

# Top Nine Insurance Industry Issues in 2009:

## Crisis and change

As the economic crisis persists, the insurance industry is seeking ways to maintain adequate capital, manage risks, retain business and contain costs in a very challenging market.

### Heart of the matter

Insurers are faced with the most challenging economic environment in decades. The ongoing financial crisis is having a profound effect on the industry and policyholders, and the current ways of doing business are under great stress. Moreover, this is perhaps *the* critical year in the current crisis, and how insurers manage uncertainty and change in 2009 likely will determine their long-term success.



# Table of contents

1. Risk management in the wake of the financial crisis	1
▪ Maintaining adequate capital and surplus	1
▪ Liquidity risk management	2
▪ Effective risk management	4
▪ Valuation	5
2. Back to basics	5
▪ Solvency	5
▪ Improving property and casualty claims	6
3. Cost reduction	8
4. Changes in sales and distribution	9
▪ Declines in business volume	9
▪ Speed to market	9
▪ Changes in customer focus and related operating models	10
5. Investment management function effectiveness	10
6. Privacy and information protection	12
7. IFRS	13
8. Regulatory reform	14
9. Economic and tax policy agenda	14



# 1 Risk management in the wake of the financial crisis

## Maintaining adequate capital and surplus

Not since the late 1980s and early 1990s has there been such an intense focus on maintaining adequate capital and surplus. Twenty years ago, collapsing asset classes included premium real estate, junk bonds and bullet commercial mortgage loans. In addition the casualty insurance industry was seizing up from the first waves of plaintiffs suits over damages from asbestos, toxic waste, breast implants and tobacco, which triggered huge increases in insurers' losses. The asset collapse caused the failure of Mutual Benefit Life and the takeover of The Equitable by AXA, while the disappearance of casualty insurance capacity spawned ACE Ltd and XL Capital. As these events were unfolding, the regulatory, actuarial and accounting communities were re-examining their approaches to regulation, management and financial reporting, ultimately ushering in Risk Based Capital ("RBC") measures, Reg. 22 cash flow testing, asset liability management (ALM) models, and launching the project to codify statutory accounting under the auspices of the NAIC.

Today, we are witnessing the collapse of structured securities, public and private equities — as well as hedge funds—a complete seizing up of the credit markets, drastic drops in sales of variable life insurance products, the halving of fees for asset management as investment fund values plummet, and massive losses by bond insurers and mortgage insurers. What will all this leave in its wake? What will insurance companies do in their struggle to maintain adequate capital and surplus, and in some cases, to survive? What role will the regulatory and accounting changes of the mid 1990s play, and what further changes can we anticipate?

We already can see trends developing. Companies with venerable franchises will attract new capital from the strongest and most far-sighted investors—such as Berkshire Hathaway, which recently made a \$2.6 billion capital infusion into Swiss Re. Other investors are waiting in the wings to make similar moves for quality companies whose stock is severely depressed or whose capital and surplus has been damaged.

Companies with depressed stock prices are easy to spot, while those with damage to their statutory capital and surplus, once almost impossible to identify, will be more visible to today's investors. The mid-1990's introduction of RBC and the use of codified statutory accounting will help today's investors, analysts and rating agencies identify those companies that are

struggling to maintain adequate capital & surplus in their regulated insurance subsidiaries. RBC is not perfect and like any formulaic measure, can be "interpreted." However, it is a good starting point and any signs of "interpretation" will likely be spotted and discounted.

Prior to codification of statutory accounting, companies were able to get permission from their domiciliary state insurance regulator for accounting treatments that improved the look of their capital & surplus without a great deal of disclosure. The Wall Street Journal recently reported that several companies are again seeking permission for such statutory accounting relief. But, accounting and audit rules now require prominent disclosure in GAAP footnotes of departures from codified statutory accounting rules, and in statutory financial statements possible extra paragraphs in auditors' reports.

However, there are many acceptable ways which companies have used to improve their reported statutory capital and surplus, including:

- Moving the ownership of insurance and other subsidiaries under the principal insurance company—so-called "capital stacking."
- Entering into reinsurance contracts that either increase capital and surplus or have an advantageous effect on RBC.
- Selling high quality bonds to record realized gains while holding onto underwater bonds at amortized cost—so-called "cherry picking."
- Issuing Surplus Notes that qualify as statutory capital but are shown as debt under GAAP.
- Securitizing reserves for certain life insurance products to reduce the negative impact of XXX reserve requirements.
- Recording investment impairment charges that are on the lower end of acceptable ranges; most fixed income securities are not marked-to-market under statutory accounting, so only impairment charges actually reduce surplus.

Fortunately for investors, analysts and rating agencies, today's disclosure requirements tend to provide transparency into these matters, allowing for fair comparisons among insurance companies.

Finally, the increased liquidity cushions that insurers may look to hold—at least in the short term until credit markets recover—will potentially reduce shareholder returns. The application of robust liquidity risk management practices can help reduce the need

for these cushions both in the short and longer terms and their resulting impact on shareholder returns.

A robust liquidity risk management framework should combine quantitative risk metrics (driven from a centralized database) with appropriate governance and oversight, including an annual liquidity strategy, a liquidity risk management policy and a contingency funding plan. In addition, stress testing should play an important part in an integrated risk management framework, helping to ensure management develops cross-business and cross-risk perspectives of their liquidity exposure.

That said, the current financial crisis has demonstrated that most—if not all—firms’ stress testing has not envisaged current circumstances. Accordingly, it is important that companies’ liquidity stress testing focuses on the three “H’s”:

- **Historical**—Testing scenarios based on significant past events. These tend to be more fully articulated and involve less judgment than the other “H’s”. However, they may be less suited to the actual risk profile of an institution and not adequately reflect advances in risk taking.
- **Hypothetical**—Testing liquidity after a significant market event or macro-economic scenario that has not yet happened. This is often labor-intensive and requires judgment or specialist expertise, although historic data can be used to identify relevant relationships between risk factors.
- **Hybrid**—These scenarios use historical market movements as a basis, but are not necessarily linked to a specific crisis. The scenarios need to balance a trade-off between realism and comprehensibility, with qualitative discussion and business context being important.

It is important that senior management dedicates sufficient time for active involvement in the scenario testing process. However, it is also important that management understands the limitations of stress testing. In particular, stress testing is a tool for improving risk management—not a substitute for good governance and oversight. Furthermore, stress scenarios are limited in number and do not reveal probabilities; they focus on unlikely events without considering how plausible or improbable they are.

### Implications

- Risk-based capital (RBC) and the use of codified statutory accounting help today’s investors, analysts and rating agencies to identify those companies that

are struggling to maintain adequate capital & surplus in their regulated insurance subsidiaries.

- Unlike in the past, accounting and audit rules now require prominent disclosure if companies seek permission for statutory accounting relief.
- There are many acceptable ways to improve reported statutory capital & surplus that allow for fair comparisons among insurance companies.
- Even in the current market, some large investors have proven willing to inject capital into insurers they feel are good long-term bets.
- In combination with good governance and oversight, stress testing is an essential and extremely valuable component of a liquidity risk management framework, which can challenge silo-based thinking. However it requires buy-in from senior management to be effective, and caution should be taken not to place “blind reliance” on the results.

