The impact of technology

- Innovation: Solutions are usually elsewhere
- Leveraging AI in commercial insurance
- P&C insurance core transformation: Beyond the first wave
Innovation: Solutions are usually elsewhere

Insurance is the industry most affected by disruptive change, according to the percentage of CEOs who are extremely concerned about the threats to their growth prospects from the speed of technological change, changing customer behavior, and competition from new market entrants.¹

Insurers know they need to innovate in order to remain competitive. In fact, 67% of insurance respondents to PwC’s 2017 CEO Survey see creativity and innovation as very important to their organizations, ahead of other financial services sectors and the CEO Survey population as a whole. And, insurance CEOs noted that the area they would most like to strengthen in order to capitalize on growth opportunities is digital and technological capabilities, followed by customer experience (reflecting the interconnectedness of the two).

However, the industry’s traditional conservatism and the dizzying pace of technological change has made it difficult to change. As a result, most insurers are looking outside the industry – typically in the InsurTech space (e.g., drones, sensors, internet of things (IoT)) – for the best ways to improve their systems, processes, and products. And there is no doubt industry stakeholders think InsurTech has real promise: annual investments in InsurTech start-ups has increased fivefold over the past three years, with cumulative funding of InsurTechs reaching $3.4bn since 2010, based on the companies PwC’s DeNovo platform follows.²

In order to facilitate a diverse approach to identifying new opportunities and potential partners from different industries and specialty areas, an enterprise innovation model (EIM) is table stakes. An EIM facilitates:

- **New product and service development:** Being active in InsurTech can help insurers discover emerging coverage needs and risks that require new insurance products and services. As a result, they can improve their product portfolio strategy and design of new risk models.

1. 2017 Insurance CEO Survey insurance report
2. Blurred lines: How FinTech is shaping Financial Services
• **Market exploration and discovery:** Prescient insurers actively monitor new trends and innovations, and some have even established a presence in innovation hotspots (e.g., Silicon Valley) where they can directly learn about the latest developments in real-time and initiate innovation programs.

• **Partnerships that drive new solutions:** Exploration typically leads to the development of potential use cases that address specific business challenges. Insurers can partner with start-ups to build pilots to test and deploy in the market.

• **Contributions to InsurTech’s growth and development:** As we describe below, venture capital and incubator programs can play an important role in key innovation efforts. Established insurers that clearly identify areas of need and opportunity can work with start-ups to develop appropriate solutions.

*Most insurers are looking outside the industry for the best ways to improve their systems, processes, and products.*
Maintaining awareness, influencing the market, and identifying the right partners

To ensure an organization’s innovation efforts are in sync with – or even driving – the latest developments in the market, an EIM needs a formalized yet agile process for identifying and incorporating best practices.

Dedicated assessment of InsurTech advancements can allow insurers to identify and promote best practices and key technologies. Moreover, maintaining a close connection with the InsurTech market can help a company develop its external knowledge and relationships with innovators. Through this process, insurers can identify potential partners that can help them understand evolving technologies and their applications, and even contribute to developing the capabilities they desire.

With a deeper understanding of the market, capabilities and key players, insurers can be better positioned to facilitate innovation, ideation, and design. While some FinTech companies already have compelling insurance applications, insurers have a great opportunity to identify and design new potential use cases.

**Fast prototyping** is key to quickly creating minimally viable products (MVP) and bringing ideas to life. Early stage start-ups develop and deploy full functioning prototypes in near-real time and go-to-market with solutions that evolve with market feedback. In this scenario, the development cycle is shortened, which allows start-ups to quickly deliver solutions and tailor future releases based on usage trends, feedback and/or to accommodate more diverse needs. Established insurers can follow the same approach or can partner with existing start-ups that have a MVP to help them to move to the next stage, scaling.

The ways to accomplish all of this vary based on how the organization plans to source new opportunities and ideas, how it plans on executing innovation, and how it plans to deploy new products and services. The following graphic provides examples of EIMs by primary function.
Figure 1: EIM required capabilities and connections

<table>
<thead>
<tr>
<th></th>
<th><strong>Innovation Center</strong></th>
<th><strong>Incubator</strong></th>
<th><strong>Strategic Venture Capital</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sourcing</strong></td>
<td>Ideas sourced from both inside and outside the company</td>
<td>Ideas mainly sourced from outside the company</td>
<td>Ideas sourced from outside the company</td>
</tr>
<tr>
<td><strong>Structure</strong></td>
<td>Dedicated corporate team constantly monitors trends and markets</td>
<td>Usually an external structure, but also “soft” internal incubators</td>
<td>New ventures division set up to identify and create new ventures</td>
</tr>
<tr>
<td><strong>Operation</strong></td>
<td>External connection with the ability to “plug” innovations into business units</td>
<td>Incubator explores and manages ventures to drive from ideation to execution</td>
<td>Pitch and invest model where the company provides cash and support for equity</td>
</tr>
<tr>
<td><strong>Governance</strong></td>
<td>Stage-gating process to balance procedural burden and risk</td>
<td>Export panel (int/ext) provides high level guidance and approval</td>
<td>Corporate network provides high level guidance for investment</td>
</tr>
<tr>
<td><strong>Go-to-Market</strong></td>
<td>Idea/venture adopted under company’s brand</td>
<td>Venture can go to market under it’s own brand or Company’s brand</td>
<td>Ventures stay in the market under its own brand</td>
</tr>
</tbody>
</table>
The innovation center

The innovation center (also named “lab” or “hub”) is a structure at a corporate level that bridges external innovation with business unit needs and innovation opportunities. It relies on internal subject matter experts and/or innovation champions to ignite and drive innovation initiatives at a business unit level. With this model, innovative new products and services go to market under the company’s brand.

The innovation hub provides an outside-in view while promoting innovation internally. With this model, the company dedicates a team to constantly monitor trends and market activity, build and maintain relationships with key InsurTech players, identify potential future scenarios, and determine new partnership opportunities.

The hub should be managed through business units in order to effectively innovate (i.e., building prototypes and scaling models). Execution is a key success factor, and we recommend insurers consider complementary innovation models to help promote positive outcomes.

Regardless of the model they use, we recommend that insurers of all sizes consider developing an innovation center and create an external connection based on potential future scenarios.

Innovation center case study:
A large global insurer wanted to enhance its advanced analytics capabilities globally and develop an appropriate innovation model. It started by first creating a center for advanced analytics in Asia that included three different countries. Corporate worked with multiple functional areas in these countries to innovate with advanced analytics in acquisition, retention, and claims management. With external third parties and solution providers, they were able to build the necessary capabilities and develop a “test and learn” culture. The company’s innovation approach and solutions won a number of regional awards. Subsequently, the company applied best practices from this initiative to expand its analytics capabilities around the world.
The incubator

An incubator can drive innovation from idea to end product by identifying new opportunities and developing related solutions. Although it does require a significant investment of both money and resources, it has proven especially effective in addressing complex problems and devising new approaches to them.

Although the incubator can be internal, external structures typically create unique development environments and attract necessary talent. Via an external approach, ideas come mostly from outside the company and a panel of internal and/or external innovation specialists provide high-level guidance and approval for the innovation the company is seeking through the incubator.

Although the incubator initially drives innovation, business units typically become involved during the development process. They have an important role, especially when planning to deploy new solutions within the organization. The incubator can wind up as a start-up that can go to the market under its own name.

One of the main strengths of the incubator model is that it facilitates execution. It holds an idea until a prototype is developed and a minimally viable product is available. The gradual involvement of business units during the process enables the model to adequately scale. Upon adoption by its future owner, the incubator and business units can address any related challenges related to operating capacity, cyber risk, regulation, and others.

Incubator case study: In 2015, AXA invested Euro 100 million in the launch of Kamet, an InsurTech incubator. Kamet conceptualizes and launches disruptive products and services for insurance clients. It works closely with AXA Strategic Ventures, which has invested seed capital in over 20 InsurTech startups that focus on wealth management, life insurance, and advice. Kamet also conducts competitions in different markets in which winners enter their incubator program and receive seed funding from AXA Strategic Ventures.
Strategic venture capital (SVC)

The SVC model offers the opportunity to participate via stake or acquisition in relevant InsurTech related players. This is a way to influence and shape the development of specific start-ups (e.g. pushing them to solve specific problems), acquire key capabilities and talent, and/or as a way to derive value from strategic investments.

In the SVC model, the company establishes a new ventures division, which sources ideas from the outside. The company provides funding and support for equity, while a SVC from this new structure explores, identifies and evaluates solutions and markets new ventures under its own brand. The funds SVC invests in a start-up help new players augment their capabilities and scale their business model. This could lead to potential market joint ventures, acquisitions, or other deals to monetize the initial investment.

Established insurers with SVC arms are usually leaders in specific market segments and therefore leverage their experience and knowledge to select key ventures. To become more active with InsurTech, we see these structures linking to innovation centers, thereby allowing companies to connect ventures with business units.

Instead of choosing one model over the other, we propose one that combines key elements from each. Companies can select elements based on their need for external innovation, the availability of talent, their ability to execute, and the amount of investment the organization is willing to commit.

SVC case study: Strategic private tech investments in InsurTech firms have increased dramatically – by 257% between 2014 and 2016. These investments have gone to InsurTech companies that focus on digital distribution, connected insurance, cybersecurity, and property and rental management. In addition to primary insurers, reinsurers have been very active in partnering and investing in InsurTech start-ups. For example, MunichRe has invested in waygum, PNP IoT, MundiLab, Lemonade, Metabiota, Helium, Plug n Play Insurance, PrecisionHawk, Slice, Trov, Slice, and Mashify since January 2015, and SwissRe has invested in startupbootcamp, digima, biovotion, and sharecare since December 2015.

