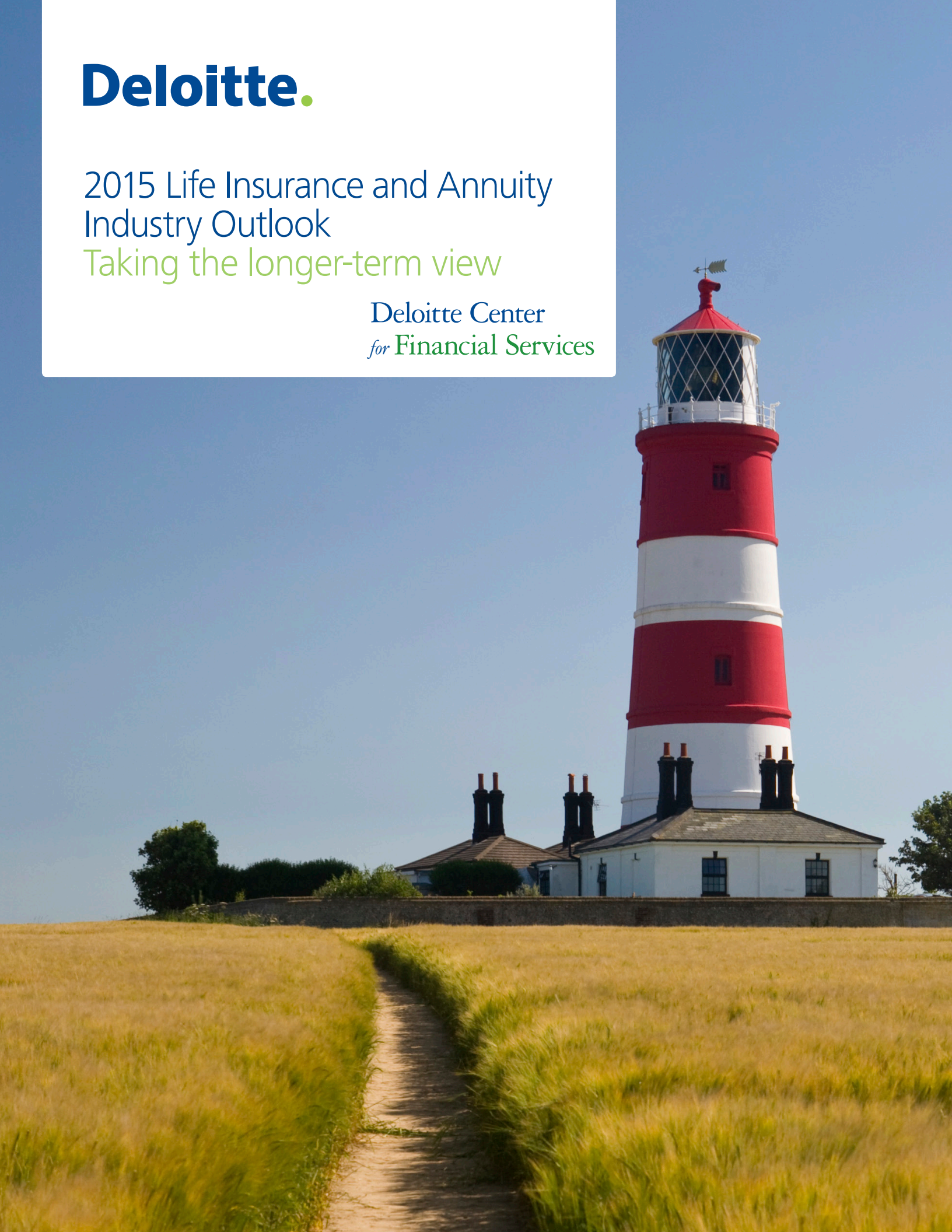




2015 Life Insurance and Annuity  
Industry Outlook  
Taking the longer-term view

Deloitte Center  
*for* Financial Services



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# Foreword

## Dear colleagues:

In many ways, the life insurance and annuities industry is on more solid footing entering 2015 than it has been for quite some time. Economic growth is improving and the unemployment rate is steadily falling, which should create a more conducive environment for carriers to market their products and services.

But fundamental challenges — some new, some ongoing — are keeping industry executives on their toes. Whether it's how to maximize information fluency in the age of big data, contain the growing threat of cybercrime, meet moving compliance targets during a time of regulatory uncertainty, or delivering on the demand for longevity products as life spans increase, life and annuities (L&A) leaders have their hands full. Agility, innovation, and collaboration will be increasingly important to upgrade capabilities and spark sustainable growth.

In this outlook, we once again strive to provide our perspective on the threats and opportunities that lie ahead, as well as practical suggestions as to what L&A insurers ought to do about them. However, while touching upon the impact of the economy and the state of cyclical insurance markets, we focus the bulk of our attention on more systemic, bigger picture agenda items that are likely to have a significant effect on consumer behavior and insurer operations well beyond the year ahead. Our views on industry trends and priorities for 2015 are based on the first-hand experience of many of Deloitte's leading practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing outlooks of this type has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we felt it was important to reflect on what we said a year ago and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 outlooks. You will find this "looking back" analysis leading off this year's edition, followed by a "looking forward" summary of our views about 2015.

The bulk of the report will explore a number of key areas for L&A companies over the coming year, each including a specific look at the industry's focus for 2015 and a "bottom line" that provides some actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your company's strategic decisions for 2015. Please share your feedback or questions with us. We would value the opportunity to discuss the report directly with you and your team.