### Liquidity risk management

Insurers are exposed to liquidity risk, both directly through their operations and indirectly through impacts on producers, investment managers, broker-dealers and business partners. Boards and senior management need to be aware of liquidity risks and implement robust contingency plans, as well as controls and systems, to carefully identify, monitor and manage them.

In particular, experienced executives know that almost every agreement their company has ever entered into has so-called Armageddon clauses. Lawyers include these clauses to protect their clients, but they are often forgotten or unmonitored, because Armageddon is never supposed to arrive. These clauses can be triggered by a significant rating downgrade, a ‘Material Adverse Change,’ a change in control, or violation of a debt covenant. In some cases, these clauses will work against a company, and in others they will give a company the right of action against others. Insurers need to ask themselves now when they last did a comprehensive ‘Trigger Analysis’ to understand their exposures and opportunities under these Armageddon clauses.

Insurers have multiple liquidity risk exposures. For example, in recent years, several publicly-traded insurers have borrowed heavily to fund stock buyback programs, or to fund acquisitions. This debt often is on the balance sheet of the public holding company whose only significant source of cash is dividends from its regulated insurance subsidiaries. As the insurance operations experience a perfect storm of declining

business, pressure from rating agencies to increase capital, OTTI charges eroding surplus, and their own liquidity strains, it may not be possible to pay dividends to the holding company.

The ongoing trend of rating downgrades is also having an effect. In some cases GIC contracts, general guarantees, support letters, credit default swaps, and other agreements have clauses requiring collateral posting in the event of a two- or three-notch drop in an insurer's rating. Reinsurance treaties often allow for rescission if ratings drop too far. For reinsurers, this could mean returning significant amounts of premiums in cash or liquid investments to rescinding cedants.

Some insurers have been seeking new capital, including access to TARP funds. If too large a portion of the capital is in new hands, change-in-control can be triggered. Many agreements have clauses giving counterparty rights upon a change in control, and tax laws at all levels (including local property transfer taxes) can trigger significant tax costs. In addition, there is an ever present threat of large CAT losses; earthquakes know no season. Replenishing capital lost to CATs will be very difficult under current credit market conditions. Moreover, a very recent and unusual risk for insurance companies is the real possibility that their 'unauthorized' reinsurers (off-shore reinsurers) may not be able to renew lines of credit supporting the letters of credit that insurers must have in order to recognize the reinsurance benefits in their statutory capital. Without the reinsurance benefits, RBC levels could be breached, ratings could take a hit, and dividend paying capacity could evaporate. The good news is that the NAIC and key states should provide some relief in this area.

Life insurers are not immune to these problems, either. Although most of them use asset/liability management (ALM) programs to measure their liquidity risk, many of these programs are conducted annually and may not reflect current market conditions. Not only could valuations be out of date, but cash inflows and outflows may need to be recalibrated. For example cash inflows could decline because of reduced prepayment speeds on mortgage-backed securities, failure or bullet mortgage loans to repay, delinquent rents on investment real estate, or a severe decline in the sales of variable products tied to the stock market. On the other hand, cash outflows could accelerate due to surrenders of BOLI/COLI policies, surrenders or withdrawals of annuities, an up-tick in policy loan requests, or defaults under securitizations such as XXX deals, European Medium Term Notes, or Trust Preferred deals.

Insurers also could be affected by the financial condition of their business partners, such as Managing General Agents (MGAs), investment managers, and insurance brokers. These partners could go into bankruptcy or receivership while owing debts to an insurer. They also could take advantage of the insurer by delaying cash transfers to meet their own immediate operating cash needs. In addition, there is a risk that a business partner could engage in fraud. They also need to understand their exposure to receivables from reinsurers and other business partners.

Insurers also are exposed to risk related to their invested capital. The liquidity, performance and safety of many investments are in question. Although most insurers have by now reviewed their portfolios to identify problematic direct holdings, they may not fully understand their exposure through assets included in partnerships such as hedge funds. In addition, the valuation of many holdings, particularly less-liquid derivative products, is far from clear. The uncertainties over mark-to-market accounting, including controversies over Financial Accounting Standards Board fair value accounting guidance under FAS 157 and FAS 159, have only added ambiguity to these calculations.

### Implications

- A sudden loss of liquidity could result in the need for a significant—and painful—infusion of capital. Unfortunately, finding that capital in the current market would be a major challenge.
- Insurers should carefully review all of their significant agreements, determine what occurrences could trigger a default or cash call and take steps to prevent such events wherever possible. In particular, they need to ask themselves now when they last did a comprehensive "Trigger Analysis" to understand their exposures and opportunities under Armageddon clauses.
- Insurers should re-evaluate their ability to renew expiring credit facilities, and closely test the performance of sidecars and other standby capital vehicles intended to protect liquidity.
- Insurers should update their ALM programs to reflect current conditions and valuations. These reviews may lead to a decision to increase the amount of liquid investments on hand—and, as importantly, decide what a liquid investment is in today's environment.

- It is crucial that management prepare contingency plans for unforeseen developments. For example, they may want to delay share repurchases, have solid lines of credit available or be able to address an event of default or cash call before it triggers a domino effect elsewhere.
- Directors also should review projected holding company and insurance subsidiary cash flows and contingencies for shortfalls. Often, cash outflows are fixed whereas cash inflows require action, approval or agreement, all of which take time.
- While many insurers may have identified the investment risks in their own portfolios, they also need to carefully monitor the risks in indirect investments made through partnerships and joint ventures. In addition, they need to pay close attention to the financial condition of their business partners, such as Managing General Agents (MGAs), investment managers, and brokers.
- Insurers need to be current with accounting guidance for valuation, in order to be able to assess potential OTTI charges on their holdings.

### Effective risk management

The role of enterprise risk management (ERM) in the recent financial crisis has been hotly debated. Some commentators believe the crisis represents a major failure in the application of ERM, while others argue it is unfair to place significant blame on what is still a relatively young management discipline. In either case, it is clear that one way insurers can help protect themselves from future turbulence in the financial markets and other unforeseen events is to develop effective and robust ERM programs.

To date, while ERM has consolidated its position as a leading Board-level priority, it has yet to take root within the wider business at many insurers. ERM cannot work in a vacuum; it needs to be embedded within the management of an organization and integrated within every aspect of the business to make a difference. Importantly, it needs to be embraced by risk-takers rather than just risk professionals.

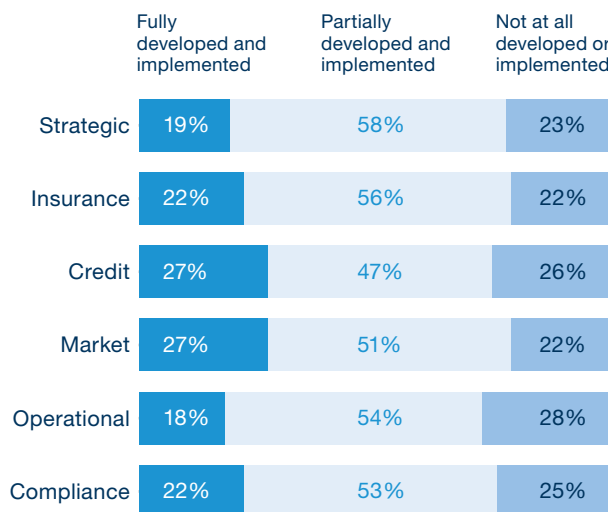
In taking ERM to the next level, companies will need to develop a clearer understanding of appropriate firm-wide roles and responsibilities; more timely reporting of relevant risk information to key decision makers; and an appropriate balance between reliance on risk models and management judgment. Making ERM work also requires an influential role for the CRO, including a clear mandate to challenge risk positions and ensure that appropriate action is taken.

