top issues

An annual report

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The insurance industry in 2011

pwc

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Changing Regulations & Standards

Regulatory Reform

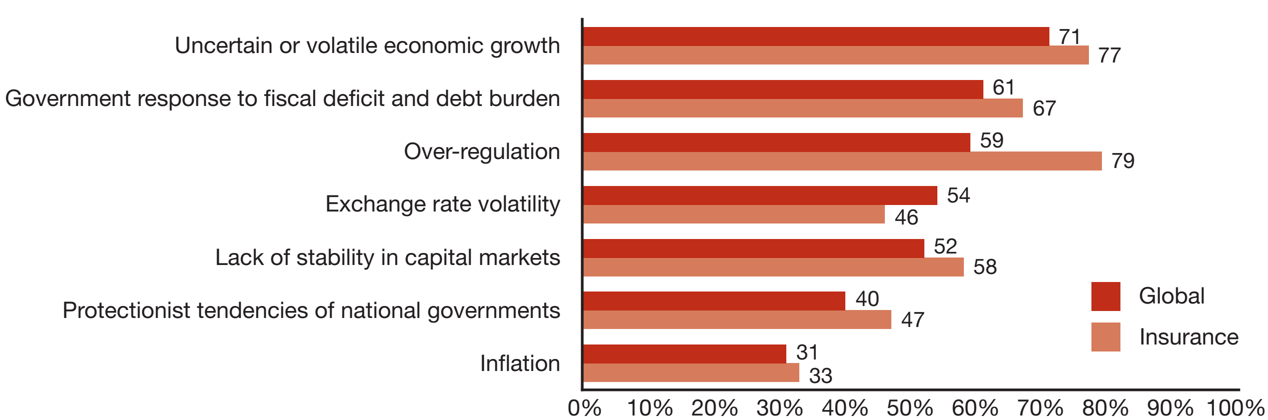
The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ushered in a new era of increased federal supervision and regulation of the financial services sector. The Act's stated purpose is to stabilize the nation's economy and limit systemic risk in the financial markets. While some industry observers view Dodd-Frank's impact on insurers as muted, it could have a profound impact on them depending on the nature and structure of their business, and the development and application of future rules. And, although Dodd-Frank did not supplant the authority of the states to regulate the business of insurance at a functional level (as prescribed under the McCarran-Ferguson Act of 1945), it did introduce a layer of federal, macro-prudential supervision.

In light of the size and scope of this legislation, rules are evolving in a very dynamic regulatory environment. Insurers should be acutely aware of how regulators formulate provisions, and how those provisions will be practically implied and enforced. In addition, the industry should continue to pay close attention to the 112th Congress' promises to "de-fund," rewrite, or otherwise lessen the expansion of government authority that Dodd-Frank stipulates.

Federal Insurance Office (FIO)—Dodd-Frank establishes the Federal Insurance Office (FIO) within the US Treasury that creates a new federal presence in the oversight of insurers. An as-yet unnamed director level appointee of the Secretary of the Treasury will head the office. While regulatory authority remains within the dominion of the states, the FIO effectively has two primary purposes:

1. It gathers and analyzes information on insurers in order to inform the federal government of their systemic significance. The FIO can recommend to the Financial Stability Oversight Council (FSOC) that an insurer be deemed systemically significant, which will subject the insurer to Federal Reserve supervision.
2. With the US Trade Representative (USTR), it represents the Treasury as the joint authority to negotiate and enter into international "covered agreements" with foreign nations on behalf of the US. When these relate to the business of insurance they must achieve *a level*

CEOs rate potential risks



Source: PwC 14th Annual Global CEO Survey *of protection of insurance or reinsurance for consumers that is substantially equivalent to the protection achieved under state law.* In other words, the FIO/USTR would not be able enter into agreements that create a regulatory standard that would be deemed less rigorous than current state law.

In addition to the above, another of the FIO's significant statutory responsibilities is to report to Congress no later than January 2012 on how to modernize and improve US insurance regulation. This one-time study will examine the efficacy and uniformity of state insurance regulation.

Financial Stability Oversight Council (FSOC)—The Secretary of the Treasury chairs the FSOC, which consists primarily of federal regulators. The FSOC has broad authority to deem non-bank financial companies as systemically significant and thereby subject to Federal Reserve supervision. There are three FSOC members who would play a large role assessing insurer significance. The Obama Administration has yet to name the FSOC's only voting member, but this presidential appointee is supposed to be someone with "insurance knowledge and expertise." The other two non-voting but nonetheless influential FSOC members are an as yet unnamed FIO Director and a current state insurance regulator, Director (Commissioner) John Huff of Missouri, whom NAIC membership chose for a two-year term. To date, the FSOC has met three times. The first two meetings dealt with formation and administrative matters; at the most recent meeting, which took place in January 2011, the FSOC exposed a Notice of Proposed Rule (NPR), which outlines broad criteria for the determination of what could make a non-bank financial institutions systemically significant.

Because of its ability to help determine systemically important institutions, the insurance industry should pay close attention to FSOC rule making, activities and developments. If an insurer winds up with a systemically important designation, then (in addition to Federal Reserve supervision) it is likely to face higher capital and liquidity requirements, limitations on leverage, and closer scrutiny of its risk management practices.

Bank and Savings Association Holding Companies—Under Dodd-Frank, insurance holding companies that also are savings and loan holding companies (SLHCs) will be subject to supervision from the Office of the Comptroller of the Currency (OCC) and the Federal Reserve rather than the now defunct Office of Thrift Supervision (OTS). According to the Volker Rule, banks and SLHCs will be restricted from engaging in propriety trading or sponsorship or owning a hedge fund; any non-bank financial companies that the Federal Reserve supervises (including insurance companies) would be required to post additional capital and meet quantitative limits for these activities, as required by the FSOC. However, there is a carve out within the rule that recognizes an "Accommodation for the Business of Insurance". Through "permitted activity," it removes limitations to "a regulated insurance company directly engaged in the business of insurance" which is "subject to regulation by the state insurance regulatory agencies."

When examining bank holding companies and SLHCs, the Federal Reserve is required to rely on and coordinate its activities with other regulators, including state insurance regulators.

Derivatives Regulation—Dodd-Frank also touches on rules that the CFTC and the SEC are promulgating on derivative transactions. Insurers that transact derivatives may be impacted if they meet the definition of a Major Swap Participant (MSP). Record keeping and reporting of transactions will be required going forward.

Implications

- Large insurers in particular need to determine how they can most effectively communicate and state their individual and collective viewpoints to the FSOC, if so notified, or the Federal Insurance Office (FIO) during the latter's determination of which companies (if any) are systemically important.
- Multinational insurers will need to closely monitor the activities of and determine the most effective way to make their concerns known to the FIO and the US Trade Representative (USTR) when they negotiate international "covered agreements."

- Although it remains to be seen if any insurer will qualify as systemically important, large companies in particular should determine what could happen to their capital and liquidity requirements, leverage, and risk management practices if they do.
- Insurers need to determine the level of banking and derivative supervision they may be subject to and how they can most effectively comply with it.

Accounting Convergence

2010 saw unprecedented activity from the FASB and IASB, which resulted in a number of important proposals that will significantly impact the accounting models for insurance contracts, financial instruments and revenue recognition. The IASB and FASB are expected to issue final standards on the latter two this year, while standards for insurance contracts under US GAAP will undergo another round of public review and comment.

Given the fundamental impact of these proposed standards on the measurement of an insurer's financial performance and position, many companies are dedicating additional resources to understand and anticipate how their business should react. Although final standards likely will allow for at least a two—or three—year lead time prior to mandatory adoption, insurers have an opportunity to take a measured approach to evaluating the impact of change on the form and content of their financial statements, data and systems, processes and controls, and people.

Insurance contracts—In 2010, the IASB published a long-awaited exposure draft, while the FASB issued a discussion paper as a pre-curser to an exposure draft which could be released as early as mid-2011. Although important differences of view exist, both Boards have proposed a measurement model based on the fulfillment of insurance contract cash flows using three primary building blocks.

The IASB has proposed the following building block components:

- An explicit, **unbiased and probability-weighted estimate** of the expected future cash flows necessary to fulfill the insurance contract;
- **Discounting** of the probability-weighted cash flows using a **modified risk free rate** that reflects the characteristics of the insurance liability (not the characteristics of assets supporting the insurance contract);
- An **explicit risk adjustment** that reflects the amount and timing of uncertainty of expected future cash flows; and,
- A **residual margin** that, at inception of the insurance contract, calibrates fulfillment cash flows and the explicit risk adjustment to ensure that no gain is recognized by the issuer upon entering into an insurance contract.

The FASB's proposal adopts the same approach to measuring the present value probability-future cash flows but combines the IASB's explicit risk adjustment and residual margin into a single "composite" margin. This difference has important consequences for both the timing of profit recognition and future earnings volatility. Under both of these proposals, the insurance measurement model is expected to result in greater P&L volatility and different profit emergence than today's approaches.

As an extension of the measurement model, the presentation of an insurer's financial statements could change radically as well. Premiums and claims for long duration contracts may be excluded from the income statement and replaced by changes in estimates, discounting and margins.

While the measurement and presentation may not change as radically for short duration contracts, given the proposal for a simplified measurement approach that is more akin to an unearned premium model, the changes in reserving and disclosures could be significant.

Changes in accounting models will impact the form and content of insurers' financial statements, data and systems, processes and controls, and people.

Companies using US GAAP should consider the following readiness actions in 2011 for insurance contracts:

- Monitor and participate in the standard setting process.
- Assess impacts on the actuarial modeling of insurance contracts on a targeted basis.
- Assess impacts on systems and data.
- Assess impacts on current projects with long-term focus.
- Assess the effort and time to implement the changes.
- Plan for future resourcing needs
- Assess the impact on new product design.

