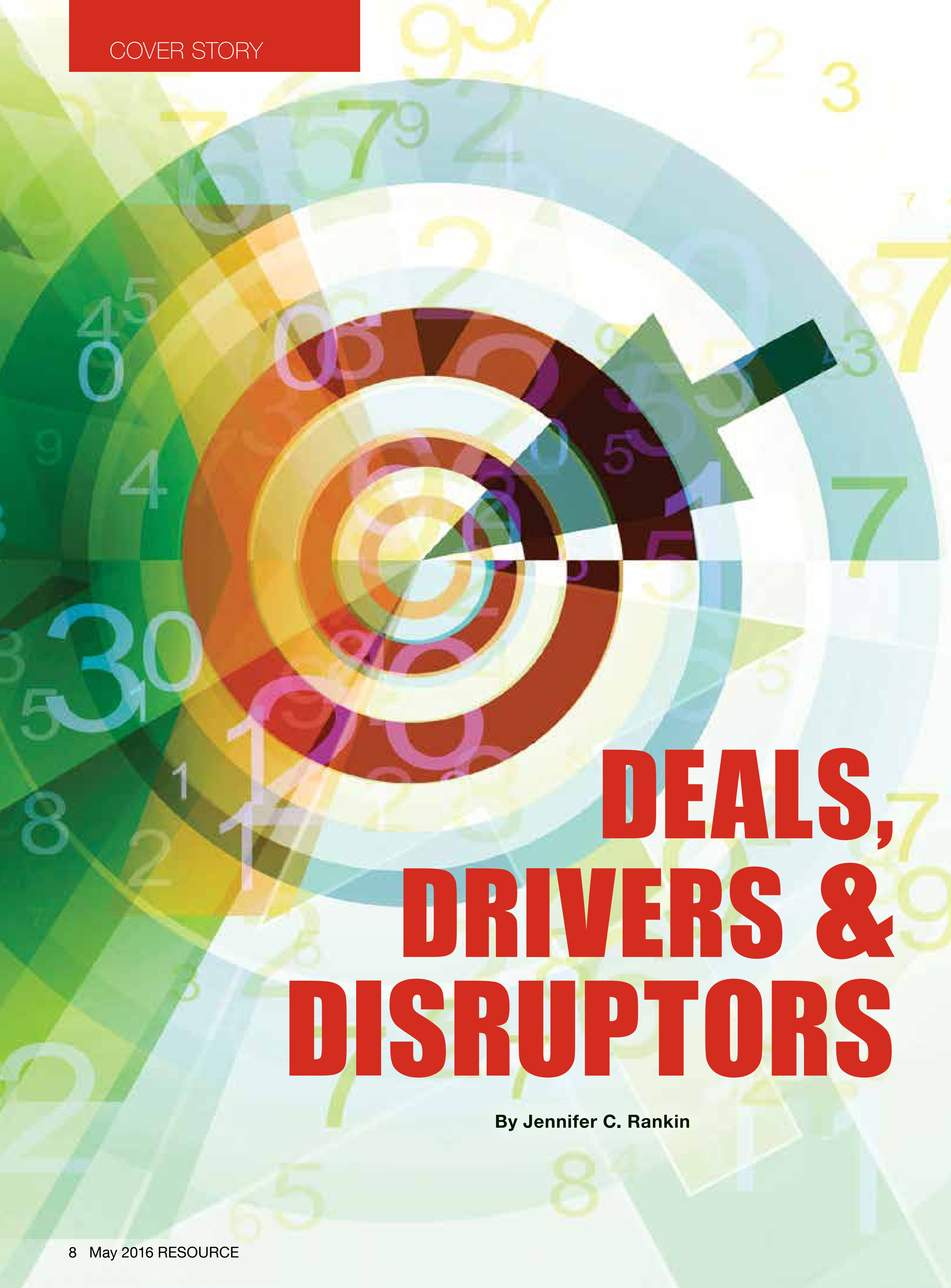


DEALS, DRIVERS & DISRUPTORS

By Jennifer C. Rankin

A new U.S. president, low interest rates, and embattled regulations are among the many challenges insurers must successfully navigate today—and for the foreseeable future.

Will the new U.S. president and Republican-controlled Congress scale back insurance regulation? Will Asian companies and alternative investors continue their shopping spree for American insurers? Will technology startups supplant traditional insurance company business models? These are among the vital questions to which life insurance/annuity companies must find answers to plot a successful course this year—and beyond. They also must navigate a macroeconomic climate that has its pros and cons.

Let's start with the current economic and interest rate environment.

U.S. life insurance companies face a number of macroeconomic headwinds this year. In fact, Fitch Ratings' sector outlook for 2017 is negative, based on sustained low interest rates, financial market volatility and weakening conditions in the credit markets. Its sector ratings outlook for the year, however, is stable, reflecting the industry's "strong balance sheet fundamentals, very strong liquidity, disciplined asset-liability matching, and operating performance."

Macroeconomic indicators, which run the gamut from real gross domestic product and current employment statistics to housing statistics and the S&P 500 stock index, influence the U.S. government's monetary policy, including interest rate decisions. They, in turn, affect insurance product spreads, asset-liability management, consumer behavior, and more.

While Fitch expects a modest increase in interest rates this year, it does expect further decline in the industry's interest margins and reserve adequacy due to low reinvestment rates as well as limited crediting rate flexibility on legacy in-force business.

During the financial crisis, the Federal Reserve—more specifically, the Federal Open Market Committee (FOMC)—took the overnight funds rate (its benchmark interest rate) to almost zero. The FOMC is the branch of the Federal Reserve Board (FRB) that determines the direction of monetary policy. The FOMC is composed of the board of governors, which has seven members, and five reserve bank presidents.

In December 2015, the FOMC began to work toward normalizing interest rates, raising its benchmark interest rate by a quarter percent, the first increase in almost a decade. In December 2016, it passed another quarter percent increase and signaled there will be more rate increases this year. Three months later, at its March 2017 meeting, the Federal Reserve did just that, raising its benchmark interest rate another quarter percent. That rate is now one percent. The market expects another rate hike in June and a third in December.

This combination of a volatile equities market and persistent low interest rates is especially difficult for life insurance companies. Low reinvestment rates hurt a company's interest margins, reserves, and investment income. It is difficult to overstate the effect low interest rates have on life insurance companies, which are conservative investors looking for steady returns. Life insurers earn much of their profits by investing policyholder premiums until claims come due.

So higher interest rates are good news for insurers. For starters, they reduce rate compression, which occurs when insurers reinvest the low yields from their fixed income portfolios into assets that return even lower yields in a sort of death spiral. They also improve product profit spreads. Moreover, as product performance improves, the consumer enjoys a better value proposition. Should interest rates rise significantly this year, the benefits will not accrue immediately. That is because it will take a few years for current assets to mature and to be reinvested at the higher rates.

