PLAYERS, PRINCIPLES & PARADIGM BUSTERS

INSURANCE IS A COMPLEX BUSINESS COMPRISED OF LOTS OF MOVING PIECES. HERE'S A PEEK AT WHO WANTS IN THE GAME, WHAT THE RULES ARE, WHO WANTS TO CHANGE THEM—AND MORE.

By Jennifer C. Rankin

Will this be the year people realize just how interesting insurance is? If you need convincing, take a minute to consider the upstarts who want in the business, the nail-biter legislative maneuvering, the Wall Street roller coaster, and increasingly finicky customers, for starters. Who said the insurance industry was boring?

You've got to have lots of mojo to play—and stay in—the game. The numbers show that the industry is holding its own in the midst of a challenging economic, political and regulatory climate. At year-end 2017, total income for the U.S. life, annuity and health industry dropped just 2.8 percent from the prior year, as a US$ 7.9 billion improvement in net investment income helped offset declines in premiums and annuity considerations, commissions and expense allowances on reinsurance ceded, and other income. These preliminary financial results are detailed in *First Look—2017 U.S. Life/Health Financial Results*, a A.M. Best Special Report released in March. Best derived the data from companies' annual statutory statements representing about 89 percent of total industry premiums and annuity considerations.

According to the report, notable changes in premium and annuity considerations in 2017 include a combined US$ 17 billion decline reported by Prudential Annuities Life Assurance Corporation and MetLife, Inc., a total decline of US$ 27.1 billion at Transamerica Life Insurance Company and Forethought Life Insurance Company related to reinsurance agreements entered into in 2017, and a US$ 14.7 billion increase at AGC Life Insurance Company, as $US14 billion of reserves were ceded in 2016.

Pretax net operating gain for the industry declined to US$ 53.2 billion in 2017, down 14.6 percent from the prior year. A US$ 4.6 billion reduction in federal and foreign taxes and a US$ 4 billion decrease in net realized losses resulted in 2017 total industry net income declining just 1.4 percent from 2016 to US$ 33.9 billion. Capital and surplus for the industry increased US$ 11.2 billion, reaching US$ 372.5 billion as of year-end 2017.

After declining in January and February 2018, U.S. life insurance activity turned positive in March, up 6.7 percent year-over-year, according to the MIB Life Index. It also was the first month this year where life insurance application activity rose across all age groups.

TAX REFORM

Presidential candidate Donald J. Trump's campaign platform included reforming the country's tax system. On December 22, 2017, he delivered on that promise as president of the United States, signing into law The Tax Cuts and Jobs Act of 2017. The law cuts corporate tax rates permanently and individual tax rates temporarily (until 2025). It also removes the individual mandate from the Obama administration's Affordable Care Act, a provision that compels every American to buy health care coverage or face a fine; this provision takes effect in 2019. In general, most taxpayers will have more money in their pockets.

> **Expect to see a number of 'wow, that changes everything' moments in 2018**

Life insurance and annuity companies will encourage them to apply that extra "spend" toward protection and retirement products. Health insurers were glad to learn that the tax law does not affect health savings accounts (HSAs). Those in the retirement space were happy the rumor that 401(k) retirement plan contribution limits would drop from the current US$ 18,000 (US$ 24,000 for those 50+ years of age) to a mere US$ 2,400 proved unfounded. The law does not change individual retirement account (IRA) contributions either. It does, however, repeal the ability to switch retroactively between Roth and traditional contributions, and vice versa.

American companies are delighted with their tax cuts. The law addresses everything from immediate expensing to net operating losses. Of particular interest to life and annuity players are the new corporate tax rate and new treatment of foreign earnings.

The law creates a single corporate tax rate of 21 percent, effective January 1, 2018, and repeals the corporate alternative minimum tax (AMT). Combined with state and local taxes, the statutory rate under the new law will be 26.5 percent, according to the Tax Foundation. Before the Act was signed into law, the top corporate tax rate was 35 percent.

This, of course, is great news for life/annuity—and most other—companies. Lowering the corporate tax rate, however, caused the net deferred tax assets (DTAs) of U.S. life and property/casualty insurers to fall sharply at the end of 2017, according to Jason Woleben of SNL. According to him, the life insurance industry's DTAs decreased 38.4 percent compared with the year-end figures for 2016. "While many insurers recorded the impact of the lower tax assets as one-time charges for the year," writes Woleben, "those with significantly lower DTAs could see their risk-based capital (RBC) ratios, a key regulatory metric, change as well."