Most **IFRS filers** likely will need to initiate full adoption activities in 2011.

Because of the potential for fundamental changes in the insurance accounting model, many companies are working to understand specifically how the proposals will affect their companies. In 2011, IFRS preparers should receive a published final standard on which to develop and execute comprehensive conversion activities. US GAAP preparers may have an exposure draft, and therefore more direction, but will need to consider any readiness activities in a strategic manner that uses the benefit of time without over-investing in aspects of the proposals that may change.

US GAAP accounting for acquisition costs—In a separate standard setting effort, the FASB issued Accounting Standard Update 2010–26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*, restricting the types of acquisition costs that are eligible for capitalization under existing US GAAP. Effective January 1, 2012, only incremental direct costs of acquisition and certain direct employee compensation costs related to successful sales efforts will be deferrable. Insurers should ensure they have devoted adequate resources in 2011 to comply with this pronouncement, which may pose significant data challenges depending on the nature of changes in deferrable costs and flexibility of systems.

Financial instruments—The FASB and IASB have taken different approaches to this “convergence” project, and proposed very different accounting models. The FASB issued a comprehensive exposure draft in May 2010 addressing classification and measurement, impairment and hedging. The IASB has separately addressed each of these topics in a classification and measurement standard in 2009 (IFRS 9, *Financial Instruments*) and issued separate exposure drafts addressing impairments and hedge accounting in 2010.

In May 2010, the FASB had proposed fair value as the default classification and measurement approach for financial instruments, with changes in fair value recognized in net income. However, certain financial instruments (principally debt securities) could be eligible for measurement at fair value with changes recorded in other comprehensive income, provided they meet certain criteria demonstrating that the investor’s business strategy is to collect substantially all contractual principal and interest. The FASB received nearly 3,000 comment letters to their exposure draft, with many voicing concern with the use of fair value for some instruments where the IASB allows amortized cost. As a result, the FASB then reconsidered its initial conclusions in this area and in January 2011 announced that they planned to allow certain financial assets to be measured at amortized cost.

IFRS 9 adopted a mixed measurement model requiring the use of amortized cost for financial instruments held for the collection of contractual principal and interest, and fair value through net income for most other instruments. The FASB and IASB have also proposed new guidance for determining impairments and whether hedging relationships are deemed effective.

A final US GAAP standard is expected in mid–2011, and companies should be ready to initiate full implementation activities that will likely impact accounting, investment, treasury, IT and other in-house and outsourced functions.

Other convergence activity—Standards setters also have several other important projects in development, notably revenue recognition and lease accounting, which are expected to result in final standards in mid–2011. While these areas traditionally have not been a primary focus for insurers, the magnitude of the proposed changes warrants a measured assessment in the near-term.

The revenue recognition standard will apply to all non-insurance revenue streams (such as agency fees or risk management services). The requirements to identify distinct performance obligations and to allocate the transaction price based on relative stand-alone sales prices will be particularly challenging for those with service contracts that are priced on an integrated basis. In addition, companies will be required to recognize a liability for individual "onerous" (i.e., loss making) performance obligations even if the customer is expected to be profitable in the aggregate.

Under the proposed lease accounting model, operating leases will be eliminated and all lease arrangements brought on-balance sheet by recognizing both a right to use asset and a financing obligation. This changes the expense recognition pattern from rental expense to a combination of amortization and interest expense, and will typically result in the acceleration of expenses compared to today's operating lease accounting and the timing of cash payments.

Implications

Each of these standards is likely to require a significant adoption effort. To complicate matters, these standards are unlikely to be issued at the same time or have the same effective dates, even though their impact to the business will need to be evaluated in an integrated manner. Accordingly, companies should consider developing a comprehensive plan of adoption that can be updated to accommodate changes in the proposed standards as they are finalized. This approach can provide a current point of view that will be useful when evaluating the accounting impact on ongoing projects (e.g. system in itiatives, product development, economic capital modeling, ERM, process/control changes, budgeting, resource planning). While future projects should not necessarily be modified to accommodate the incremental data needs of these draft standards, there may be multiple allowable alternatives (e.g. project timetables, functionality, vendor selection) that would benefit from this insight. Other areas to consider include:

- **Financial results**—The proposals for both insurance contracts and financial instruments will result in a significant *mismatch in earnings* because insurance liabilities may be discounted using liability specific discount rates rather than asset-based rates. *Earnings volatility* will increase both as a consequence of this accounting mismatch and the increased prevalence of fair value measurements adjusted in net income. Insurers will also need to evaluate how to most effectively measure underwriting performance from a business perspective—either by modifying management-basis reporting to align with the revised GAAP measures, or by measuring and rewarding performance based on existing premium and claims-based metrics.
- **Data and systems**—In general, the proposed standards require insurers to record, process and report a greater volume of data with an increased level of complexity. Insurers should begin to evaluate their existing data strategies and determine whether significant data gaps are likely to exist relative to the future state. The pervasiveness of change may provide an opportunity to develop integrated data solutions across different business functions.
- **Process and controls**—Existing processes will need to be significantly re-engineered. In addition to developing a strategic vision of the future state, insurers should evaluate whether the proposals impact the scope and timing of existing strategic initiatives (such as systems conversions) to avoid potentially significant re-work in the future. The increased use of complex actuarial models will also require insurers to establish robust model governance procedures to support the integrity of actuarial projections.

- **People**—The demand for skilled professionals will increase significantly and insurers should begin to develop an appropriate people strategy designed to develop and embed knowledge across business units, including the finance, actuarial and investment functions.

Solvency

While not all US insurance and reinsurance companies will be directly subject to Solvency II, most insurers will likely feel its impact. Many non-EU insurance regulators have accepted the regulatory practices as defined within the Solvency II framework as leading—albeit untested—practices. The International Association of Insurance Commissioners' (IAIS) is in the process of revising its Insurance Core Principles (ICPs), the set of regulatory principles against which regulatory regimes around the world will be periodically assessed. Many revised ICPs now reflect Solvency II principles, including the ICPs addressing group solvency, ERM, and capital adequacy.

Europe and Solvency II—Solvency II contains a broad range of new requirements, including quantitative measures for demonstrating capital adequacy (Pillar I), qualitative measures for providing evidence of a strong "system of governance" (including ERM) and guidance for supervisory reviews (Pillar II), and expectations for financial reporting and public disclosure (Pillar III). European insurers are working diligently to prepare these new requirements even as the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) continues to develop implementation guidance.

While most European insurers have been devoting the vast majority of their attention to Pillar I quantitative requirements, an increasing number are turning their attention to the requirements of Pillar II by enhancing their governance systems (ERM, Internal Audit, Compliance, and Actuarial) and developing a formal process for the Own Risk and Solvency Assessment (ORSA). For now, it appears that the level of information that an insurer's ORSA requires will be both extensive and highly strategic in nature; in light of limited regulatory guidance, insurers are largely responsible for making their own best efforts to design and document their ORSAs.

IAIS and Revisions to the Insurance Core Principles (ICP)—In 2003, the IAIS developed a set of twenty-eight insurance core principles to provide "a globally-accepted framework for the regulation and supervision of the insurance sector." The International Monetary Fund (IMF) uses these core principles to periodically assess insurance regulatory regimes. The US recently underwent such an assessment, and performed very well. However, in light of changes to global regulatory practices, the IAIS is in the process of revising the ICPs to improve alignment with global regulatory practices, and anticipates having an approved set of revised ICPs by October 2011. Several of the revised ICPs currently drafted describe regulatory practices consistent with those anticipated under Solvency II. In particular, ICP 16, ICP 17, and the revised ICP 23 appear to align closely with Solvency II.

The US and the NAIC's Solvency Modernization Initiative—Solvency II's impact is evident within the NAIC's Solvency Modernization Initiative (SMI), an ongoing internal assessment of the US insurance regulatory framework that includes a review of international developments in regulation and accounting. The NAIC's objective is to enhance the US insurance regulatory environment in several key areas, including capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues.

With the SMI, the NAIC's objective is to enhance the US insurance regulatory environment in several key areas, including capital requirements, international accounting, insurance valuation, reinsurance, and group regulatory issues.

As part of its focus on group regulatory and capital issues, the NAIC reached a decision to introduce a US ORSA requirement in an effort to expand regulators' understanding of insurers' risk management processes and risk quantification findings, as well as to complement the enhanced risk-focused surveillance process. The introduction of a US ORSA will serve to satisfy several elements of ICP 16 that current regulatory practices may not adequately address. While the structure of this new US requirement is still in development, insurers who have performed and documented ORSAs in connection with Solvency II should be well prepared for the US introduction of this tool.

Although the NAIC has no plans to adopt the use of internal models to determine required capital for regulatory purposes as Solvency II allows and as the new ICP 17 addresses, it continues to examine ways to improve the US "standard formula" (the NAIC risk-based capital (RBC) formula) to ensure adequate coverage of all material risks to which insurers are exposed, as well as to develop greater transparency around the calibration levels (safety levels) of the capital charges these standard formulas contain.

In the planned activities that focus on group supervision, the NAIC will be looking to update the Holding Company Model Act to, among other objectives, enhance both the coordinated oversight between federal and state financial regulators and communication with international regulators through supervisory colleges. In addition, the NAIC will present a study of the best practices for group-wide supervision and a proposed approach for group-wide capital assessments by the end of 2012. Each of these enhancements will serve to satisfy the revised ICP 23.

In August 2010, the NAIC stated that it wanted CEIOPS to consider including the US in the "first wave" of the Committee's equivalence assessments. Because the NAIC is currently working to enhance group supervision in the US, CEIOPS initially demurred. Given the ongoing review of and changes to group supervision within the US, it is likely that US insurance regulatory regime would need to be assessed as a "transitional regime", requiring the European Commission (EC) to amend the Solvency II Framework Directive. It is unclear at this time if the EC will take such a step and thereby allow the US to seek equivalence ahead of the Solvency II effective date.