While equities market volatility is a challenge, its general direction is quite positive. In fact, the bull market celebrated its eighth birthday in March. It was on March 9, 2009 that the Standard & Poor's 500 stock index "tumbled 57 percent from its October 9, 2007 high, becoming the worst bear market since the Great Depression," according to *Investment News* journalist John Waggoner. "Since its 2009 low, the blue-chip index has soared ahead at a blistering 19.45 average annual pace, including reinvested dividends."

There is a good chance the bulls will continue to run a while longer. Many analysts believe we will experience more economic growth, lower taxes and reduced regulation during the next few years (more on the Trump effect on taxes and regulation to come). Others, however, are getting nervous. Many analysts think market valuations are much too high and that the length of the run is unsustainable.

Like Fitch Ratings, A.M. Best revised its outlook for 2017 for the life insurance/annuity industry from stable to negative.

"The revision is reflective of an industry that does not look vulnerable to any single shock, but is susceptible to a multitude of pressures that raise operational risk and is placing increasing time constraints on senior management," according to the January 25 press release announcing its special report *Many Headwinds, But Life/Annuity Insurers Remain Focused on What They Can Control*.

According to A.M. Best, "low interest rates continue to impact both sides of the balance sheet through increased credit and liquidity risks, lower investment portfolio returns and increased reserving. Robust equity markets and benign credit markets have offset some of this pressure, and many companies have taken advantage of lower financing costs to prepay near-term debt maturities, resulting in modest short-term increases to financial leverage.

"The significant near-term regulatory challenges, such as principles-based reserving or the U.S. Department of Labor's pending fiduciary rule, remain largely the same as last year, but the biggest unknown for the life insurance/annuity industry is which of these regulatory changes will remain intact under the new Republican administration, or whether some or all will be either materially delayed, overhauled or repealed altogether."

> **U.S. life insurance companies face a number of macroeconomic headwinds this year.**

REGULATORY ROLLBACK?

In its *2017 Insurance Outlook*, Deloitte says, "heightened regulatory oversight could cause turbulence this year as insurers cope with changing international, national, and state regulations. According to the consultant:

- The International Association of Insurance Supervisors (IAIS) is working on a new worldwide regulatory framework for enhanced prudential standards that could impact insurers globally.
- Nationally, the 2016 election results have left the regulatory landscape in limbo as the new administration and Congress are expected to seek substantial changes to the Dodd-Frank Act, the DOL's new fiduciary rule, and other regulations.
- At the state level, regulators are addressing a number of issues, including principles-based reserving for life companies, market conduct examination standards, and cyber risk management.

This year, the Department of Labor's (DOL) new fiduciary rule garnered the most regulatory headlines. This rule, the final version of which was released on April 6, 2016, disrupts the industry's traditional product distribution (sales) model. It is a game changer that was scheduled to take effect in April 2017, with full implementation by January 1, 2018. Now its fate is up in the air.

At issue are the standards to which insurance and other financial services salespeople should be held when making product recommendations. Most financial advisors have been held to the suitability standard—that is, they must reasonably believe their product recommendations meet the customer's needs and tolerance for risk. Among the advisors to which the suitability standard has applied are stockbrokers, broker-dealer representatives, and people who sell financial products for banks and insurance companies. Under a fiduciary standard, they would have a legal obligation to act in their clients' best interest. Before the new rule, only registered investment advisors (RIAs) were required to meet a fiduciary standard.

In a September 15, 2015 analysis for MarketWatch, Robert Powell summarizes which salespeople have been held to which standards:

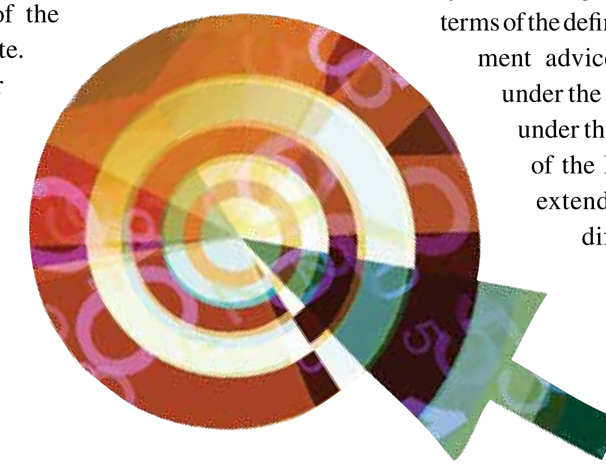
- **Broker (registered representative)**. Sells stocks, bonds, mutual funds. Paid by commission. Held to a suitability standard. Primarily regulated by Finra.
- **Registered investment advisor (RIA)**. Manages assets. Fee-based pay (percent of assets under management). Held to a fiduciary standard. Primarily regulated by the SEC.
- **Insurance agent**. Sells annuities, mutual funds, life insurance. Paid by commission and/or fee. Held to a fiduciary or suitability standard, depending on the product or service. State insurance agencies regulate insurance, but not retirement products.
- **Dually registered advisor**. Sells annuities, investments, stocks, and more. Pay is product- and service-dependent. Held to a fiduciary or suitability standard depending on the product or service. Primarily regulated by Finra and/or the SEC.

The new DOL regulations require best interest contract exemptions (BICE) to ensure clients understand what they are paying for. In addition, they are forcing many financial services companies to restructure their compensation models for their sales forces. Specifically, there is a shift from commission-based compensation to fee-based compensation.

Opponents of the fiduciary standard say it not only is unnecessary, but also will increase the regulatory and liability costs for brokers, which will force them to drop investors with modest investible assets. Proponents say all financial services sellers should hew to the fiduciary standard to avoid potential conflicts of interest.

Members of the House and Senate have floated a dozen or so bills to shut down the DOL's fiduciary rule. In addition, the U.S. Chamber of Commerce, the Financial Services Institute and others have filed lawsuits in Dallas, Texas and New Orleans, La. to halt its implementation. Despite these efforts, on January 29, 2016, the DOL sent its rule (formally known as the Conflict of Interest Rule—Investment Advice) to the OMB which had up to 90 days to review and sign off on it. On April 5, 2016, the OMB did just that and the DOL released the final rule publicly.

According to LIMRA's *Financial Services Evolution: 2017 Predictions Report*, "Members of the Trump team are not in favor of the DOL regulation, although it is unclear how high it ranks on the administration's list of priorities. It is likely that the regulation will at least be postponed." (Editor's note: On February 3, President Trump directed the DOL to study the rule to see if it harms the ability of Americans to get retirement information and financial advice. On March 1, the DOL asked the Office of Management and Budget (OMB) for a 60-day delay in the applicability of the fiduciary rule—that is, to push back its applicability date from April 10 to June 9. During the comment period, a large group of financial services and insurance industry stakeholders asked the DOL for a 180-day delay of the rule's original April 10 implementation date. The OMB has granted the DOL's proposal for a June 9 implementation date, with a transition period for exemptions to the rule to run from June 9 through January 1, 2018. This will give the DOL extra time to gather and assess information related to the issues raised in President Trump's February 3 memorandum.



