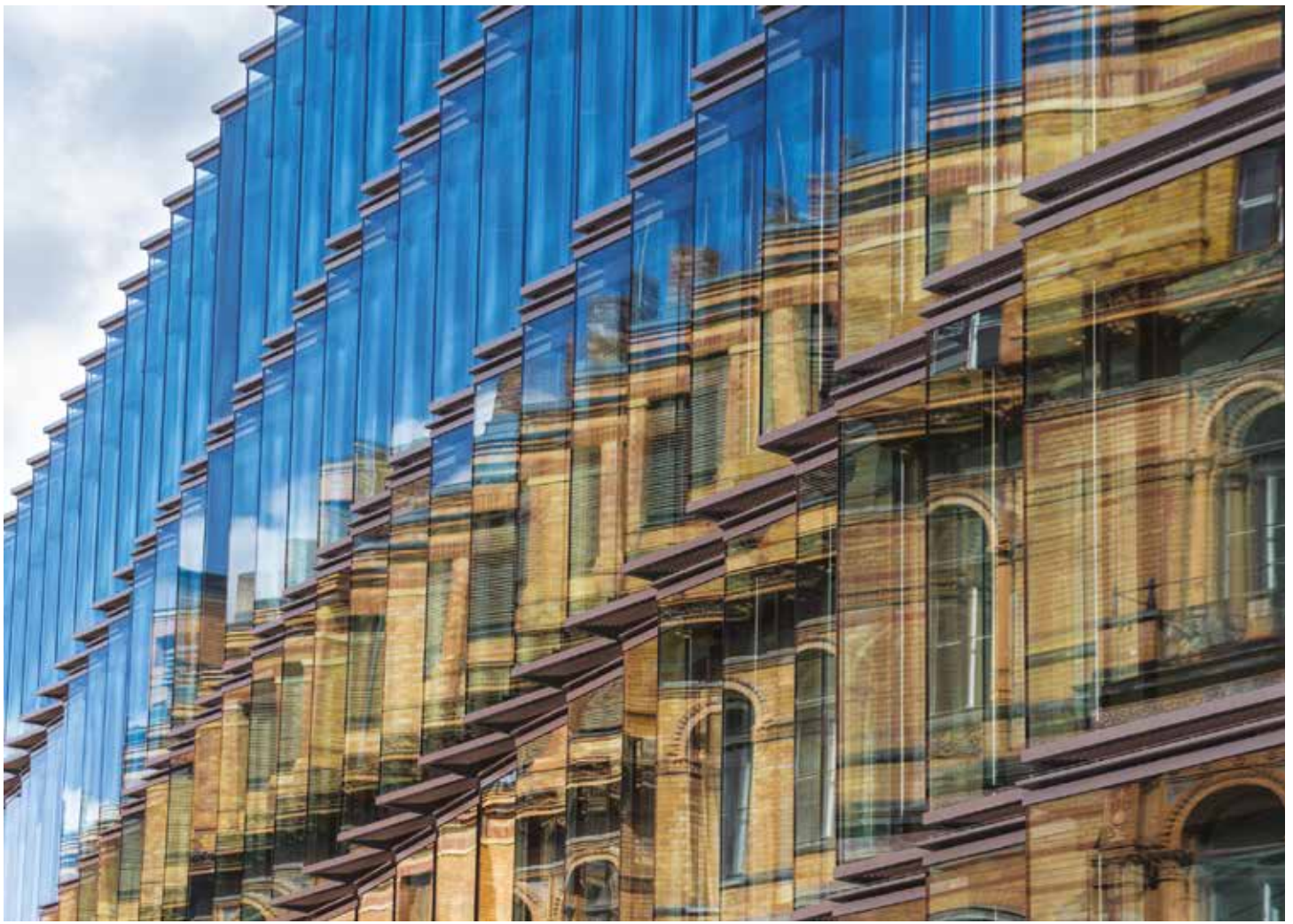
1 Thanks to AXA US CRO Jürgen Schwering for recommending the essay as pertinent to this topic.

Putting a price on priceless information

In a business that is all about taking risk, most senior management teams certainly would rank good information about risk as essential to the effective management of their business. To call this information "priceless" would not be an exaggeration.

The last recession put great pressure on regulators and, through them, on insurance companies to quickly upgrade their risk capabilities. For many regulators, the cost of achieving these upgrades was much less of a concern than thoroughness and completeness. Both of these forces, business need and regulatory pressure, put significant demands on the risk function. Faced with these demands, it has been fairly easy to put programs and people in place that address acute needs without being unduly constrained by program price.

However, the absence of price constraints has obvious negative implications. Any business has limited resources. And, for much of the insurance industry, the trends in customer demands and purchase/service platforms is away from high margin options. Furthermore, the lack of spending discipline can easily lead to maintaining a status quo that overspends on some areas and ignores others. As priceless as good risk information can be, some is more valuable than others, and some can be produced with the same value but at a lower cost.



Implications: Where is ERM heading and how can CROs prepare?

The CRO's role has evolved significantly over the last several years. CROs' early focus was on the development and implementation of EC and a concerted effort to meet enhanced regulatory expectations.