Implications

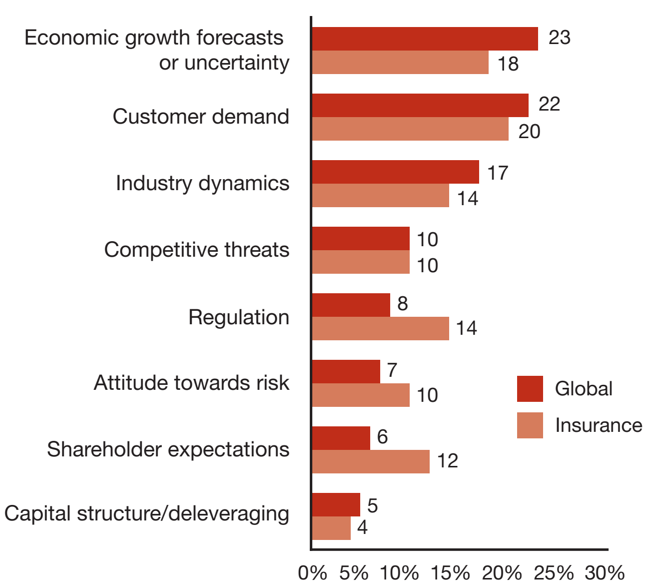
- Whatever the current level of European parent outreach, it is likely that US subsidiaries will need to become more formally integrated into the group Solvency II compliance function as the effective date draws near and as the financial and regulatory reporting requirements move into a production environment.
- US groups with European subsidiaries will need to comply with Solvency II at the solo entity level, and also will need to develop a strategy for responding to European or equivalent third country regulators about the group's system of governance (including ERM) and provide the appropriate level of information for solo entity ORSAs. This will require the establishment of linkages between intended solo entity regulatory responses, group risk management, and strategic decision-making processes.
- Considering the significant expectations of both regulators and rating agencies, US groups will find it useful to develop an overall strategy for responding to these external stakeholders in order to avoid creating duplicative streams of documentation and reporting.
- The Bermuda Monetary Authority (BMA) is in the process of enhancing its own regulatory regime with the intention of gaining Solvency II equivalence. While the Bermuda regulatory regime will be similar to Solvency II in principle, the actual adoption of certain regulatory tools and processes (e.g., Commercial Insurer's Solvency Self-Assessment (CISSA) rather than ORSA) will require groups domiciled in Bermuda or US insurers with subsidiaries in Bermuda to develop an understanding of Bermuda's unique regulatory requirements.

Growth and Profitability

Product and Service Innovation, Customization and Simplification

A challenging global economy, changing consumer preferences and behavior, and rapidly changing information technology provide insurers with opportunities to transform their business model (including pricing, products, services, risk appetite and management, and distribution channels) and all or parts of their operating model (including processes, technology, and organization). Information analytics, social media, and mobility are just a few of the things insurers will consider as they think about the purpose of their business, how they go to market, and how they can remain competitive. Some insurers may rethink the types of risks they can price and how to aggregate and pool risk. Others may re-think their role as "manufacturers" of insurance products and begin to use their information assets to create new market positions.

Factors behind strategic change



Source: PwC 14th Annual Global CEO Survey

Significant gains in market share and profitability are attainable through incremental innovations in the operating model. Several carriers have found new ways to bundle their products or add new features and benefits to better meet customer needs and to improve profitability. Others are exploring creative ways to sell products and price products through new channels such as smart phones and telematics. For example, product bundling and cross-selling incentives at the distribution and consumer levels are becoming more popular. P&C insurers also are competing on innovative pricing—and technology—driven business models, such as pay-as-you-drive auto insurance via telematics. Moreover, because competition in personal lines centers on taking away market share from others, enabling consumers to compare prices and offering them online quote engines and price comparisons is now essential. In the individual life and annuity space, external information (such as behavioral data for jet underwriting), products that combine life insurance and annuities with long-term care or critical illness features, and new retirement income products are some new innovations. The ability to configure product platforms across multiple customer segments and states also is becoming an important differentiator in the market.

In order to market these new products and services more effectively, insurers are increasing their investments in upgrading information analytics, marketing infrastructure, and talent by attracting marketing and market analytics experts from the packaged goods, telecom, and credit card services industries. In order to drive "outside-in" strategies and focus on the customer's agenda, they also are increasingly incorporating more sophisticated marketing analytics and segmentation techniques (clustering, decision trees, multi-dimensional scaling) to better understand customer behavior, attitudes, and preferences. In addition, they are using more powerful analytical tools (e.g., neural networks) to identify and understand customer preferences, as well as create new customer segments. Moreover, they are integrating data from each customer interaction with new third-party data sources, and employing behavioral economics and predictive modeling to forecast future behavior and risks across different products and markets.

Implications

- To offset commoditization of core personal lines products, insurers—especially those that wish to compete on more than just price—are looking to service innovations to differentiate their offerings.
- Product and service customization is no longer just the preserve of specialty insurers. Personal lines insurers are attempting more customization of their products and service to achieve a competitive advantage.
- While some companies will consider reinventing their business, incremental innovations can result in market gains.

60%

The percentage of insurance industry respondents who identified "growth through increased market penetration" as their top strategic objective in a recent PwC-Diamond Advisory Services business design survey.

Enhancing Distribution

There has been a significant decline in the number and productivity of producers (including captive agents, independent agents, and brokers). The number of registered representatives selling life insurance dropped by 5.6 between 2006 and 2010, and, as a result of increasing direct sales of auto insurance (41 percent, including 28 percent Web and 13 percent by phone in 2010 alone), the number of agents and brokers selling personal lines insurance also is declining.

This decline in producer numbers did not initially alarm the industry. Many carriers had been moving from a captive distribution force to an independent one in order to limit fixed costs, and had changed performance metrics to reward the most profitable producers and purge lower performing ones. In addition, technological improvements in processing new business and serving existing policyholders led insurers to expect equal or greater productivity from fewer agents. Lastly, the rise of the Internet and other direct channels led many insurers to question the future necessity and value of producers in the sales process.

However, the industry has been rethinking some of its earlier assumptions. Difficult economic conditions, increasing regulatory oversight, and mistrust from some consumer segments—all of which have resulted at least in part from the financial crisis—have made it difficult to attract new and talented agents. In addition, consumer values and attitudes about financial institutions and products have changed significantly. Producers can play a vital role in building customer relationships and retaining and growing business. Accordingly, insurers are now renewing their efforts to attract, retain, and develop quality producers while simultaneously developing, expanding, and integrating direct channels.

- Some insurers with captive agents are offering marketing, regulatory, training and administrative assistance to ease new talent into the profession and enable existing agents to increase their focus on selling. They also are assisting agents and advisors by generating leads through alternative channels such as call centers, the Internet, customer service, and regulatory filing support. For example, the use of technologies like tablet computers and smartphones to develop personalized planning, provide pre-quotes, and close deals while the consumer is still in the 'hot' state is showing promise to substantially improve the customer experience and agent productivity.
- Decreasing insurer margins and distributor productivity during the financial crisis have increased carrier attention to distribution value management. Leading insurers are using advanced analytics and geomapping tools to precisely identify market penetration, potential product

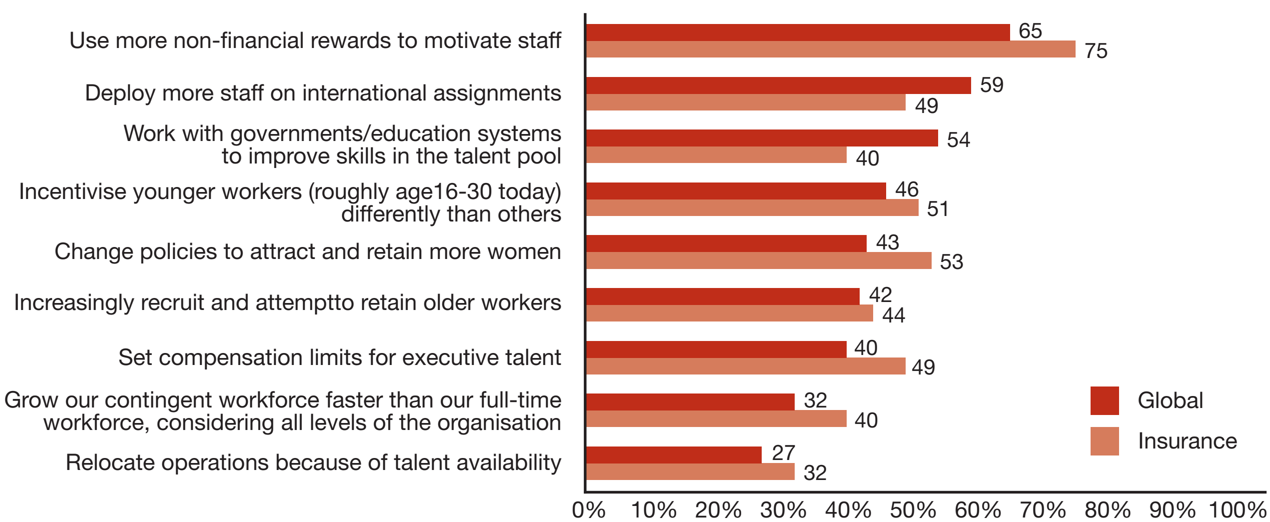
markets, market share information, and determine distributor potential and profitability by zip code. Insurers then use this data to manage the profitability of their overall distribution force; they will sever relationships with unprofitable brokers and cultivate brokers or advisors who are or have significant potential to be more profitable.