3 For more information, please see https://www.cbinsights.com/blog/2016-insurance-cvc-total/
## EIM operating options

<table>
<thead>
<tr>
<th></th>
<th>Innovation Center</th>
<th>Incubator</th>
<th>SVC</th>
</tr>
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<tbody>
<tr>
<td>Innovation Portfolio</td>
<td>High</td>
<td>Medium</td>
<td>Medium</td>
</tr>
<tr>
<td>Best Practices</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>External knowledge and relationships</td>
<td>High</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Ideation and Design</td>
<td>High</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>Prototyping</td>
<td>Low</td>
<td>High</td>
<td>High (indirectly)</td>
</tr>
<tr>
<td>Scaling</td>
<td>Low</td>
<td>Medium</td>
<td>High (indirectly)</td>
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## EIM operating characteristics

<table>
<thead>
<tr>
<th></th>
<th>Innovation Center</th>
<th>Incubator</th>
<th>SVC</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main objective</strong></td>
<td>Ability to leverage an external connection to drive innovation and face implications of future scenarios</td>
<td>Accelerate, design, development and execution of solutions for complex industry challenges</td>
<td>Invest in strategic capabilities and talent, through acquisition or taking stake</td>
</tr>
<tr>
<td><strong>Trigger to adopt</strong></td>
<td>Limited ability to respond to emerging trends and lack of relevant connections</td>
<td>Ideas to develop new sources of competitive advantage while protecting IP</td>
<td>Awareness of relevant start-ups and need to have an active participation</td>
</tr>
<tr>
<td><strong>Key success factor</strong></td>
<td>Sponsorship and ability to execute through business units</td>
<td>Ability to “plug” incubated solutions in to business units</td>
<td>Leverage industry knowledge and future scenarios view for relevant ventures in early stage</td>
</tr>
<tr>
<td><strong>Options for externally sourced</strong></td>
<td>Supported by different players but a key corporate function</td>
<td>Ecosystem incubators and/or accelerator can be leveraged but IP has to be protected</td>
<td>CVC partners can be leveraged to identify potential targets, but a corporate structure should drive ventures and related innovation efforts</td>
</tr>
<tr>
<td><strong>Most typical complementary model</strong></td>
<td>Strategic Venture Capital</td>
<td>Innovation Center</td>
<td>Innovation Center</td>
</tr>
<tr>
<td><strong>Ability to attract relevant talent</strong></td>
<td>Medium to High if Innovation Hub deployed in innovation hotspots</td>
<td>High for external incubators</td>
<td>High by acquisition of JVs, challenge to retain talent</td>
</tr>
<tr>
<td><strong>Investment considerations</strong></td>
<td>Depends on FTEs and physical structure (in hotspots)</td>
<td>Can be optimized in an open model where new start-up can be funded by external investors</td>
<td>Depends on available total funding and analyst capability (FTEs)</td>
</tr>
</tbody>
</table>
Complicating the need to innovate is the fact that an insurer’s culture often influences an external company’s decision about partnering with it. In fact, according to our 2016 Global FinTech Survey, over half of FinTechs see differences in management and culture as a key challenge in working with insurers. Insurers also realize this, and 45 percent of insurance companies agree that this is a major challenge.

Accordingly, insurers will need to assess the availability and compatibility of existing resources and determine how and where they can find what may not currently be available. By clearly articulating the organization’s needs, defining explicit roles, and establishing a model for enterprise innovation, an insurer can address any underlying concerns it may have about partnerships.

While insurers can create internal structures to support innovation, most of them will have to enlist external resources in one way or another. In fact, we expect many talented professionals without insurance-specific skills will be the ones who wind up driving innovation.

Figure 2: What challenges did/do you face dealing with FinTech companies?

Source: PwC Global FinTech Survey 2016
Attracting and developing innovators

How does a company attract and retain this kind of talent? There are four primary ways:

• **Acquire** the new talent from start-ups. This works well if the acquired company keeps running its business under its own start-up rules, away from the acquirer’s bureaucracy. Otherwise, if there is too much acquirer interference, then retention will be a challenge in a market that covets innovators.

• **Attract** the talent directly from the market. This option typically requires a new mindset from the hiring company in terms of business role, work environment, and even location. Establishing a presence in relevant innovation hotspots will help to make an offer more attractive, facilitate external connections, and demonstrate the insurer’s commitment to letting innovators be free to innovate.

• **Partner** with start-ups, technology vendors, universities, researchers and other proven innovators. This option represents a major opportunity because it enables the insurer to create the connections to and formal partnerships with new talent. However, while identifying desired capabilities is relatively easy, there will need to be strong alignment of purpose between the organization and the new partners for the relationship to work. In this case, the Innovation Hub should be the most helpful model.

• **Grow** the talent. This option is probably the least disruptive because it doesn’t require external changes. Large organizations have the opportunity to discover talent within their structures. But, the organization will have to ascertain and leverage the mentality and professional background of employees in many different ways. Gamification, internal collaboration groups, and other resources can help in the search for potential in-house innovators, but most companies will need a more sophisticated staffing model in order to develop this talent (e.g., having specific development plans and offering “external” experiences in projects and/or with partners).

Complementing these options is insurance industry leadership’s advocacy of new methods to foster change in employee skill sets. According to insurance respondents to PwC’s 2017 CEO Survey⁴,

• 61 percent are exploring the benefits of humans and machines working together (considerably higher than any other FS sector), and

• 49 percent are considering the impact of artificial intelligence on future skills needs (also considerably higher than any other FS sector).

Insurers can create internal structures to support innovation, but – as EIMs stipulate – success ultimately depends on having the right talent. And, most insurers will have to enlist external resources – ones with an entrepreneurial mindset and who are well connected to InsurTech – in one way or another.
In response to this rapidly changing environment, incumbent insurers are approaching InsurTech in various ways, prominently through joint partnerships or start-up programs. But whatever strategy an organization pursues, InsurTech’s main impact will be new business models that create challenges for market players and other industry stakeholders (e.g., regulators). In this environment, insurers will need to move away from trying to control all parts of their value chain and customer experience through traditional business models, and instead move toward leveraging their trusted relationships with customers and their extensive access to client data.

For many traditional insurers, this approach will require a fundamental shift in identity and purpose. The new norm will involve turning away from a linear product push approach, to a customer-centric model in which insurers are facilitators of a service that enables clients to acquire advice and interact with all relevant actors through multiple channels. By focusing on incorporating new technologies into their own architecture, traditional insurers can prepare themselves to play a central role in the new world in which they will operate at the center of customer activity and maintain strong positions even as innovations alter the marketplace.

In order to effectively develop these new business models and capabilities and establish mutually beneficial InsurTech relationships, established insurers will need to start with a well thought-out innovation strategy that incorporates the following:

- An effective **enterprise innovation model** (EIM) will take into account the different ways to meet an organization's various needs and help it make innovative breakthroughs. The model or combination of models that is most suitable for an organization will depend on its innovation appetite, the type of partnerships it desires, and the capabilities it needs. EIMs feature three primary approaches to support corporate strategy, partnering via innovation centers (or hubs), building capabilities via incubators, and buying capabilities via a strategic ventures division. Companies can select elements from each of these models based on their need for external innovation, the availability of talent, their ability to execute, and the amount of investment the organization is willing to commit.

- Even though insurers can create the internal structures that support innovation, most of them will have to enlist **external resources** in one way or another. Accordingly, they will need to assess the availability and compatibility of existing talent and determine how and where they can find what may not currently be available. Much like with enterprise innovation models, there are certain ways (often in combination) that insurers can locate and obtain the resources they need, including acquiring it, trying to attract it, partnering, and/or growing it internally.
Leveraging AI in commercial insurance
Softening prices, little or no organic growth, and increased competition have characterized most of the commercial insurance environment in recent years. These factors and a relatively benign cat environment continue to attract new types of capital providers (e.g., hedge funds, pension funds, foreign investors, capital markets) looking to diversify their investment portfolios with uncorrelated insurance assets.

Limited organic growth opportunities also have led to a broad consolidation of distributors, with an increasingly large number of private equity-backed brokers looking for short-term gains and opportunities to reduce systemic inefficiency. In turn, this has led to significant carrier investments in automation to facilitate effective and efficient straight through processing (STP).

More specific responses to market conditions from commercial insurance constituents include:

- **Distributor response** – Distributors are increasingly looking for ways to (1) negotiate more aggressively on individual transactions (e.g., appetite exceptions, non-standard terms and conditions, pricing), (2) operate more efficiently (e.g., customized processes, only partial completion of applications), and (3) exert their bargaining power to gain higher commissions and other sources of revenue (e.g., access to market intelligence).

In addition, brokers are becoming increasingly organized. They are looking to 1) reduce the number of carriers with whom they place business in favour of ones that have a broad underwriting appetite and are easy to do business with, and 2) exit the service arena, especially on small commercial accounts where margins are already extremely thin.

- **Carrier response** – Carriers are intensifying their efforts to compete for a “top 3” position with distributors by attempting to (1) be easier to do business with (both in terms of technology and personal relationships), (2) increase product specialization and related underwriting expertise, (3) increase their appetite for more hazardous risk, and 4) (as a less favored option) lower rates and pricing.
Although more and more carriers have invested in automated underwriting and pricing, broker/agent expectations are only increasing. They not only want to clearly understand a carrier’s underwriting appetite, they also want to get near real-time quotes on the majority of standard risks without extensive manual data entry on their side.

For now, carriers have avoided being “spread-sheeted” by using proprietary agent portals to increase ease of business interactions, rather than directly integrating with agency management systems and comparative raters. Distributors have not yet increased their demands for the latter two, recognizing that they could lead to a commission squeeze or even losing their appointment if the profitability of their book declines with a given carrier.

• **Customer response** – Last but not least, customers’ behaviors and expectations are changing, too. They are becoming more comfortable researching business insurance online, and expect their shopping experience to reflect what they see in personal insurance. However, they are still turning to an agent (whether digitally or in person) to confirm their purchase decision and complete the deal. This is especially the case when businesses mature and risk management becomes more critical to their success.

As all this has been happening, artificial intelligence (AI) has matured significantly, demonstrating that it can markedly improve existing STP. We describe below the AI technologies – including robotic process automation, natural language processing, and machine learning – that can increase commercial insurance’s efficiency and effectiveness and thereby benefit investors, distributors, and carriers themselves.
The next generation of straight through processing

Although many carriers are already heavily automated, their initial focus has largely been on automated underwriting and pricing. This has left considerable manual intervention in the issuance process, post-bind audits, and other down-stream transactions. All of these can be streamlined to further drive down costs. Once carriers move to truly mechanized underwriting, the next step will be to embed third-party data feeds and advanced analytics in order to drive straight through processing (STP) of risks.

For example, imagine a small business owner being able to enter just four pieces of information (e.g., business name, business address, and owner’s name and DOB) on a policy application and receiving a real-time business insurance quote with the option to immediately purchase and electronically receive policy documents. Furthermore, imagine this approach having no impact on underwriting quality or manual back-end processing requirements for the carrier. Integrating AI techniques and additional internal and external data sources into small business processing have the potential to make this a reality.