The trend now is more nuanced. CROS are trying to address more qualitative risks and incorporate a business-centric focus. With this in mind, we offer some suggestions:

1. CROs would do well to take stock of their current ERM program inventory. What are the approximate costs of different programs? Are they meeting objectives and are those objectives still as important as when the programs were initially established? Is there an overlap? For example, does stress testing address only the same risks EC already covers effectively, and if so, would it make sense to deploy resources in a different way?
2. In taking stock of current benefits, ERM efforts that enhance shareholder value should be receiving high priority. Considerations focused on pricing and new business challenges present a good opportunity to use risk knowledge to add value, not just conserve it.
3. Lastly, consider if reshaping emphasis across the program portfolio requires some ERM team members to alter their orientation, e.g. behave more like "foxes." Or, if there's a need, consider adding new team members with the required skills and mind set.

As ERM continues to develop, both hedgehogs and foxes are necessary

IFRS 17:
Illustrative Product Actuarial Implications

IFRS 17, Insurance Contracts, the new accounting standard issued by the IASB to be adopted in January 2021, fundamentally changes the way that insurance contracts are measured and results are communicated to the market. As firms continue to progress with the preparations to comply with the new accounting standard, the full implications of the standard on the management and presentation of the business continue to emerge.

Companies – particularly those that currently leverage US GAAP as their basis for IFRS accounting – have expressed concerns over the potential impact the new standard will have on their existing accounting practice. In the following paragraphs, we share observations on the potential impacts of transitioning from US GAAP to the new IFRS 17 standard for sample life and annuity products.[1]

1 Our commentary is based on representative product designs and does not consider the full range of product types or options. Anticipated impacts for any individual company may differ from our observations depending on particular facts, circumstances and accounting decisions adopted for its business, such as the OCI election, discount rate development approach, risk adjustment methodology, etc. In particular, our analysis does not consider options for transition (such as the fair value option or modified retrospective approach), which may have significant impact on the level of reserves and therefore on the equity position at the date of transition.

IFRS 17 potential product impacts relative to US GAAP

Product	Opening equity	Profit emergence	Earnings volatility
Level Term Life	Decrease	Delayed	More
Payout Annuities	Decrease	Accelerated	More
Universal Life	Decrease	Accelerated	Less
Fixed Deferred Annuities	Decrease	Accelerated/Delayed	Less
Variable Annuities	Decrease	Accelerated	Less

Level Term Life Products

Opening equity: We anticipate an increase in level term life liabilities, leading to a decrease in opening equity (assuming a retrospective transition approach).

We derive our outlook based on the following three factors:

- US GAAP best estimate earned rates, which many insurers have locked-in over the last decade or more, may be as much as 300 to 400 bps higher than IFRS 17 discount rates (bottom up approach assumed of current risk free rates plus liquidity premiums), resulting in higher liability balances under IFRS 17 at transition.
- Companies are required to update historical locked-in assumptions with current estimates under IFRS 17, with an expected reduction in the liability levels based on assumed life expectancies improving faster than anticipated mortality rates. Our analysis does not consider the impact of post-level term assumptions, for which the impact could be significant if such assumptions are either particularly conservative or optimistic.
- The Risk Adjustment (RA) is anticipated to be less than historical provisions for adverse deviations (PADs) that companies commonly have used of 5-10%.

All else being equal, the combined impact of the above factors is a decrease in opening equity under IFRS 17.

Profit emergence: We anticipate profit emergence will be delayed for newly issued term life policies.

We base our perspectives on the three components underlying the source of earnings:

- **Investment spread** – Investment spreads are earned as the difference between the investment return on underlying assets and the interest accretion on the liabilities. Given that these are recurring premium contracts, investment margin recognition will build gradually as premiums are received and reserves grow and then decrease as lapses and death occur. Discount rates under current US GAAP are generally based on portfolio earned rates adjusted for defaults and investment expenses commonly with a PAD that lowers the discount rate. We assume that the discount rate under IFRS 17, which is a risk free rate plus an adjustment for liquidity, will typically be lower than the US GAAP discount rate. We therefore anticipate that an additional investment margin will be recognized under IFRS 17, but in a slower pattern than the offset to the profit loading described further below.
- **PADs and RA** – For US GAAP, PADs are commonly applied to best estimate mortality. The mortality PAD is released in proportion to both volume and level of expected death benefits. Since mortality increases with age, a practice of applying a level percentage PAD to the mortality rate pushes some of the profit recognition to the tail of the contract. Under IFRS 17, the RA is expected to be relatively small for well diversified companies, resulting in a larger IFRS 17 profit loading amount (CSM), which is recognized in a more straight-line pattern as described below.
- **Profit Loading** – The remaining underwriting margin for current US GAAP is released in proportion to gross premiums. Under IFRS 17, the residual margin is the contractual service margin (CSM), which is released in proportion to coverage units. We expect this amortization to be generally consistent between US GAAP and IFRS 17 if projected in-force amounts are used as the basis to estimate coverage units.

Overall, we assume that the differential between IFRS 17 and US GAAP discount rates and resultant impact on profit loading will dominate the difference in mortality PAD vs. RA, leading to a deferral of IFRS 17 income vs. US GAAP.

Earnings volatility: We anticipate an increase in earnings volatility for term life business.