- As a result of increasing competition for shelf space, proliferation of product and product features, and regulatory concerns about consumer protection and improper selling, insurers who sell through independent brokers and advisors have a tougher job. Clear messaging for targeted customer segments, simplicity of product features, bundling of multiple products to address the unique needs of specific segments, speed of response, and ease of doing business all can improve the customer and agent experience, as well as the latter's productivity.
- Insurers who focus on group benefits and defined contribution plans also face challenges. Employers are cutting down on ancillary benefits and matching contributions, demanding more transparency in fees from distributors, and transferring some financial burden to employees. As a result, distributors increasingly have to convince employers and the employees of the value of the insurance benefits they provide.

In addition, more employers are moving to voluntary benefits for employees. A possible consequence of health care reform is employees of small firms moving to state-based health exchanges for their medical and ancillary products (i.e., dental and vision). In response, group insurers must equip their distributors to sell to employees as well as employers, and providers of both individual and group products should exploit their knowledge of and experience serving both segments. The interplay of individual and group distribution will be critical for retirement product providers who wish to encourage 401k/403b rollovers into IRAs and the transfer of retirement payouts into annuities.

- Trust in evolving technologies has continued to grow and people now use social media and smart phones to research, shop, transact, perform self-service, and obtain support for the products and services that they

90% of Insurance CEOs are changing their talent strategy



Source: PwC 14th Annual Global CEO Survey

In the future, growth will not come from simply distributing products to potential customers; to capture market share, insurers will have to creatively appeal to their unique needs. They will have to build loyalty and increase retention by anticipating customer needs before they occur.

acquire. Up to now, many carriers have dabbled in social media and launched mobile apps, but these and other technologies have become potentially key channels for certain customer segments. Because of concerns about conflicts with existing agent and broker channels, some insurers may take the interim step and use social media and smart phones with their channel partners and producers instead of offering them as customer direct options. Although this may appear to be a conservative strategy, it will enable insurers to better control their brand and customer experience, as well as potentially increase channel loyalty and productivity by improving territory management and producer training, sales and service consistency, and product cross—and up—sell.

Implications

- Recruiting captive or independent agents, advisors, and brokers, training them and assisting them in practice management, and succession planning will become increasingly important across both P&C and life and health distribution space.
- The use of advanced analytics in market and opportunity sizing, territory management, and distributor productivity and profitability will differentiate leading insurers from their competitors.
- Connecting distributors with one another and with their customers using emerging technologies and devices (e.g., tablet computers and smart phones for illustrations and collaborations, social networking sites like LinkedIn for recruitment) will distinguish the leading insurers from the rest.
- Insurers are creating new strategies that integrate direct distribution with existing channels, occasionally eliminate select channels, and/or take advantage of emerging channels. For example, breaking down individual and group distribution and product silos has helped some insurers increase insurance and investment business.
- Insurers have to delicately balance the need to maintain and build quality producers while developing, expanding, and integrating direct channels.

Customer-Centricity

Advancing technology is placing more information in the hands of consumers, which allows them to learn about, purchase, and manage their products and relationships with sellers anytime and anywhere. In addition, they are interacting more and more with others in social networks, intermingling work and personal life, having online conversations and interactions with like-minded friends and strangers, and receiving multi-media, multi-sensory input from a variety of devices. In addition, the responsibility for retirement planning is continuing to shift from the government and employers to individuals.

This increasing consumerism is forcing companies to become more customer-centric. Consumers are used to real-time, interactive, multi-channel, multi-media interaction with retailers, banks, and investment firms, and expect the same convenience and accessibility from their insurers. Accordingly it is imperative that insurers, who have typically viewed their customers as brokers, agents or advisors, increase interactions with consumers beyond just sales and claims.

That said, there are a number of challenges to becoming more customer-centric. Initially, it is vital that initiatives to improve product innovation, customer segmentation, and distribution channels also make the customer experience more efficient, more responsive, more transparent, and less complex. Several insurers have created customer experience teams that focus on defining and delivering a better experience to the customer and more profit to the company. In doing so, they have had to answer three difficult questions:

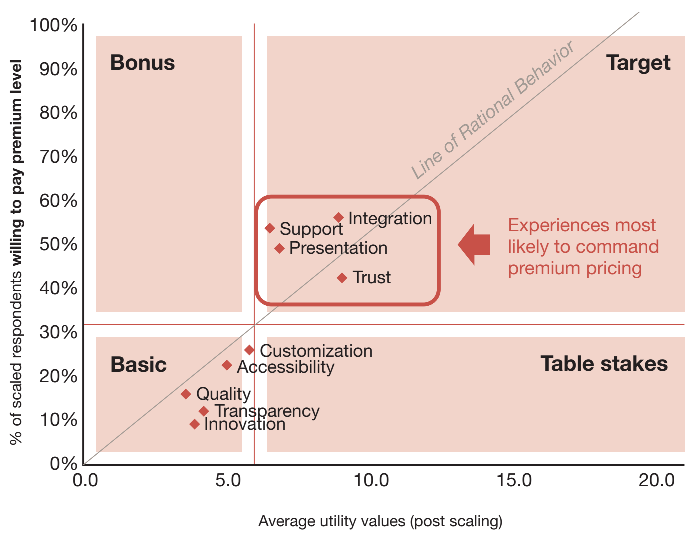
- **Who is our customer?** Is it the channel partner, the end buyer, or the insured? The answer is all of them. This means that insurers need to appropriately address all of these individuals' needs simultaneously.
- **Who owns the customer?** Does distribution, marketing, claims, or customer loyalty own the customer? Who owns the prospect before they become a customer? Sorting through these questions enables insurers to create a uniform (and unified) customer experience.
- **Who speaks for the customer?** Who has the authority to make customer experience decisions on behalf of the customer? Who has the authority to prioritize between the customer and the producer? Who has the authority to prioritize short-term revenue over potentially longer term profitability? Determining the answers to these questions is vital in determining the value of customer experience elements and maintaining the consistency of the customer experience across multiple channels.

This represents part of the puzzle; other important pieces include:

- **Understanding the customer experience**—Insurers tend not to understand the experience attributes that consumer segments value and will pay for. The feedback insurers receive from customers in an effective customer experience program will help them understand the factors that lead to dissatisfaction with existing products and services.
- **Evaluating consumer behavior and its impact on the financials**—Insurers who do understand what consumers want and how they behave find it difficult to measure the consumer experience in terms of greater market share, increased revenues, or reduced costs. Typical customer satisfaction measures, such as CSAT and Net Promoter Score (NPS), while useful, are too high-level to drive actionable insights. However, insurers are starting to use more sophisticated analytics, behavioral modeling, and simulation techniques to evaluate consumer behavior and its impact on financial results.
- **Making interaction with customers multi-channel, multi-sensory, and multi-media**—Just as insurers are becoming more comfortable with integrating call center and online channels within their operations, they are faced with a number of different avenues for interaction, such as social networks, touch-sensitive devices, tablets, smart phones, and smart TVs. In addition, as consumers spend more time on social media than in front of their TVs, online interaction is supplementing traditional advertising and mass media communication. Social media mining and sentiment analysis will become one of the tools that insurers will use to gauge consumer opinions and react effectively to them (see figure below for sentiment analysis of P&C consumers). The companies who get this right will be able to exploit the power of 'word-of-mouth' and trust-based social relationships to enhance their brands.

A recent PwC-Diamond Advisory Services study, called Experience Radar, shows that personal line consumers expect quality, transparency, innovation, and accessibility, and are unwilling to pay a premium for them. However, they are willing to pay more for integration, support, and presentation.

Experience radar 2010—P&C survey of experience attributes



Implications

- Understanding the needs and expectations of consumer segments and their interaction with carriers, agents, and others is becoming increasingly important.
- Customer segmentation, product and service innovation, and channel optimization initiatives can help carriers allocate resources and capital to retaining existing customers instead of constantly seeking ways to obtain new ones that they may lose a year later.
- Having a single view of customers and understanding their behavior and sentiments will drive marketing and advertising initiatives.
- Use of advanced behavioral finance and behavioral modeling techniques and analytics will increase.
- Multi-channel integration with newer channels and devices will accelerate.
- Integrating superior consumer understanding with enhanced distribution reach and innovative product design will differentiate leaders from the rest of the pack.

Execution

Developing an Information Advantage

Insurers are actively seeking ways to gather, interpret and utilize data to increase operational efficiencies, segment marketing initiatives, improve pricing, build new and tailored products, and reduce potential losses. This focus on information is primarily the result of three factors:

- **Urgency for differentiation**—The information insurers gather is the basis of product development, customer lifecycle management, risk and profitability management, and growth and sales management (particularly in the more saturated markets). The need to offer products that customers value, grow and maintain market share, command higher prices, and create a sustainable competitive advantage in a very competitive market requires more accurate, timely and actionable insight into customer behavior.
- **Tightening the bottom-line**—As organizations become leaner and assign talent to areas that require relationship building and decision-making skills, they are creating an information-driven, automated rules-based environment for remaining processes.
- **Need to better manage systemic, macro-economic risks**—In the wake of the financial crisis, there is a need to integrate new sources of external information with internal data in order to more effectively identify and monitor potential risks (and opportunities).