A combination of leveraging internal data from prior quotes and policies, integrating external structured data feeds, and mining a business’s website and social media presence could provide carriers with enough information to determine a business’s operations, applicable class codes, property details, employment and payroll, and other key risk characteristics to underwrite and price low complexity risks. In cases where more information is needed, dynamic question sets with user-friendly inputs could streamline the application process without sacrificing underwriting quality.

How AI can improve straight through processing

In addition to immediate cost improvements, commercial carriers that leverage internal and external data resources and apply AI to commercial processing can benefit from reduced turn-around time, better and more consistent decision-making, and improved agent/customer satisfaction.
Some of the most promising AI techniques that can help insurers improve STP include:

- **Robotic process automation (RPA)** is an area of AI that could increase STP efficiency and bring down costs at acceptable level of increased risk. RPA automates data entry, third-party data integration, form filling, and data validation. More advanced process mining techniques use machine learning to infer business processes from transaction logs, web and call center logs, email, and workflow logs. They profile the time it takes for different steps of the quote-to-issue process to be fulfilled and, to streamline the process, plot a distribution that enables the identification of outliers. They also track exceptions, and the reasons for them, thereby enabling greater efficiency. RPA is also tracking conformance and compliance with established standards, thereby leading to more consistent and compliant service delivery.

- **Machine learning** is building routing logic and underwriting-related models. For example, a detailed analysis of a commercial book of business over time can identify the need for no-touch, medium-touch or high-touch interaction models. This categorization enables better routing across multi-segment (i.e., small commercial, middle market, and large commercial) commercial insurers. In addition, machine learning can inform a wide variety of predictive models.

- Using open source technology, PwC has built natural language processing engines that continuously evaluate a large number of news and social media sources and report on key concepts. Commercial insurers and brokers can use this ontology of “key concepts” to traverse the output, identify drivers of specific risks, and refer to articles related to these risks. By indicating the relevance of articles (e.g., via a thumbs up or thumbs down) insurers can “train” the natural language engine to look for specific sources and type of articles. As the system learns over time, it can graph trending topics, the sectors and companies associated with certain risks, and the underlying impacts if the risks develop adversely. We also have built a question-answer engine that allows risk experts to make natural language inquiries and retrieve relevant reports and documents to conduct further analysis. With natural language generation, the engine also can create risk profiles for senior management’s consumption.
By coupling deep learning systems with natural language processing, PwC has been able to create powerful risk analysis enablers that enhance and speed up emerging risk analyses. When analyzing text from news sources or social media sources, the system needs to understand the context under which certain words are used. For example, a common word like “run” has over 645 meanings according to the Oxford English Dictionary. “Deep Learning” or neural network-based machine learning systems can actually capture the context of words within sentences, sentences within documents, and documents within a collection of documents.

In closing, even with their increased focus on ease of doing business, there is still much room for carriers to improve. There currently is a clear opportunity for prescient and proactive carriers to separate themselves from the pack, but doing so will require a competitive mindset that has not traditionally defined the industry. Small and medium commercial carriers must find ways to improve their cost structures in order to compete profitably in the long-term. AI-enabled solutions offer some of the most promising ways to do this.
Implications

- New investors in the commercial insurance market are increasingly looking for short-term gains and greater efficiencies from the industry.

- Moreover, distributors are looking for greater ease of doing business with commercial carriers and have demonstrated a willingness to favor the ones that can meet their expectations.

- Commercial carriers have automated quoting in an attempt to facilitate effective straight through processing. This has increased efficiencies, which has benefitted investors and helped improved the distributor experience.

- However, many manual processes and inefficiencies still remain. Once carriers move to truly mechanized underwriting, the next step will be to embed third-party data feeds and advanced analytics in order to drive straight through processing of risks. Recent developments in artificial intelligence (AI) can help carriers do this.
P&C insurance core transformation: Beyond the first wave

Insurance carriers are making an unprecedented investment in transforming their policy, billing and claims systems and processes. We are in a unique period where the convergence of aging legacy platforms, complex market dynamics, and a mature vendor landscape has made transformation a top priority for carriers of all sizes and profiles. We expect core system transformations will continue to be a top priority for insurers – regardless of size and product mix – in the coming year.

Trends in the following three areas have been dominating our recent conversations with the industry:

1. Digital transformation and analytics: Carriers are looking to extend their core platforms to develop the foundation for digital transformation and analytics. They have more ambitious visions for how these programs should drive growth strategies and are no longer satisfied with simply implementing a new platform and then searching for ways to achieve benefits in the post-implementation environment. Looking forward, a successful transformation should include broader strategies for 1) data analytics, 2) a positive digital customer and agent experience, and 3) underwriting efficiency.

2. Greenfield and Cloud: Carriers are looking at alternate delivery approaches that align with their broader organizational visions. Some of them have recently started to explore the business and architectural simplicity of greenfield and Cloud delivery scenarios.

3. Specialty and E&S: An increasing number of carriers’ core transformation focus is on modernizing platforms that process specialty and E&S products. We expect the next wave of transformation will impact specialty line carriers, which we categorize as non-admitted (E&S), Bermuda, and London market carriers.

Insurers are looking for more than just up-to-date systems. They also want digital and analytics platforms that can help them realize the full benefits of a core transformation.
Several carriers have increased their investments in core transformation and recognize they need to add digital and analytic platforms in order to realize the following, additional benefits and capabilities:

1. **Better data and analytics** – In recent years, carriers have recognized the value of building or improving an enterprise data warehouse (EDW) in parallel with traditional core transformation initiatives. This has enabled them to plan for strategic data analysis and build necessary components into core systems. Modernizing core systems often leads to more reliable data, and when this data is coupled with strategic data analytics initiatives it facilitates improved process metrics, work queue volumes, and claims fraud detection.

2. **Better customer and agent experience** – Good customer and agent experiences most often occur with modern underlying core platforms, most of which now offer self-service capabilities and can even open new customer channels. Carriers are looking to advance core system capabilities by customizing an agent and policyholder portal layer that enables users to intuitively interact with the system; a claims transformation can improve the claims reporting, servicing, and resolution process and fundamentally alter how a customer interacts with the carrier’s claims processing division. Billing transformation programs also typically include self-service capabilities that can improve the overall customer experience.

3. **Improved underwriting efficiency** – This can be a direct benefit of any core transformation simply because of the resulting modern screen flow. However, carriers can gain much more by coupling the screen flow with an operational redesign that integrates the underwriting department with the new system capabilities (although this may entail an assessment and reconfiguration of the underwriting organization.) This is of particular importance in commerical and speciality lines transformations that seek to automate repetitive manual tasks but still require experienced underwriters to fully evaluate risks.
Greenfield implementation

Over the past two years, carriers have become increasingly interested in greenfield transformations. Such a transformation provides simplicity and gives carriers a unique opportunity to reinvent their business, IT, and organizational culture. This is in contrast to traditional transformation programs that unfortunately can “recreate the sins of the past” and implement relatively obscure business scenarios for the purpose of transferring the existing book of business.

A greenfield implementation approach tends to be straightforward. It eliminates the need to integrate with antiquated legacy platforms and thus can lead to speedier delivery time. It also tends to require fairly simple product design, which makes it well suited for mid-tier carriers that are looking to leverage off-the-shelf vendor products.

Some key advantages of a greenfield approach are its product and solution simplicity, increased speed to delivery, and the opportunity it provides the organization to break with the past. However, there are disadvantages if a carrier doesn’t go into this kind of implementation with eyes wide open. For instance, it will limit book of business conversion capabilities in the near term, and can create some intermediate operational challenges by adding to the overall portfolio of applications in the near term.

Greenfield offers design simplicity that can enable carriers to break from the architectural complexity of the past.
Cloud technologies

Though cloud deployments are not new for insurance carriers, their scope has primarily been limited to productivity applications with minimal connectivity to the broader enterprise ecosystem. However, there are different expectations of the cloud today.

The five key factors behind them are:

1. **Aging infrastructure** – Many carriers looking to modernize their core systems are discovering that their on-premise hosting environment is insufficient to support new core system technology, as well as customers’ and agents’ real-time “always on” expectations. Cloud solutions can meet many business and IT needs, and carriers now have a viable option to deploy new core systems in the cloud instead of investing in upgrading and maintaining new IT infrastructure.

2. **Expanding technology ecosystem** – Many small to mid-sized carriers do not have the capital or resources to support the complexity of a large transformation, but without transformations are constrained in their ability to respond to the market. Technology companies are beginning to offer complete, integrated ecosystems that include all the technology that runs core operations. This includes standard integrations of key ancillary systems (e.g. document generation, document management) and digital front-end portals and mobile, data analytics, underwriting desktops, and predictive modelling. Better yet, automated refresh capabilities keep product versions up-to-date.
3. **Need for new products and markets**
- Insurers need to quickly respond to changing market conditions in order to compete in a very competitive landscape. Cloud core systems provide carriers the opportunity to quickly test and learn new business ideas – such as new products or expansion into a new market – with minimal investment.

4. **Need to facilitate product development and innovation**
- IT is beginning to shift from being a provider of all technology services to a broker or orchestrator of business services and technology innovation. Creativity requires experimentation and, by nature, many experiments fail. Core systems in the cloud can help carriers reduce the cost of the experimentation and failure cycle, enabling them to greatly increase the potential for innovative ideas and solutions.

5. **Talent shortages**
- It is difficult for many carriers to attract enough skilled employees, not least in infrastructure hosting and core development and testing. Cloud core systems alleviate the need for a full complement of IT staff because cloud solution providers already feature many of these resources.

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*There now are complete, integrated ecosystems that include all the technology that runs core operations, and automated refresh capabilities keep product versions up-to-date.*
Over the past decade, standard lines carriers have been challenged to improve profitability through reduced IT expenditures and policy acquisition costs. In response, these carriers have made significant investments in modernizing their aging policy administration platforms to improve automation and speed to market.

We believe a significant share of the standard lines market now operates on a modern policy administration platform, with a final group of very large carriers starting to migrate to commercially off the shelf platforms over the next three to five years.

We believe the next wave of transformation will impact specialty line carriers, which we categorize as non-admitted (E&S), Bermuda, and London market carriers. Although they historically have been insulated from the deflationary pressures of technological automation, we believe three factors have aligned that will accelerate their transformations over the next five years.