It is also important for companies to learn from the recent financial crisis. In general, companies that were less affected by the crisis shared some of the following key attributes:

- Strong risk culture, including a clear allocation of roles and responsibilities with associated accountability linked to performance objectives and individual incentives;
- Effective alignment between strategy, risk appetite and regularly monitored risk limits;
- Timely and effective identification, communication and escalation of issues;
- Avoiding over-reliance on modeling and historical data points, including readiness of senior management to understand and challenge underlying risk assumptions; and
- Consistent implementation of risk management practices and standards across the business.

Two key components of effective ERM that may help prevent future failures include the monitoring of emerging risks and the development of model governance frameworks. Along with active involvement in industry forums and monitoring of relevant publications, emerging risk practices should include regular senior management brainstorming and risk workshops. Further, while quantitative modeling is an important input in the management of an insurance company, the ever increasing complexity of many key models is demanding a higher standard of validation and governance around the use of model results.

Processes for identifying emerging risks within risk categories



Example Source: PricewaterhouseCoopers 2008 Global ERM Survey

## Implications

- Development and effective embedding of ERM can play an important role in helping to prevent future failures.
- Key elements of focus should include the monitoring of emerging risks and model validation practices.
- ERM can only be effective if it is embraced by risk-takers rather than just risk professionals.

## Valuation

Determining values in illiquid markets can be challenging, and the current unusual market conditions and complexity of many financial instruments make it particularly difficult. Due to less liquidity in most markets and none in certain markets, more and more estimates of values are being determined using valuation models. Though insurance companies have used models to estimate a broad range of exposures, generally they have not had to use models to determine fair values in their financial statements. Because of this, insurance companies need to ensure that the proper controls over these valuation processes are effective.

In developing and implementing controls over such processes, companies need to assess the adequacy of their resources and effectiveness of checks and balances. Though the people who initially determine a fair value should have the appropriate tools and data, companies also need to make sure that those responsible for verifying the values also have an ability to independently develop a view of the values. This means they need to fully understand the product being valued, the method being used, and the current market conditions.

In addition to these detailed procedures, companies need to ensure the process is governed appropriately. Senior managers need to be provided with adequate information so that they can assess significant judgments as well as the final results of the valuation process.

The use of models to determine fair value used in public reporting inevitably creates some concern. However, with the proper infrastructure and controls, companies can estimate fair values, even in these unusual times.

## Implications:

- Expanding role of models in financial reporting requires additional controls.
- Controls need to cover the detailed valuation processes as well as the governance over the results of the process.

- Companies need to assess the adequacy of their control people, models, and data.

## 2 Back to basics

### Solvency

Insurers need to consider back-to-basics performance improvement initiatives for every front and back-office process, from sales through claims, finance, HR, and IT. In the pages that follow, we focus on two areas in particular that can benefit from a back-to-basics approach: solvency and P&C claims performance improvement.

*Maintaining solvency in a down market* — The insurance industry has diversified its product portfolios during the past two decades, which—as the current financial and credit crisis has shown—has made it more vulnerable to market downturns. Specifically, life insurers have expanded their product portfolios from whole and term life to more market-sensitive products that provide competitive returns to policyholders while enabling the issuing companies to remain competitive in a rapidly integrating financial services market. However, these new products present insurers with new complexities and risks. Notably reserve calculations have become more complex and subjective, and investment portfolios require more intensive management in order to align return and cash flow modeling with pending liability.

For life insurers, long-term investments will yield lower long-term returns due to worldwide credit concerns and the Federal Reserve's lowering of interest rates. Short-term rates of return are close to 0 percent and are not likely to rebound in the immediate future. In addition, as a result of the continuing deterioration of investment grade securities, a market recovery is not expected in 2009. Specifically, Alt-A investments are just beginning to deteriorate, much like subprime investments did in 2007-08. Moreover, credit default swap exposure is not yet fully known across the industry.

For property and casualty insurers, the risk profile and short-tail nature of their products mean that their portfolios generally are less affected by valuation concerns. However, short-term liquidity is an important consideration for them, and market volatility, poor short-term market returns, and pricing and customer credit pressures will put more pressure on key factors in their loss-ratio analysis (e.g. actual versus expected written premiums).

For the insurance industry as a whole, poor returns and questionable credit quality of assets are forcing insurers to find other ways to ensure solvency. The market decline of 2008 is likely to continue throughout 2009, and ongoing volatility in financial markets will make effective investment modeling an increasing challenge. This will increase product pricing pressure and business retention efforts for both life and property and casualty companies. Adverse selection will continue to drive success at companies that have effective product development and understand which products are profitable and at what cost to whom.

The profitability of the majority of the industry's key products will remain closely tied to the ups and downs of the market. Products that were marginally profitable, or even break-even prospects, may now be less attractive to insurers. Driving out competition on products without profitable margins will be less appealing in a market with little to no investment returns. These diminished (and in some cases negative) investment returns have eliminated the margin for error in assuming risk for certain product types. This is further complicated by the fact that insurers do not always know the true risk profile of the newer, more unique products until a few years after they begin selling them.

Accordingly, insurers will renew their focus on solvency, and pay particular attention to risk-based capital. As a result, they will have to focus on long-term risk and profitability of existing product mixes. A number of insurers have already exited certain products, and we expect this trend to continue. Because it will gradually reduce portfolio risk, we also expect to see the implementation of stricter underwriting guidelines during rate renewal filings, as well as the use of reinsurance to reduce risk profiles. In addition, there is a greater chance of stable insurers acquiring struggling companies, particularly when the latter are available at deep discounts.

*Developments in solvency regulation* — Many industry stakeholders have argued that there is disparity between true economic capital and the capital required by traditional regulatory frameworks. For example, US capital requirements are typically based on standard formulae or include calculations based on prescribed assumptions with limited provisions to reduce capital based on risk mitigation or diversification between products or marketplaces. In contrast, under the proposed European Union Solvency II framework, EU companies would be able to use their own approved internal models, incorporating an allowance for diversification into a unique but credible capital assessment.

As a result, US insurers are continuing to watch developments surrounding the emerging Solvency II regulations. Under the proposed Solvency II framework, insurance assets and liabilities would be measured using economic principles, with the resulting capital requirements based directly on risk-based measures.

Although Solvency II would at present apply only to EU insurers, many other jurisdictions are monitoring how it develops to assess its competitive impacts and determine which of its elements might be applied further afield. In the US, the NAIC's International Solvency and Accounting Working Group is performing an analysis of the proposed Solvency II framework and identifying areas for US regulators to consider including in current NAIC programs.

The companies most likely to benefit from lower capital charges under Solvency II are larger, diversified insurance groups with effective risk management. Of course, US insurers with European subsidiaries (and US subsidiaries of European companies) will clearly be affected.