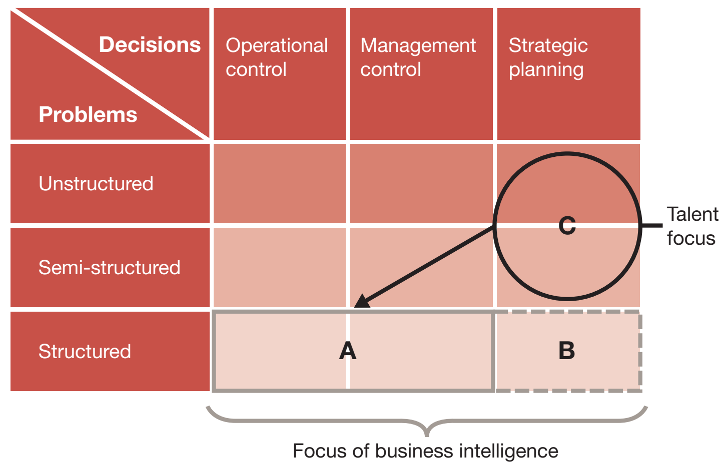
Accordingly, the following will be on many insurers' agendas in 2011:

- **Integration of external sources of data**—Insurers will invest more in sophisticated analytics engines that integrate new and non-traditional sources of data in order to price risks as well as reduce losses. Examples of ongoing initiatives in this area include:

    1. *Using information in new ways*, including identifying proclivity for fraud by constantly studying online search words characteristic of various crimes, including by geographic area, and working with authorities to preempt them.

2. *Identifying highly indicative risk variables* while simultaneously reducing the tedium of data gathering for agents and actuaries. This includes leveraging third-party data that lists equipment age, and incorporating human behavioral preferences as indicators for pricing individual risk.
3. *Enhancing modeling techniques*, including using macro-economic variables and geocoding data in the redesign of pricing and distribution models when identifying concentration of risk to prevent systemic exposures over time.

- **Enterprise-wide intelligence—**Insurers recognize the value of the information they accumulate simply by pricing risk. They are making major investments in consolidating this information from each business and functional unit to enable enterprise-wide access to it. Doing so can create detailed customer and agent/broker views that facilitate understanding of unaddressed customer product needs and the potential for increased cross—and up-sell, as well as how to better recognize high performing agents and brokers.
- **Using information management to better leverage human talent—**Automating processes that do not necessarily require human decision making can enhance an insurer's competitive advantage by enabling its most capable people to focus on complex and unstructured strategic decisions that require human intelligence and judgment. This sophisticated use ofinformation also indicates a *shift in organizational mindset* from "on-demand" leveraging of information for generally tactical purposes to ongoing, strategic planning and decision-making via a more focused, rules-driven environment.
- **Cockpits that look to the future instead of dashboards that look to the past—**Analyzing historic behavior can help insurers prepare for the future, but seldom as comprehensively as executives would like. There are new analytic techniques, such as *non-linear dynamic models*, that account for the *interactivity* between market variables instead of representing them individually. This approach has promise to be especially useful in an environment in which many things, such as consumer attitudes and behaviors, legislation, macro-economic factors, and competitor strategy, change simultaneously.



Implications

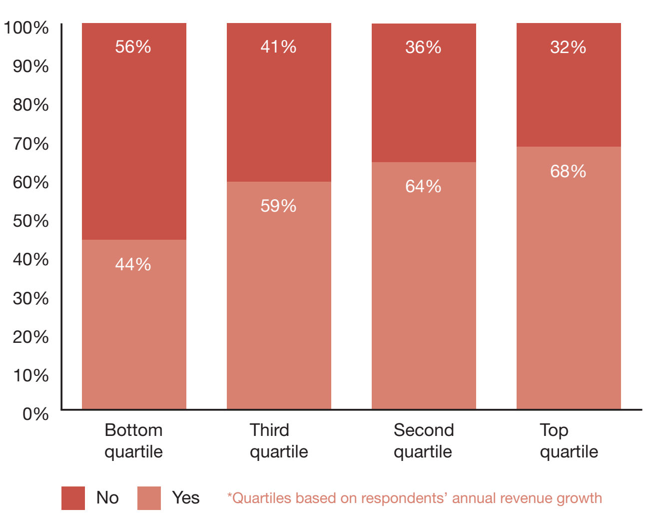
- Information is not the preserve of only one or even a few business units; all parts of the company create and maintain it. Accordingly, more effective integration and use of information can improve the performance of all aspects of the business.
- Especially in light of industry stakeholders' heightened expectations of companies' risk management initiatives, more effective, enterprise-wide use and interpretation of information will help companies better manage economic and business cycles, as well as improve their standing in the capital markets and with industry analysts.
- More effective management of information will enhance management's ability to focus on strategic and complex issues, as well as provide them better insight into those issues.
- Because of the limitations of linear, historic date, non-linear dynamic models that account for the interactivity between market variables will gain wider use in anticipating current and future trends.

Mobilization: The Critical Component in Transformation Initiatives

As insurance companies face increased pressures from more demanding customers, new regulations, and aging technology systems, they will continue to invest in improving operational efficiency, increasing revenue, and reducing costs. Insurance executives are particularly focused on making improvements to core operations, including policy administration, claims management and billing.

A recent PwC-Diamond Digital IQ study found that only 16 percent of all IT projects at 451 companies delivered expected results. The same study found that 77 percent of projects wound up using more resources than planned because of a failure to properly mobilize, and over 50 percent did not achieve desired business capabilities. Accordingly, when insurers undertake policy, claims and billing transformation programs, it is critical that they understand and overcome the economic, operational, technological and cultural challenges that may stand between their strategic vision and their realization of it. It also is critical they understand that a major transformation is not an easy undertaking, and that it is nearly impossible to realize strategic goals if mobilization is flawed (or ignored altogether).

A single roadmap exists for corporate strategy



Source: Diamond Management & Technology Consultants, third annual *Digital IQ* study

If the mobilization phase is so critical, why do companies struggle with it? For starters, many of them do not understand the phase's necessity because there is a common assumption that a strategy is ready for implementation upon definition (assuming there even is a strategy: According to a recent PwC-Diamond Digital study, and as shown in the graphic below, only 68 percent of top-quartile companies have a single corporate strategy roadmap, and only 44 percent of lower-performing companies do). In addition, some companies lack the requisite experience and/or capabilities to translate their strategy into an actionable plan for large-scale, high-risk transformations. Moreover, many transformations fail because of organizational inertia or passive resistance that has to be overcome during the mobilization phase. Without mobilizing the organization, recruiting key resources, preparing a broad change management plan that includes customers, agents, internal sales representative, and operational staff, companies run the risk of ramping up too quickly and burning through their budget before they make any real progress

Implementing change is difficult under the best circumstances and especially so when there are poorly defined scope, timelines, staffing, processes, and tools. Effective mobilization can reduce ambiguity, but must thoroughly address key business and technical architectures in order to create the requisite mechanisms for executing, measuring progress, and delivering results.

Effective mobilization usually consists of the following major components:

Release Planning	Program Design
• Business case definition	• Estimation
• Scope chunking	• Organization/team design
• Capability bundling and sequencing	• Program/project planning
• Market/competitive analysis	• Sourcing strategy
• Budgeting	• PMO processes, templates & tools
• Architectural blueprint	• Launch criteria definition
• Change management	• Governance/gating

> *"Survey after survey confirms policy administration replacement and modernization as a top-of-mind concern for insurers."*
>
> Insurance Networking News, January 2011[1]

Implications

It usually takes a significant investment of time during planning to get mobilization right, but doing so significantly improves the likelihood of a project's success. Moreover, investing time and money during mobilization helps prevent unwelcome changes during the execution phase. Without adequate mobilization, companies should anticipate the following roadblocks in their attempts to operationalize strategy:

1. **Inability to define a clear strategy.** This most often results in either vague high-level visionary statements and targets or detailed functionality wish lists that lack an over-arching objective.
2. **Difficulty in identifying and quantifying customer experience or market needs.** Expressing strategy goals in terms of growth and profitability targets often fails to take into account what customers want or what is feasible from a market perspective.
3. **Difficulty in translating strategic objectives into operational processes and technology requirements.** An organization's business and IT stakeholders need a common language to determine and understand operational implications and technology requirements, and if necessary, modify the latter.
4. **Complexity of ongoing initiatives across divisions overwhelms attempts to develop an integrated plan.** Agreement among key business and IT stakeholders on a common goal with clearly defined deliverables helps create a transparent and harmonious mobilization and execution. "Changing the wings while flying" or incorporating new initiatives that require complex operational and technology changes mid-stream challenge even the most capable organizations.
5. **Difficulty in sequencing projects, and quantifying and assigning responsibilities for business benefits and costs.** Organizations often do not rigorously quantify, assign responsibility for, and measure business benefits and costs. Even when organizations measure the costs of a program, they often fail to quantify its benefits.
6. **Inconsistent understanding or lack of commitment between different levels and/or divisions of the organization.** Agreement in principle does not necessarily translate into a clear strategic vision. Because mobilization relies heavily on estimates and assumptions, continued validation and reiteration of initial assessments is necessary to confirm that a transformation remains on target. Everyone involved in a transformation should know his and his department's role in the program, including how departments are supposed to interact and collaborate with others to achieve set goals.
7. **Insufficient and/or inadequate resources.** Many companies believe that they can mobilize a large-scale transformation program because they have successfully planned and executed systems projects in the past. However, because of the scale and risk associated with policy, claims and billing transformation programs, it is crucial to have an adequate complement of personnel who have prior experience with large-scale projects.

1 See http://www.insurancenetworking.com/issues/14_1/insurance_technology_policy_administration_replacement_Fidelity-26813-1.html

M&A

As a result of a general recovery in asset valuations, as well as a boost in earnings and capital from reserve releases at many P&C companies, more and more insurers were looking for ways to deploy surplus capital and bolster returns on it in 2010. However, despite high expectations for more insurance deals in 2010, activity was as sluggish as it was in 2009. According to data obtained from Thomson Reuters, only 108 deals with non-disclosed values occurred during FY 2010, compared to 110 for FY 2009. However, as the result of a few significant transactions, deals with disclosed values increased during 2010 compared to 2009. Through December 31, 2010, there were 46 deals with disclosed values totaling approximately $11.9 billion, compared to 21 deals worth $5.9 billion in 2009. The 2010 deals feature a few large transactions, including Fairfax Financial Holdings Ltd's acquisition of Zenith National Insurance Corp for approximately $1.32 billion, Berkshire Hathaway Inc's acquisition of Swiss Reinsurance Co Ltd-US for $1.26 billion, Stone Point Capital LLC and Hellman & Friedman LLC's acquisition of Sedgwick CMS Holdings Inc. for $1.1 billion, and ACE Ltd's acquisition of Rain & Hail Insurance Services Inc. for $1.1 billion.