1. Organic growth – Over the past decade, the specialty market has outpaced industry growth averages and, thanks to a variety of market dynamics, we believe that this will continue. However, maintaining these increased growth patterns while managing their historically low policy acquisition costs will be a challenge for many specialty and E&S companies. They are likely to respond by increasing and improving internal underwriting staff, as well as through increased use of technology to automate lower value aspects of the policy placement process. For example, specialty carriers will automate back office and clerical work through new policy administration systems, while empowering their specialist underwriters to continue risk selection and pricing.
2. Technological maturity –
Commercially available policy administration systems have traditionally focused on standard market products, thus requiring extensive customization to meet specialty carriers’ unique needs. For E&S and Bermuda carriers, we have seen products that now support multi-segment program policies, feature robust manuscript forms functionality, and can set IRPM factors at exposure and policy levels. For London market carriers, vendors are now supporting accelerators that enable core systems to interact with the Lloyd's and companies markets using ACORD XML standards, and integrate their back office systems with the relevant Xchanging market systems.

3. Organizational reporting/controls –
Many specialty carriers have difficulty providing sufficient data to their internal auditors and enterprise risk managers for the purposes of regulatory and group reporting. Modern policy administration systems enable underwriters, actuaries, and internal controllers to more effectively track and analyze the carrier’s book of business. These systems support granular exposure, risk concentration, and premium reporting, thereby easing the reporting burden. Moreover, powerful predictive analytics platforms enable underwriters to marry internal and external risk models to their expert judgement, resulting in a clearer decision making and more effective management across the enterprise.

New policy administration systems can help specialty carriers automate back office and clerical work, ease their reporting burden, and improve their risk-based decision making.
Implications

• Carriers have increased their expectations of core transformations and increasingly look to transformation to include robust digital and analytics capabilities.

• They also will continue to look at alternative delivery options in an effort to simplify their technology environment and their implementation roadmaps.

• Many transformation programs will are starting to include portal and data warehousing components, and off-the-shelf package solutions are well equipped to integrate those components with the core back office systems.
Business & operating models

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Modernization of insurance accounting is finally here. The FASB issued its final guidance on enhanced disclosures for short duration contracts in May of 2015 and published an exposure draft in September of 2016 on targeted improvements to the accounting for long-duration contracts.

After literally decades of deliberations, the IASB has completed its most recent exposure draft and plans to issue a final comprehensive accounting standard in the first half of 2017. Moreover, additional changes in the statutory accounting for most life insurance contracts are coming into effect; a company can elect to have Principles Based Reserving (PBR) effective on new business as early as January 1, 2017. Companies have three years to prepare for PBR with all new business issued in 2020 required to be valued using PBR.

The impact of these regulatory changes is likely to be significant to financial reporting, operations, and the business overall. Instead of approaching accounting modernization as a compliance exercise, companies instead should view the changes holistically, with an understanding that there will be impacts to systems, processes, profit profiles, capital, pricing, and risk. Planning effectively and building a case for change can create efficiencies and enhanced capabilities that benefit the business more broadly.

Financial reporting modernisation will affect the entire organisation, not just the finance and actuarial functions. Operations and systems; risk management; product development, marketing and distribution; and even HR will need to change.
The enhanced disclosures will be effective for public business entities for annual reporting periods beginning after December 15, 2015 (i.e., 2016 for calendar year end entities) and interim reporting periods thereafter. The new disclosures may require the accumulation and reporting of new and different groupings of claims data by insurers from what is currently captured for US statutory and other reporting purposes. Public companies are currently preparing now by making changes to existing processes and systems and performing dry runs of their processes to produce these disclosures. Non-public business entities will have a one year deferral to allow additional time for preparation.

In September of 2016, the FASB issued a proposed ASU on targeted improvements to the accounting for long-duration contracts. Proposed revisions include requiring the updating of cash flow assumptions and use of a high-quality fixed income discount rate the maximizes the use of market observable inputs in calculating various insurance liabilities, simplifying the deferred acquisition costs amortization model, and requiring certain insurance guarantees with capital market risk to be reported at fair value. The FASB also proposed enhanced disclosures which include disaggregated rollforwards of certain asset and liability balances, additional information about risk management, and significant estimates, input, judgments, and assumptions used to measure various liabilities and to amortize deferred acquisition costs (“DAC”). No effective date was proposed, and transition approaches were provided with the recognition that full retrospective application may be impracticable.
The IASB’s journey to a final, comprehensive insurance contracts standard is nearly complete. After reviewing feedback from field testing by selected companies in targeted areas, the IASB completed its deliberations in November of 2016.

The IASB staff is proceeding with drafting IFRS 17 (previously referred to as IFRS 4 Phase II) with a proposed effective date of January 1, 2021. Three measurement models are provided for in the standard: 1) Building Block Approach (“BBA”); 2) Premium Allocation Approach (“PAA”); and 3) the Variable Fee Approach (“VFA”).

The default model for all insurance contracts is the BBA and is based on a discounted cash flow model with a risk adjustment and deferral of up-front profits through the Contractual Service Margin (CSM). This is a current value model in which changes in the initial building blocks are treated in different ways in the P&L. Changes in the cash flows and risk adjustment related to future services are recognized by adjusting the CSM, whereas those related to past and current services flow to the P&L. The CSM amortization pattern is based on the passage of time and drives the profit recognition profile. The effect of changes in discount rates can either be recognized in other comprehensive income (OCI) or P&L.

The IASB has also allowed for the use of the PAA for qualifying short term contracts, or those typically written by property and casualty insurers. This approach is similar to an unearned premium accounting for unexpired risks with certain differences such as deferred acquisition costs offsetting the liability for remaining coverage rather than being reflected as an asset. The claims liability, or liability for incurred claims, is measured using the BBA without a CSM.
Statutory accounting: The move to principles-based reserving

The recently adopted Principles-Based Reserving ("PBR") is a major shift in the calculation of statutory life insurance policy reserves and will have far reaching business implications. The former formulaic approach to determining policy reserves is being replaced by an approach that more closely reflects the risks of products. Adoption is permitted as early as 2017 with a three year transition window. Management must indicate to their regulator if they plan on adopting PBR before 2020. Retrospective adoption for business in the three-year transition window.

PBR’s primary objective is to have reserves that properly reflect the financial risks, benefits, and guarantees associated with policies and also reflect a company’s own experience for assumptions such as mortality, lapses, and expenses. The reserves would also be determined assessing the impact under a variety of future economic scenarios.

PBR reserves can require up to three different calculations based on the risk profile of the products and supporting assets. Companies will hold the highest of the reserve using a formula based net premium reserve and two principle-based reserves – a Stochastic Reserve (SR) based on many scenarios and a Deterministic Reserve (DR) based on a single baseline scenario. The assumptions underlying principles-based reserves will be updated for changes in the economic environment,
changes in company experience, and for changes in margins to reflect the changing nature of the risks. A provision called the “Exclusion Tests” allows companies the option of not calculating the stochastic or deterministic reserves if the appropriate exclusion test is passed. Reserves under PBR may increase or decrease depending on the risks inherent in the products.

PBR requirements call for explicit governance over the processes for experience studies, model inputs and outputs, and model development, changes and validation. In addition, regulators will be looking to perform a more holistic review of the reserves. Therefore, and as we noted in the 2015 edition of this publication, it is critical that:

- The PBR reserve process is auditable, including the setting of margins and assumptions, performing exclusion tests, sensitivity testing, computation of the reserves, and disclosures;
- Controls and governance are in place and documented, including assumption oversight, model validation, and model risk controls; and
- Experience studies are conducted with appropriate frequency and a structure for sharing results with regulators is developed.

PBR will introduce volatility to life statutory reserving causing additional volatility in statutory earnings. Planning functions will be stressed to be able to forecast the impact of PBR over their planning horizons because three different reserve calculations will need to be forecast.

There is no “one size fits all” approach to addressing the FASB’s and IASB’s changes. Each company will likely be starting from a different place and may have different goals for a future state.
A company’s approach to addressing these changes can vary depending on a variety of factors, such as the current maturity level of its IT architecture and structure, potential impact of proposed changes on earnings emergence and/or regulatory capital, and current and planned IT and actuarial modernization initiatives. In other words, there is no “one size fits all” approach to addressing these changes.

Each company likely will be starting from a different place and may have different goals for a future state. A company should invest the time to develop a strategic plan to address these changes with a solid understanding of the relevant factors, including similarities and differences between the changes. In doing so, companies should keep in mind the following potential implications:

**Accounting & Financial Reporting**

- Where accounting options or interpretations exist, companies should thoroughly evaluate the implications of such decisions from a financial, operational, and business perspective. Modelling can be particularly useful in making informed decisions, identifying pros and cons, and facilitating decisions.

- Financial statement presentation, particularly in IFRS 17, could change significantly. Proper planning and evaluation of requirements, presentation options, granularity of financial statement line items, and industry views will be essential in building a new view of an insurer’s financial statements.

- Financial statement disclosures could increase significantly. Requirements such as disaggregated rollforwards could result in companies reflecting financial statement disclosures, investor supplements, and other external communications at lower level than previously provided.

- Change is not limited to insurance accounting. Other areas of accounting change include financial instruments, leasing, and revenue recognition. For example, the impact of changes in financial instruments accounting will be important in evaluating decisions made for the liability side of the balance sheet.

**Operational**

- Inherent in each of these accounting changes is a company’s ability to produce cash flow models and utilize data that is well-controlled. Companies should consider performing a current state assessment of their capabilities and leverage, to the extent possible, infrastructure developed to comply...
with other regulatory changes such as Solvency II and ORSA and identify where enhancements or new technology is needed.

- Given the increased demands on technology, computing and data resources that will be required, legacy processes and systems will not likely be sufficient to address pending regulatory and reporting changes. However, this creates an opportunity for these accounting changes to possibly be a catalyst for finance and actuarial modernization initiatives that did not historically have sufficient business cases and appetite internally for support.

- As these accounting changes are generally based on the use of current assumptions, there will be an increased emphasis on the ability to efficiently and effectively evaluate historical experience on products by establishing new or enhancing existing processes. Strong governance over experience studies, inputs, models, outputs, and processes will be essential.

- As complexity increases with the implementation of these accounting changes, the impact on human resources could be significant. Depending on how many bases of accounting a company is required to produce, separate teams with the requisite skill sets may be necessary to produce, analyze, and report the results. Even where separate teams are not needed, the close process will place additional demands on existing staff given the complexity of the new requirements and impact to existing processes. Companies may want to consider a re-design of their close process, depending on the extent of the impacts.
Business

- Product pricing could be impacted as companies consider the financial impacts of these accounting changes on profit emergence, capital, and other internal pricing metrics. For instance, the disconnect of asset yields from discounting used in liabilities under US GAAP and IFRS could result in a different profit emergence or potentially create scenarios where losses exist at issuance.