### Implications

- Insurers need to embed enterprise risk management into their overall decision-making process, particularly for underwriting, investments, and product development, because they most significantly impact solvency.
- As part of an increased focus on overall risk and its impact on risk-based capital, insurers are elevating (or creating) chief risk officer (CRO) roles; moreover, the expansion, enhancement, and elevation of the internal audit function supports a more stringent review of risk management and compliance.
- This is a good time to upgrade staff because experienced talent is more readily available than in recent years.
- Developments in the pipeline in the US may help some insurers reduce the costs of more onerous domestic capital requirements, but they may not be sufficient to offset the advantages European insurers may realize under Solvency II. If, as anticipated, Solvency II leads to markedly lower capital charges for EU-based companies, then European companies will have a significant competitive advantage over their US competitors.

### Improving Property and Casualty Claims

*Technology*—Because most of them are looking to modernize their processes, P&C claims departments

are focusing on transformational technologies to improve on or replace traditional methods. Ninety percent of the insurance companies with whom PwC regularly meets have initiated or are contemplating the initiation of a claims transformation initiative. Most of them are looking to improve their claims performance index numbers (expense, indemnity, operations, customer satisfaction, sales) with modern technology.

Modern technologies at the forefront of discussion include business process management suites (work automation), analytics of work and enterprise data, easy integration of applications (supporting mobile technologies and other external and internal applications), and internet self-service. This functionality can be found in stand-alone technologies that leverage existing investments, as well as in some newer releases of claims administration systems.

However, these functions will not provide the value for investment by themselves. While modern technology does encourage rationalized spending and company-wide streamlining of the claims process, companies need two things to realize the full value of a transformation initiative: data and vision.

Data ultimately determines the success or failure of transformational technologies. For example, if a company is seeking to provide better self-service to a claimant and display claims status via the web, there will be no status to display if the claims system does not house the requisite data—even if the portal is integrated with the claims system.

Vision enables the success of a transformation initiative. Too frequently, insurance companies buy technology and build their future vision around it. Such buying patterns yield marginal returns on a large investment that do not always result in competitive gains. Creating a vision and buying the technology with which to build the envisioned future should yield far greater returns on the investment.

### Implications

- Modern technology enables companies to reduce cost and increase customer satisfaction.
- Transformational initiatives will take longer in the research and planning stage.
- Return on investment analysis will be more complex.

*First Notice of Loss* — FNOL is reemerging as a hot topic, particularly among personal and small to mid-size commercial lines. A focus on customer service

is growing as competition increases in a shrinking market and claims is emerging as a real differentiator in customer service.

To achieve this, companies are moving towards an integrated, efficient, and customer-focused FNOL process. Historically, when the insurance industry bifurcated FNOL from the balance of the claims process, it leveraged new call center technology, old claims administration systems, old policy administration systems, multiple different channels with multiple different handling procedures, and lower skilled resources. This early operational design added both complexity and expense to the claims process.

Today's designs are different. PwC sees companies undertaking a number of different initiatives, including in-sourcing—rather than outsourcing—the FNOL process, and re-evaluating online self-service strategy. In addition, carriers also are testing the bounds of tolerance for policyholder self-adjudicated claims. Finally, most carriers are evaluating new FNOL technologies on how seamlessly they connect call center technology with claims and customer service systems, how effectively they facilitate a single FNOL process with variation limited to channel and user, and how efficiently they automate work.

With one view of the customer, an FNOL agent could change an address, provide notification of an overdue premium payment, and so on. All of this has the potential to reduce the need for human integration, thereby resulting in more efficient FNOL, as well as enable companies to reallocate funds to a customer service or revenue-generating activity.

### Implications

- Policyholders will choose insurance companies based on how easy they are to work with—not just price—and there is more pressure than ever to get FNOL right.
- An efficient initiation of the claims process will yield returns along the entire claims continuum.

*Claims Defense Cost*—Insurance companies typically find the cost of defending claims to be among their largest line items. While there are inherent challenges to reducing claims defense costs, there are opportunities for cost avoidance.

One such challenge is the unanticipated impact of cost cutting on indemnity; any initiative, its timing, roll-out strategy, and projected results all merit careful consideration. For example, terminating a law firm that knows the company and its underwriters' intent in favor

of a lower priced, less experienced firm might backfire and wind up costing the company more in the long run. Similarly, it would not be ideal to negotiate a decreased rate with a law firm in the middle of a class-action suit. Doing so might result in short-term cost savings, but might well jeopardize the successful conduct and resolution of the suit.

Another challenge is managing the expectation of return. Rarely will a claims organization realize an immediate return on a defense cost-cutting initiative because results will take time to realize. For example, the savings that result from instituting bill review software will materialize gradually as bills are received over time.

However, there are opportunities for cost avoidance. One sure way is to immediately and sustainably reduce defense costs is to avoid incurring unnecessary expenses in the first place. For example, companies can implement an analytics initiative that, based on historical data, predicts the likely financial outcome of a litigated matter versus an arbitrated matter versus a well-negotiated matter. (An analytics initiative also offers the benefit of new business information for underwriters when pricing policies and introducing new products.) Another way to reduce costs would be to offer sliding premiums based on a policyholder's willingness to participate in the insurers legal cost management program.

### Implications

- Alternative approaches to reducing defense costs may be more sustainable than quick wins.
- Indemnity may be adversely affected by a poorly executed cost reduction effort.
- Harnessing information to develop cost management and avoidance techniques is an alternative to the traditional approach to litigation cost management.

## 3 Cost reduction

Sustainable, intelligent cost reduction is an integral part of any back-to-basics initiative (and vice-versa). While many companies will react quickly to the financial crisis with concerted attempts to align revenue and costs, rapid fire, broad-based cost cutting efforts could have devastating consequences, both in the short and long term, as well as tactically and strategically.

The foundation of any effective cost cutting initiative is a systemic understanding of a business's people,

processes and technology, with a primary focus on carefully adjusting what drives costs. Without a basic understanding of the latter, attempts to drive down costs in one area can easily drive up costs in another, eventually undermining a company's ability to compete. Examples are plentiful:

- Marketing and distribution cuts leading to lower sales;
- Outsourcing complications adversely impacting customer loyalty;
- Benefit reductions working against retention of key employees;
- Compliance cuts increasing exposure to litigation; and,
- Staff cuts leading to unacceptable cycle times.

The most critical success factor for effective cost reduction is thoughtful, rapid execution of a strict methodology. Beginning with analysis, use external benchmarking as a point of reference, keeping in mind the numerous translations that occur during external data collection, synthesis and comparison. Accordingly, internal benchmarking and performance measurement is much more valuable. Review internal and external cost drivers (e.g. vendor contracts) to develop a business improvement plan that reduces costs. Then design, pilot and implement the plan based on priorities, resources and dependencies. Never forget the human element of the plan, as communication, training and ongoing performance management are key.

Moreover, well-defined ownership of and proper accountability for the decision-making process greatly facilitates effective cost reduction. Most large, complex insurers have multiple business units. Regardless of how a company is organized (by products, markets, customer segments, or otherwise), there is typically a senior operating team that is responsible for running business units and an executive team that resides in a geographic location that manages all of the businesses. These organizational layers can complicate the decision-making process because there are potentially conflicting sources of authority over investments, spending, accountability and other vital considerations in a sustainable cost reduction effort.

Even if decision-making authority is clear, these layers still can cause inefficiencies, particularly the extra time and effort it takes to approve decisions as numerous people in the organization may have consultative roles in the process. In some cases this is good, because it can prevent unnecessary spending, but

it generally lengthens the time it takes to get things done. Institutions that make effective decisions on cost reduction initiatives typically designate authority at the proper levels without overly relying on multiple reviews and approvals at other levels.