As has been the trend in recent years, there remains a significant amount of pre-deal activity taking place, but many deals are not actually closing. Valuation gaps due to differences in buyers' and sellers' expectations of future profitability present significant challenges to agreement on pricing and structuring and is preventing many potential buyers and sellers from consummating a deal. In addition, there is still significant uncertainty about the financial impact of regulatory and tax reform, which will continue to pose valuation challenges for buyers and sellers.

Furthermore, many buyers are looking to deploy excess capital in building scale and efficiencies instead of diversification. The valuation gap and a lack of willing sellers are causing many would be buyers to look to alternative uses for capital, including organic growth, loss portfolio transfers and renewal rights transactions, as well as the acquisition of key human capital. There is still some deal activity driven by distressed or "forced" sellers; however, the source of this deal flow seems to be slowing significantly, particularly as capital levels and market expectations recover. In place of deals, many distressed sellers have considered strategic alternatives, including IPO's and renewed levels of debt issuances. Other sellers are looking to divest non-core businesses and assets in an effort to improve profits and focus on their core competencies (and in some instances repay the government). However, buyers may be less inclined to diversify and venture into the unknown in a still tentative economic recovery.

There remains a significant amount of pre-deal activity, but many deals are not actually closing.

Implications

While insurance M&A activity may strengthen in 2011, we expect a number of issues will impact it, including:

- Legislation—Hesitancy in the market is expected to continue because of uncertainty surrounding legislative initiatives. The Neal Bill and Obama Proposals could have a significant impact on offshore property and casualty reinsurance strategies and offshore reinsurers. Healthcare reform could have a significant impact on accident and health and life insurers and other writers of related workers compensation, long term disability or long term care products.
- Solvency II—While there appears to be declining interest among European investors in the US M&A market, Solvency II will impact European insurers and reinsurers (and their US subsidiaries) by increasing the amount of capital they are required to hold.
- We expect that P&C rates will continue to soften due to excess capacity and the relatively moderate impact catastrophic events have had on investment yields and spreads. Soft P&C rates may affect perspectives on appropriate scale and the corresponding need or desire to consolidate in order to more effectively and efficiently "run more premium" through the system.

- The interest rate environment likely will remain low and low investment yields will impact the profitability of P&C and—because they rely on the spread between investment income and investment credited to policyholders—especially life insurers.
- Excess capacity and a residual soft market could lead to increased consolidation of underwriters, particularly in Bermuda, and potentially increase interest in vertical acquisitions of MGA's, MGU's or captive agents.
- Insurers who have excess capital may choose to fund stock buybacks or increase dividend levels rather than search for an ROE-enhancing transaction.

Risk Management

Interest Rate Environment

The brush with one percent yields in 2010 and concerns that the US may have entered a long-term, low interest rate environment have led risk managers in the life insurance industry to consult their "worst case scenario" action plans. The challenging interest rate environment has had a significant influence on insurers' financial results and has affected virtually every aspect of their financial activity, including:

- **Asset/liability management**—As interest rates move lower, the duration of fixed income assets becomes shorter compared to the duration of typical insurance contract liabilities. At today's levels, it is already difficult to achieve a very close match without investing in non-standard asset classes. If rates move higher, it will be easier to do this, but an effective risk management strategy includes consideration of how these duration relationships are likely to change in the future if interest rates move lower, as well as, for example, the derivatives that might be helpful under those circumstances.
- **Product development**—New product initiatives already are incorporating design elements to mitigate the risk of interest rate changes, as well as changes in equity markets. For example, insurers are de-emphasizing the savings element associated with level premium, lifetime protection products by modifying the premium patterns as with level premium term products or no-lapse universal life product forms. Insurers are reducing the significance of investment spread as a source of profit via newer product designs and by fee-based margins or true mortality risk premiums.
- **In force management**—Balancing the margins earned on policyholder account balances against policyholder expectations s is always challenging. Conventional wisdom holds that achieving a good balance is most possible when the interest environment is stable and most challenging when rates are volatile. However, in a stable but low interest rate environment the portfolio earned rate inevitably marches down, first piercing desired spreads and then, in a worst case scenario, falling through floor guarantees. How quickly to drop credited rates or dividend scales in such times is a difficult decision for management. If they lower rates too quickly, then they are likely to be less competitive and lose business as policyholders go elsewhere. If they lower rates too slowly, then earnings (and shareholders) suffer.
- **Liability valuation**—The rate insurers use to discount liability cash flows is front and center in the discussions of proposed changes to insurance contract accounting. Determining how to reflect the liquidity characteristics of those cash flows in determining the discount rate is developing into a true science. Current approaches effectively allow consideration of the credit spread available on investment grade corporate bonds, but this seems unlikely to remain the case in the future. The closer the ultimate outcome is to the swap curve, then spread-based products make less sense from a profitability perspective; compound this with a low

The brush with one percent yields has led risk managers in the life insurance industry to consult their "worst case scenario" action plans.

interest rate environment and the potential implications are vast. The amounts that will be recorded for current insurance contracts in force will be significantly higher than current ones. As a result, the capital base of the industry will shrink dramatically over night.

Implications

- Based on their recent experience, many insurers will re-evaluate their strategies for addressing low yields in the fixed income markets. Moreover, if the considerations factoring into their analyses did not change after the last evaluation, then they likely will soon. The factors driving this reassessment include:
  - » US insurance regulations on non-forfeiture values have changed to help the industry adapt to lower available yields.
  - » The industry's risk profile has changed to include a different mix of interest rate and equity risks.
  - » Accounting standards are in a state of flux and in the future are likely to include an increase in the values associated with minimum interest guarantees and require marking of recorded values to the current rate environment.
- Experience tells us that the best time to put in place a strategy for managing a particular risk is before the risk is significant. Accordingly, as yields appear to be trending upward, 2011 will be a good year to "lay in" a strategy for mitigating the financial impact of low interest rates.
- Companies will not be able to simply dust off old strategies for managing in a low interest rate environment, but will need to evaluate their effectiveness in today's world, from both an economic and a financial statement perspective. Changes are necessary to account for the present realities of product design, the sophistication of the insurance-buying market, and the complex reporting requirements.
- Products that effectively match benefit outflows with premium inflows will fare best when future insurance contract accounting standards apply and in low interest rate environments. However, it remains to be seen if these contracts will fulfill the insurance market's need for products that effectively allow for the budgeting of life protection needs.

CRE Investments and Portfolio Risk

Insurers' holdings in commercial real estate (CRE) assets come in several forms, including investments in commercial mortgage backed securities (CMBS), direct commercial loans, and direct real estate holdings. Traditionally, life insurers have held more of these investments than property and casualty insurers, which give the former longer liability durations. A recent Fitch Ratings report, "2011 Outlook: US Life Insurance,"[2] on the life insurers it rates estimates an exposure of approximately $300 billion of direct commercial real estate loans and $150 billion of CMBS and commercial real estate collateralized debt obligations (CDOs). Fitch notes that this represents approximately 15-16 percent of invested assets for these insurers, and that one of its three "primary rating concerns" for US life insurers over the next 12 to 18 months is "higher than expected losses on commercial real estate (CRE) related assets."

A thorough understanding of the specific nature and risks of CRE investments represents the best defense against unpleasant surprises.

2 Available to Fitch subscribers at: http://www.fitchratings.com/creditdesk/public/top_20.cfm

Implications

In light of this potential risk, what should an insurer focus on at this time to ensure a thorough understanding of the specific nature and risks of its CRE investments?

- **Direct vs. indirect exposures—**Life insurers with well performing direct loan portfolios may have very different CRE exposures through purchased CMBS. Just as insurers with direct loan portfolios should not assume similar loss experiences for their CMBS investments, those holding only CMBS investments should recognize that loss experience on those investments has historically differed significantly from direct loans.
- **Loan specific information—**Commercial loan underwriting typically involves more specific knowledge of property characteristics and projected cash flows than residential loan underwriting, where assumptions regarding classes of borrowers are often made based on credit scores, income levels and other factors. As a result, analyzing the current and projected value of CRE assets typically involves a more time-consuming, loan-specific process. Applying this process to a single CMBS which may be backed by thousands of individual commercial loans can make valuation and impairment analyses extremely difficult. A thorough understanding of the nature of the loans underlying CMBS investments is needed in order to determine a range of acceptable performance scenarios for these analyses. Loans with certain vintage years (e.g., 2006–2008) and exposures to certain property sectors (e.g., hotel and multifamily residential) may perform very differently than loans with different characteristics. Investors relying on third party service providers for detailed CMBS deal information should assess these entities' competency, procedures and controls. As with any valuation service provider, the insurer also should understand and assess the reasonableness of the assumptions used in the CMBS valuation process.
- **Refinancing concerns** -Early last year, the media warned about a looming "refinancing crisis" in corporate debt, including CMBS. According to these reports, reduced lending capacity and appetite could lead to a spike in defaults related to the $2 trillion of corporate debt that is estimated to refinance over the next five years. However, since that time, property market fundamentals have improved in many areas, and a certain amount of liquidity has returned to the CMBS market. Although fears of performing loans defaulting at maturity ("balloon defaults") continue to exist, insurers may be better positioned than other investors to weather any storm that develops. Historically, life insurers have invested in more senior tranches and less risky direct loans than many other lenders. This investment discipline may serve them well in the coming years, as any reduction in lending capacity is likely to affect lower rated borrowers first. Investors should understand the maturity profile of their CRE investments and consider if there is anything they can do now to avoid or mitigate potential future losses. Investors also should continue to monitor the potential implications of refinancing liquidity on assumed default rates which impact investment valuation and impairment measures.