According to a December 2017 S&P Global Ratings analysis, as reported by Woleben, "Those write-downs may have more than a temporary effect and could impact insurers' year-over-year capital adequacy. The National Association of Insurance Commissioner (NAIC) risk-based capital (RBC) formulas use after-tax capital factors. The lower future tax benefit would mean an insurer must maintain higher capital levels than previously used. That higher required capital level, combined with lower DTA balances, could lead to lower RBC ratios for some insurers, several of which have already disclosed the potential impact to [their] RBC ratios from tax reform." According to an S&P Global Market Intelligence analysis, notes Woleben, 13 of the top 20 companies with the largest net DTAs at the end of 2017 are life insurance companies, among them TIAA and Northwestern Mutual.

The tax overhaul has compelled the NAIC to revisit its three-decades-old RBC formula for 2018, though implementation could be pushed back to 2019. The tax law changes "are going to have a significant impact on the RBC requirements for life insurance companies," according to the American Council of Life Insurers (ACLI), which expects RBC ratios to drop for all life insurers.

With respect to foreign earnings, the law enacts a tax rate of 15.5 percent for repatriated overseas profits in the form of cash and equivalents as well as an eight percent tax rate for reinvested earnings. The law also includes provisions meant to counteract base erosion and profit shifting (BEAT)—that is, moving taxable profits made in one country to another with low or no taxes. Many insurers are multinationals with far-flung operations and subsidiaries.

BUSINESS CLIMATE

On the economic front, there is good and bad news. Let's start with the former.

On April 6, in his first speech as Federal Reserve chairman, Jerome Powell said, "the Fed remains committed to raising its key interest rate gradually unless events change." In March, the Federal Reserve raised its key rate by a quarter of a point, from 1.5 to 1.75 percent, the sixth increase since 2015. He depicted that rate hike as "another step in the ongoing process of gradually scaling back" the ultra-low rates it employed to lift the economy out of the recent Great Depression, according to the Associated Press. He also signaled that the Fed hopes to raise rates two more times by year-end. Powell, whom President Trump chose to succeed Janet Yellen, took office on February 15.

Rising interest rates are good news for life and annuity companies. 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.

Sharp highs and lows in the equities market have characterized the year thus far. Roiling the equities markets are the Trump administration's overhaul of the U.S. tax system, the spending omnibus bill, the federal deficit, trade tension between the country and China, and more.

The Trump administration's tax overhaul is forecast to raise the federal deficit by hundreds of billions of dollars—as much as US$ 2 trillion even—over the coming decade, according to Investopedia's David Floyd. "Estimates vary depending on assumptions about how much economic growth the law will spur, but no independent estimates follow Treasury Secretary Steven Mnuchin in predicting a net reduction to the national debt as a result of the overhaul." Time will tell how such an increase in the national debt will play out in the U.S. economy, which, of course, comprises a large part of the business climate in which corporations must strive to succeed.

On the other hand, the tax overhaul may keep more U.S. dollars in the country. Supporters of the corporate tax rate cut believe it will reduce incentives for corporate inversions—that is, companies shifting their tax base to low- or no-tax jurisdictions, often through mergers with foreign firms. Goldman Sachs estimates that U.S. companies hold US$ 3.1 trillion of overseas profits. Repatriation of those profits certainly would give a boost to the national economy.

While the tax overhaul may be good for insurers, recent equity market volatility has the potential to hurt them, according to the A.M. Best Special Report *Rising Volatility—Negative Implications for Insurers*, which was published in March. According to the report, "Equity market volatility has been elevated since the spike in early February 2018, and with the announcement of steel and aluminum tariffs, the stock market will most likely experience more volatility than last year. Equity market volatility historically has had severe negative implications for life insurers whose assets and liabilities correlate strongly with equity prices. Nevertheless, de-risking in the form of decreased exposure to annuities and new products such as managed volatility funds have dampened the sensitivity.

"Although changes in equity values affect the capital and surplus of all [insurance] sectors, only the life/annuities segment sells products that are tied to the equity markets. Steps variable annuity writers took to de-risk their products since the late 2000s have proven effective in limiting earnings volatility; however, the de-risking measures, along with the increased investment fees associated with managed volatility funds, have made newer variable annuity products less attractive to consumers and is one reason among many other reasons that have caused a decline in sales."

According to A.M. Best, the industry remains well capitalized and it would take another major financial crisis to jeopardize that.

Despite recent market volatility, more than half of Americans feel financially prepared for their future, according to a COUNTRY Financial survey conducted in March. Unfortunately, only 28 percent have a financial plan in place. Even the two recent Dow Jones Industrial Average (DJIA) drops of more than 1,000 points in a single day have not discouraged them. Despite the plunges, about half report they are financially prepared should it happen again—in fact, they say they could handle it if the Dow were to lose an additional 6,000 points.