The impact of assumption updates will be offset by adjustments to the CSM for non-onerous contracts, but this will be limited for contracts with low profit margins. Losses could be recognized earlier than under US GAAP for unfavorable assumption updates because the level of aggregation (i.e., contract grouping) in IFRS 17 is expected to be at a more granular level than what is currently used for US GAAP loss recognition testing.

Payout Annuity Business (life contingent)

Opening equity: We anticipate an increase in payout annuity liabilities leading to a decrease in opening equity.

We base our outlook on similar reasons as term life products; lower IFRS 17 discount rates compared to US GAAP along with the update of historical locked-in mortality assumptions are expected to exceed the impact of releases in PADs. In addition, the lower level of aggregation, compared to the loss recognition test requirements under US GAAP is expected to likely increase payout annuity liabilities.

Profit emergence: We anticipate profit emergence will accelerate for newly issued payout annuity business.

We base our perspectives on the three components underlying the source of earnings:

- **Investment spread –** Investment spreads are earned as the difference between the investment return on underlying assets and the interest accretion on the liabilities. Given that these are single premium contracts, more investment margin will be recognized in the early years because the amount of assets under management and the reserves decrease over time. For payout annuity contracts with life contingencies, discount rates under current US GAAP are generally based on portfolio earned rates adjusted for defaults and investment expenses commonly with a PAD that lowers the discount rate. We assume that the discount rate under IFRS 17, which is a risk free rate plus an adjustment for liquidity, will typically be lower than the US GAAP discount rate. We therefore anticipate that the recognition of the investment margin will accelerate under IFRS 17.
- **PADs and RA –** For US GAAP, PADs are generally applied to best estimate mortality assumptions. The mortality PAD is released in proportion to both volume and level of expected benefit payments. Under IFRS 17, we assume relatively small RA (and note that the RA does not consider financial risk); thus, we expect more margin from release of PADs under US GAAP than release of RA under IFRS 17. Such differences in mortality margin will have offsetting impacts in the profit loading.
- **Profit Loading –** The remaining underwriting margin for current US GAAP, the DPL, is released in proportion to expected benefit payments. Under IFRS 17, one potential option would be to use expected benefit payments as the coverage units used to release the CSM. Under this assumption, we would not expect a significant difference in the pattern of recognition of the remaining underwriting margin under IFRS 17.

Overall, we expect the recognition of investment margin to dominate and result in accelerated income under IFRS 17.

Earnings volatility: We anticipate increased earnings volatility for payout annuity business.

We expect the new standard will introduce additional earnings volatility. The CSM adjustment mechanism and the OCI election (if selected) will partially mitigate this, but volatility will increase for similar reasons as discussed in the term life section.

There is a range of further considerations specific to certain types of payout annuities that will impact how performance metrics compare under US GAAP and IFRS 17. For example, for life contingent annuities with certain periods, the certain period is considered as an investment component and would be excluded from revenue and expenses in the presentation of the income statement. Payout annuities without life contingencies would be considered investment contracts and therefore valued under IFRS 9.

Universal Life Products

Opening equity: We anticipate an increase in universal life liabilities, leading to a decrease in opening equity (assuming a retrospective transition approach).

The following informs our outlook:

- Under current US GAAP, the insurance contract liability for universal life contracts consists of the policyholder's account value plus certain additional liabilities for guarantees embedded in the contract, such as secondary guarantees. Any additional liabilities (not embedded derivatives) required to be recorded are valued under SOP 03-1 requirements, which accrues the ultimate expected benefits over time. Under IFRS 17, the cost of all options and guarantees embedded in the contracts are fully reflected at the valuation date, similar to a fair value measurement approach.
- The incorporation of the RA is expected to increase liabilities compared to current US GAAP as this component (or a concept of a PAD) does not exist for universal life contracts.
- Due to the lower level of aggregation in IFRS 17, the two above mentioned factors may result in more onerous groups of contracts at the transition date.

Profit emergence: We anticipate profit emergence will accelerate for newly issued universal life contracts.

We base our perspectives on the three components underlying the source of earnings:

- **Investment spread –** Under current US GAAP, the investment margin is recognized as it is earned (in the same way as for other products we list above). For IFRS 17, the analysis needs to consider a few moving pieces. Part of the investment margin will be recharacterized as CSM given that an asset-based discount rate may be used for discounting cash flows that vary with the performance of the underlyings (i.e., projecting cash flows at the credited rate and discounting at a higher asset based discount rate will produce a CSM). Assuming that the CSM is amortized in proportion to the net amount at risk (NAAR), we anticipate that the recognition of the investment spread will accelerate compared to US GAAP.

- **PADs and RA –** For US GAAP, there is no concept of PAD so the incorporation of the RA in IFRS 17 is expected to delay the profit emergence of the contracts.

- **Profit Loading –** The main additional sources of profits under current US GAAP are: (1) the mortality margin, which we assume to be back-ended as a level percentage of the cost of insurance; and (2) the surrender margin, which is typically driven by high surrender charges in early years. Under IFRS 17, assuming that the CSM is released in proportion to the NAAR, we expect, on balance, the underwriting margin to be accelerated compared to US GAAP.

Earnings volatility: We anticipate a reduction in earnings volatility for universal life type contracts.