#### Implications

- Develop a systemic understanding of the business that takes into account the changes resulting from the current financial crisis.
- Prevent or quickly remedy drastic cost cutting tactics.
- Don't forget that people are among a company's most valuable assets.
- Determine clear ownership of and authority for decisions on cost reduction at proper levels in the organization.

## 4 Changes in sales and distribution

### Declines in business volume

Historically, insurers have weathered economic downturns better than other financial institutions. However, because of its unprecedented nature and magnitude, the current financial crisis is proving to be challenging for insurers and brokers. With protection of capital and financial ratings as primary motivators, insurers are using conservative pricing as one of their main counter-strategies. While this is offsetting some premium and exposure growth concerns, long-term market and underwriting cycle recovery in the post-AIG bailout era is uncertain.

Despite these challenges, insurance customers and distributors are showing some of the resilience historically seen in the insurance market. According to a recent research report released by LIMRA, nearly half of producers surveyed reported an uptick in business and referrals despite the economic crisis. Similarly, consumer confidence seemed to be higher with insurance carriers than other financial institutions.

Some of the key sales trends in the industry:

- Life sales have been declining over the years, and this trend is expected to continue.
- Equity market volatility has adversely affected variable annuity sales across the board, and carriers with guarantee products are trying to renegotiate the price on existing contracts.

- Fixed annuities are experiencing significant growth as consumers look for low-risk income protection options.
- Personal lines auto and home carriers are trying to fight a softer underwriting cycle by firming up pricing and risk selection. As a result, slower policy and premium exposure growth could be offset by firm prices.

#### Implications

- To avoid price/premium deterioration, focus on producer and customer relationships.
- Focus on agent productivity and profitability to grow channel performance.
- Improve ease of doing business from producer and customer's perspective.
- Improve proactive communication with producers to reassure clients about financial stability of the company.
- Reinvent life and annuities around asset protection and retirement.

### Speed to market

The current economic climate and the seemingly perpetual cycle of soft and hard markets have sharpened insurers' focus on reducing acquisition and retention costs and increasing the ease of doing business. The acquisition and retention of customers and producers traditionally has been costly and labor intensive, and there is growing pressure on insurers to transform their core operations in order to achieve cost reductions, growth, and scale. A recent industry survey found even as premiums in many lines of business continue to drop, insurers are devoting 15% or more of their new project spending to new business improvements. Accordingly, improving the ease of doing business and the need to reduce overall complexity is a strategic priority.

Insurers across lines of business have begun to realize that business process improvement and automation are key enablers to increasing acquisition and retention, as well as improving underwriting effectiveness. Business process management—both as a discipline and a technology—will enable insurers to create a platform for innovation, integration and flexibility that will ultimately help eliminate obstacles to acquiring customers and producers.

Key strategies to improve business processing include:

- Increasing the quality of submissions and the “hit ratio;”
- Eliminating redundant data entry and reducing data entry errors;
- Improving the speed and quality of underwriting decisions;
- Reducing the cost of underwriting decisions; and,
- Reducing post issuance rework.

#### Implications

- Insurers need to better understand their appetite for customer and segmentation risks early in the underwriting process.
- Process optimization and automation facilitate business process outsourcing.
- The increase in the ability to leverage “straight through processing” and predictive analytics improves underwriting quality and time to market.

#### Changes in customer focus and related operating models

Insurers have been slow to take advantage of the Internet’s potential. A few auto insurers have strong self-service models both in acquisition and servicing, but most others have not focused as strongly on online channels and the supporting operating models. Moreover, other lines of insurance have been even slower to embrace the power of the internet.

However, this is beginning to change. Many forces that work to the consumer’s advantage are converging to provide those who want it more self-service capabilities, in particular:

- Demands from customers who are familiar with other online financial services (brokerage, banking, and employer-sponsored benefits);
- Comfort with the internet among the next generation of insurance customers, especially Gen Y and Gen X;
- Cost pressures on insurers; and,
- Growing maturity of the customer experience discipline, and the availability of customer experience skills in the marketplace.

Notable trends that insurers are experiencing with their online presence and self-service models include:

- Some life insurance companies have seen 30% annual growth rates in the total number of prospects as a result of new visitors who come to their websites to search for information.
- The online channel is becoming an important lead generation mechanism, and some companies are witnessing 100% growth rates year-over-year in qualified leads.
- Now, more than 1 in 5 consumers who bought life insurance have used the internet as part of the information gathering process.
- Over 50% of policyholders have registered for online service even though the function often fails to meet expectations.

#### Implications

- As insurers balance the needs of their producer base with the power of the internet in lead generation, sales channel conflict will continue to be a problem for those that do not address market dynamics.
- Consistency in multi-channel customer interaction is becoming critical to meet customer expectations.
- Cost efficient and effective self-service capabilities are becoming vital to customer retention efforts.
- For multi-line insurers, active management of multi-line customers across varying levels of customer self-service will be problematic.

## 5 Investment management function effectiveness

As a result of the general decline in investment markets, the investments insurance companies hold on their balance sheets have been subject to marginal to significant impairment losses. In addition to increasing calls for additional transparency and market disclosures, the implications of these impairment write downs on capital positions have led companies to very carefully review their risk appetite, investment strategies, and internal compliance policies.

#### Risk Management

Identifying asset quality and performance (which are not always the same) has been an industry priority since the second half of 2008, and will continue to be so for at least the next year. In a down market, with fewer dollars apportioned to investment management, the average cost of managing assets is likely to increase; this inevitably will lead to cost pressures on the investment management function.

There will be several likely responses to these cost pressures, including cost reduction exercises (as noted in the cost reduction section of this document). Investment management functions will continue to explore other business models, such as outsourcing some or all of the investment function, as they search for a cost effective operating model. Some key cost savings focus areas include:

- Review and renegotiation of vendor service contracts, such as transaction service processing, or custody relationships;
- Identification and decommissioning of possibly duplicative applications (such as multiple order management systems); and,
- Streamlining and automating manual reporting processes and/or redundant databases.

### Transparency and reporting

There are increased demands for additional, more detailed reporting on insurers' investment management functions, particularly on their portfolio make up and related characteristics. These requests originate both externally from rating agencies, regulators and shareholders, and internally from corporate and insurance business management. Increased scrutiny of the valuation of illiquid securities, including private equity funds, could come from regulatory bodies ranging from the Securities Valuation Office to the NASD and the SEC. Moreover, market analysts of public companies, as well as policyholders and regulatory bodies, are demanding and will continue to demand increased transparency from management on the following:

- Value at Risk (VAR) metrics
- FAS 157
- Impairment and valuation methodology.

Companies who are leaders in transparency and reporting are reviewing their people, processes, technology, and organizational structure, and are identifying ways to improve the following areas:

- Centralized control structures to identify manual work arounds, and inaccurate management reports;
- Identification and elimination (where possible) of multiple access database aggregators of information that are neither complete nor well controlled;
- Formalization of processes for the review of ad hoc data; and,

- Increased efforts to retain and motivate top resources, and improve and augment skilled investment management resources.