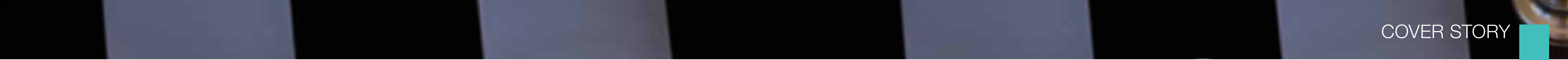
DISMANTLING DODD-FRANK

During his 2016 campaign, presidential candidate Trump pledged to "do a big number" on The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and to consider a "modern version" of Glass-Steagall, the legislation that kept commercial and investment banking completely separate for years, only to be dismantled in 1999. Dodd-Frank imposed numerous financial regulations, the purpose of which was preventing a repeat of the devastating 2008-9 financial crisis. In a nutshell, the legislation aimed to decrease various risks across the financial system and to increase regulatory oversight to prevent another crisis down the road. Part of that legislation addressed reducing the risks too-big-to-fail-institutions pose for consumers, taxpayers, and the U.S. economy.

Simultaneously, Representative Jeb Hensarling (R-Texas), chairman of the House Financial Services Committee, was leading his own effort to override Dodd-Frank, an attempt that went nowhere under the Obama administration.

In January 2017, newly elected President Trump reiterated his campaign pledge. He also signaled his intent to defang financial regulations by, during the course of the year, appointing banking and brokerage veterans to serve as financial regulators.

In February 2017, President Trump signed an executive order that gave Treasury Secretary Steven Mnuchin the task of reviewing existing financial regulations and figuring out how to rework them so they would align with the president's goals. The result would be a series of Treasury Department reports outlining the Trump administration's ideas and proposals.



In December, President Trump delivered on that promise, signing into law The Tax Cuts and Jobs Act of 2017.

In April 2017, the House Financial Services Committee released a draft of The Financial CHOICE Act of 2017 (H.R. 10), which would overturn much of the Dodd-Frank Act. Among other things, the Act:

- Exempts some financial institutions from Dodd-Frank's risk-taking limits
- Weakens the powers of the Consumer Financial Protection Bureau (CFPB) and shifts its funding to the annual appropriations process
- Replaces Dodd-Frank's process for unwinding troubled companies with a new Bankruptcy Code chapter
- Strips the Financial Stability Oversight Council (FSOC) of its power to designate large non-banking companies as systemically important financial institutions (SIFIs)
- Eliminates the Department of Labor (DOL) rule that requires brokers to meet a fiduciary standard when giving retirement investment advice
- Ditches the Volcker Rule, which bans investment banks from trading for their own gain

The Act also targets the current powers of the Securities and Exchange Commission (SEC). Among its proposed laws are:

- Increasing the penalties the SEC can impose for securities law violations (as long as the penalty doesn't harm shareholders)
- Restricting the SEC's ability to handle cases in-house by giving defendants the right to be heard in federal court
- Taking away the power of the SEC to bar a guilty party from serving as an officer or director of a publicly-traded party and giving it to the federal courts
- Requiring the SEC to prove its enforcement actions did not exceed its legal authority
- Creating the position of enforcement ombudsman, an individual who serves as a liaison between the SEC and the defendant and whose job is to help "in resolving problems such persons may have with the commission or the conduct of the commission staff"

"The attack on administration proceedings," writes New York Times reporter Peter J. Henning, "is a reaction to a provision of the Dodd-Frank Act that authorized the SEC to pursue a wider range of penalties in cases filed with its own judges." According to critics, that provision hurt defendants' rights and gave the SEC an unfair "home court" advantage. As you can see, the proposed legislation would bring the SEC to heel. Whether that is a good or a bad thing remains to be seen.

June 2017 was a busy month on the Dodd-Frank front. On June 8, 2017, the House approved the Financial CHOICE Act. On June 12, 2017, the Treasury Department released the first in a series of reports that disclosed the Trump administration's proposals for easing financial regulations. Those plans closely mirror the provisions of the Financial CHOICE Act and single out small community banks for extra regulatory relief. Finally, the Senate continued work on its own legislation on financial regulations.

On October 6, 2017, the Treasury Department released the second in its series of reports, which contained additional proposals for easing financial regulation. They include promoting arbitration (versus the court system) to resolve company-shareholder disputes; fixing regulatory overlaps between the SEC and the futures trading commission (FTC); jettisoning the requirement that companies publish the pay ratio of chief executives to workers; and repealing rules that require companies to disclose products containing conflict minerals and payments involving foreign resource extraction.