Under US GAAP, revenue (amounts assessed against policyholders such as COI charges, surrender fees, policy fees, etc.) and benefits are reported in the period in which they are incurred. In addition, the retrospective unlocking approach currently used for DAC has been a significant source of earnings volatility. IFRS 17 generally achieves a smoother earnings pattern, but can be expected to result in some level of earnings volatility in universal life contracts, for example, due to the immediate earnings recognition of changes in estimates of financial options and guarantees. IFRS 17 has a mechanism to reduce volatility for changes in non-financial cash flow estimates and the discretionary portion of the change in expected interest crediting whereby such changes adjust the CSM. In addition, to the extent changes in future cash flow estimates are driven by changes in credited rates due to economic variables, the impact may be recorded in OCI. The crediting rate, including any revised crediting rate, is reflected in income on an effective yield basis.

Although we have not addressed them in our analysis, indexed universal life products have become extremely popular in recent years. Generally, embedded derivatives in these products are unbundled under current US GAAP. However unbundling requirements are not necessarily the same under IFRS 17. If measured under IFRS 17, financial options and guarantees are required to be measured on a basis consistent with observable market prices. However, the extent to which changes in value are immediately reflected in income will depend on the particular facts and circumstances of the contract and how it is classified under IFRS 17.

Fixed Deferred Annuities

Opening equity: We anticipate an increase in fixed deferred annuity liabilities, leading to a decrease in opening equity.

Fixed deferred annuities are typically classified as investment contracts under US GAAP, but these contracts will typically be included within the scope of IFRS 17 (and IFRS 4) due to their underlying annuitization guarantees. Given IFRS 17's more granular aggregation requirements and the market guarantees commonly contained in older blocks of business, along with the requirement to value all financial options and guarantees, we expect that implementation of the standard will result in higher reserves and a reduction in opening equity.

Profit emergence: We anticipate profit emergence may accelerate or be delayed for newly issued fixed deferred annuity contracts, depending on the relative significance of investment spread versus surrender charges in the analysis below.

We base our perspectives on the three components underlying the source of earnings:

- **Investment spread –** Similar to other universal life products, the investment margin is recharacterized as CSM under IFRS 17, which is expected to accelerate profits compared to current US GAAP.
- **PADs and RA –** There is no concept of PAD under current US GAAP for these products. We expect a relatively small RA under IFRS 17, principally relating to lapses, resulting in no significant impact to profit emergence compared to US GAAP.
- **Profit Loading –** Surrender charges are a key source of earnings in deferred annuity contracts. Under current US GAAP, surrender charges are recognized as they occur (generally in early years). Under IFRS 17, surrender charges will be embedded in the CSM and, if we assume that the CSM is amortized on a straight line basis, the recognition of the underwriting margin will likely be delayed compared to US GAAP.

Earnings volatility: On balance, we anticipate a reduction in earnings volatility for fixed deferred annuity contracts, although this will be driven mostly by company-specific considerations.

As we discuss in the universal life section, the profit recognition approach (i.e. revenue and benefits as they occur) along with the retrospective unlocking of DAC, can produce significant volatility in US GAAP financials. IFRS 17 provides companies with a mechanism to reduce volatility through the effective yield approach or adjustments to the CSM or OCI, but the lower level of aggregation will likely result in faster recognition of losses, especially for spread products like fixed deferred annuities. Whether or not the implementation of the new standard will result in higher earnings volatility compared to current US GAAP will depend of specific facts and circumstances of the product itself.

Fixed indexed annuities (FIAs) are popular in the US. While we have not explicitly covered this product in our analysis, we anticipate the implications will be similar to those described above for indexed universal life contracts.

Variable Annuity Business[2]

Opening equity: We generally expect that variable annuity contracts will include groups that are onerous under IFRS 17, which will lead to a reduction in opening equity.

We base our perspective on the lower level of aggregation required under IFRS 17 compared to US GAAP, and on the assumption of a significant impact of some of the minimum guaranteed benefits (GMxB) offered in these contracts changing from being accounted for under SOP 03-1 under US GAAP to a fair value type approach under IFRS 17.

Profit emergence: We anticipate profit emergence may be accelerated for newly issued variable annuity contracts, before considering the recognition of any unhedged GMxBs or similar financial guarantees.

We base our perspectives on the three components underlying the source of earnings:

- **Investment spread and fees –** Given that the performance of the underlyings are passed directly to the policyholders, there are no investment margins for these products (assuming no general account allocation). Management fees and other asset based charges are considered in the "profit loading" component for the purposes of this analysis.
- **PADs and RA –** Under current US GAAP, risk margins are reflected in the fair value measurement of embedded derivatives, but no risk provisions are established for guarantees with insurance risk (as they would be valued under SOP 03-1). The impact on profit emergence will depend on the magnitude of the RA compared to risk provisions under current US GAAP and the amortization pattern of the CSM as discussed below.

2 In order to analyze the impact that the implementation of IFRS 17 will have on the variable annuity business, we need to consider important technical decisions and accounting policies that may vary from company to company. Some of those decisions include the accounting treatment for financial options and guarantees (and the corresponding hedges), the determination of the discount rates under IFRS 17, and the basis for release of the CSM for "investment" driven products. Given that some of these issues are expected to be discussed by the IASB's Transition Resource Group (TRG) in the future, our analysis may be updated in the wake of additional discussions on these topics.