### Product Rationalization

In light of the market risk associated with investment portfolios, investment management functions will have to work with insurance products divisions to determine the appropriateness of all insurance products currently being sold. In addition, rationalization of existing investment portfolios should continue, as companies evaluate successful insurance products, and identify potentially duplicative or non-performing investment portfolios.

### Asset Protection and Intergenerational Wealth Transfer

As the Baby Boomers begin to turn 65 and fund inflows decline and rollover payout functions become more prominent, wealth managers are focusing more on customer retention and relationships. Locking up customers (as well as their children and grandchildren) will be a priority, as customer service and wealth protection take the place of maximizing returns. In addition, assisting high net worth individuals with basic needs, such as IRA beneficiary forms, customized trusts, property designations, and tax issues across multiple financial relationships, will increase in importance. Accordingly, fostering a corporate culture that emphasizes responsive and appropriate handling of retirees' questions, integrated financial planning, and attentive review of client portfolio performance and plan progress vis-à-vis investment goals will continue to increase in importance for life insurers in 2009 and beyond.

### Implications

In 2009, insurers' investment management functions will need to continue to address the following:

- **Talent management**— Stronger companies will have to make an effort to retain top resources and augment organizational talent, notably in risk, compliance, and financial reporting.
- **Sustainable cost reduction**— Investment management functions will need to carefully review their technology and processes in order to identify a more cost-effective IT structure, as well as consolidation or outsourcing options in the front, middle and back office. In addition, investment management functions must actively review existing contracts to identify cost savings, as well as review individual roles and responsibilities to identify redundant capabilities across portfolios.

- **Risk management**—Efforts to identify and write down risky assets will come under scrutiny, and methods to evaluate assets will need to be more transparent, and perhaps even disclosed.
- **Product rationalization**—Investment management functions will have to work with insurance products divisions to determine the appropriateness of all insurance products currently being sold. In addition, rationalization of existing portfolio holdings should continue, as companies evaluate operational costs and identify potentially duplicative functions.

## 6 Privacy and information protection

Insurance companies face a myriad of privacy laws and regulations. In order to maintain a competitive edge amid the increasing regulatory and consumer demands for information protection, companies must address data protection and privacy issues in a cost-effective manner. Today's marketplace demands that firms collect personally identifiable information from both customers and employees in order to conduct business, and in some cases, to maintain a competitive advantage. At the same time, many firms are engaging third-party service providers and offshore vendors. With a deluge of constantly changing privacy-related requirements, the challenge of protecting the personal information of customers and employees has grown exponentially. Privacy-related requirements encompass data breach notification and data protection laws, rules, and various global regulations.

The consequences associated with inadequate internal controls over privacy and data protection continue to mount. Business headlines emerge almost daily with reports of corporate data breaches which have compromised a reported 245 million personal records in the United States alone since January 2005. In fact, approximately one third of all consumer complaints received by the FTC during the past three years have been related to identity theft (FTC 2008 Consumer Fraud and Identity Theft Complaint Data). In the wake of a breach, firms often suffer significant reputational damage and risk incurring significant financial costs. The average loss from a breach is estimated to be \$6 million (Symantec Global Internet Security Threat Report 2007).

The cost of compliance also has an impact. Many organizations have separate approaches to complying with Sarbanes-Oxley, GLBA, and HIPAA (among others), which often results in redundant processes and spending.

An effective approach to privacy and data security should include the following elements:

- Develop a strategy and manage through a detailed implementation plan.
- Understand the applicable regulations for your organizations considering product mix, the states and countries of operation, and the nature of the data you collect.
- Identify, inventory and classify sensitive data, where it is stored, how it is used and transmitted.
- Understand threats that are specific both in the industry and specific to your environment.
- Where possible, reconcile each regulation's requirement to consolidate policies, procedures and solutions.
- Align protections and technical controls to the sensitivity of your data.
- Assess and monitor third party vendors with access to your critical data.
- Monitor and test your systems and processes for compliance.
- Plan for a controlled and coordinated incident response.
- Privacy and security considerations should be integral to discussions regarding operating locations, new products or sales channels and the risks and benefits of potential outsourcing solutions. Connecting privacy, data protection, and information security requirements as part of a comprehensive, holistic governance model is a first step toward responding to the regulatory challenges of today's global marketplace. Importantly, those firms that embrace privacy and data protection as integral components of their risk management structure will be the ones positioned strategically to compete for and retain market share in the future.

### Implications

- Don't neglect this area: companies can lose significant market share as a result of reputational damage.
- You may be paying more on compliance than necessary because of redundant processes and capabilities.

## 7 IFRS

Because IFRS is in the process of becoming the accounting basis for many insurance companies around the world, a number of insurers in the US are considering how to adequately prepare for it. US public companies and other users of US GAAP are reacting to a proposed SEC roadmap that requires adoption of IFRS as soon as 2014 and comparative financial statements in 2012 and 2013. Therefore, while 2014 may seem a long way off, large accelerated filers may face an actual IFRS transition date of January 1, 2012. In fact, in light of its imminence, IFRS—until now not a major concern of US state regulators—is now an item for consideration in the NAIC’s Solvency Modernization Initiative. By acting now, US insurers have an opportunity to make informed decisions about how to best approach implementation, both in the US and abroad. Early action will allow insurers to control costs, understand and manage the challenging scope of implementation, and ensure a smooth transition over the long term.

Insurers and other financial services institutions have unique characteristics that influence how they must address IFRS, particularly the global nature of the industry, changing global statutory and regulatory reporting requirements, and the importance they place on data and information systems. Accordingly, even though it is not yet final, prescient public, private and mutual insurers are preparing for the implications of the insurance contract accounting standard that is now a joint project between the FASB and IASB (i.e., Phase II). Several insurers are taking an active role in the debate on the expected 2009 IASB exposure draft, as it is likely to result in a fundamental change in insurance accounting.

Companies cannot let the uncertainty surrounding the insurance standard delay their attention to foreign subsidiaries in international markets with looming IFRS deadlines. Insurers are carefully observing the transition cost (both time and resources) at many of their foreign subsidiaries as they prepare in 2009 for the upcoming IFRS conversion of local statutory accounts. Additionally, subsidiaries may make decisions on those aspects of local adoptions that, while sufficient for local reporting by each entity, could be insufficient for future US consolidation. In order to develop measured, strategic steps to effectively and efficiently manage the change, companies should have a centralized corporate framework for IFRS. A measure of centralized oversight and monitoring by corporate management teams during those local conversions may prevent subsequent rework and unintended policy results, as well as ensure that local conversion efforts take place within a broader, enterprise-wide framework.

### Selected countries requiring IFRS for local statutory reporting

Country	Year of adoption
Brazil	2010
Chile	2010
Canada	2011
India	2011
Mexico	2012
South Korea	2011

Experience in Europe, Asia, and Australia has shown that IFRS adoption often takes more time and resources than anticipated. Historically, this has led some companies to rush and risk mistakes or to outsource more work than necessary, thereby driving up costs and hindering the necessary embedding of IFRS knowledge within the company. That said, some companies view IFRS conversion as a strategic, one-time opportunity to comprehensively reassess financial reporting and take “a clean sheet of paper” approach to financial policies and processes. Moreover, insurers who use this approach should be able to determine any ripple effects that such comprehensive accounting and reporting changes may have on the many parts of their organizations.