There had been much speculation that the Treasury's second report would propose "restricting the government's power to designate insurance companies, corporate lending subsidiaries and other firms as too big to fail, a label that subjects a company to additional rules and higher capital requirements," according to a September 8, 2017 New York Times editorial. It did not. Anyway, only two insurers—Prudential Financial and AIG—currently have the SIFI designation. In 2016, federal regulators rescinded that designation for GE Capital and the courts rescinded it for MetLife.

Of course, only Congress has the authority to change Dodd-Frank. It is important, however, to note that Dodd-Frank gives a sitting U.S. president broad authority over how the law's provisions will be implemented. In addition, while some of the proposals contained in aforementioned Treasury Department reports require legislation, the Trump administration can implement many of them simply by having regulatory agencies adopt them as new policies.

That brings us to 2018. On March 14, the Senate passed The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (S. 2115). Sponsored by Senator Mike Crapo (R-Idaho), chair of the Senate Banking Committee, the bipartisan legislation aims to re-write parts of Dodd-Frank. "At the core of the Crapo bill," according to Emily Stewart, VOX analyst, "is the assumption that the Dodd-Frank financial overhaul was overly aggressive and harmed smaller banks in attempting to rein in the larger financial institutions that caused the 2008 financial crisis." One provision of the bill increases the threshold for SIFI designations. Under Dodd-Frank, firms with assets of US$ 50 billion or more are considered SIFIs and are therefore subject to stricter oversight and higher capital standards. The Senate bill increases that threshold to US$ 250 billion. It also exempts small banks from various Dodd-Frank requirements.

We now have a House bill and a Senate bill on the table. What happens next? If both houses agree on and pass a final bill, it will be the first major piece of bipartisan legislation to come out of Congress this year.

LEGISLATIVE HOPPER

Also in the legislative hopper are the Federal Insurance Office (FIO) Reform Act of 2017 (H.R. 3861) and the International Insurance Standards Act of 2017 (H.R. 3762).

Congressmen Sean Duffy (R-Wis.) and Denny Heck (D-Wash.) introduced the FIO Reform Act on September 28, 2017. The Act would:

- Move the FIO to the Office of International Affairs within the Treasury Department
- Limit the FIO's role largely to international matters and provide that the FIO speaks for Treasury (but not other federal agencies) in international discussions
- Authorize the FIO to coordinate federal insurance policy and require that the FIO achieve consensus with the states before advocating or agreeing to positions in international forums such as the International Association of Insurance Supervisors (IAIS)
- Eliminate the FIO's authority relating to purely domestic issues, including the authority to engage in broad information gathering authority and reporting obligations and to issue subpoenas
- Retain the FIO's existing authority to "monitor all aspects of the insurance industry" and to advise the Treasury Secretary on the administration of the Terrorism Risk Insurance Act (TRIA)
- Continue the authority of Treasury and the United States Trade Representative (USTR) to negotiate and enter into covered agreements (but the Secretary, not the FIO Director, would have the authority to determine whether a covered agreement preempts state law)
- Provide that a covered agreement may not include new prudential requirements for U.S. insurers
- Limit the number of FIO employees to five (recognizing the much more limited federal coordination and international role set forth for FIO and that the states already have more than 10,000 regulators adequately overseeing the industry domestically)

Title V of the Dodd-Frank Act established the FIO, which is part of the U.S. Treasury Department and is headed by a director who is appointed by the Treasury Secretary. The FIO's authority extends to all lines of insurance other than health insurance, long-term care insurance (unless it is coupled with life insurance/annuity products), and crop insurance. While the FIO does not have formal supervisory or regulatory authority over the business of insurance, its charge includes monitoring all aspects of the insurance sector, including activities that might contribute to systemic risk, the extent to which under-served communities have access to affordable insurance products, and insurance regulations. Additional charges include helping with the resolution of troubled insurers, assisting the Treasury Secretary with the negotiation of covered agreements, and advising the Treasury Secretary on major domestic and international insurance matters. The director of the FIO is a non-voting member of the Financial Stability Oversight Council (FSOC), which Title I of the Dodd-Frank Act established. He also has the authority to represent the U.S. federal government internationally at meetings of the IAIS.

As you can see, the Act would severely clip the wings of the FIO. The bill rests in the House Committee on Financial Services and has yet to pass.

The stated purpose of H.R. 3762, which Congressmen Duffy and Heck introduced on September 13, 2017, is "to preserve the State-based system of insurance regulation and provide greater oversight of and transparency on international insurance standards setting processes." A November 2017 A.M. Best update summarizes its provisions: "[The Act] would give Congress additional formal oversight of any international standards. In addition, any international agreements must reflect the U.S. state-based insurance system, according to the office of bill sponsor U.S. Rep. Sean Duffy. If changes need to be made to any international insurance agreements, those changes must be enacted in the U.S. first before being ratified in international forums. Also, the bill would ensure state insurance regulators are part of any U.S. team negotiating international agreements." They referred the bill to the Committee on Financial Services and the Committee on Rules, where it currently rests.