- **Profit Loading –** Under US GAAP, surrender charges are recognized as they occur, but the main profit drivers in these contracts are generally the management fees and rider charges, which we assume to total higher in later years as the assets under management grows over time, at least initially. Assuming the CSM is amortized on a straight line basis for variable annuity contracts, the profit loading component will likely be accelerated under IFRS 17. However, to the extent there are unhedged market losses relating to GMxBs or similar financial guarantees in excess of any CSM, these will be recognized more quickly than under current US GAAP.

Earnings volatility: We anticipate earnings volatility will be lower for variable annuities contracts.

When analyzing earnings volatility we need to consider the relationship between accounting policies for guarantees offered in variable annuity contracts and their corresponding risk management (hedges). Under current US GAAP, GMxBs classified as embedded derivatives (e.g., GMWB and GMAB) are fair valued through income with changes in the fair value of the hedges also recorded in net income. Other guarantees with insurance risk (e.g., GMDB and GMIB) are generally valued under SOP 03-1 and usually not, or partially, hedged.

Under the Variable Fee Approach (VFA), IFRS 17 allows the total change in financial guarantees to be recognized in CSM instead of earnings. However, since the results of derivatives purchased to hedge these guarantees will run through earnings, IFRS 17 allows the option to recognize hedged financial guarantee liability changes in earnings as well. Therefore, on balance, it would seem reasonable to assume that earnings volatility under IFRS 17 will be reduced. Under US GAAP, volatility will primarily depend on whether or not the guarantees fall under the embedded derivative fair value model or under the SOP 03-1 spreading model and the related the hedging strategy, along with effects of the retrospective DAC unlocking.

The structuring of hedging strategies will be a key area of review for companies with variable annuity contracts. Pricing is another area that companies will need to review because the new grouping requirements under IFRS 17, where loss making contracts are reported separately, may highlight issues in historical pricing practice.

Implications

- Implementers of IFRS 17 continue to evaluate their accounting policies in order to gauge the impact the new standard will have on their products.
- Opening equity at transition, volatility of future earnings and the timing of profit recognition will change. All of these indicators are extremely important and as such need to be closely monitored.
- Delving into the specific drivers of change will provide an increased understanding of the transition and on-going financial implications of accounting policy choices and how these may impact management decisions, product design and risk management strategies.

Tax

76 The operational impacts of the 2017 Tax Cuts and Jobs Act

The operational impacts of the 2017 Tax Cuts and Jobs Act

The December 22, 2017 Tax Cuts and Jobs Act ("the Act") is the most sweeping piece of US tax legislation in over 30 years. It will have wide-ranging impacts on insurers' business, including corporate structure, regulatory capital, and products.

We describe in detail elsewhere the Act's technical details and will continue to address what insurers need to do to comply with this new legislation as its implications become clearer. On a broader level, and as we describe below, the Act has clear operational impacts that go far beyond compliance.

The reduced corporate tax rate benefits most insurers, but leads to long-term strategic questions

The GOP-sponsored tax reform slashes the corporate tax rate from the headline 35% rate to 21%, bringing the US rate closer to the median when compared to other industrialized nations within the Organization for Economic Cooperation and Development (OECD). A 21% rate on taxable income will increase after-tax profit margins for legacy businesses and capital investment scenario planning considerations.

For the life and P&C industries, this should boost margins on legacy books of business and increase premium revenue if job and economic growth prospects materialize as the Act's sponsors claim. In the near term, insurance companies are focusing on financial statement management considerations, such as how to adjust deferred tax assets and liabilities, required changes to loss reserving methodologies and computations of taxable income, and reporting any untaxed foreign earnings and profits for the 2017 year-end statement as part of the repatriation "toll tax."

With more expected income to deploy, companies should consider the investments they can make to support operations, growth, and productivity.

However, insurers shouldn't ignore longer term considerations related to scenario and strategic planning in response to the rate cut. The corporate tax rate reduction should motivate insurers to consider how to deploy additional after-tax capital. Scenario planning should first evaluate the overall net impact of tax reform changes and quantify the amount of capital that could be retained by balancing the lower corporate rate against a tightening of deductions and the changes to taxable income computations. Modeling potential implications starting in 2018 and then forecasting mid-term planning and longer term strategic initiatives can provide management different views to assess the implications of redeploying additional capital.

With more expected income to deploy, companies should consider the investments they can make to support operations, growth, and productivity. Examples include enhancing IT infrastructure, investing in new product lines or capabilities, opportunities to expand brand presence through acquisition, and/or providing more free cash flow to policyholders and shareholders.

US-based insurers may be more globally competitive

The sponsors of the Tax Cuts and Jobs Act claim it will make the US tax system more attractive on a global scale. The shift to a territorial tax system, complemented by the reduction in the tax rate on non-US profits, is likely to help at least some US-based insurers be more globally competitive. The previous US tax system put US-parented insurers at a tax liability disadvantage compared to foreign-parented firms because all non-US income was taxed at the higher domestic corporate rate. Going forward, foreign subsidiaries of a US company no longer must pay a 35% US rate, which previously may have deter companies from expanding outside the US or repatriating earnings.