"In the meantime, companies are moving ahead with their implementation plans. Some have signaled their intention to reduce the scope of their changes if there is a softening of the DOL's position, and others are developing contingency plans."

If the original fiduciary rule is implemented, LIMRA sees several repercussions. The first is increased cost, which really is an opportunity cost since valuable resources are diverted to regulatory compliance instead of, say, product innovation. Companies may limit or cease providing certain products and services. They may curtail existing service functions that educate consumers and provide non-fiduciary guidance. Some distribution firms may drop commission-based products and/or move to salaried advisors.

U.S. life insurance companies have invested meaningful resources over the past year in preparation for the implementation of the new regulations, according to Fitch Ratings. "Insurers selling affected products have made various changes to their distribution strategies and compensation structures and have developed new products that comply with the new exemption rules."

Fitch believes that some of the changes made by insurers selling affected products will remain in place regardless of the ultimate outcome of the DOL's examination of the final fiduciary rule. These include the expansion of sales of fixed indexed annuities into the bank channel, some of the changes made to compensation structures in terms of fees and commissions, as well as enhance record keeping and compliance functions.

At press time, Fitch said that there is a "strong likelihood that the final rule and/or related prohibited transaction exemptions (PTEs) will be revised by the DOL over the course of the delay period given the general concerns cited and breadth of scope in the president's memorandum. Fitch anticipates this period will be extended beyond the initial 60 days. The changes may be considerable in terms of the definition of fiduciary investment advice or products covered under the BICE, the requirements under the BICE, or the existence of the BICE itself, though the extend of such revisions is difficult to predict."

RISKY BUSINESS

Does the new administration also have designs on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010? In a word, yes. On February 3, President Trump issued an executive order for Treasury Secretary Steven Mnuchin to review the law. The presidential order lists seven so-called Core Principles to regulate the U.S. financial system and gives Mnuchin the task of consulting with the heads of the member agencies of the Financial Stability Oversight Council (FSOC) and report within 120 days if existing laws and regulations support those principles.

Since the financial crisis, Congress has passed and proposed many regulations. They spin largely around two goals. The first is curtailing risk in the financial services system, particularly with respect to capital adequacy; the second, achieving clarity and parity in accounting and financial reporting methods. They affect companies at the state, national and global levels.

After the 2008 financial crisis, the regulation of financial services companies came under intense scrutiny. In response to the crisis, the U.S. signed Dodd-Frank into law. Under Dodd-Frank, regulators have broad new powers to protect the financial system, including authority to regulate derivatives, impose stricter capital and supervisory requirements on financial firms, and regulate consumer financial products.

Dodd-Frank created the aforementioned FSOC, which, among other things, assesses the risk in the U.S. financial system. The FSOC includes the heads of the Federal Reserve and the Securities and Exchange Commission (SEC). Dodd-Frank also created the Federal Insurance Office (FIO) within the U.S. Department of the Treasury. The FIO advises the Secretary of the Treasury on major domestic and international insurance policy issues and serves as a non-voting member on the FSOC.

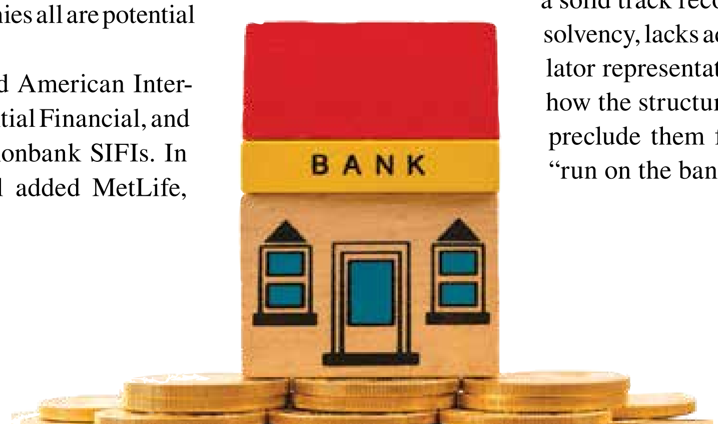
Under Dodd-Frank, the FSOC may designate a company as a systemically important financial institution (SIFI). The Federal Reserve supervises companies designated as SIFIs and they may face higher capital requirements and closer supervision. Banks, insurance companies and asset management companies all are potential SIFI designees.

In 2013, the FSOC named American International Group (AIG), Prudential Financial, and GE Capital Corporation as nonbank SIFIs. In December 2014, the council added MetLife, which took the matter to court, filing a federal lawsuit against the FSOC. On February 10, 2016, a federal court heard oral arguments. On March 2, 2016, the FSOC voted not to rescind MetLife's SIFI designation following its annual review. On March 30, however, the federal judge considering MetLife's lawsuit against the FSOC ruled in the insurer's favor, striking down the SIFI designation. The Obama administration appealed that ruling and the Trump administration has yet to scrap that appeal. In the meantime, MetLife is following through on spinning off its retail unit.

Fitch Ratings believes "deregulation is likely to be a significant theme for U.S. financial institutions, with the Trump administration and Republican leaders in Congress indicating broad support to limit and simplify the regulatory regime." Fitch does not believe that Dodd-Frank will be repealed in full, but does believe that select provisions could be subject to substantial revision. It also believes that the Financial Choice Act (FCA) proposed by Rep. Jeb Hensarling (R-Texas), House Financial Services Committee chairman, could serve as the blueprint for any changes ahead. The FCA proposes to "modify and potentially reduce financial regulators' authority, limit regulatory burdens for certain financial institutions, add greater Congressional oversight of regulators, and reform the market infrastructure." Hensarling introduced the FCA to the 114th Congress last year; at press time, he had not reintroduced it to this year's Congress, the 115th.

Most industry players are strongly opposed to what they see as the application of bank-centric standards to life insurance companies and continue to press their case. The American Council of Life Insurers (ACLI) is among those hoping the new Congress will reevaluate how the FSOC decides who poses enough risk to the financial system to warrant a SIFI designation. On March 28, it went on record supporting Hensarling's blueprint, the FCA. The bill would repeal the FSOC's ability to identify life insurers as SIFIs.

In a statement submitted to the House Financial Services Committee's Subcommittee on Oversight and Investigation, the ACLI said the FSOC uses unfair methods to choose SIFIs, fails to acknowledge that state insurance regulators have a solid track record of protecting life insurer solvency, lacks adequate state insurance regulator representation, and fails to understand how the structure of life insurance products preclude them from producing any sort of "run on the bank."



Members of the House and Senate have floated a dozen or so bills to shut down the DOL's fiduciary rule.