Taxation

Outlook for 2011 Tax Legislation

The results of the 2010 Congressional midterm elections may mark a turning point in debate over tax legislation, with control of Congress divided between a Republican-led House of Representatives and a Democratic-led Senate. The outlook for tax legislation is complicated by uncertainty if President Obama's relationship with Congress will be characterized by compromise or gridlock.

We expect concern over the unsustainable growth of the federal debt to be both a key motivator of and constraint to action on federal spending and tax policy legislation in 2011. The new 112th Congress and the Obama Administration are set to engage this year in an extended debate on legislative priorities that will be influenced by annual federal deficits that recently have exceeded $1 trillion, or between nine to ten percent of gross domestic product (GDP).

In late December 2010, Congress passed an $858 billion tax bill that included provisions extending Bush-era individual tax provisions generally through 2012 and retroactively extending the research credit and other business tax provisions through 2011. Business provisions of interest to many US multinational insurers renewed through 2011 include the temporary exceptions to certain subpart F insurance income provided under sections 953(e) and 954(i).

With key individual and business provisions temporarily renewed, President Obama and some members of Congress have expressed an interest in considering tax reform proposals along with deficit reduction efforts. Disagreements on the appropriate role of the federal government and the correct level of overall federal expenditures may diminish prospects for bipartisan compromise on tax reform and deficit reduction. These differences may become apparent when Congress considers the President's proposed federal budget for FY 2012.

While there still may be some support for the Administration's earlier tax proposals in the Democratic-controlled Senate, the Republican-led House is expected to consider much of the Administration's FY 2012 budget to be dead on arrival. House Republicans have stated their support for making current individual tax rates permanent. Incoming House Ways and Means Committee Chairman Dave Camp (R-MI) also has expressed an interest in examining the global competitiveness of the US tax system. Divided government may forestall consideration of significant tax increases that could have a negative impact on businesses or individuals.

Tax proposals affecting US multinationals—On February 14, 2011. President Obama submitted a proposed budget for FY 2012 that features several international tax proposals that a Democratic-controlled Congress did not enact in the past. As noted above, the House is expected to reject similar proposals this year, but debate over the Administration's tax proposals could be of interest to insurers. The Treasury Department's General Explanation of the Administration's Fiscal Year 2012 Revenue Proposals released in February 14, 2011 (known as the "Green Book")[3] describe the President's international tax provisions.

Other international tax reform proposals (listed immediately below) which affect many US multinational insurance companies are directed generally toward perceived abuses of the deferral and repatriation of non-US earnings. Unless otherwise noted, all of these proposals would be effective for taxable years beginning after December 31, 2011.

- **Deferred interest expense**—The deduction of interest expense that is properly allocated and apportioned to a taxpayer's foreign-source income that is not currently subject to US tax would be deferred. Foreign-source income earned by a taxpayer through a branch would be considered currently subject to US tax, thus the proposal would not apply to interest expense properly allocated and apportioned to such income. Other directly earned

3 Available at: http://www.treasury.gov/resource-center/tax-policy/Documents/Final percent20Greenbook percent20Feb percent202012.pdf

foreign source income (for example, royalty income) would be similarly treated. Pages 40-41 of the Green Book contain additional details.

- **FTC blending**—A US taxpayer would determine its deemed paid foreign tax credit on a consolidated basis based on the aggregate foreign taxes and earnings and profits of all of the foreign subsidiaries with respect to which the US taxpayer can claim a deemed paid foreign tax credit (including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the US taxpayer in that taxable year. The Secretary would be granted authority to issue any Treasury regulations necessary to carry out the purposes of the proposal.
- **Expiring provisions**—A number of temporary business tax provisions are scheduled to expire on December 31, 2011. The Administration proposes to extend several of these through December 31, 2012, including the Subpart F "active financing" and "look-through" exceptions. Page 32 of the Green Book contains details.
- **Capital gains and dividends**—Zero and 15 percent rates for qualified dividends and capital gains currently have been extended through 2012. The Administration would make these rates permanent for individuals with incomes below $200,000 ($250,000 joint filers). Under the President's proposal, a new 20 percent rate would apply in 2013 for taxpayers with income above those amounts. Page 11 of the Green Book contains details. As noted above, the House is expected to propose making permanent current rates for qualified dividends and capital gains for all taxpayers. It is uncertain whether Congress will be able to pass any legislation addressing this issue during 2011.

International tax increase proposals are directed generally toward preservation and expansion of the US income tax base.

- **Transfers of intangibles**
  - » **Transfers of intangibles offshore**—If a US person transfers an intangible from the United States to a related controlled foreign corporation that is subject to a low foreign effective tax rate in circumstances that evidence excessive income shifting, then an amount equal to the excessive return would be treated as subpart F income in a separate foreign tax credit limitation basket. Pages 43–44 of the Green Book contain details.
  - » **Intangible property transfers**—To prevent inappropriate shifting of income outside the United States, the definition of intangible property for purposes of sections 367(d) and 482 would be clarified to include workforce in place, goodwill and going concern value. Page 45 of the Green Book contains details.

International tax proposals affecting foreign multinational insurance companies—International tax increase proposals affecting foreign multinational insurance companies doing business in the US are directed generally toward preservation and expansion of the US income tax base. Green Book proposals include:

- **Disallowance of the Deduction for Non-Taxed Reinsurance Premiums Paid to Affiliates**—Page 46 of the Green Book contains a proposal would (1) deny an insurance company a deduction for reinsurance premiums paid to an affiliated foreign reinsurance company to the extent that the foreign reinsurer (or its parent company) is not subject to US income tax with respect to the premiums received and (2) exclude from the insurance company's income (in the same proportion that the premium deduction was denied) any ceding commissions received or reinsurance recovered with respect to reinsurance policies for which a premium deduction is wholly or partially denied. A foreign corporation that is paid a premium from an affiliate that would otherwise be denied a deduction under this proposal would be permitted to elect to treat those premiums and the associated investment income as income effectively connected with the conduct of a trade or business in the United States and attributable to a permanent establishment for tax treaty purposes. For foreign tax credit purposes, reinsurance income treated as effectively connected under this rule would be treated as foreign source income and would be placed into a separate category within section 904.

This provision would be effective for policies issued in taxable years beginning after December 31, 2011. Treasury estimates that it will raise approximately $2.6 billion over the 10 year period following its enactment.

An earlier version of this proposal appeared in the "2011 Green Book". However, there are significant differences between the FY 2011 and FY 2012 proposals:

» In the FY 2011 Green Book proposal, the US insurance company would be denied a deduction only to the extent that the amount of non-taxed reinsurance premiums (net of ceding commissions) paid to foreign reinsurers exceeds 50 percent of the total direct insurance premiums received by the US insurance company and its US affiliates for a line of business. On the one hand, the current proposal is harsher as it does not contain this 50 percent threshold. It may be noted that it is also harsher than the Neal Bill, which proposed using certain industry factors by line of business as a similar threshold. On the other hand, unlike either the FY 2011 Green Book Proposal or the Neal Bill, the current proposal excludes from the ceding company's income ceding commissions and reinsurance recoveries in the same proportion as the denied deduction.

» The FY 2011 Green Book proposal did not mandate separate basket treatment under section 904 for reinsurance income treated as effectively connected income under the proposal.

» The current proposal is scored at significantly more revenue than the FY 2011 Green Book proposal (which was only $519 million over the 10 year period following enactment), presumably because of its potentially broader reach.

- **Earnings Stripping Reform.** Pages 47–48 of the Green Book include provisions that are intended to impose greater restrictions on interest earnings stripping for certain expatriated groups of corporations.

- **Transfer Pricing.** A wide variety of informal public statements and media reports indicate a general perception that taxpayers are aggressively employing transfer pricing principles to related party payments. These considerations are consistent with worldwide transfer pricing trends and increased governmental focus, but, as evidenced on pages 43–44 of the Green Book, recent comments indicate even closer scrutiny from US tax authorities.

Prospects for tax reform—President Obama has expressed a strong interest in individual and corporate tax reform under which various deductions and credits would be reduced or eliminated in exchange for lower statutory tax rates. Last December, the President requested the Treasury Department to review base-broadening reform options.

While the President's National Commission on Fiscal Responsibility and Reform did not secure the "super-majority" required under its charter to make formal recommendations to Congress, the Commission's report may influence debate on deficit reduction and tax reform efforts in the future. The plan outlined cuts in domestic and military spending, reductions in Medicare and other mandatory spending, and tax reforms intended to reduce the federal deficit by $3.88 trillion between 2012 and 2020.

Eleven of the eighteen commission members support tax reform proposals that would lower rates for individuals and corporations by repealing individual and business “tax expenditures” to broaden the tax base while contributing to deficit reduction. The Commission’s report suggested in an illustrative tax reform plan that the US should reduce its corporate tax rate from 35 percent to 28 percent, and also should establish a territorial system for foreign-source dividends to put US companies on a more equal footing with foreign competitors. While disagreeing with the Commission’s proposed revenue increase, incoming Ways and Means chairman Dave Camp has separately referenced the “backdoor proliferation” of tax expenditures since the 1986 tax act—which he called “spending through the tax code”—as having pushed tax rates higher and harmed economic growth.

Implications

- Divided government may forestall consideration of significant tax increases that could have a negative impact on businesses or individuals.
- International tax reform proposals that affect many US multinational insurance companies are directed generally toward perceived abuses of the deferral and repatriation of non-US earnings.
- International tax increase proposals that affect foreign multinational insurance companies doing business in the US are directed generally toward preservation and expansion of the US income tax base.