Last but not least, IFRS is likely to affect key performance metrics, and the adoption process will require thoughtful communication plans for the board of directors, shareholders and other key stakeholders. As necessary as this is with IFRS as it is currently written, it will be even more necessary under the future IFRS insurance contract standard that likely will require a much different accounting and valuation model than the one used today. Internally, IFRS could have a wide impact on a company’s infrastructure, including underlying processes, systems, controls, valuation models and other fundamental aspects of the insurance business.

### Implications

In order to address IFRS in a measured and strategic manner, US insurers should consider the following in 2009:

- Assemble a core team to identify and monitor the high level impacts of IFRS on financial statements, systems and operations. Develop a global strategy to address IFRS that will facilitate a smooth and economical conversion by preventing rework and future inefficiencies.

- Introduce a standardized approach for IFRS implementations at foreign subsidiaries to allow for consideration of corporate views, maximize benefits and efficiencies, and build knowledge for future U.S. conversion activities.
- Educate corporate finance, tax, accounting and other personnel on the possible effects of current year decisions on a future IFRS adoption.
- Identify planned projects and activities where IFRS could have an impact (e.g., on the general ledger, product design, transactions and structures, actuarial process and controls, investment accounting systems).
- Understand the implications of the IFRS insurance contract accounting standard (i.e., Phase II) and consider level of involvement in the debate on the expected 2009 exposure draft.
- Report to the audit committee and/or the board of directors on management's vision on addressing IFRS' impact on the company.

## 8 Regulatory reform

The market events of the second half of 2008 and the current economic state will spur the ongoing debate about the need—if any—for insurance regulatory reform. More robust dialogue and action on the issue are likely now that a new president and Congress are in office.

There has been bipartisan support in recent Congressional sessions to introduce federal insurance regulation of the life and P&C industries in the form of an Optional Federal Charter (OFC). Recent market failures may provide the required momentum for the newly elected Congress to continue to push the issue. However, it also is possible that turbulence in the financial markets will move the federal government beyond the tipping point for an OFC.

In the wake of investment and commercial bank failures and asset write-downs across financial services sectors, broader regulatory reforms that affect insurers may be expected. The modernization of financial services regulation may entail a transition away from oversight based on product, industry, or legal entity shifting instead to a risk-based regulatory scheme, in which a regulator (or regulators) would monitor company solvency and liquidity at the holding company level.

Meanwhile, as many eagerly await the Obama administration's views on insurer oversight and other financial services regulatory reforms, state insurance

regulators continue to monitor the financial condition of domestic insurers. As each jurisdiction responds to asset devaluations by life insurers and resulting capital and surplus impairments on a case-by-case basis, the current regulatory environment stands to grow more inconsistent and less predictable.

This near-term state of regulatory flux was brought about recently after the National Association of Insurance Commissioners (NAIC) declined to adopt on an "emergency basis" any of the nine American Council of Life Insurers' (ACLI) proposals to give life and health insurers regulatory capital and surplus relief. By declining to universally adopt the ACLI proposals, each of the 56 US insurance jurisdictions will be making independent determinations on the extent to which it will grant permitted practices on a case-by-case basis that would depart from the prevailing regulatory capital requirements. Depending on regulatory structure, other states may be able to issue state-prescribed practices that all companies domiciled in the state may use which depart from NAIC prescribed practices. These developments have the potential to undermine the uniformity in solvency standards and financial reporting otherwise achieved through the NAIC's financial accreditation program, and they usher in a degree of uncertainty for life insurers adversely affected by market downturns.

### Implications

- Consumer interests and protection, not deregulation, will drive regulatory reforms.
- Congress will consider new measures aimed at monitoring solvency and risk management programs at a holding company level.
- The stakes will be high for state insurance regulators, as they are challenged by asset impairments to the life industry at the same time they are vigorously defending the current regulatory framework.
- The cost of capital for insurers will remain high. Life insurers seeking capital and surplus relief will need to appeal directly to domestic regulators; different standards may apply to affiliated companies in multiple jurisdictions.

## 9 Economic and tax policy agenda

The Senate Finance Committee is expected to focus at a high level on the effects of US tax policy on corporate competitiveness and more specifically on a variety of international tax issues, including transfer pricing, cost sharing, earnings stripping, and deferral. Two issues

receiving particular attention are the US corporate tax rate and the tax rules applicable to foreign earnings of US companies.

- **Corporate tax rates.** The US statutory corporate tax rate is much higher than the rates of most of its trading partners. The combined top federal, state, and local US corporate income tax rate is 39.3 percent—the federal rate of 35 percent plus an average state and local tax rate of 6.54 percent (4.3 percent after deduction against federal income tax). This is the second highest (after Japan) among the 30 members of the Organization for Economic Cooperation and Development (OECD) and 12.7 percentage points greater than the OECD average.
- **US taxes on foreign income.** For many US companies, another key issue for maintaining competitiveness abroad is the ability to defer US tax on active foreign earnings until this income is brought home. Approximately one-third of OECD countries provide for such worldwide taxation. The remaining two-thirds have “territorial” tax systems, under which active foreign earnings are not taxed at all by the home country. Enacting further limitations on the ability of US companies to defer US tax on foreign earnings could erode the competitiveness of US companies.

*Neal Foreign Reinsurance Tax Bill* — Ongoing debates within the insurance industry concern the use of offshore domiciles, perceived tax havens, and a competitive advantage. Representative Richard Neal (D-MA) introduced HR 6969 to reflect his concern that affiliated reinsurers are being used by US insurers to migrate US insurance risks to offshore reinsurance markets so as to avoid US tax. Under HR 6969, the deduction for a portion of reinsurance premiums paid to affiliates would be disallowed.

Generally, the bill would disallow any deduction to covered insurance companies for excess reinsurance premiums with respect to US risks paid to affiliated insurance companies that are not subject to US income taxation. According to the bill, the premium limitation would be determined by comparing a covered insurance company’s reinsurance with an industry average amount of reinsurance based on an industry fraction determined and published on the basis of published aggregate data from annual statements of insurance companies by the Treasury Department for each calendar year. The legislation would disallow entirely the deduction for reinsurance premiums paid to an affiliated corporation if the company’s reinsurance premiums paid to corporations that were not affiliated exceeded the amount of the company’s premium limitation for that line of business.

A foreign corporation may elect under Section 953(d) to be treated as a domestic corporation for US income tax purposes. Thus, any foreign corporation that may be affected by the provision is assured that it will, if it so chooses, be treated in the same manner as any US corporation.

According to Rep. Neal, the market share of offshore affiliates’ direct premiums more than doubled from 5.1 percent to 10.9 percent, including the growth of the Bermuda-based share from 0.1 percent to 4 percent. Neal stated the bill would significantly impact the market advantage enjoyed by foreign reinsurers and suggested that the percentage of premiums ceded to affiliates of non US-based companies grew from 13 percent to 67 percent.

In December 2008, Chairman Max Baucus (D-MT) released a discussion draft proposing to modify the tax treatment of insurance companies who deduct premiums in excess of the industry average. The draft is virtually identical to the bill sponsored by Neal. Chairman Baucus invited public comment to further understand the potential impact that changes may have for insurance companies as well as consumers to be submitted by no later than February 28, 2009. A Senate Finance Committee member stated that its version differs from HR 6969 by taking into account offshore income already subject to US tax.