- Companies may make different decisions on asset & liability matching or choose to hedge risk on products differently. Analysis should be performed to understand changes in the measurement approach with respect to discount rates and financial impacts of guarantees such that an appropriate strategy can be developed.

- The move to accounting models where both policyholder behavior and market-based assumptions are updated more frequently will likely result in greater volatility in earnings. Management reporting, key performance indicators, non-GAAP measures, financial statement presentation & disclosure, and investor materials will need to be revisited such that an appropriate management and financial statement user view can be developed.

- The impact from a human resources perspective should not be underestimated. Performance-based employee compensation plans which are tied to financial metrics will likely need to change. Employees will also need to receive effective training on the new accounting standards, processes, and systems that will be put in place.

Forming a holistic strategy and plan to address these changes will promote effective compliance, reduce cost and disruption, and increase operational efficiency, as well as help insurers create more timely, relevant, and reliable management information. Given the pervasive impact of these changes, it is important that companies put in place an effective governance structure to help them manage change and set guiding principles for project. For example, this involves the development of steering committees, work streams, and a project management office at the corporate and business group level that can effectively communicate information, navigate difficult decisions, resolve issues, and ensure progress is on track. Each company has a unique culture and structure, therefore, governance will need to be developed with that in mind to ensure it works for your organization. Companies that do not plan effectively and establish effective governance structures are likely to struggle with subpar operating models, higher capital costs, compliance challenges, and overall competitiveness.
Changing business models and the “new” ERM

Significant social, technological, economic, environmental, and political, forces are reshaping the needs and expectations of insurance buyers, as well as the business environment in which insurance providers operate.

Even a partial list of these forces is daunting: aging populations in developed markets, different needs and purchasing behavior of younger buyers of insurance, self-driving vehicles, telematics, artificial intelligence, the internet of things, and persistent low interest rates. With so many forces in play, it’s difficult to determine the exact landscape of the new insurance world. But, it’s not too early for insurers to prepare.

Regardless of exactly how they plan to address a rapidly changing and more unstable world, one capability that will remain critical to all insurers’ success is enterprise risk management. We describe below three key developments that insurers should incorporate into their ERM evolution.

1 For a detailed look at the rapidly changing insurance market and industry, and the STEEP factors that are influencing them, please see our Insurance 2020 & Beyond report as well as our Future of Insurance initiative.

2 We describe at length innovation in the insurance industry in our Innovating to Grow report, as well as in the 2016 edition of Top Insurance Industry Issues.
Stress testing will join economic capital as the main risk decision tool

VAR-based economic capital measures originated in banking and asset portfolio management more than 40 years ago. Over the last couple of decades, the insurance industry has widely adopted the concept.

This is particularly true for insurers’ credit and market risk taking, areas where the VAR concept is endemic. For some aspects of insurance risk, like statistical variability around a stable mean, the concept also fits well. In an insurance world where credit, market and insurance are insurers’ main risks, economic capital is effective. But what if the world changes to one where other risks join these at center stage?

Life insurance in a persistent low interest rate environment with rapidly evolving distribution models provides a clear example of recent change and its implications for ERM. The bulk of many life insurers’ liabilities and supporting assets are comprised of permanent type products they wrote when asset returns were markedly higher. These higher returns supported the stable distribution model of an up-front commission based sales force. In turn, this fit the products’ complex features that needed such a model to explain and sell them. Delivering on these guarantees necessitated focus on the credit and market risks they created. And VAR was developed to manage these risks.

However, now that asset returns are much lower, supporting this distribution model will be difficult. Fortunately, other less costly models are available and probably preferable to younger buyers of insurance. This demographic group has shown a preference for a more fit-to-purpose protection model that is less permanent and less complex. As a result, credit and market risks cease to be ERM’s overwhelming focus. Instead, strategic and operational challenges created by transitioning to and maintaining the new business model take center stage, as do the risk tools that can address these challenges. Among these, stress testing figures most prominently.³

Trends in the property and casualty sector also point to a shift in risk focus and risk management tools. Impending and actual changes in the nature of driving and vehicle ownership will radically and permanently alter the auto insurance landscape. Developing an understanding of the implications of these changes and their risks to an insurance enterprise needs a tool like stress testing. Similarly an increased emphasis on assisting customers with mitigating and managing their own risks, rather than just insuring them, moves more of an insurer’s risk profile out of the traditional risk-taker role and into a service provider model. VAR is a good risk tool for a risk taker, but stress testing is the tool best suited to the service provider model.

³ Our paper, Doubling an Insurer’s Enterprise Risk Management Output, expounds on the characteristics of stress testing that make it well suited to these challenges.
Lastly, we note that rapidly emerging technologies, often cited for their role in shaping customer preferences, also shape insurers’ own capabilities. Insurers have begun to modernize their back offices and computing power continues its exponential growth. Operational challenges and resource demands to implement new and improved risk tools, like stress testing, will diminish significantly. With benefits going up and costs going down, it seems clear that stress testing is on its way to a prominent ERM role.

As insurers start to help customers mitigate and manage their own risks, the former’s risk profile will move from that of traditional risk-taker toward a service provider.
Customer analytics decision platforms will become the key focus of model risk management efforts

Model risk management (MRM) is receiving extensive ERM focus at present. Much of the original impetus may have come from European companies seeking to validate their Solvency II internal models. In the US and Canada, due in part to direct or indirect regulatory encouragement, the scope goes beyond economic capital and solvency models, and most insurers seek to apply their efforts to all models.

The early priority for validation has skewed toward economic capital and complex liability valuation models. Insurers with advanced MRM capabilities have begun to focus more attention outside of risk and financial reporting models. This is to be expected to some degree, as insurers model validation activities work their way through their inventory of models. In addition, as they develop a working experience of risk rating their models, many are reconsidering the irrecoverable nature of product pricing decisions and the importance of getting those models right. In other words, while small errors in financial and risk reporting models can be rectified once errors are uncovered, losses from inadequate premium charges are permanent.

The impetus for higher attention to pricing and risk selection models is further amplified when insurers implement newer, non-traditional approaches. Without a long history of successful use, newer customer analytic models put a higher priority on their timely and thorough validation. Additionally, we have observed insurers further enhancing their level of attention when these models move to autonomous execution mode. In this mode, the model makes decisions in an automated fashion without manual intervention or deliberation. Deploying more models of this sort is a common feature of most visions of the near-term future of insurance. As their use expands, so too should ERM's focus on effective risk management of these models. In an environment in which these types of customer analytics decision platforms become an insurer's key business engine they also will need to become the key focus of MRM efforts.

Small errors in financial and risk reporting models can be remedied; however, losses from inadequate premium charges are permanent.
Risk diversification measurement will become the single most important element in economic capital calculations

There is a continuing focus on the effectiveness of economic capital modelling, especially in connection with IAIS and regulatory efforts outside of the US. In the US as well, insurers continue to look at how they can improve their calculations. However, one area that we believe attracts insufficient attention is diversification. Not only is an effective understanding and quantification of diversification an important goal in the current insurance environment, it likely will become even more critical in the future. As the new risk profile moves away from a credit/market nexus to a more diverse insurance, business and strategic risk set, managing the interaction between and among them will be especially important. If customers move to a more holistic view of insurance and blur the distinctions between life, property and casualty and health, just quantifying the diversification across all insurance risks will be a key task on its own.
Implications

If they haven’t done so already, CROs should start to sketch out a few versions of what their company might look like in the future and consider what might be required of their ERM capabilities. They can adjust and clarify this high-level road map as the future becomes clearer.

Considerations they should keep in mind while creating this roadmap include:

- On the life side in particular, credit and market risks will cease to be ERM’s overwhelming focus, but stress testing will figure more prominently with new business models.
- Assisting customers with mitigating and managing their own risks instead of just insuring them will move more of an insurer’s risk profile out of the traditional risk-taker role and into a service provider model. VAR is a good risk tool for a risk taker, but stress testing – which is becoming cheaper and easier to do – is better suited to the service provider model.
- As advanced customer analytics decision platforms become an insurer’s key business engine, they will need to become the key focus of model risk management efforts.
- As insurance becomes more holistic for customers, quantifying diversification across all insurance risks will be a key task for insurers.
DOL Fiduciary Rule – Anything but just a compliance exercise

In April 2016, the US Department of Labor (DOL) released a regulatory package that established a new standard for fiduciary investment advice. Under the Fiduciary Rule (“the Rule”), investment recommendation given to an employee benefit plan or an individual retirement account (IRA) is considered fiduciary investment advice and therefore must be in the “best interest” of the investor.

As a result, financial advisors who provide investment advice under the new standard now face limits on receiving commission-based compensation. Considering 50 percent of US financial assets is held in retirement accounts, the impact of the Rule is significantly affecting insurers, broker dealers, and investment managers.

Purpose of the Rule

The DOL has long been concerned that people rolling over assets from an employer sponsored pension plan to an IRA are not being well advised and, as a result, are investing in products that are not most suitable for their needs and/or are unnecessarily expensive. Central to the DOL concern is what it perceives to be a lack of transparency around the standard under which an advisor is providing advice and how he/she is compensated. This is not surprising since advisors operate under multiple standards with a majority of asset flows falling under a “suitability” rather than fiduciary standard.

To address these concerns, the DOL expanded the definition of the term “investment advice” under ERISA, thereby imposing fiduciary status under both ERISA and the Internal Revenue Code on firms and advisors who provide investment advice under this expanded standard. A fiduciary is subject to the duties of prudence and loyalty and is prohibited from acting for his/her own interests or in a manner adverse to those of the ERISA plan or IRA. Accordingly, fiduciary status will have a fundamental impact on advisor compensation, as advisors who are fiduciaries may not use their authority to affect or increase their own compensation in connection with transactions involving an ERISA plan or IRA.

The Fiduciary Rule is a catalyst for change that goes far beyond compliance – in many cases, change that insurers and distributors are in the process of making or have contemplated making for some time.