An altered or rescinded Dodd-Frank could result in the dropping of the nonbank SIFI designation for AIG, Prudential Financial and MetLife. It is important to remember, however, that they also are global SIFIs in the eyes of regulators in the European Union (EU) and elsewhere around the world. "From their perspective," states a Reuters news release, "state watchdogs might not cut it. Under a proposed agreement between the EU and the U.S. on insurance regulation, the Europeans may recognize America's state-based system. But the not-yet-final deal would stop short of granting states' oversight a trusted status that could free U.S. firms of certain EU rules."

Dismantling Dodd-Frank, however, would be quite an undertaking. "It has taken seven years to put in place the regulatory strictures imposed on Wall Street after the financial crisis," according to Bloomberg reporters Robert Schmidt, Jesse Hamilton and Elizabeth Dexheimer. "They won't be removed fast or easily."

On the chopping block are the Dodd-Frank ban on proprietary trading, Federal Reserve oversight of SIFIs, the rules for taking down failed banks, and the Consumer Financial Protection Bureau (CFPB). According to the Bloomberg reporters, "Democratic Senator Elizabeth Warren of Massachusetts is expected to be among those leading the fight to prevent an overhaul of Dodd-Frank in the Senate, where passing a law requires 60 votes to overcome a filibuster. Republicans hold just 52 seats."

STATES' RIGHTS

In addition to these international and federal regulatory issues are several proposals at the state level by the National Association of Insurance Commissioners (NAIC):

- **NAIC ORSA.** The Own Risk and Solvency Assessment (ORSA), a confidential, internal company assessment of the material and relevant risks identified by the insurer with respect to its current business plan and its capital sufficiency. A company conducts the assessment annually and presents the results to the applicable state insurance commissioner. ORSA is in the process of being adopted nationwide and will remain an area of examination and focus for the foreseeable future.
- **NAIC ComFrame Development and Analysis Working Group.** The committee has begun to consider developing a new group capital standard for internationally active U.S. insurance groups, according to SNL.
- **NAIC Cybersecurity Task Force.** In 2015, the NAIC formed the Cyber Security Task Force, which issued two foundational documents. One is a set of principles for effective cybersecurity. The other is a draft cybersecurity Bill of Rights that points out to consumers what protections they should expect from companies handling their personal data. The NAIC now has fully integrated cybersecurity into its regulatory examinations.
- **NAIC Corporate Governance Annual Disclosure Model Act.** "Corporate culture is often seen as a leading indicator of corporate behavior," notes Deloitte in its 2016 regulatory trend report, "prompting regulators in the insurance industry and elsewhere to push for improved oversight of corporate governance." To this end, the NAIC has enacted a corporate governance model act that has a proposed effective date of June 2016. At press time, a handful of states had adopted the model act and several were actively considering it.
- **NAIC VM-20 / Principles-Based Reserving (PBR).** Adopted by the NAIC in December 2012, the NAIC Valuation Manual (VM) establishes minimum, principles-based, reserve requirements for life insurance, accident and health, and deposit-type contracts in jurisdictions that have adopted the NAIC 2009 Standard Valuation Law. Principles-based reserving (PBR) represents a big change for the industry; for more than 100 years, it has calculated reserves using rules-based actuarial data. The threshold for national adoption is passage in 42 states representing 75 percent of total U.S. premiums; as of November 30, 2015, 39 states, representing 71.78 percent of premiums, had adopted the model law and seven state legislatures—Alabama, Idaho, Massachusetts, South Carolina, Pennsylvania, Utah and Washington—currently are reviewing it, according to the ACLI. The deadline for state legislatures to enact enabling laws is July 1, 2016 in order for the proposed January 1, 2017 deadline for PBR implementation to occur. Last year, a pilot test for PBR took place with up to 10 volunteer companies along with their associated domiciliary states.

POLITICAL FRONT

In addition to calibrating the effects of the economy and regulation, insurers are carefully monitoring the political climate, which changed dramatically with the election of Donald J. Trump as the 45th president of the United States. This year, the Republican Party candidate is in the White House and it now controls both houses of Congress. This is almost certain to have huge consequences for financial services and insurance regulation, the country's tax system, and national health care, against which candidate Trump campaigned throughout 2016.

It is just as certain that the road to change will be bumpy. For starters, the Democratic Party will resist the dismantling of the regulatory safety net signed into law by President Obama's predecessor George W. Bush after the 2009 financial crisis. In addition, the House of Representatives and the Senate do not see eye-to-eye on a number of issues.

Some of these differences have surfaced in the reactions to President Trump's proposed budget for fiscal year 2018, a partial outline of which he unveiled on March 16. His US$ 1.1 trillion spending plan proposes deep cuts to most government agency budgets and big increases to military and homeland security budgets. The budget does leave Social Security and other so-called entitlement programs untouched. At present, Congress, which controls the purse strings, is studying the proposal.

> **This year, the Republican Party candidate is in the White House and the GOP controls both houses of Congress.**

One of President Trump's campaign platform planks was tax reform, a promise on which he is working. At press time, his administration had not revealed the details of its tax reform plan other than to say it is mulling over a blueprint put forth by the Republican members of the House Ways and Means Committee.

The new president is determined to overhaul the U.S. tax system. Broadly speaking, both Congress and the White House want broad tax cuts for corporations and individuals. The ideas getting the most press coverage are a possible corporate tax rate reduction as well as the addition of a border-adjusted tax on companies' domestic sales and imported goods, a carbon tax, and a value-added tax. All are under fierce debate, as is a proposal to eliminate the payroll tax, which begs the question of how Social Security would be funded going forward.

Playing a large role in the process is the House Freedom Caucus, a bloc of three dozen conservatives who are waiting for more specifics before weighing in. Led by Mark Meadows (R-NC), the group opposed President Trump's and Speaker Paul Ryan's initial efforts to shepherd an Obamacare replacement bill through the House, "arguing that it didn't hew to conservative principles," according to *Financial Advisor* journalists Sahil Kapur and Lynnley Browning.

When Congress cuts taxes, it must find the money to pay for those cuts or the federal deficit will grow. Unfortunately, this frequently leads to discussions about eliminating the tax breaks currently given for contributions to 401(k)s, individual retirement accounts (IRAs), and other retirement savings accounts. This is a perennial insurance industry concern, because many insurance and retirement savings products enjoy tax-favored treatment. In addition, beneficiaries often use tax-free life insurance proceeds to pay estate taxes.

While lower corporate tax rates are a net positive for insurance companies, other tax mandates could negatively affect life insurer reserve deductibility, tax treatment of offshore reinsurers formed by hedge funds and private equity funds, and other matters, according to Deloitte's *2017 Insurance Outlook*. In addition, compliance with a new tax regime will involve major documentation requirements, added costs, and potential public relations matters if reporting information is publicized.

Treasury Secretary Steve Mnuchin originally had set a deadline of August for tax reform. On March 20, however, White House Press Secretary Sean Spicer said, "We're in the first stages of the process" and that it could take "several months."