President Obama has expressed a strong interest in individual and corporate tax reform under which various deductions and credits would be reduced or eliminated in exchange for lower statutory tax rates.

Life Reserve Issues

The major life insurance company tax reserve issues for 2011 are a direct outgrowth of developments occurring during 2010. These developments include the implementation of NAIC Actuarial Guideline 43 (AG 43) for variable annuities, results from recent cases, US Internal Revenue Service (“IRS” or “Service”) pronouncements and audit activity in the reserve area, and the continued progress at the NAIC in the development of principle based reserves (PBR) related to life insurance products.

The NAIC adopted AG 43 with an effective date of December 31, 2009. For statutory purposes, AG 43 applies to covered variable annuity contracts issued on or after January 1, 1981. This effectively repealed prior Actuarial Guidelines 34 and 39 and changed the definition of the Commissioners’ Annuity Reserve Valuation Method (CARVM) prospectively for the covered contracts. Since the Internal Revenue Code prescribes that in the case of annuities, the prescribed reserve method is the interpretation of CARVM in effect at the date of contract issuance, the adoption of AG 43 also had effects on reserving for federal income tax purposes.

AG 43 clarifies and interprets the provisions and standards under CARVM for determining reserves for variable annuity contracts and other contracts with certain types of “guaranteed benefits” (guaranteed minimum death benefits, guaranteed living benefits, etc.). In doing so, the NAIC moved from basing reserves solely on a single deterministic component involving prescribed assumptions for interest and mortality to one that also introduced a stochastic component to the reserve calculation based on varying patterns for future interest rates, etc. and actuarial judgment. Under AG 43, the reserve is equal to the deterministic component (standard scenario amount or SSA) plus the excess, if any, of the stochastic component over the SSA (Stochastic Excess). On March 25, 2010, the US Treasury issued Notice 2010-29, which provided “interim” guidance on certain life insurance company tax issues related to the adoption of AG 43. While Notice 2010-29 answered many questions about the proper tax reserving approach for the affected contracts, it did not specifically address several issues. The most significant unanswered questions/topics of discussion include:

- Is the Stochastic Excess amount determined on a statutory basis included in the "statutory cap" for purposes of the "three-pronged comparison" prescribed under Section 807 of the Internal Revenue code?
- The Section 807(f) 10-year spread rule applies to changes in tax reserves resulting solely from changes in the AG 43 statutory reserves capping.
- Although AG 43 is not "retroactive" for contracts issued prior to December 31, 2009, can it be applied to prior year issues as a "permissible interpretation of CARVM" in certain circumstances?

The American Financial vs. US case of July 2007[4] dealt with the effect of Actuarial Guideline 33 (AG33) as it related to contracts covered under CARVM that were issued prior to the formal adoption of AG 33 in 1995. The court ruled that in relation to the issues of the case, AG 33 was a clarification of existing CARVM principles. Therefore, the company was correct in applying AG 33 principles to contracts issued prior to 1995 as it correctly involved the interpretation of the CARVM in effect at the date of contract issuance. The IRS has filed a notice of appeal on this case.

The appropriateness of the "account value drop and recovery" assumption under Actuarial Guideline 34 (AG 34) was included initially in an IRS notice of deficiency involving CIGNA. The IRS suggested that this was not an appropriate assumption to use for CARVM tax reserving purposes as it did not involve a mortality or interest assumption. While the IRS may be backing away from this position, other AG 34 issues are arising. Most visible is the issue of whether the applicable federal rate or prevailing state assumed rate (statutory rate) should be used in the determination of the "go forward rate" under AG 34. In recent audit examinations, the IRS is challenging the use of AG 34 for tax reserving purposes prior to its formal adoption by the NAIC.

In addition to its standard IRS Section 807 Reserve Questionnaire, the Service has been issuing additional IDRs on certain specific reserve issues as a part of recent audits. IDRs dealing with the determination of tax reserves related to guaranteed minimum death benefits and variable annuity separate account reserves under AG 34 and the accumulation of charges reserve related to variable annuities with guaranteed living benefits (VAGLBs) under AG 39 have been issued as part of ongoing audits at several companies. If these issues relate to a material amount of reserves, similar IDRs may be issued as part of future company audits. There also continues to be uncertainty about how to match for tax purposes the taxable income on options related to hedged reserve liabilities and the deductions related to the AG 39 reserves.

The NAIC has made substantial progress towards a principle-based reserves (PBR) approach related to life insurance products for statutory purposes. It is unlikely that PBR will become effective prior to 2015 because of certain unresolved issues and the difficulty of adoption by the various states. A committee of the American Academy of Actuaries and other organizations already are examining tax reserve issues related to PBR, and there have been initial discussions with the US Treasury on this subject. While many of the tax reserving issues will be similar to those under AG 43, there will be certain tax reserving issues unique to PBR.

Although it does not relate directly to reserves, there were developments related to the insurance separate account dividends received deduction in 2010 and there could be legislative activity in 2011. In 2010, the IRS agreed not to pursue adjustments for the separate account dividends received deduction, assuming that taxpayers followed the common methodology of calculating the company share based upon net investment income less fees paid to the general account. However, it is uncertain whether the US Congress could pursue eliminating this benefit, which can be a significant deduction for life insurance companies with variable products.

4 Information is available at: http://meetings.abanet.org/webupload/commupload/TX323000/otherlinks_files/AmFinUpdate.pdf

Implications

- AG 43 tax reserving issues will continue to be discussed and a part of IRS examinations in future years. Part of this is due to the fact that Notice 2010-29 is an "interim notice" and further clarification is to be expected on certain issues that the IRS did not fully address. Furthermore, some of the unanswered questions will begin to have a more material effect on 2010 and future year tax returns.
- Ongoing and new IRS audit examinations may deal more specifically with tax reserve issues related to Actuarial Guidelines 34, 39 and 43. In some cases and for some tax return years, material amounts could be involved.
- While implementation of PBR may not be mandatory until 2015, companies should begin to address tax reserve related issues at the same time they are dealing with other PBR related implementation issues.

Uncertain Tax Positions

In an effort to increase certainty, consistency, and efficiency in the administration of tax, the IRS issued the final Schedule UTP form and instructions on September 24, 2010. Disclosures on Schedule UTP will be required for positions a corporation takes on its US federal income tax return for the current tax year or a prior tax year if either the corporation or a related party has recorded a reserve with respect to the tax position in audited financial statements or did not record a reserve for that tax position because the corporation or related party "expects to litigate" the position.

The filing requirement for Schedule UTP has a five-year phase-in, with corporate taxpayers which have total assets equal to or exceeding $100 million required to file beginning with the 2010 tax year. The total asset threshold will be reduced to $50 million starting with the 2012 tax year and to $10 million starting with the 2014 tax year. In response to comments and concerns the IRS received from taxpayers and practitioners earlier in the year after the release of the draft form, the final Schedule UTP and instructions contain significant revisions to the originally proposed form, including:

1. Elimination of the requirement to provide the rationale and nature of the uncertainty as part of the concise issue description on the form, with specific emphasis that corporate taxpayers should not disclose privileged information.
2. Elimination of the requirement to disclose uncertain tax positions for which a financial statement reserve was not recorded due to a "widely understood" administrative practice.
3. Replacement of the maximum tax adjustment calculation with a ranking method for all positions disclosed on Schedule UTP, based on the size of the US tax reserve amount, but not disclosing the amount.
4. With respect to positions for which there was an expectation to litigate, the IRS clarified that it does not intend to require disclosure of highly certain or immaterial positions.

Despite the release of additional guidance, there are some areas of uncertainty which the IRS did not fully address, including the definition of the phrase "recording a reserve," whether the ranking of uncertain tax positions should be based on the gross or net liability, which is particularly relevant to temporary differences, and the treatment of uncertain tax positions acquired through mergers or other acquisitions.

Additionally, in conjunction with the issuance of the final Form UTP, the IRS released Announcement 2010-76, which expands the IRS policy of restraint in connection with Schedule UTP and states that the IRS will forego actions to seek particular documents that relate to uncertain tax positions and the workpapers that document the completion of Schedule UTP. Furthermore, IRS Commissioner Shulman stated that the IRS will adopt a policy that it will not seek documents that would otherwise be privileged, even though the taxpayer has disclosed the document to a financial auditor as part of an audit of the taxpayer's financial statements. The IRS Large Business and International Division also will establish a centralized process to review the disclosed uncertain tax positions to identify trends of areas of uncertainty, as well as to evaluate the duplication of existing reporting on Schedule M-3 of the tax return. Additional IRS initiatives in this area include the expansion of the Compliance Assurance Program (CAP) and the expansion of the Industry Issue Resolution program. In response to comments the IRS received from taxpayers and practitioners, Commissioner Shulman also stated that there would not be automatic disclosure of Schedule UTP to foreign countries.

Implications

- Complying with the IRS' UTP reporting requirements will be a significant for many corporations. Although the reporting of uncertain tax positions for tax return purposes is linked to the financial reporting of uncertain tax positions, additional potentially complex information is required to be disclosed on Schedule UTP.
- Schedule UTP also inserts an increased level of transparency into the income tax compliance and examination cycle, which may lead to elevated risk for many companies. In order to manage the IRS' UTP reporting requirements, organizations will need to develop and execute a process to report timely, accurate, and balanced disclosures on Schedule UTP.
- Additionally, corporations may find it beneficial to strategically address IRS examination issues and reduce uncertainty prior to the release of audited financial statements. Strategies which can often enable a corporation to achieve certainty on key issues include the filing of changes in accounting method, private letter rulings, advance pricing agreements for transfer pricing issues, and pre-filing agreements.

Changing Regulations and Standards

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