1 For our perspectives on the technical details of the Fiduciary Rule, please see PwC’s April 2016 regulatory brief from the time of the Rule’s enactment. For our perspectives on the Rule’s status in the wake of the 2016 election, please see PwC’s November 2016 regulatory brief.
A catalyst of widespread organizational change

The DOL Rule is causing and contributing to significant changes to the insurance industry that go well beyond compliance. While the industry needs to be prepared for the April 2017 applicability date, the Rule (even if delayed) is also a catalyst for more meaning change for both insurance manufacturers and distributors. In many cases, these changes have been contemplated for some time.

Compensation – For starters, in order to mitigate any actual or potential conflicts of interest resulting from distribution compensation, insurers should inventory current compensation and understand the impact of changing models to various distribution channels. The industry has been focusing on the issue of compensation for some time, anyway (e.g., moving to flat commissions for annuities), and the DOL Rule provides further impetus for change. This change will not be easy, not least because the industry has a variety of products and uses different distribution models. To facilitate their transition to the new environment, carriers and distributors will need to:

1. Understand the current hierarchy and how it might change:
   a) What is the distribution channel? Is the distributor a fiduciary? If so, what exception or exemption is the distributor using?
   b) How will changing the hierarchy impact agents' livelihood?
   c) Do you risk losing agents to a carrier that will pay “conflicted” compensation?
   d) How do you factor in outside compensation (e.g., marketing fees & allowances, 12-B1 Fees)?
   e) Depending on the product shelf, there will be different types of conflicts.
   f) Determine which transactions are prohibited. Determining “red” and “green” transactions should be relatively easy, but determining “yellow” ones will be much more difficult, especially because the Rule is fairly ambiguous in this regard.
   g) Understand each other’s point of view. Distributors will create rules for types of compensation they will allow in their systems. Although they are currently uncertain about how they will have to adapt, carriers will have to change their compensation structures and communicate them to distributors.
2. Safeguard against personal and organizational conflicts of interest:
   a) How do we pay our workforce and others?
   b) What is non-cash compensation?
   c) How do we incentivize agents to sell products and sell certain product classes over others?
   d) What is the difference between suitability and fiduciary?
   e) Inventory products and create a tool to identify potential conflicts. This will be a complex undertaking, but it will enable carriers to determine who and how much carriers pay and why, as well as if conflicts are permissible or need to be disclosed.
   f) Perform a compensation impact analysis; assess the performance of distribution compensation as it currently exists and what seems likely in the future. This should include an assessment of the future model’s effect on revenue, profitability, market position, channel attractiveness, overall company performance.
   g) As part of a change management strategy, ensure that there is regular, clear, and informative communication – both internally and externally – on impending change.

Changes in agent training
Once the Fiduciary Rule is in effect, agents will need to be advisors first and sellers second. Even though many insurers, especially ones with captive sales forces, have already tightened sales practices in recent years, this does represent a genuine cultural shift and a novel convergence between compliance and sales & distribution. As a result, agents will need more training on their fiduciary role – all the way down to call center scripts – and, with rationalized product lines, most likely less product training than in the past.

Some carriers are experiencing impacts they didn’t foresee. Because of their increasing need to respond to fiduciaries’ requests, they’re having to adopt their distributors’ policies and procedures (including access data requests), and change their product portfolios, share classes, and fee structures. And, if they don’t do this, they risk losing shelf space to insurers that do.
**Product rationalization** – Related, the DOL Rule is intensifying carriers’ and distributors’ focus on product rationalization. Smaller product portfolios and resulting streamlined distribution models will facilitate carrier understanding of its product suite and compliance risks when providing “best interest” advice to consumers, reduce training required for agents, and help the industry reduce costs and increase scale. For example, with annuities:

- There are many providers providing many similar products, and oftentimes riders emulate characteristics of other carriers’ products that companies can’t build themselves. The Rule provides the industry further incentive to address the inherent inefficiency in this state of affairs.

- When determining which products to sell, financial strength is going to be a key product rationalization consideration for distributors because compensation will be more normalized with fewer products. When product portfolios shrink, lower-rated carriers’ products aren’t going to receive shelf space, especially if distributors can’t clearly demonstrate their benefits to customers. As a result of portfolio rationalization and likely decreases in commissions, both carrier and distributor consolidation is likely to increase.

- Moreover, this isn’t just a business decision but also a compliance one; distributors will have monitoring policy procedures to confirm adherence to this policy. Accordingly, distributors will have to establish a product selection methodology for each segment that accounts for appropriateness and applicability.

**Portfolio rationalization and expected decreases in commissions are likely to increase both carrier and distributor consolidation.**

However, regardless of product, the challenges of rationalization also represent an opportunity for insurers to have more profitable product portfolios because they can focus on what they’re best at. They also should be able to create products that are less capital intensive and, with a level fee/different fee structure, potentially profitable in earlier years. In addition, rationalization can help solve the challenge of a shrinking captive and independent agent workforce; fewer and more transparent products should reduce the need to replace many of the agents who are at or near retirement age. Related, because of its ability to inexpensively manage small accounts and automatically comply with fiduciary
standards, as well as its potential to increase scale as needed, robo-advisors should become an even more popular way for insurers to sell products.

Data and technology – Moreover, the DOL Rule makes capturing and maintaining new types of data a high priority for carriers and distributors. Agents will need to track from the time contact is made with a client how they acted in his/her best interest, and this record – which should be readily available to customers – will demonstrate that agents are being compliant (i.e., defensibility), as well as facilitate ongoing monitoring. Automating data capture, which should be especially effective via the robo-advisor channel, is the easiest way to ensure data is repeatable and transparent (again, defensible). This requires automating certain process to maintain compliance and be competitive in the future. Most of the industry has been aware of the need for technological changes, namely process automation, for some time – and many have been making them – but the DOL Rule serves as yet another catalyst, especially for those companies that have been hitherto slow to act.

Facilitating effective compliance
Distribution traditionally has had little to no involvement in regulatory compliance, and the DOL Rule represents a new challenge for most organizations. We recommend that compliance should:

1. Oversee distribution;
2. Provide quarterly “health checks” to the board of directors in order to review compliance on a quarterly basis;
3. Maintain a traceability matrix that outlines key strategic and operational decisions related to Rule requirements and thereby provides the company defensible documentation to minimize and mitigate losses.
**Implications: Far beyond compliance**

The Fiduciary Rule is playing a significant role in the structural and operational changes taking place at affected companies. Many insurers have already undertaken significant evaluations of their business and operating models, including customer segmentation analysis and consideration of different channels for fiduciary and non-fiduciary advice.

As a result:

- The industry is likely to increase its already growing investments in and use of digital and online channels, including robo-advice.
- Some insurers are divesting their broker-dealers; as a result, we expect to see consolidation among smaller insurance broker-dealers, independent broker-dealers, and regional brokerages over the next three years.
- The DOL’s move to increase transparency and eliminate conflicts of interest is helping drive convergence of regulation towards a broad fiduciary standard. Whether or not the SEC proposes to cover non-retirement accounts given the mandate for a federal uniform fiduciary standard under the Dodd-Frank Act, some fiduciary agents have already started to consider extending the DOL standard to an increased scope of accounts in order to avoid potentially awkward double standards for investors who hold both retirement and non-retirement accounts.

Lastly, regardless of political developments, we believe the Rule’s core framework will remain intact. The industry has already made significant progress toward complying with it, and there is general recognition of the importance of removing conflicts of interest between financial advisers and retirement investors. As a result, financial advisers and firms should continue their work to meet the Rule’s requirements, not least considering the still extant April 10, 2017 deadline.
The deals environment
Insurance M&A remained very robust in 2016 after record activity in 2015. There were 482 announced transactions in the industry for a total disclosed deal value of $25.5 billion. Asian buyers eager to diversify and enter the US market; divestitures; and insurance companies looking to expand into technology, asset management, and ancillary businesses were the primary drivers of deals activity.

Looking ahead, we expect continued strong interest in M&A, driven primarily by inbound investment. In addition, bond yields have spiked over the last few months and are likely to continue to increase. Combined with expected rate hikes by the Federal Reserve, this should positively impact insurance company earnings and in turn likely encourage sales of legacy and closed blocks.

However, with a new US president has come tax and regulatory uncertainty that may temporarily decelerate the pace of deal activity; President Trump is expected to prioritize the repeal and replacement of Obamacare, tax reform, and changes to US trade policy, all of which will have potentially significant impacts on the insurance industry. Moreover, the latest Chinese inbound deals have drawn regulatory scrutiny, and there is skepticism in the US stock market about their ability to obtain regulatory approval.
Major deal trends included:

- Asian insurers seeking to grow their footprint in the US continued in 2016 with Japan's Sompo Holdings agreeing to acquire Endurance Specialty for $6.3 billion and China Oceanwide's announced acquisition of Genworth Financial for $2.7 billion.

- Domestic companies' expansion into new lines of business also drove deal activity, as evidenced by Liberty Mutual's announced acquisition of Ironshore for $3.0 billion and Fairfax Financial's announced acquisition of Allied World for $4.9 billion.

- US insurers, including AIG and MetLife, sought to divest noncore legacy businesses. AIG sold its mortgage insurance business, United Guaranty, to Arch Capital for $3.4 billion and MetLife sold its retail advisor force to MassMutual and planned to divest its consumer unit, Brighthouse.

- Insurers have been focused on expanding into new technology-enabled markets and products, and in many instances are seeking to do so via acquisition. Allstate's announced its acquisition of SquareTrade, an extended warranty service provider for consumer electronics and appliances, for $1.4 billion. Another example is Intact Financial's investment in Metromile, a company that offers pay-per-mile insurance.