Because US parent companies are no longer taxed on worldwide income, the M&A market could see an uptick.

Because US parent companies are no longer taxed on worldwide income, the M&A market could see an uptick with more incentives-based buyers because of the deduction for affiliated inbound transactions from foreign subsidiaries. In effect, global insurers may be more inclined to consider US inbound investment to seek a lower tax domicile. Moreover, with the discontinuance of a higher US tax on all foreign profits could result in US outbound expansion also could become more common.

The Base Erosion and Anti-Abuse Tax applies to select offshore tax practices

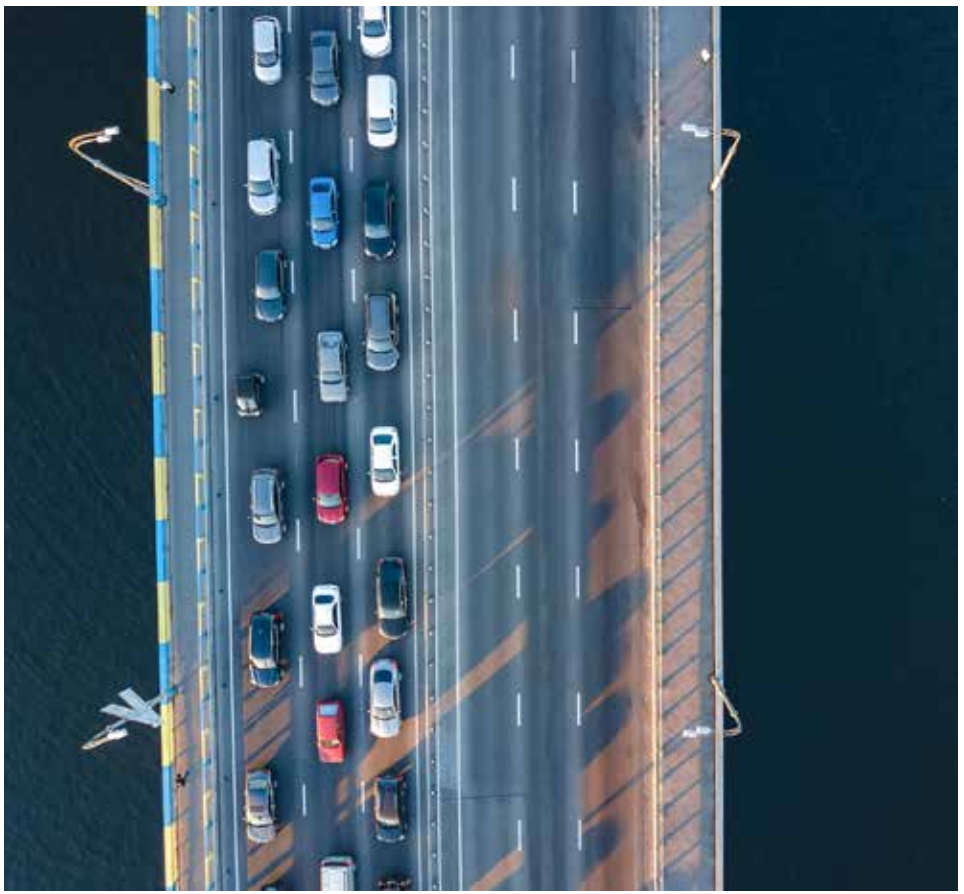
In alignment with the territorial tax system theme, the Act includes a base erosion and anti-abuse tax (BEAT) that imposes a new tax on certain base erosion payments made by a US taxpayer to a foreign affiliate. A minimum tax of 10% (5% in 2018) will be assessed when base erosion payments exceed a modified taxable income amount. The legislation explicitly mentions reinsurance payments as a base erosion payment, and thus is likely to significantly impact reinsurance arrangements between US-domiciled entities and affiliated entities located outside of the US, such as in Bermuda and the Cayman Islands.

BEAT is likely to significantly impact reinsurance arrangements between US-domiciled entities and affiliated entities located outside of the US.

The classification of reinsurance payments as "base erosion payments" will cause companies to take a look at affiliated reinsurance arrangements in offshore jurisdictions in 2018 and 2019. Companies that use offshore affiliate transactions to manage capital will need to reassess their costs and benefits. The BEAT minimum tax likely will motivate ceding companies to reconsider quota shares with affiliates altogether, reinsure with offshore third party reinsurers instead of affiliated captive reinsurance arrangements, retain or reallocate more risk to the US, or elect to be taxed as a US corporation .

Critics of the BEAT claim it's a form of double taxation on non-US insurance and reinsurance companies; domestic US insurers seem to favor the provision, because it will disincentive offshoring of profits by non-US companies to tax havens. Regulatory and industry efforts have been beginning to push for changes in this direction, but now the legislative tax impact, which took effect beginning January 1, 2018 creates an immediate deadline and thus a sense of urgency to review existing impacted arrangements to assess for options to manage BEAT liability and reporting requirements in later years.