The Republican members of the House Ways and Means Committee unveiled the aforementioned blueprint in June 2016, a plan championed by both the House Speaker Paul Ryan (R-Wis.) and Rep. Kevin Brady (R-Texas) who chairs

the committee. It is variously referred to as "A Better Way Forward," the Brady blueprint, and the Ryan-Brady plan. The proposal includes tax cuts for the highest earners and eliminates the estate and generation-skipping transfer (GST) taxes.

At press time, the Ryan-Brady plan was the only detailed blueprint on the table; neither the White House nor the Senate had released their plans.

"The first stab at realizing the [Ryan-Brady plan] took concrete form at the start of the 115th Congress in January, when Rep. Bob Latta (R-Ohio) introduced the Permanently Repeal the Estate Tax Act of 2017 (H.R. 451)," according to Think Advisor journalist Warren S. Hersch. "Backed by eight co-sponsors, [it] is similar to [the identically named, but differently numbered] (H.R. 725) legislation that Latta unveiled in the 114th Congress. A longer bill, [the Fair Tax Act] (H.R. 25), would replace the federal income tax, estate tax, gift tax and federal payroll taxes with a national sales tax. That bill had 35 co-sponsors."

While estate, generation-skipping transfer and gift taxes are challenges for an extremely limited percentage of taxpayers, the insurance industry does help them meet those challenges with tax-offsetting products and advice. If those taxes go away, the industry takes a hit, albeit on a small part of the business.

Retirement savings accounts, however, are another matter. They comprise a big part of the life insurance/retirement industry and the tax advantages thereof are a big deal for middle class and mass affluent consumers. So important, in fact, that a diverse group of industry advocates launched the Save Our Savings Coalition in April, an alliance dedicated to protecting Americans' retirement savings as Congress plans a comprehensive tax overhaul. "Misguided [tax] proposals could unintentionally undermine the incentive for employers to offer retirement plans for working people to save," says Jim McCrery, former ranking member of the House Ways and Means Committee.

According to the SOS Coalition, research shows that Americans overwhelmingly support tax incentives for retirement savings. Eighty percent of households who have a retirement account say its positive tax treatment is a big incentive to contribute. About 90 percent of households oppose both taking away the tax advantages of retirement accounts and reducing the amount individuals can contribute to them.

Nationwide, 75 percent of private sector workers are offered a workplace retirement plan and 82 percent of those offered the plan choose to participate, according to the SOS Coalition. The new organization says the private retirement system is particularly important for middle class families, with 80 percent of participants in workplace defined contribution (DC) retirement plans earning less than US$ 100,000 annually.

The membership of the SOS includes the American Benefits Council (ABC), Employee Benefit Research Institute (EBRI), Financial Services Roundtable (FSR), Investment Company Institute (ICI), Principal, and TIAA.

NEW ENTRANTS

Economic, regulatory and political issues, then, are keeping insurance executives up at night. So are a slew of new entrants into the life insurance space, among them InsurTech startups and alternative investors. The former are upending traditional business models, while the latter are buying up life insurance companies.

Google the word 'insurtech' and 100+ start-up companies result, most having hip names such as Friendsurance, Lemonade and Oscar. So what is InsurTech? Investopedia defines it as "the use of technology innovations designed to squeeze out savings and efficiency from the current insurance industry model." InsurTech companies want to offer things like ultra-customized policies and social insurance and they are using new streams of data from Internet-enabled devices to dynamically price premiums according to observed behavior. They also are bandying about phrases such as "ridiculously easy," "radical transparency," "transformation."

Traditionally, insurers have used medical test information and broad actuarial tables to assign policy seekers to a risk category and then adjusted the group to ensure a good price for the customer and profitability for the company. InsureTech is refining this pricing model by gathering and analyzing data from all sorts of devices, including car GPS and wrist fitness devices, and databases of banking, driving, education and other records. In the old days, life insurers relied on an analysis of blood and urine; these days, life startups such as Haven Life are using algorithms built upon applicant answers to questions,

Research shows that Americans overwhelmingly support tax incentives for **retirement savings.**

prescription drug databases, motor-vehicle records and other data instead. These algorithm-driven policies are available for some of the best prices out there. "The firms are making a calculated bargain, writes *Wall Street Journal* reporter Leslie Scism. "Obtaining less information than before to get a deal done is better than selling nothing at all."

"In addition to better pricing models," notes Investopedia, "InsurTech startups are testing the waters on a host of potential game changers. These include using deep learning trained AIs to handle the tasks of brokers and find the right mix of policies to complete an individual's coverage. There is also interest in the use of apps to pull disparate policies into one platform for management and monitoring, creating on-demand insurance for micro-events like borrowing a friend's car, and the adoption of the peer-to-peer model to both create customized group coverage and incentivize positive choices through group rebates." Be that as it may, many InsurTech startups still need the help of traditional insurers to handle underwriting and manage catastrophic risk.

While most these companies are tackling property/casualty, cyber risk, and health insurance, life insurance startups are catching up.

Let's take a closer look at Lemonade, which Bankrate says could become "the Uber of insurance." Founded in June 2015, the start-up explored the term life insurance space, but has settled on selling renters' and homeowners' insurance products in New York City. It employs a mobile-based, peer-to-peer (P2P) sales model. A P2P model typically consists of a small group of policyholders who pay premiums into a claims pool; if there's money left over at the end of the policy period, the policyholders get a refund they may donate to charity. Lemonade takes a flat 20 percent fee from all claims. Its homeowner policies start as low as $35 per month and renters' at $5 per month. Everything is digital. Customers use an app to sign up for the service by answering questions via text message and signing with their finger. Claims are made via video recording and, once approved, Lemonade immediately deposits the money into the policyholder's bank account. The company sold 2,000 policies in its first 100 days; more than 80 percent were first-time buyers.

Lemonade's model is riveting. When the policyholder makes a claim, AI Jim, the firm's claims bot, reviews it, cross-checks it against the policy, runs 18 anti-fraud algorithms, approves it, sends payment instructions to the bank and informs the customer. "Lemonade's bots are still learning and pass more complex claims to humans," according to a March article in *The Economist*. "It is hoped that one day they will handle 90 percent of claims. In an industry with expense ratios as high as 30 percent, this could offer huge savings. But there are limits to the claims that bots can be let loose on. And [traditional insurance companies] have one advantage: data. For bots to get really clever, they need lots. If Lemonade's customer numbers remain small, they will not learn fast enough to stay ahead of the big boys using the same technology."

Clover Health and Bright Health are examples of startups taking on the health insurance industry. Clover is a full service insurance company that serves private Medicare patients. It uses a mix of analytics, lab data, risk factors such as age and previous conditions, and medical records to figure out to which illnesses their patients may be vulnerable. Clover's on-call nurse practitioners and social workers ensure patient follow-up and education. The former CEO of United Healthcare founded Bright Health, which filled the gap left when UnitedHealth Group and Humana left Colorado's insurance exchange. The startup offers exclusive prover organization (EPO) plans, in which patients see a predetermined network of physicians and specialists.