There always has been a certain tension between federal and state regulators in the insurance sector. The Congressional Findings section of H.R. 3762 sums up the spirit of many new bills, which is to secure the state-based regulatory system, to ensure that system has at least equal footing with federal players, and to ensure the states have a voice in international standards. “The State-based system for insurance regulation in the United States has served American consumers well for more than 150 years,” reads H.R. 3762 “and has fostered an open and competitive marketplace with a diversity of insurance products to the benefit of policyholders and consumers. [In addition,] protecting policyholders by regulating to ensure an insurer’s ability to pay claims has been the hallmark of the successful United States system and should be the paramount objective of domestic prudential regulation and emerging international standards.”

FIDUCIARY DUTY

Once again, the Department of Labor (DOL) fiduciary rule (formally known as the Conflict of Interest Rule—Investment Advice) is in the news. 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 on April 10, 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.

The DOL rule requires best interest contract exemptions (BICE) to ensure clients understand what they are paying for. In addition, it forces 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. Various plaintiffs have filed lawsuits. The SEC is at work drafting its own fiduciary rule, which has been challenging because SEC commissioners disagree on its necessity. The NAIC is working on a model law that creates a uniform standard for annuity sales for the states to adopt. Bypassing everyone, the states—among them, New York, Nevada, New Jersey and Connecticut—are enacting their own fiduciary regulations (or are floating bills to do so).

On February 3, 2017, 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, 2017, 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, 2017 to June 9, 2017. 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 implementation date. The OMB chose to accept the DOL’s proposal for a June 2017 implementation date, with a transition period for exemptions to the rule to run from June 9, 2017 through January 1, 2018.

In June 2017, all of the rule’s provisions, with the exception of BICE, went into effect. On November 2, 2017, the DOL sent a proposal for an 18-month delay of the rule’s BICE component to the OMB. “While expected, the request is another step toward undoing the controversial regulation,” writes Financial Planning analyst Andrew Welsch.

Then BAM! In a surprising turn of events, a federal appeals court vacated (voided) the fiduciary rule on March 15, 2018. Judges from the 5th Circuit Court of Appeals (a New Orleans, La.-based federal appellate court) ruled that the DOL had exceeded its regulatory authority when it established the fiduciary rule. Because the rule had survived repeated court challenges, that decision was unexpected. The ruling was a victory for the plaintiffs, who included the American Council of Life Insurers (ACLI), the National Association of Insurance and Financial Advisors (NAIFA), the Financial Services Institute (FSI), the U.S. Chamber of Commerce, and various others.

Two days earlier, another federal appellate court, the Denver, Colo.-based 10th Circuit Court of Appeals, produced a different opinion. The plaintiff was Market Synergy Group, a Topeka, Kan.-based insurance marketing organization (IMO). The judge ruled that the Obama DOL had “examined the relevant data and articulated a rational connection between the facts found and the decision made and thus did not act in an arbitrary or capricious manner as charged by the plaintiff.” The 10TH Circuit, however, did not consider whether the DOL had the authority to issue the BICE or to revise the fiduciary rule the way it had.

On March 16, 2018, the DOL issued a statement that “pending further review, the Department will not be enforcing the 2016 fiduciary rule. Will the DOL accept the 5th Circuit ruling, ask for a rehearing, seek to have the U.S. Supreme Court overrule it, rewrite the rule, let the rule die? Will state and federal regulators come together and develop a “harmonious” fiduciary rule? Will there be 50 sets of fiduciary rules, one for each state? Only time will tell.

Because of the delay, the LIMRA Secure Retirement Institute expects annuity sales to rebound this year. The Institute forecasts that sales of fixed annuities will increase across all product lines—that is, indexed, fixed-rate deferred and income annuities—to reach near record levels. With the DOL rule delayed, the Institute is projecting indexed annuity sales to rebound five to 10 percent this year, compared with 2017 sales results.

> **Once again, the Department of Labor (DOL) fiduciary rule is in the news.**

According to the *Retirement Income Journal*, “variable annuity (VA) sales have declined for the past five years, in part because companies have been carefully managing their VA sales volume. The decline of VA sales accelerated once [an early version of the] DOL fiduciary rule was published in 2015. The delay in implementing the DOL rule, and thus the best interest contract requirements, will reduce some of the pressure on the VA market in 2018 and help improve sales.” Nevertheless, the Institute predicts a decline in VA sales this year, albeit a smaller than predicted when the rule was on schedule.