*Chairman Rangel’s tax reform legislation* — In October 2007, Ways and Means Chairman Charles Rangel introduced a comprehensive tax reform bill (HR 3970, the Tax Reduction and Reform Act of 2007) that would repeal the individual AMT and reduce the corporate income tax rate from 35 percent to 30.5 percent. HR 3970 is revenue neutral, with revenue loss from individual AMT repeal fully offset by individual tax increases, and revenue loss from corporate rate reduction offset by business tax.

Three corporate revenue-raising provisions account for most of the offsets proposed to pay for rate reduction. These are proposals to repeal the domestic manufacturing deduction, repeal the last-in, first-out (LIFO) accounting method, and a measure to defer deductions allocable to foreign-source income and restrict the use of foreign tax credits. That last proposal has generated considerable concern within the business community.

This year, Rangel is expected to propose a revised version of his comprehensive tax reform bill. Among other changes, Rangel is expected to propose reducing the corporate income tax rate to 28 percent. If so, the bill could include other business tax increases, such as additional limitations on accelerated depreciation, to

offset the additional revenue loss associated with the anticipated further reduction in the corporate tax rate.

For purposes of economic recovery legislation, Congressional “pay-as-you-go” budget rules—requiring any tax cuts to be completely offset with either tax increases or reductions in mandatory (entitlements) spending—are not expected to apply. However, as the economy begins to recover, there may be renewed focus on the need to control federal budget deficits. As a result, there likely will be pressure to consider business tax increases and other revenue-raising tax proposals to offset future tax legislation.

Congress has considered a number of revenue-raising proposals in recent years that were not enacted and hence remain available for potential use as offsets. In addition, the tax reform bill proposed by Rangel (discussed above) contains a number of revenue-raising provisions. Some of the revenue raisers proposed by Rangel in 2007 have been enacted.

## Implications

- Potential for corporate tax rate reductions, but other business tax increases.
- Congressional focus on a variety of international tax issues, including transfer pricing, cost sharing, earnings stripping, and deferral.
- Potential disallowance of migrating US insurance risks to offshore reinsurance markets in order to avoid US tax.

### Previously proposed revenue-raising insurance tax provisions

Provision	Source	10-year Revenue Estimate (millions)
Modify rules for capitalizing policy acquisition costs of insurance companies	Clinton	8,842
Require recapture of policyholder surplus accounts	Clinton	1,844
Increase the proration percentage for property and casualty insurance companies	Clinton	1,288
Disallow deduction for interest on debt allocable to tax-exempt income of insurance companies	JCT	1,200
Modify treatment of sales of life insurance contracts	Clinton	407
Disallow a deduction for “excess” reinsurance premiums paid to foreign affiliates	Other	NA

# For more information

## **Maintaining adequate capital and surplus**

### **Liquidity risk management**

Bill Chernelich  
Partner, Assurance and Business Advisory Services  
Tel: 1 646 471 8780  
william.chernelich@us.pwc.com

### **ERM**

Mary Ellen Coggins  
Director, Assurance and Business Advisory Services  
Tel: 1 617 530 7427  
mary.ellen.j.coggins@us.pwc.com

Paul Horgan  
Partner, Advisory Services  
Tel: 1 646 471 8880  
paul.l.horgan@us.pwc.com

Nick Ranson  
Director, Actuarial & Insurance Management Solutions  
Tel: 1 646 471 9040  
nick.ranson@us.pwc.com

### **Valuation**

Doug Summa  
Partner, Advisory Services  
Tel: 1 646 471 8596  
douglas.summa@us.pwc.com

### **Solvency**

Kristin D'Ambrosio  
Director, Advisory Services  
Tel: 1 617 530 6014  
kristin.dambrosio@us.pwc.com

Josh Goldfarb  
Director, Advisory Services  
Tel: 1 860 241 7297  
joshua.goldfarb@us.pwc.com

### **Improving claims**

Marc Gallo  
Principal, Advisory Services  
Tel: 1 415 498 7387  
marc.gallo@us.pwc.com

Kate Gingras  
Director, Advisory Services  
Tel: 1 617 530 4191  
kathleen.gingras@us.pwc.com

### **Sustainable cost reduction**

Paul Veronneau  
Principal, Advisory Services  
Tel: 1 860 241 7568  
paul.veronneau@us.pwc.com

### **Declines in business volume**

Abhijit Mukhopadhyay  
Director, Advisory Services  
Tel: 1 312 298 2984  
abhijit.mukhopadhyay@us.pwc.com

## **Speed to market**

Larry Rosen  
Director, Advisory Services  
Tel: 1 617 530 7887  
lawrence.s.rosen@us.pwc.com

Chris Scarpati  
Director, Advisory Services  
Tel: 1 646 471 7099  
christopher.v.scarpati@us.pwc.com

## **Changes in customer focus and related operating models**

John Swadener  
Director, Advisory Services  
Tel: 1 312 298 2479  
john.r.swadener@us.pwc.com

## **Investment management function effectiveness**

Josh Goldfarb  
Director, Advisory Services  
Tel: 1 860 241 7297  
joshua.goldfarb@us.pwc.com

## **Privacy and information protection**

Jim Koenig  
Director, Advisory Services  
Tel: 1 267 330 1537  
james.h.koenig@us.pwc.com

Joe Nocera  
Principal, Advisory Services  
Tel: 1 312 298 2745  
joseph.nocera@us.pwc.com

## **IFRS**

Jim Svab  
Partner, Assurance and Business Advisory Services  
Tel: 1 312 298 2304  
james.l.svab@us.pwc.com

## **Regulatory reform**

Barbara Law  
Manager, Insurance Regulatory Practice  
Tel: 1 617 530 4761  
barbara.law@us.pwc.com

Ellen Walsh  
Principal, Advisory Services  
Tel: 1 646 471 7274  
ellen.walsh@us.pwc.com

## **Economic and tax policy agenda**

Tony DiGilio  
Partner, Tax Services  
Tel: 1 202 414 1702  
anthony.digilio@us.pwc.com

# Editorial Board

Jim Scanlan  
Insurance Practice Leader  
Tel: 1 267 330 2110  
james.j.scanlan@us.pwc.com

Paul Veronneau  
Insurance Advisory Leader  
Tel: 1 860 241 7568  
paul.veronneau@us.pwc.com

Sue Leonard  
Insurance Tax Leader  
Tel: 1 213 830 8248  
susan.leonard@us.pwc.com

Bill Chernelich  
Partner, Assurance and Business Advisory Services  
Tel: 1 646 471 8780  
william.chernelich@us.pwc.com

John Garvey  
Financial Services Advisory Leader  
Tel: 1 646 471 2422  
john.garvey@us.pwc.com

Eric Trowbridge  
Insurance Marketing Leader  
Tel: 1 410 296 3446  
eric.trowbridge@us.pwc.com



[pwc.com](http://pwc.com)

© 2009 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a Delaware limited liability partnership) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.

PricewaterhouseCoopers shall not be liable to any other user of this report or to any other person or entity for any inaccuracy of this information or any errors or omissions in its content, regardless of the cause of such inaccuracy, error, or omission. Furthermore, in no event shall PricewaterhouseCoopers be liable for consequential, incidental, or punitive damages to any person or entity for any matter relating to this information. This report is provided for informational purposes only and does not constitute the provision of tax, accounting, legal, or other professional advice. This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. Federal, state or local tax penalties. PM-09-0547