InsurTech startups increasingly are setting their sights on life insurance. Examples include:

- **Ladder.** In January, startup Ladder launched what it dubs "the first-of-its-kind, digital life insurance product" with Fidelity Security Life and Hannover Re. Using a computer or phone, consumers visit the company web site, calculate their needs, get a quote, and apply for instant coverage of up to $8 million. Ladder charges no annual policy fee.
- **Haven.** Haven Life is another InsurTech startup. Launced in May 2015, Haven offers its "high quality, affordable term life" product in 42 states and Washington, D.C. It is a tech-focused life insurance agency that's wholly owned by MassMutual, which allows Haven Life to offer "a better, faster, funner life insurance purchasing experience with the backing of a trusted insurer."
- **Fabric.** In March, Fabric started selling life insurance in 32 states. "Gone are the meetings with agents, complex and costly policies, and weeks of waiting," says its press release. "Fabric uses proprietary technology to offer simple and affordable coverage that can be bought in two minutes and upgraded at any time." The consumer buys accidental death coverage on his mobile device, laptop or desktop. The coverage is upgradable to a 20-year term life insurance policy.

"As insurers migrate online, they are often partnering with web-savvy firms. In November [2016], Protective Life began selling term life with FinTech lender Social Finance. Other insurers are getting in on the action through Covr Financial Technologies, an Idaho firm that provides an online life insurance sales platform to banks and financial advisory networks. Banner Life is rolling out its new digital system slowly, with human underwriters reviewing algorithmic decisions before policies are issued."

So how much is the industry investing in InsurTech companies? In an interview with LifeHealthPro reporter Warren S. Hersch, Mark Purowitz, principal, Deloitte, said the 500-plus companies Deloitte tracks have invested almost $6 billion in InsurTech during the past three years. Among them are major life insurers, including Allstate, American Family, AXA, MassMutual, Nationwide, Transamerica and USAA. Joining them are a wide array of venture capitalists. According to Gartner, about two-thirds of the 25 largest insurance companies have started to invest in InsurTech startups through their venture capital arms.

Insurance companies, then, increasingly see FinTech and InsurTech startups both as venture portfolio investments and as acquisition targets to be integrated into existing operations. Recent examples include ACE's investment in CoverHound and John Hancock's acquisition of Guide Financial. "2016 could be a tipping point for FinTech, as these digital, highly scalable organizations continue to multiply and impact competitive dynamics within the insurance industry—especially as Millennials gain more buying power and insurance carriers try to figure out ways to be more attractive to them." In addition, insurers with old legacy systems may try to acquire assets that can help them establish or expand their digital capabilities.

FinTech/InsurTech continues to dominate industry news feeds. For example:

- The prospect of disruption from financial technology/insurance technology companies likely will drive highly strategic-focused merger and acquisition activity, said A.M. Best in a January 25 press release.
- InsurTech companies could grab up to a fifth of the insurance business within the next five years, according PWC's *2016 Global FinTech Survey*. "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."
- Over the past four years, insurance companies have dealt with the incursion of InsurTech in several ways, according to Deloitte's *2017 Insurance M&A Outlook*. Among them are acquiring InsurTech assets outright; making off-the-balance-sheet moves into InsurTech via investment vehicles; making on-balance-sheet investments in InsurTech with the intent to test/incubate a business opportunity or capability; and, partnering with InsurTech start-ups on projects and proof-of-concept initiatives that could lead to outright equity investments.
- "Cutting edge customer interaction and data analytics have enabled InsurTech businesses to set the pace in the marketplace, especially in relation to customer intelligence," according to *Embracing Possibility*, a recent PWC report. "The threat has been heightened by a fivefold increase in annual investments in InsurTech start-ups in the three years up to 2016, with cumulative funding since 2010 reaching $3.4 billion. [PWC expects] this to have increased significantly [by the end of 2017]. However, rather than being just a threat, the growing presence of InsurTech companies could open up valuable opportunities for insurers to make the leap from incremental to breakthrough innovation. InsurTech partnerships can help insurers improve their processes and thereby strengthen efficiency and reduce costs. They also can help insurers improve their analysis of the huge amounts of data at their disposal, which can lead to better customer understandings, higher win-rates, and more informed underwriting."

- "Increasingly, established insurance companies are implementing dedicated venture capital units that are investing in InsurTech," according to LIMRA's *Financial Services Evolution: 2017 Predictions Report*. "The organizations seek alternative investments to boost yield, while (to a lesser extent) they are interested in developing solutions to protect or improve current market positions."

Also entering a crowded life insurance space are alternative investors. These have emerged since the financial crisis and they include private equity and hedge funds. Examples include:

- **Athene Holding.** Purchased Liberty Life (U.S. operations of RBC Insurance) (2010), Investors Insurance (SCOR's annuity business) (2011), Presidential Life (2012), Aviva Life & Annuity Company (U.S. operations of Aviva plc) (2012), and Delta Lloyd Deutschland (a unit of the eponymous Dutch multinational insurer) (2015). Reinsured blocks of business from American Equity Investment Life (2009) and Transamerica Life (2011). This year, it went public via an IPO. During a recent earnings call, CEO Jim Belardi said Athene intends to expand and diversify its product portfolio as well as explore partnership, M&A and organic growth strategies. He sees opportunity in the pension risk transfer market and in institutional channels.
- **Guggenheim.** Purchased EquiTrust Life (2011) and Sun Life Assurance Company of Canada (2012). Reinsured blocks of business from Standard Life (2010) and Industrial Alliance (U.S. fixed annuities) (2012).
- **Global Atlantic Financial Group (Goldman Sachs plus individual investors).** Purchased Presidential Life-USA (Athene) (2013) and Forethought Financial Group (2013). Reinsured blocks of business from Aviva USA Life & Annuity (life insurance business) (2013) and ReliaStar Life (ING's annuity business) (2014).
- **Reservoir Capital/Black Diamond Capital Partners.** Purchased SBLI USA Mutual Life Insurance Company through a sponsored demutualization (2013).
- **Harbinger Capital Partners.** Purchased Fidelity & Guarantee Life (U.S. operations of Old Mutual) (2010).

Life insurers are carefully monitoring these InsurTech startups, alternative investors, and other new entrants. In fact, many are doing more than that by learning from them and elbowing into these and other nontraditional spaces. Look for more news to come.

COMPANY RESPONSES

Growth is extremely challenging in today's economic, regulatory, political, and "new entrant" climate. To induce it, life insurers are working to manage their capital more effectively, looking for merger and acquisition (M&A) opportunities and repurchasing stock. They also are taking a hard look at their lines of business, especially those in which they do not have a significant presence or that are becoming unsustainable due to spread compression. Some are bolstering those lines of business by acquiring the same lines from other insurers to build scale and market share; some are spinning them off instead. Some are pruning the number of products and product variations they offer. Many are reworking policy terms and crediting rates, moves that may improve product profitability, but also may force policyholders to pay more for their coverage or relinquish benefits.