- Deal volume in the insurance brokerage space continues apace. Brokerage deals, most notably the management-led buyout of Acrisure for $2.9 billion, accounted for 84% of total deal volume.
<table>
<thead>
<tr>
<th>Month announced</th>
<th>Target name</th>
<th>Incubator</th>
<th>Sector</th>
<th>Value ($mn)</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Innovation Portfolio</td>
<td>Endurance Speciality Holdings Ltd.</td>
<td>Sompo Japan Nipponkoa Insurance Inc.</td>
<td>P&amp;C</td>
<td>$6,304</td>
<td>24.7%</td>
</tr>
<tr>
<td>August</td>
<td>United Guaranty Corporation</td>
<td>Arch Capital Group Ltd.</td>
<td>P&amp;C</td>
<td>$3,425</td>
<td>13.4%</td>
</tr>
<tr>
<td>December</td>
<td>Ironshore Inc.</td>
<td>Liberty Mutual Insurance Company</td>
<td>P&amp;C</td>
<td>$3,000</td>
<td>11.8%</td>
</tr>
<tr>
<td>October</td>
<td>Acrisure, LLC</td>
<td>Management group</td>
<td>Broker</td>
<td>$2,900</td>
<td>11.4%</td>
</tr>
<tr>
<td>October</td>
<td>Genworth Financial, Inc.</td>
<td>Asia Pacific Global Capital Co Ltd.</td>
<td>Life &amp; Health</td>
<td>$2,729</td>
<td>10.7%</td>
</tr>
<tr>
<td>July</td>
<td>Medical Liability Mutual Insurance Company</td>
<td>National Indemnity Company</td>
<td>P&amp;C</td>
<td>$1,452</td>
<td>5.7%</td>
</tr>
<tr>
<td>November</td>
<td>SquareTrade Holding Company, Inc.</td>
<td>Allstate Non-Insurance Holdings, Inc.</td>
<td>P&amp;C</td>
<td>$1,400</td>
<td>5.5%</td>
</tr>
<tr>
<td>February</td>
<td>Swett &amp; Crawford Group Inc.</td>
<td>BB&amp;T Corporation</td>
<td>P&amp;C</td>
<td>$500</td>
<td>2.0%</td>
</tr>
<tr>
<td>April</td>
<td>CIFG Holding, Inc.</td>
<td>Assured Guaranty Corp.</td>
<td>P&amp;C</td>
<td>$451</td>
<td>1.8%</td>
</tr>
<tr>
<td>January</td>
<td>Century-National Insurance Company/Western General Agency Inc.</td>
<td>National General Holdings Corporation</td>
<td>P&amp;C</td>
<td>$323</td>
<td>1.3%</td>
</tr>
<tr>
<td></td>
<td>Top 10 deal value</td>
<td></td>
<td></td>
<td>$22,483</td>
<td>88.2%</td>
</tr>
<tr>
<td></td>
<td>Total disclosed deal value</td>
<td></td>
<td></td>
<td>$25,497</td>
<td></td>
</tr>
</tbody>
</table>

Source: S&P Global Market Intelligence, Excludes Managed Care. Note deals included where target is Bermuda. Fairfax’s acquisition of Allied World is excluded from the table given Allied World redomiciled to Switzerland from Bermuda.
Deals market characteristics

- Drivers of consolidation include the difficult growth and premium rate environment. In particular, there has been continuing consolidation among Bermuda insurers, notably the acquisitions of Allied World, Endurance and Ironshore.
- Asian insurers remain interested in expanding their US footprint and accounted for two of the top-10 transactions.
- There has been expansion in specialty lines of business, as core businesses have become more competitive. This is evidenced by
  - Arch’s acquisition of mortgage insurer United Guaranty, which becomes its third major business after P&C reinsurance and P&C insurance;
  - Allstate’s acquisition of consumer electronics and appliance protection plan provider SquareTrade, which should enable them to enhance their consumer-focused strategy; and,
  - Berkshire Hathaway subsidiary National Indemnity’s agreement to acquire Medical Liability Mutual Insurance Company, the largest New York medical professional liability provider. (This deal is expected to close in 2017.)
  - Fairfax Financial’s December 2016 announcement of a $4.9 million acquisition of Allied World. The Ontario Municipal Employees Retirement System (OMERS), one of Canada’s largest pension funds, is contributing $1 billion in financing toward the acquisition. (This deal is expected to close in 2017.)
- The insurance brokerage deals space remains active and saw two of the top ten deals.
- Many acquirers are scaling up in order to generate synergies, as evidenced by Assured Guaranty’s and National General Holdings’ acquisitions.
- Insurers continue to grow their asset management capabilities. For example, New York Life Investment Management expanded its alternative offerings by announcing a majority stake in Credit Value Partners LP in January of 2017 and MassMutual acquired ACRE Capital Holdings, a specialty finance company engaged in mortgage banking.
**Sub-sector highlights**

The **life and annuity** sector has been impacted by Asian buyers diversifying their revenue base, regulations including the Fiduciary DOL Rule and the SIFI designation, and divestitures and/or disposal of underperforming legacy blocks (specifically, variable annuity and long term care).

The **P&C** sector has been experiencing a challenging pricing cycle which has driven carriers to 1) focus on specialty lines and specialized niche areas for growth and 2) consolidate. Furthermore, with an abundance of capacity and capital, the dynamics of the reinsurance market has changed. Reinsurers are trying to adjust by turning to M&A and innovating with new products and in new markets.

There has been a wave of **insurance broker** consolidation, largely because of the current low interest rate environment, which translates into cheap debt. The next wave of consolidation is likely to affect managing general agents because they have flexible and innovative foundations that set them apart from traditional underwriting businesses.

According to PwC’s 2016 Global FinTech Survey, **InsurTech** companies could grab up to a fifth of the insurance business within the next five years. In response, insurers have set up their own venture capital arms, typically investing at the seed stage, in order to keep up with new technologies and innovations and find ways to enhance their core businesses. Investments by insurers and their corporate venture rose nearly 20 times from 2013 to 2016.

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**Figure 3: Sub-sector deals by volume and value**

<table>
<thead>
<tr>
<th></th>
<th>2016 Volume</th>
<th>2016 Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life</td>
<td>5%</td>
<td>13%</td>
</tr>
<tr>
<td>P&amp;C</td>
<td>9%</td>
<td>63%</td>
</tr>
<tr>
<td>Broker</td>
<td>85%</td>
<td>24%</td>
</tr>
</tbody>
</table>

Source: S&P Global Market Intelligence
Implications

- **Sale of legacy blocks**: There is a continuing focus on exiting legacy risks such as A&E, long-term care, and variable annuities by way of sale or reinsurance. Already this year, there have been two significant announced transactions: AIG is paying $10 billion to Berkshire for long-tail liability exposure and The Hartford is paying National Indemnity $650mm for adverse development cover for A&E losses.

- **Expansion of products**: P&C insurers are focusing on expanding into niche areas such as cyber insurance, and life insurers are focusing on direct issue term products.

- **Technology**: Emerging technologies, including automation, robo-advisers, data analysis, and blockchain are expected to transform the insurance industry. Incumbents have been responding by directly investing in start-ups or forming joint ventures to stay competitive, and will continue to do so.

- **Foreign entrants**: Chinese and Japanese insurers have keen interest in expanding to the US market due to limited domestic opportunities, as well as a desire to diversify products and risk and expand capabilities.

- **Private equity/hedge funds/family offices**: Non-traditional investors have a strong interest in expanding beyond the brokers and annuities businesses to other areas within insurance (e.g., MGAs).
Insurance taxation
Comprehensive tax reform that lowers business and individual tax rates, simplifies the tax code, and makes US businesses more competitive in the global economy is one of the top priorities for the Trump administration and Republican Congressional leaders.

During his campaign, President Donald Trump identified tax reform as a central pillar of his agenda to create 25 million new jobs over the next decade. Similarly, Congressional Republicans have said that tax reform is essential to increasing economic growth and hope to complete action on tax reform legislation before the end of this year. Many Congressional Democrats, including Senate Democratic Leader Schumer and Senate Finance Committee Ranking Member Wyden, also have supported corporate rate reduction to boost US international competitiveness, provided it is done on a revenue-neutral basis.

While there is little detail on specific tax reform proposals at this early stage in the process, insurance companies will be asking how various tax reform proposals may affect the US tax treatment of their domestic and foreign operations as tax reform efforts advance in 2017.
On February 9, 2017, Trump Administration officials announced plans to release an updated outline of a plan for comprehensive tax reform “in coming weeks.”

During his campaign, President Trump proposed reducing the US corporate tax rate from 35 percent to 15 percent. He also would repeal the corporate alternative minimum tax (AMT). His plan would eliminate “most business tax expenditures,” except for the research credit. President Trump's tax plan also would impose a one-time, 10-percent repatriation tax on overseas corporate profits. Earlier in his campaign, Trump’s tax plan specifically called for the repeal of tax deferral on the foreign earnings of US-based companies, but his most recent plan does not address the taxation of future foreign earnings.
In June 2016, House Republicans released a 35-page tax reform plan (the Blueprint) that proposes to lower corporate and pass-through business tax rates, reduce individual tax rates, and provide full expensing for business costs (with no deduction for net business interest expense) under a border-adjustable destination-based cash-flow business tax system.

A House Republican task force on tax reform, led by Ways and Means Committee Chairman Brady, prepared the Blueprint. Chairman Brady and committee staff have been working since July of last year to draft statutory language that reflects the goals and principles outlined in the Blueprint.

Under the Blueprint, the top US corporate income tax rate would be reduced from 35 percent to 20 percent. The Blueprint generally proposes eliminating all business tax expenditures except for the research credit. In addition, the Blueprint would move the United States from a worldwide international tax system to a “territorial” 100 percent dividend-exemption system, and impose a mandatory “deemed” repatriation tax (8.75 percent for cash or cash equivalents and 3.5 percent for other accumulated foreign earnings).

The cash flow system proposed by the Blueprint includes immediate expensing of all depreciable and amortizable new business investment and denying a deduction for net interest expense. The Blueprint notes that special rules are needed for banking, insurance, and leasing business activities under the proposed border adjustable destination-based cash-flow tax system. As of mid-February 2017, the details of such special rules remain under consideration by Chairman Brady and his staff.

The Blueprint notes that special rules are needed for banking, insurance, and leasing business activities under the proposed border adjustable destination-based cash-flow tax system.
The Blueprint proposes to establish a “destination-based” business tax system that would be “border adjustable” by exempting the gross receipts from export sales and imposing tax on imports, which could be achieved through the denial of a deduction for the cost of the imports.

In recent interviews, Chairman Brady has described border adjustability as critical part of the Blueprint, stating, “It became clear we needed border adjustability to eliminate all the incentives for companies to move jobs, innovation and headquarters overseas.”

Chairman Brady and other House Republican leaders also have cited border adjustability as a key means of offsetting the cost of lowering the US corporate tax rate to 20 percent. Although there are no official revenue estimates for the House Republican Blueprint, the Brookings Institution-Urban Institute Tax Policy Center has estimated that border adjustment raises $1.2 trillion over 10 years and the cost of lowering the US corporate tax rate to 20 percent, while the cost of repealing the corporate AMT was projected to be $1.8 trillion over the same period.