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 fate of the 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.

As you can see, economic, regulatory and political issues are keeping insurance executives up a night. What else is on the table? Continued disruption from non-traditional players, customer value creation, and more merger and acquisition (M&A) activity, to name a few current challenges.

BUSINESS DISRUPTION

It is becoming increasingly clear that wealth management, insurance, banking, brokerage and other financial services are no longer just the purview of banks, brokers and insurers. They used to own the space, but today’s digital technology has created a parade of paradigm busters. Among these are InsurTech startups, alternative investors, and—believe it or not—Costco, Walmart, Overstock, Target and what analysts have dubbed the FAANGs—that is, Facebook, Amazon, Apple, Netflix and Google. It is no surprise, then, that the business word *du jour* is ‘disruption.’

Let’s start with the InsurTech companies. Google the word ‘insurtech’ and 100+ startup 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. They are using new streams of data from Internet-enabled devices—smartphones, car global positioning systems (GPS), and wrist fitness devices, for example—to price premiums on the fly based on observed behavior. They are tapping databases of banking, driving, education and other records as well. They are leveraging all that data to develop algorithm-driven policies that are available for some of the best prices out there. They bandy about phrases such as “ridiculously easy,” “radical transparency,” and “transformation.”

In addition to better pricing models, they are exploring artificial intelligence (AI) systems to handle the tasks of brokers and find the right mix of policies for customers; applications to pull disparate policies into one platform for management and monitoring; on-demand insurance for micro-events like borrowing a friend’s car; and peer-to-peer models for customized group coverage and rebates.

Dodd-Frank imposed numerous financial regulations, the purpose of which was preventing a repeat of the devastating 2008-9 financial crisis.

While most of these companies are targeting property/casualty and health insurance, life insurance startups are catching up. Examples on the life side include Ladder, Haven and Fabric.

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, Guggenheim, Global Atlantic Financial Group (Goldman Sachs plus individual investors), Reservoir Capital/Black Diamond Capital Partners, and Harbinger Capital Partners. Between them, they have snapped up Aviva Life & Annuity, Delta Lloyd Deutschland, Equitrust Life, Fidelity & Guarantee Life, Forethought Financial Group, Investors Insurance, Liberty Life, Presidential Life, SBLI USA Mutual Life, Sun Life Assurance, and blocks of business from other insurers.

Big retailers are elbowing their way into the insurance and financial services space as well. Costco, for example, offers home mortgages; auto, home, health and life insurance; auto buying; payment processing; and, discount personal and business checks, according to Sharon Adario, a business writer for *Financial Planning*. Walmart offers check cashing services, tax preparation, money transfers and bill pay and money orders. Amazon makes small business loans and offers prepaid cards. How hard would it be for them to offer their customers a robo advisor from a technology firm as well?

"With the exception of Overstock, no mass retailer has announced a wealth management offering online," writes Adario. "But, the seeds are there. Any retailer with a robust e-commerce digital platform, physical ubiquity, brand awareness and trust built over many years of effective marketing could find an opening."

Some industry observers say it is the financial advice space that concerns insurance and financial services companies the most. Since, according to research firm Cerulli, the digital advice opportunity segment represents only some 12 percent of investors, it has lots of room to grow. Digital advice often means disintermediation—that is, a direct consumer-to-company connection that cuts a human advisor or agent out of the equation.

These companies do face barriers to entry. For starters, the regulatory and compliance requirements governing insurance and financial services are extensive and complex. In addition, their fiduciary duty is to their shareholders, not to their customers.

The most surprising recent moves, however, have occurred in the health insurance sector. For example:

- Twenty of the country's largest companies—among them, American Express, Berkshire's BNSF Railway, Caterpillar, Coca-Cola, du Pont, IBM, Ingersoll Rand, Marriott and Verizon—teamed up two years ago to create the Health Transformation Alliance. "The goal of the group," reports Kathryn Mayer for *Benefit News*, "is to use data analytics, collective leverage and shared expertise to lower costs for all members. The group has grown to almost 40 members."
- Last year, drugstore chain CVS Health bought insurance company Aetna. In another deal, health insurer Cigna purchased Express Scripts, a huge pharmacy benefits manager (PBM). PBMs manage the prescription drug programs for insurance companies.
- Big corporations have begun to put health care clinics on their campuses, hiring private companies to run them or public companies such as Walgreens. Apple just announced it was going to set up a network of health care clinics for employees and their families at its California headquarters.
- In January, Amazon, JP Morgan and Berkshire Hathaway announced they would form an independent healthcare insurance company for their U.S. employees. Their stated goal is to give employees and their families "simplified, high-quality and transparent health care at a reasonable cost." In addition, "Amazon's e-commerce operation could be used to send medication direct to patients' homes, saving them trips to a pharmacy," writes Mayer. "Its cloud-computing division can store patient health care records so they can be easily accessed by doctors anywhere. And its payments system could be used to a automate payments with health care providers." It does not get any more disruptive than that.
- At press time, the *Wall Street Journal* reported that retail giant Walmart was in talks to purchase Humana, a dominant player in the Medicare space. Some say Walmart may use its onsite health care clinics to offer employees and their families basic treatments.