Consultant PWC surveyed 95 insurance CEOs in 39 countries for its February 2017 report *Embracing Possibility, Boosting Innovation*. When asked what they plan to do this year to drive growth and/or profitability, they said grow organically (81 percent), reduce costs (61 percent), forge new strategic alliances and/or joint ventures (45 percent), collaborate with entrepreneurs and/or start-ups (37 percent), make M&A moves (35 percent), outsource (25 percent), and sell a business or exit a market (nine percent).

On the capital management front, many insurers are increasing their exposure to risk assets to meet their investment goals, according to Boston, Mass.-based research firm Cerulli Associates, as well as outsourcing more assets to third-party asset managers.

Total invested assets in U.S. insurance general accounts were nearly US$ 5.7 trillion at year-end 2015, just a smidge higher than 2014, says Cerulli. According to the asset managers it surveyed for the just-published report *U.S. Insurance Asset Pools 2016: Meeting the Investment Needs of the U.S. Insurance Industry:*

- The largest increases in investment holdings will be in corporate private placement fixed income (67 percent), investment-grade corporate (public) fixed income (62 percent), real estate debt or equity (55 percent), and floating-rate or bank-loan securities (54 percent).
- A majority of (internal) insurance company investment professionals (53 percent) say they currently outsource public equity, while 44 percent say they are considering outsourcing high-yield bonds.
- Nearly three-quarters (71 percent) of institutional asset managers and consultants say their insurance clients are considering alternative investments to protect against a surprise reversal in interest rates. More than half (57 percent) say their clients are increasing credit exposure.
- When asked about the top strategies they manage for insurance separate accounts—variable annuities, for example—62 percent of insurance asset managers cite investment-grade corporate bond strategies.
- More than one-third of insurance asset managers (36 percent) report being "very likely" to get subadvisory business on individual variable annuities, group life, and group annuity platforms.

The Insurance Asset Outsourcing Exchange, a service offered by consulting firm Eager, Davis & Holmes, which took its own survey around the same time, also found that insurance companies increasingly are turning to alternative investments managed by third-party managers to meet the challenges of today's capital markets. The survey found that on a global basis, alternative investments—among them, private equity, private debt and hedge funds—accounted for 21 percent of new mandates in 2016, up from just 15 percent in 2015.

In addition to capital management strategies, life insurers are studying new business opportunities. One that has really taken off is the pension risk transfer.

More and more employers are entering into these annuity buy-out transactions, which eliminate their defined benefit (DB) pension plan liabilities by transferring them to a third party. During the past five years, insurance company interest in annuitizing those liabilities, then taking over administration and benefits administration, has ramped up significantly. Insurers are well equipped to take on the contracts. They are used to managing large pools of assets and have experience dealing with risk tied to life expectancies. Not surprisingly, a number of them have taken the plunge:

Google the word 'insurtech' and 100+ start-up companies result, most having hip names such as Friendsurance, Lemonade and Oscar.

- In 2012, Prudential accepted $25.1 billion of General Motors' DB pension liabilities and $7.5 billion of Verizon's liabilities. These were groundbreaking agreements.
- In 2013, MassMutual struck a $625 million pension risk transfer deal with SPX Corporation.
- In 2014, Prudential accepted $3.1 billion of Motorola's DB pension liabilities as well as $1.4 billion of Bristol-Myers Squibb's.
- In 2015, Prudential and MassMutual teamed up to accept $2.5 billion of Kimberly-Clark's DB pension liabilities. Sun Life accepted $5 billion of DB pension liabilities from BCE, Canada's largest telecommunications provider.

Due to prolonged low interest rates, noted A.M. Best in a January 16 press release, mega-sized pension risk transfer (PRT) deals were modest in 2016. The exceptions were MetLife and MassMutual's partnership to execute a joint $1.6 billion PRT transaction and Prudential Financial's $2.5 billion PRT transaction with WestRock Company.

DEAL DRIVERS

Life insurers also are looking for merger and acquisition (M&A) possibilities. In fact, "The stars may be aligning for increased M&A activity in 2017," according to Deloitte's *2017 Insurance Outlook*. "However, the 2016 election results have created uncertainty about the economic climate, which may give some insurers pause about their short-term strategy. Volatility in deal volume and size among individual segments of the business should be expected in any case, thanks to the following factors:

- The U.S. insurance market remains the largest globally on a premium-dollar basis, and it offers more growth potential than any other market, making domestic carriers attractive to foreign buyers.
- At the same time, InsurTech firms could have a disruptive impact by compounding the forces of change already reshaping the industry, while also being potential M&A targets for insurers.
- In addition, M&A activity could be spurred both by insurers looking to divest noncore assets for both regulatory and competitive reasons, and by those seeking acquisitions to increase scale and capabilities."

Examples of the first bullet include four significant deals involving an Asian life insurance company acquiring a U.S. company. In February 2015, Dai-ichi Life (Japan) closed on its deal to acquire Protective Life Corp. for US$ 5.6 billion. In July 2015, Meiji Yasuda Life (Japan) agreed to acquire StanCorp Financial Group for US$ 5 billion. In August 2015, Sumitomo Life (Japan) announced its plan to acquire Symetra Financial Corp. for US$ 3.7 billion. In November 2015, Anbang Insurance Group (China) agreed to acquire Fidelity and Guaranty Life for US$ 1.6 billion in a deal expected that continues to face regulatory hurdles. And in October 2016, China Oceanwide, a real estate development and financial services firm, agreed to acquire Genworth Financial.

Other M&A examples include:

- In January, New York Life Investment Management bought a majority stake in Credit Value Partners LP.
- In February, Global Bankers Insurance Group agreed to acquire Pavonia Holdings (U.S.) from Enstar Group and to purchase what amounts to a majority stake in Cincinnati Equitable Companies. The deals represent what Global Bankers described as its sixth and seventh insurance company acquisitions since 2014. According to SNL, "When the targets of the two transactions are combined with Bankers Life, which Global Bankers bought in December 2016…the resulting consortium of U.S.-domiciled life insurers will double the size of the group's pre-existing domestic franchise."
- In February, Blackstone acquired Aon Hewitt. This is the latest example of the stepped-up consolidation activity in the defined contribution (DC) pension plan record keeping space that has occurred during the past few years. Since 2014, Aegon, Ameritas, Great-West Financial, John Hancock, and OneAmerica Financial Partners have made high profile acquisitions to add scale to their existing record keeping platforms and to gain access to different market segments. What makes the Blackstone acquisition different is that Blackstone is a total newcomer to the DC record keeping space. Will other asset managers join Blackstone? While the verdict is out, there is $27 trillion in 401(k) plans up for grabs.
- In March, Nationwide completed its acquisition of Jefferson National, which offers tax-advantaged investing solutions to registered investment advisors (RIAs), fee-based advisors and the clients they serve. Jefferson National is now a wholly-owned subsidiary that will transition to the Nationwide brand. "This partnership allows for growth in ways that our companies could not have achieved individually and complements our strong brokerage distribution channel," says Kirt Walker, president and COO, Nationwide Financial.