House Republican leaders have noted that they would need to identify alternative means offsetting a reduction in corporate tax rates if their border adjustment proposal is not adopted. In 2014, former House Ways and Means Committee Chairman Dave Camp (R-MI) introduced a tax reform bill (H.R. 1) that included provisions to lower the US corporate tax rate to 25 percent and included a broad range of revenue offsets affecting various industries. Revenue offsets in H.R. 1 affecting insurance companies included proposals to change the way life insurance reserves and non-life insurance reserves are computed, and changes to the taxation of deferred acquisition costs (the “DAC” tax). Other offsets included changes to life and non-life insurance company proration for DRD and tax-exempt interest. H.R. 1 also proposed an increase in the discount rate used to compute life insurance reserves. Under H.R. 1, US insurance companies also were not permitted to deduct reinsurance premiums paid to a related company that is not subject to US taxation on the premiums, unless the related company elects to treat the premium income as effectively connected to a US trade or business (and thus subject to US tax).

The Blueprint states that that transition rules will be needed for tax reform in general and in particular for the move to a destination-based cash-flow business tax system; however, it does not describe those transition rules. Chairman Brady recently has reaffirmed that he does not support exemptions for individual business sectors, but he is prepared to consider transition relief.
In a February 1, 2017 speech, Senate Finance Committee Chairman Orrin Hatch (R-UT) said the Senate is working on its own tax reform plan and the “hope is to have a tax reform proposal in one form or another to discuss publicly in the near future.”

Chairman Hatch has expressed hope that the Senate tax reform effort will be able to secure bipartisan support. Without Democratic support, Chairman Hatch has noted that “we’ll basically need universal Republican support to pass anything through [budget] reconciliation” procedures that allow for legislation to pass with a simple majority. Most Senate legislation requires approval by a 60-vote supermajority.

Chairman Hatch has not taken a position on the border tax adjustment. However, he has noted that several Senators have expressed concerns or opposition to the House proposal. Senators who have announced opposition to the House border adjustment proposal include Senate Majority Whip John Cornyn (R-TX), who also serves on the Finance Committee, and Senator David Perdue (R-GA).

“What it means is that the Senate will have to work through its own tax reform process if we’re going to have any chance of succeeding,” said Chairman Hatch in his February 1 remarks. “No one should expect the Senate to simply take up and pass a House tax reform bill, and that’s not a bad thing.”

While now focused on pursuing comprehensive tax reform, Chairman Hatch and his staff had been working over the last two years on an as yet unreleased corporate integration proposal that would subject business income to a single level of tax. The proposal, which has not been released to date, has been expected to adopt a dividends-paid deduction approach in which dividends are treated like interest (i.e., deductible payments) and a withholding tax is imposed on both to ensure one level of US tax on interest and dividend income.

Senate Finance Committee Chairman Hatch and his staff had been working over the last two years on an as yet unreleased corporate integration proposal that would subject business income to a single level of tax.
Implications

- There is little detail on specific tax reform proposals that could affect the insurance industry at the time of this document’s publication. Accordingly, insurance companies will need to closely monitor how various tax reform proposals may affect the US tax treatment of their domestic and foreign operations as tax reform efforts advance later in 2017. PwC will provide timely updates on developments as they arise.
A number of administrative developments occurred in 2016 concerning insurance companies.

These developments affected insurers in various lines of business:

- **Life insurers** – The most significant development for life insurers remains the adoption of Life Principles Based Reserves (PBR), effective as early as January 1, 2017, for some companies and some contracts issued on or after that date. Life PBR has a number of related tax issues, and the IRS and Treasury Department provided its first guidance in Notice 2016-66, setting forth rules for implementing the 2017 CSO mortality tables. Life PBR remains on the annual Priority Guidance Plan, was recently identified as one of 13 “campaigns” to which the IRS will devote significant resources in the coming months, and is the subject of an Industry Issue Resolution (IIR) project.

  Two other 2016 administrative developments are particularly important for life insurers. First, Notice 2016-32 provides an alternative diversification rule under section 817(h) for a segregated asset account that invests in a government securities money market fund. The new, alternative diversification rule in Notice 2016-32 facilitates such investments. Second, Field Attorney Advice 20165101F concludes that a change in the computation of the statutory reserves cap that applies to life insurance reserves is a change in basis and therefore required to be spread over 10 years. Although Field Attorney Advice is not precedential, this conclusion was controversial and companies are still considering the issue as potential changes in basis arise.

- **Non-life insurers** – IRS Attorney Memorandum (“AM”) 2016-002 addresses the mechanics of a change in method of accounting for unearned premiums by a Blue Cross or Blue Shield organization that fails to meet the medical loss ratio (MLR) requirement of section 833(c)(5). The guidance is helpful to a broader class of nonlife insurers than Blue Cross organizations because it illustrates the operation of the unearned premium reserve and the application of section 481 to changes in accounting method more generally.

  In addition, in early 2017, the Departments of Labor (DOL), Health and Human Services (HHS) and Treasury issued Frequently Asked Questions about ACA implementation, including guidance defining the term “health insurance coverage.” Under that guidance, the provision of Medicaid coverage to Medicaid recipients as a Managed Care
Organization, and the provision of coverage under a Medicare Advantage organization or plan or a Medicare prescription drug plan is not “health insurance coverage.” This interpretation could have the effect of excusing some companies from the compensation deduction limitation of section 162(m) (6) and could clear up confusion created by two prior Chief Counsel Advice memoranda (201610021 and 201618010).

• **Health insurers** – No payments will be required in 2017 under the Affordable Care Act (ACA) Health Insurance Provider fee as a result of that fee’s suspension under the Consolidated Appropriations Act of 2016. Health insurance providers are still required to file Form 8963 for the 2016 year pending legislative developments on the repeal and replacement of the ACA. In addition, some insurers (particularly health insurers) anticipate significant guaranty fund assessments as a result of the liquidation of the Penn Treaty America Insurance Company. Many such companies (other than Blue Cross organizations) account for those payments on a reserve basis as premium-based assessments under Rev. Proc. 2002-46.

• **Captive insurance companies** – Section 831(b) allows certain small, nonlife insurance companies to elect to be taxed only on investment income and not on underwriting income. The IRS and Treasury Department have not provided guidance on changes that the Protecting Americans from Tax Hikes (PATH) Act of 2015 made to the requirements to qualify for that provision.

Captive insurance companies -- particularly small (“micro”) captive insurance companies -- remain a significant administrative priority, however. For example, Notice 2016-66 identifies a significant number of such companies as “transactions of interest” for which reporting is required. Those reporting requirements are drafted broadly and a large number of companies are in the process of reporting. The IRS also has identified “micro captive” insurance companies as a “campaign” issue that is a priority for the IRS in targeting its examination resources. Furthermore, practitioners and taxpayer alike are still waiting for the Tax Court’s decision in Avrahami v. Commissioner, which could provide even more judicial guidance on insurance qualification in the context of captive insurance.

• **Regulations under Section 385 (characterization as debt or equity)** – In spring 2016, the IRS and Treasury Department proposed regulations that would establish a contemporaneous documentation requirement that must be satisfied for certain related-party debt to be respected as debt and recharacterize as equity certain instruments that were intended to be treated as debt for Federal income tax purposes if they are issued in connection with certain distributions and/or acquisitions, even if they met the documentation requirements. The proposed regulations generated significant Congressional and taxpayer concern, including nearly 200 unique comment letters. In fall 2016, the IRS and Treasury Department released final and temporary regulations. The government made significant changes in the final regulations in response to taxpayer comments. The overall scope of the proposed regulation has been reduced through a number of exemptions in the final and temporary regulations. The final and temporary regulations do not apply to debt instruments issued by foreign corporations. They also do not
apply to interests issued by regulated insurance companies other than captive insurance companies. The final regulations also treat surplus notes of an insurance company as meeting the documentation requirements of the regulations, even though approval or consent of a regulator may be required for payments under the notes. However, the final regulations make no special provision for life insurance companies that are prevented from joining a consolidated return by the life-nonlife consolidated return limitations, nor do they provide specific guidance on the treatment of a company’s obligations under funds withheld reinsurance.

- **Regulations Under Section 987** –
  The IRS has issued final and temporary Section 987 regulations in December 2016. The final regulations implement an accounting regime based largely on proposed regulations issued in September 2006, to account for income earned through a qualified business unit (QBU) that operates with a functional currency different than that of its owner (e.g. foreign branches). Similar to the 2006 proposed regulations, the final regulations generally do not apply directly to insurance companies but may be relevant to non-insurance affiliates.
As in prior years, the IRS and Treasury jointly issued a Priority Guidance Plan outlining guidance it intends to work on during the 2016-2017 year. The plan continues to focus more on life than property and casualty insurance companies.

The following insurance-specific projects, many of which carried over from last year’s plan, were listed as priority items:

- Final regulations under §72 on the exchange of property for an annuity contract. Proposed regulations were published on October 18, 2006;

- Regulations under §§72 and 7702 defining cash surrender value;

- Guidance on annuity contracts with a long-term care insurance rider under §§72 and 7702B;

- Guidance under §§807 and 816 regarding the determination of life insurance reserves for life insurance and annuity contracts using principles-based methodologies, including stochastic reserves based on conditional tail expectations;

- Guidance on exchanges under §1035 of annuities for long-term care insurance contracts; and

- Guidance relating to captive insurance companies.

Less clear is what projects the 2017-2018 Priority Guidance might include. For example, the Trump administration may have different guidance priorities than its predecessor. In addition, a recent Executive Order requiring agencies to relieve existing regulatory burdens in exchange for imposing new ones could complicate the number of guidance items that may be published or the form those items may take.
Implications

- Life insurers should consider the effect of Life PBR tax issues on product development, financial modeling, and compliance as some companies consider a January 1, 2017, effective date.

- Nonlife insurers who move in and out of insurance company status (or whose products move in and out of insurance contract status) should consider whether the recent Attorney Memorandum sheds light on the application of section 481 to insurance-specific items such as unearned premium reserve.

- Health insurers can expect significant changes in tax rules and, in particular, one-time transition rules as a result of the 2017 suspension of the Health Insurance Provider Fee and the likely repeal (and possible replacement) of the ACA.

- Captive insurers should be prepared for additional IRS scrutiny as a result of the Priority Guidance Plan item promising guidance, identification of the micro captive issue as a “campaign,” and the possibility that a decision in the Avrahami case could shed more light on insurance qualification for Federal income tax purposes.
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The impact of technology

Innovation: Solutions are usually elsewhere

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