Most eyes are on Amazon, which many industry watchers expect to make a giant push into health care. That is not as crazy as you may think. After all, the company just bought Whole Foods, a retail grocer way, way outside of its wheelhouse. Even driving service Lyft is looking into health care and medical transport.

VALUE CREATION

So how can the insurers and other financial players compete with these big technology firms, retailers and other paradigm busters? According to global management consultancy Oliver Wyman, traditional financial services firms must accelerate customer value creation or risk conceding an increasing share of customer attention and wallet share to them.

Although the largest financial services firms in the world trace their histories back, on average, 150 years, Oliver Wyman notes, the largest 10 consumer technology leaders have reached an average market capitalization 2.3 times that of global financial leaders in just one-fifth the time. Its 2018 report *The Customer Value Gap—Re-calculating Route* notes that while financial services companies largely have recovered from the 2008-9 financial crisis and conditions have improved significantly, there is a gnawing sense of concern regarding the prospects for future industry growth.

The most prominent concern highlighted is that a group of highly successful, big technology firms are generating new customer value at a much higher rate than financial services firms. "The lessons from big tech in the last decade are not just about gaining and growing customer mindshare; they also reveal the nature of future competition they will pose," says Rick Chavez, report co-author and partner at Oliver Wyman. "The basis for competition has shifted from products to active solutions, from product-selling to problem-solving for customers with systematic improvement in the overall value delivered to customers."

The report looks at the global mass market to demonstrate the customer value gap in financial services, undertaking extensive primary and secondary research, which included surveying some 4,000 mass and mass affluent customers across the U.S., the U.K., France and Australia about their perception of value and their unmet financial needs. The survey respondents focused on three categories of financial need—borrow, safeguard and grow—but Oliver Wyman says there are three others—earn, spend and transfer. According to the report, it is in these additional categories that new companies are creating new value. Since 2010, notes the report, US$ 1 trillion of new value has been created in the U.S. in the borrow, save and secure businesses, largely by incumbent banks, asset managers and insurers. But an additional US$ 1 trillion of new value has been created in businesses focused on spend, earn, transfer and this has largely been created by big tech and other non-financial firms.

"The techniques used to create new customer value have dramatically changed and the big tech industry is dominating customer mindshare and reaping the rewards, says Ted Moynihan, managing partner for financial services at Oliver Wyman. "It's time for financial services to learn and react, or continue to watch value shift to other parts of the economy."

M&A MOVES

According to the EY report *Global Insurance M&A Themes 2018*, 2017 was not a stellar year for insurance M&A in terms of the overall number or value of deals—with both broadly comparable to 2016. However, deal activity last year contained signs of the M&A trends that the consultancy expects to accelerate as more insurers seek to transform themselves.

Among the top deals involving a U.S. target were the acquisition of USI Insurance Services by KKR & Co. and Caisse de depot et placement du Quebec; of Fidelity & Guaranty Life by CF Corp.; of Talcott Resolution by Bank J. Safra Sarasin (Switzerland) and other financial investors); of The Warranty Group by Assurant; of OneBeacon Insurance Group by Intact Financial (Canada); and of Aetna (U.S. Group Life & Disability) by Hartford Life & Accident.

"The long-term nature of many insurance risk types means that a process of rationalizing legacy commitments is a critical early step prior to more forward-looking transformation," note the report authors. "During 2017, we saw many examples of such 'portfolio optimization' or simplification of existing legacy business. We [also] have seen continuing investment into new technologies (whether via investment into InsurTech or the acquisition of key capabilities) and we also have seen early signs of convergence, with technology-oriented businesses starting to invest into insurance."