On the capital management front, many insurers are increasing their exposure to risk assets to meet their investment goals.

Expect 2017 to be a year of deal making in the insurance industry, according to *The New Deal: Driving Insurance Transformation with Strategy-Aligned M&A*, a new report from KPMG International that's based on a survey of 200 global insurance decision-makers.

Eighty-four percent of the insurance companies surveyed plan to make between one and three acquisitions in 2017, while 94 percent plan at least one divestiture. Two-thirds of insurers say they expect to undertake a cross-border acquisition this year.

What's driving this interest? Thirty-three percent say transforming their business model will be the primary driver of acquisitions in 2017, with an equal percentage citing enhancing their existing operating model and transforming their operating model as the motivators for deal activity.

"Insurers are clearly hungry for good M&A opportunities," says Ram Menon, global lead partner, Insurance Deal Advisory with KPMG in the US. "They are focused on transforming their business and operating models, and even with geopolitical uncertainties, they are aggressively looking at deals that can help meet their objectives."

Partnerships are also viewed as critical for operational transformation, with 87 percent of insurers indicating they will partner for new operating capabilities, while 76 percent say they will partner to access new technology infrastructure.

They identified the U.S. as their top national destination for acquisitions, followed by China. Regionally, however, the Asia Pacific dominates, with 47 percent looking at the region for acquisitions, more than twice the percentage for North America. Western Europe is seen as presenting the most divestiture opportunity.

Despite the strategic need for business transformation, the report finds that many insurers continue to take an opportunistic approach to M&A. Just 47 percent of those insurers with dedicated M&A teams say their deal identification objectives are aligned to their corporate strategy. Thirty-seven percent admit their approach to deal making is still largely reactive.

"If you are using M&A to effectively transform your business, you can't just jump at opportunistic deals, you need to be much more strategic," says Menon. "Insurance organizations need to make investments that deliver on the longer-term strategy for the organization. And that is where the big challenges will lie."

The report says that insurers are taking a number of paths to secure transformative deals. Corporate venture capital (VC), in particular, is gaining traction with 62 percent of insurers saying they are either already active or currently setting up a corporate venture capability as a way to build technical capabilities. More than a quarter of the existing VC funds claim more than $1 billion in allocated funding.

"In this environment, the key to M&A success is to align financial, business and operating models so that you can achieve clarity about the markets and geographies you wish to play in and how you will win," says Matthew Smith, insurance sector lead, Global Strategy Group, KPMG in the UK. "You must also be prepared to analyze your capabilities in the areas of due diligence and targeting in order to understand how to extract maximum value over the medium term and how the target's capabilities complement your own."

What does the year ahead hold for mergers and acquisitions activity in the life/annuity sector? It depends. Will a Republican president and Republican-controlled Congress dismantle post-financial-crisis regulations and rewrite U.S. tax code? Will the bull market continue its run? Will the DOL fiduciary rule go into effect? Will insurers decide to partner with InsurTech companies or acquire them? All of these things—and more—will play a role as companies consider M&A opportunities.

The business climate, then, is challenging to say the least. According to *The Deals Environment*, a just-published PWC report, the insurance industry will be impacted by the proposed policies of the Trump administration, especially tax and regulatory. Increasing bond yields and the Fed's latest signal about a quick pace of rate hikes in 2017 are expected to improve portfolio income for insurers. In addition:

- **Macroeconomic environment.** U.S. equity markets have been rallying since election, with President Trump's policies to boost growth and relieve regulatory pressures driving the optimism in part. The rally may be short-lived, however, if policies fail to meet investor expectations. While the Fed is widely expected to raise rates again in 2017, other central banks around the world are easing and uncertainty in Europe has spread with the possibility that countries leave the euro zone or the currency union breaks apart.
- **Regulatory environment.** The direction of regulatory and tax policy is likely to change materially as the President has campaigned for deregulation and reducing taxes. Uncertainty around the DOL's proposed fiduciary rule has been mounting.
- **Sale of legacy blocks.** Focus on exiting legacy risks such as long-term care and variable annuities by way of sale or reinsurance will continue in 2017. This year already has brought two significant transaction announcements—AIG paying $10 billion to Berkshire for long-tail liability exposure and Hartford paying National Indemnity $650 million for adverse development cover for A&E losses.
- **Expansion of products.** Insurers will focus on expanding into niche areas such as cyber insurance (expected to be the fastest-growing insurance product fueled by a slate of recent corporate and government hackings). Further, life insurers are focusing on direct issue term products to the market.
- **Technology.** Emerging technologies including automation, robo-advisers, data analysis, and blockchain are expected to transform the insurance industry. Incumbents have been responding by direct investment 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 due to weak domestic economies, intent to diversify products and risk, and expand capabilities.

Finally, private equity, hedge funds and family offices are entering the fray. These nontraditional companies have a strong interest in expanding beyond the brokers and annuities business to include other sectors within insurance such as managing general agencies (MGAs).

INFLECTION POINT

Despite all the aforementioned headwinds, insurance CEOs are optimistic about their own companies' prospects. Consultant PWC surveyed 95 insurance CEOs in 39 countries for its February 2017 report *Embracing Possibility, Boosting Innovation*. Over a third (35 percent) of them are very confident that they can achieve revenue growth over the next year and more than 80 percent are at least somewhat confident.

However, notes the report, they are "acutely aware of the disruption and change facing the industry, the transformational impact in areas ranging from robo-advice to pay-as-you-go and sensor-based coverage. Concerns over regulation, the pace of technological change, shifting consumer behavior, and competition from new market entrants have continued to rise from their already high levels. When the impact is put together, no other sector is facing as much disruption in these four areas."

Another report, *The Transformation Mandate*, which EY published in February, concurs. The report covers key insights from members of the Insurance Governance Leadership Network (IGLN), who met in December 2016 to discuss enterprise transformation. Several leading insurers attended.

According to the report, historical business models are unsustainable, making transformation imperative. "A host of well-documented challenging economic, regulatory, technological, and customer-related conditions have made it clear that there is no alternative other than rapid transformation. There has not been a point in history that the operating model has been strained so significantly, from so many directions," said one attendee. "Insurance rates are falling, global growth is slowing, and interest rates are profoundly affecting us. We can't grow out of these problems." In short, notes the report, "The insurance industry is at an inflection point where the risk of inaction exceeds the risks inherent in transformation."

Yikes. Looks like life insurance/annuity companies have their work cut out for them. As always, *Resource* will keep you abreast of the strategies they employ to succeed during these challenging times. ❖