In the near term, corporate finance and accounting functions must evaluate the impact of business tax reform changes to future financial statement provisions and line items



Certain business tax reform changes will impact insurers' corporate taxes, financing, and investment portfolios, namely (i) the repeal of the Alternative Minimum Tax (AMT), (ii) the reduction of the corporate tax rate, (iii) new limiting net interest deductions, and (iv) modifications to net operating loss deductions. Insurers expect longer term after-tax income relief with a lower corporate rate and a repeal of corporate AMT. But, in the near term, they must evaluate what adjustments are necessary in the form of write-downs to deferred tax assets and how the changes to net interest and net operating loss deduction amounts may impact future financial statements.

For example, some finance and accounting functions need to consider future business interest deductions, as the lower overall amount available to deduct could modify intragroup financing strategies for US multinationals, such as intragroup loans by the parent to provide capital to US subsidiaries, and shifting debt from highly leveraged US subsidiaries to non-US jurisdictions.

Changes to specific insurance provisions will have an impact on longer term financial statements and ultimately how regulators and rating agencies perceive a company's financial strength.

We expect that the reduction in the corporate rate will offset the increase in taxable income, but the changes to specific insurance provisions will have an impact on longer term financial statements and ultimately how regulators and rating agencies perceive a company's financial strength. In order to better understand the scale of beneficial or adverse effects, companies will need to analyze and project the net effect of expected write downs and limitations to deductions against the expected after-tax income relief from the reduced corporate rate and use of AMT refund credits. Through these exercises, corporate finance, tax, and accounting functions can guide business leaders to help inform business strategy by demonstrating the potential benefits of lower corporate taxes against potential negative effects of tightening limitations on previous deductions.

Product pricing will be an area of focus in 2018

We expect product pricing will be an industry focus because the lower corporate tax rate must be balanced against modified provisions that limit deductions and increase taxable income. Higher US corporate tax rates had previously always been a factor in new product pricing for both life and P&C products, and the new reduction in the corporate rate will offer more margin flexibility.

Finance and product leads will have to consider impact on product pricing of not just the new lower corporate tax rate, but also an increased deferred acquisition cost (DAC) tax capitalization percentage, as well as changes to tax reserving. In addition, the new minimum tax on reinsurance payments to offshore affiliates will cause companies to examine their capital management strategies and determine if the tax leads them to increase prices in order to address increased capital pressure.

Finance and product leads will have to consider the impact on product pricing of a lower corporate tax rate, an increased DAC tax capitalization percentage, and changes to tax reserving.

Given the higher commoditized and shorter term nature of personal products, price competition is likely to occur sooner than in life, and any decline would subdue some of the bottom line benefits from the lower corporate tax rate. Overall commercial prices probably will continue to result in positive underwriting and favorable returns, but the total benefits will be more favorable for domestic insurers than cross-border ones.

Life companies will have to balance the effect of the lower corporate rate on premium pricing with tax reserving changes, principle based reserving adoption, and other state regulatory initiatives.

Implications

- With more expected income to deploy, companies should consider the investments they can make to support operations, growth, and productivity. This could include enhancing IT infrastructure, investing in new product lines or capabilities, opportunities to expand brand presence through acquisition, and/or providing more free cash flow to policyholders and shareholders.
- Because US parent companies are no longer taxed on worldwide income, the M&A market could see an uptick.
- BEAT is likely to significantly impact reinsurance arrangements between US-domiciled entities and affiliated entities located outside of the US.
- Changes to specific insurance provisions will have an impact on longer term financial statements and ultimately how regulators and rating agencies perceive a company's financial strength.
- Finance and product leads will have to consider the impact on product pricing of a lower corporate tax rate, an increased DAC tax capitalization percentage, and changes to tax reserving.

Contacts

Digital

A new take on digital

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Tom Kavanaugh
Insurance Advisory Principal
+1 312 298 3816
tom.kavanaugh@pwc.com

Juneen Belknap
Insurance Advisory Principal
+1 407 236 5102
juneen.belknap@pwc.com

Alex Jaeger
Advisory Senior Associate
+1 212 671 8432
alexandra.m.jaeger@pwc.com

P&C insurance core transformation: Exploring the possibilities

Scott Busse
Insurance Advisory Principal
scott.busse@pwc.com

Rajesh Srinivasa
Insurance Advisory Director
rajesh.srinivasa@pwc.com

Josh Knipp
Insurance Advisory Director
+1 312 298 3044
josh.knipp@pwc.com

Matt Wolff
Insurance Advisory Director
+1 847 650 7348
matthew.wolff@pwc.com

Imran Ilyas
Insurance Advisory Principal
+1 630 699 0657
imran.ilyas@pwc.com

Deals

The deals environment

John Marra
Partner, PwC's Deals Practice
+1 646 818 7870
john.p.marra@pwc.com

Mark Friedman
Partner, PwC's Deals Practice
+1 646 818 7657
mark.friedman@pwc.com

Mike Mariani
Principal, PwC's Deals Practice
+1 617 530 4252
michael.j.mariani@pwc.com

Nisha Sheth
Partner, PwC's Deals Practice
+1 646 818 8081
nisha.sheth@pwc.com

Fit for Growth

Are your strategy & structure fit for purpose?