Among the key takeaways from the report are:

- The question of "buy or build" has become central to many insurance M&A decisions and will continue to underpin consolidation as well as targeted acquisition of capabilities
- Insurers will continue to invest into InsurTech businesses, partly as a response to the ongoing question of buy or build, but increasingly as a way of accessing and operating in emerging 'digital ecosystems'

- The drive to access and create sustainable revenue models from such ecosystems will lead to new types of partnership and joint venture arrangements
- For insurers, new digital ecosystems are both a massive opportunity and an existential threat as such ecosystems also will be a route for sector convergence, with players from outside of the insurance sector competing for roles in the value chain

According to the report, U.S. tax reform is providing one catalyst for M&A transactions. "U.S. reform is a great example of how tax law changes can stimulate (or nullify) the deal market," according to Jeff Soar, global insurance tax leader, EY. "The U.S. rule changes are wide ranging. Changes such as the reduction in headline rate will make the U.S. a more attractive place to invest. The ability for U.S. companies to repatriate previously trapped offshore profits will put more acquisition funding into the market and changes to the way a U.S. company interacts with its foreign subsidiaries should stimulate U.S. investment overseas. On the flip side the changes to some of the rules around investments in what appear to be "passive" companies may limit investor choices and the U.S. base erosion anti-avoidance (BEAT) rules could make cross border trade and capital provision uneconomic. Tax is never, and should never be, the driver for a deal, but we are starting to see a few [insurance industry] transactions where U.S. tax reform is cited as a contributing factor. I suspect we will see many more."

It is **no surprise,** then, that the business word ***du jour*** is **'disruption.'**

Another M&A catalyst is the InsurTech industry. "In 2018," notes the report, "Insurtechs will continue to move from proof of concept to proof of scalability, demonstrating the ability to achieve scale across multiple insurance lines, components of the insurance value chain, and geographies." EY expects emerging InsurTech winners to attract significant M&A interest from a range of potential investors, among them incumbent insurers, large technology companies, and institutional and retail investors.

EY also expects to see a number of 'wow, that changes everything' moments in 2018, as participants or new entrants announce innovative business initiatives that fundamentally alter the role and economics of significant elements of the insurance sector.

As the year unfolds, then, expect to see more legislative battles, unexpected players and maneuvers, and interesting new partnerships in the insurance sector. As always, *Resource* will keep you posted as events unfold. In the meantime, it's your move.

Strategic Resources

Information and Insight

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Strategic Resources

Transitioning to a Data-driven Underwriting Environment

By Dawn Boitnott
VP, Underwriting
Velogica®
dboitnott@scor.com

The following interview with Dawn Boitnott, VP, Underwriting—Velogica, is excerpted from an issue of SCORviews featuring a Q&A with three SCOR underwriters who transitioned from a traditional production environment to data driven underwriting environment. You can read the interviews at https://bit.ly/2HoRl8d

You spent most of your career in traditional underwriting roles. How does that experience help in your role on the Velogica team?

I couldn't do what I do without it. I've moved from a traditional production to a technology-driven environment, and we use different tools to underwrite, but the goal is the same: evaluate individual mortality risk and protect the insurer from taking on too great a risk.

We have professionals on the Velogica team that come from various disciplines. They bring skills that are fundamental to building and maintaining an algorithm—in actuarial, data science, behavioral sciences, artificial intelligence and machine learning. But everyone on the team needs to learn underwriting concepts—and they do—just in a different way than I did.

What data sources does the Velogica engine use today?

Velogica uses information in the application, prescription data, MVR, MIB, criminal history, clinical lab data, and we are in process of implementing credit-based mortality scores.

How do the newer and emerging data sources compare to the more tried and tested e-data sources?

Rx was a big leap forward because it brought medical information into the automated process. The newer data we are integrating into Velogica—like clinical lab data (CLD)—has enormous potential. CLD can be a highly effective alternative for fluids from both a risk and cost perspective, giving the underwriter the ability to stratify otherwise declinable cases on a simple product.

CLD is just the most recent example of how SCOR keeps the flexibility and power of Velogica up to date and with the latest data available to underwriting automation.

What products can be underwritten using Velogica?

Velogica is being used across the product spectrum from final expense and simple to fully underwritten. It also has the potential to underwrite group, disability, long term care, and critical illness. The algorithm obtains evidence, correlates both disclosed and discovered evidence and renders an evaluation most of the time in less than a minute.

It can be used many ways including straight through decisioning, triage, and input to a carrier's workflow either to take a case down a certain underwriting path or as input to a predictive model. A carrier can have a multi-line distribution and/or traditional life-focused agent driven business with various products and underwriting rules represented in Velogica.

How many applications have been underwritten by Velogica?

Since inception, about 3.8 million

How can automated underwriting be expanded to higher face amounts with rates closer to fully underwritten?

SCOR focuses on two approaches. One is to add new data sources that can provide protective values with no degradation in the speed of the decision. The other is to get smarter about when "slow evidence" is really required. We need to identify where time and money are spent on traditional evidence that adds no—or minimal—protective value when compared to instant data.