Bruce Brodie
Managing Director
PwC Strategy&
+1 646 471 3311
bruce.brodie@pwc.com

Financial challenges are clear but financial wellness is elusive

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Juneen Belknap
Insurance Advisory Principal
+1 407 236 5102
juneen.belknap@pwc.com

Kent Allison
Tax Partner
+1 973 236 5253
kent.allison@pwc.com

Caitlin Marcoux
Insurance Advisory Manager
+1 (412) 737 3421
caitlin.k.marcoux@pwc.com

Shifting cost curves to stay in the commercial insurance race

Jamie Yoder
US Insurance Market Leader
Tel: +1 (773) 255-2138
Jamie.yoder@pwc.com

Francois Ramette
Principal
PwC Strategy&
Tel: +1 (773) 612-7952
francois.ramette@pwc.com

Bruce Brodie
Managing Director
PwC Strategy&
Tel: +1 (203) 864-5204
Bruce.brodie@pwc.com

Joseph Calandro, Jr.
Managing Director
PwC Strategy&
Tel: +1 (203) 906-6595
calandro.joseph@pwc.com

Katie Klutts
Manager
PwC Strategy&
Tel: +1 (202) 255-0843
kathryn.klutts@pwc.com

Matt Shuman
Senior Associate
PwC Strategy&
Tel: +1 (781) 915 4433
matthew.a.shuman@pwc.com

The three C's: How consolidation, customization and collaboration will continue to impact commercial brokers in 2018

Richard Mayock
Global Insurance Brokerage Leader
+1 646 471 5090
richard.mayock@us.pwc.com

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Francois Ramette
Principal, PwC Strategy&
+1 773 612 7952
francois.ramette@pwc.com

Marie Carr
Principal, PwC Strategy&
+1 312 298 6823
marie.carr@pwc.com

Matthew Wolff
Director, PwC
+1 847 650 7348
matthew.wolff@pwc.com

Joseph Calandro, Jr.
Managing Director, PwC Strategy&
+1 203 906 6595
joseph.calandro@pwc.com

Expanding Into Small Commercial

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Francois Ramette
Principal, PwC Strategy&
+1 773 612 7952
francois.ramette@pwc.com

Marie Carr
Principal, PwC Strategy&
+1 312 298 6823
marie.carr@pwc.com

Jon Blough
Manager, PwC Strategy&
+1 312 479 2178
jonathan.g.blough@pwc.com

Fit for Growth (continued)

Group insurance: No longer an overlooked market

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Marie Carr
Principal, PwC Strategy&
+1 312 298 6823
marie.carr@pwc.com

Jim Quick
Principal, Advisory Services
+1 312 298 6882
james.m.quick@pwc.com

Mike Mariani
Principal, Advisory Services
+ 1 505 715 1334
michael.j.mariani@pwc.com

Josh Schwartz
Principal, Advisory Services
+1 845 893 7327
joshua.schwartz@pwc.com

Risk & Regulatory

Cognitive dissonance and the CRO

Henry Essert
US Insurance Risk & Capital Services Leader
+1 646 471-4400
henry.essert@pwc.com

IFRS 17: Illustrative Product Actuarial Implications

Rodrigo Careaga
Life Actuarial Director
+1 312 298 6041
rodrigo.careaga@pwc.com

David Honour
Life Actuarial Principal
+1 646 471 1696
david.honour@pwc.com

Michael Lockerman
Life Actuarial Principal
+1 646 471 2179
michael.lockerman@pwc.com

David Scheinerman
Life Actuarial Principal
+1 860 241 7129
david.c.scheinerman@pwc.com

Mary Saslow
Managing Director
National Professional Services Group
+1 860 241 7013
mary.saslow@pwc.com

Donald Doran
Partner
National Professional Services Group
+1 973 236 5280
donald.a.doran@pwc.com

Tax

The operational impacts of the 2017 Tax Cuts and Jobs Act

Chris Joline
Tax Reform Leader
+1 646 471 5659
chris.joline@pwc.com

David Schenck
US Insurance Tax Leader
+1 202 549 9412
david.a.schenck@pwc.com

Mark Smith
Managing Director, Tax Services
+1 202 312 7518
mark.s.smith@pwc.com

Tom Swoboda
Manager, Advisory Services
+1 314 518 9184
tom.swoboda@pwc.com

Ed Hirsh
Senior Associate, Advisory Services
+1 646 471 3534
edward.t.hirsh@pwc.com

PwC insurance practice leadership

Greg Galeaz
US Insurance Practice Leader
+1 617 530 6203
gregory.r.galeaz@pwc.com

Matt Adams
US Insurance Assurance Leader
+1 646 471 8688
matt.adams@pwc.com

Ellen Walsh
US Insurance Advisory Leader
+1 646 471 7274
ellen.walsh@pwc.com

David Schenck
US Insurance Tax Leader
+1 202 549 9412
david.a.schenck@pwc.com

Jamie Yoder
US Insurance Market Leader
+1 312 298 3462
jamie.yoder@pwc.com

For more information

Eric Trowbridge
US Insurance Marketing Leader
+1 202 248 4470
eric.trowbridge@pwc.com

Amy Rose
US Insurance Marketing Manager
+1 571 766 9266
amy.n.rose@pwc.com

www.pwc.com/us/insurance