Regards,

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# Looking back

## Carriers taking steps to boost capabilities, but industry “transformation” yet to occur

Our 2014 L&A outlook evaluated the general state and direction of the market, while offering suggestions and making a number of predictions across a range of issues. However, when it comes to fulfilling the headline and overall theme of last year’s report, “Transforming for growth,” efforts to significantly upgrade insurer efficiency, effectiveness, and capabilities remain very much a work in progress.

Consider the following recap of what we saw in our crystal ball a year ago:

- **New avenues for expansion:** Calling on the industry to go beyond sharing the proverbial pie to enlarging its size, we noted that a growing number of carriers would be taking on large books of annuity business in one fell swoop in the form of pension plans sold off by private employers, and we have seen an uptick in such transactions. We also reported that the establishment of private online health insurance exchanges, prompted by implementation of the Affordable Care Act, could set the stage for cross-selling of L&A and ancillary products, and that has indeed been taking place within the group market. However, the industry still has work to do in three areas we emphasized last year — targeting underserved markets, simplifying products, and launching new distribution platforms. We see these as continuing areas of emphasis.
- **Regulatory threats:** When the long-awaited Federal Insurance Office (FIO) report on state regulation finally came out just before we published our 2014 outlook, we reassured the industry that there was “no immediate threat to state supremacy” because most of the recommendations required Congressional action (which we said wasn’t likely in the current political environment) or called on the states to make changes themselves (which we noted FIO could not compel). Our assessment turned out to be well founded, as the

**Figure 1: 2014 Life & Annuity outlook scorecard**



Key:

- Turned out as expected
- Partially turned out as expected
- Did not turn out as expected or unresolved

Source: Deloitte Center for Financial Services analysis

FIO report generated far more media attention than actual regulation or legislation. Otherwise, we observed that L&A insurers needed to get used to operating in a state of perpetual limbo as regulators worked on major changes to capital and reserving standards as well as the use of their own captives for reinsurance. While there has been some progress in these areas, final rules and their application remain unresolved.

- **Talent transformation:** Here we spotlighted the industry's need to bolster its "people power" by launching more creative and flexible talent development programs. As rationale, we cited the pressing concern over how to compensate for the looming number of retirements in an aging insurer work force, while offsetting chronic shortages in critical skill sets such as tech and analytics. Although a number of carriers are at least starting to upgrade their core human resource systems, many have been slow to broadly revamp their traditional approaches to recruitment, retention, and cross-training, particularly in adding badly needed specialists, such as data scientists.
- **Tech to the rescue:** We emphasized the need for carriers to substantially upgrade their technology capabilities, and a number of major carriers are at least starting down that road, including efforts to enhance self-service, mobile, and communications tools for producers and policyholders. In addition, more L&A insurers are exploring predictive modeling applications for "likely to buy" marketing and "likely to qualify" underwriting. However, many carriers are still struggling to transition off more time-consuming paper forms and convert to electronic applications.

We also warned about the rise of cyber risks for data-rich insurers, which might have even been understated in light of the number of massive breaches among banking, retail, and even entertainment companies this past year. Carriers are typically aware of the exposure they face, both in terms of potential liability and harm to their reputation. But many should still take additional steps to prevent a systems breach and be prepared to respond decisively if a successful attack is launched.

- **Growth by acquisition:** We focused on the potential for carriers to compensate for rather anemic organic growth rates by adding scale, market reach, and capabilities via mergers and acquisitions (M&A). We told insurers to "brace for a more dynamic M&A market." But while there was at least one major acquisition of a US insurer by a foreign carrier, which by itself boosted overall deal value, transaction volume was actually down considerably in the first three quarters of 2014 compared to the same period a year earlier. Many carriers continued the trend of the past few years of allocating excess capital to boost shareholder value via stock buybacks and/or dividend payments rather than attempting potentially more problematic M&As.<sup>1</sup>

Looking ahead, the prospect of interest rates starting to rise by mid-2015 may spur more insurers to take the plunge and initiate a sale or acquisition to take advantage of currently favorable financing rates. In addition, while stock buybacks are likely to continue, some companies may reassess whether they still represent the best possible use of excess capital, as such an option has become a less efficient capital management alternative with the rise in the stock markets to near record levels in 2014.

In the end, while some of the issues we raised in last year's outlook have been slow to develop, those observations remain relevant and these trends should continue to evolve and shape the industry over the course of 2015 and beyond.



# Looking forward

## Fundamental shifts challenge traditional insurer business models

The L&A industry is long overdue for a wide-ranging reinvention. Many carriers have made adjustments in the types of policies and features they offer, but have steered clear of more fundamental changes in how they connect with prospects, communicate their value, and distribute their products and services. The result has been sluggish sales overall each year and shrinking market penetration.

For the short-term, L&A carriers should have a more favorable environment for growth in the United States if, despite occasional turbulence in equity markets, the US economic recovery maintains and even accelerates its momentum through 2015 and the Federal Reserve finally starts raising interest rates in the second half of the year.

Real GDP growth is predicted to rebound to 3.5 percent in 2015 and 4.2 percent the year after under the most likely scenario laid out in Deloitte's "US Economic Forecast."<sup>2</sup> Both net household wealth and real disposable personal income are expected to increase as well over the next two years.<sup>3</sup> When combined with a falling unemployment rate,<sup>4</sup> there should be improving conditions for sales of life insurance and annuity products.

However, L&A carriers should not be solely relying on the rising tide of an improving economy to lift all boats. Over the next few years, insurers will likely have to adapt to fundamental sea changes underway that are threatening to upend their business models and distribution systems.

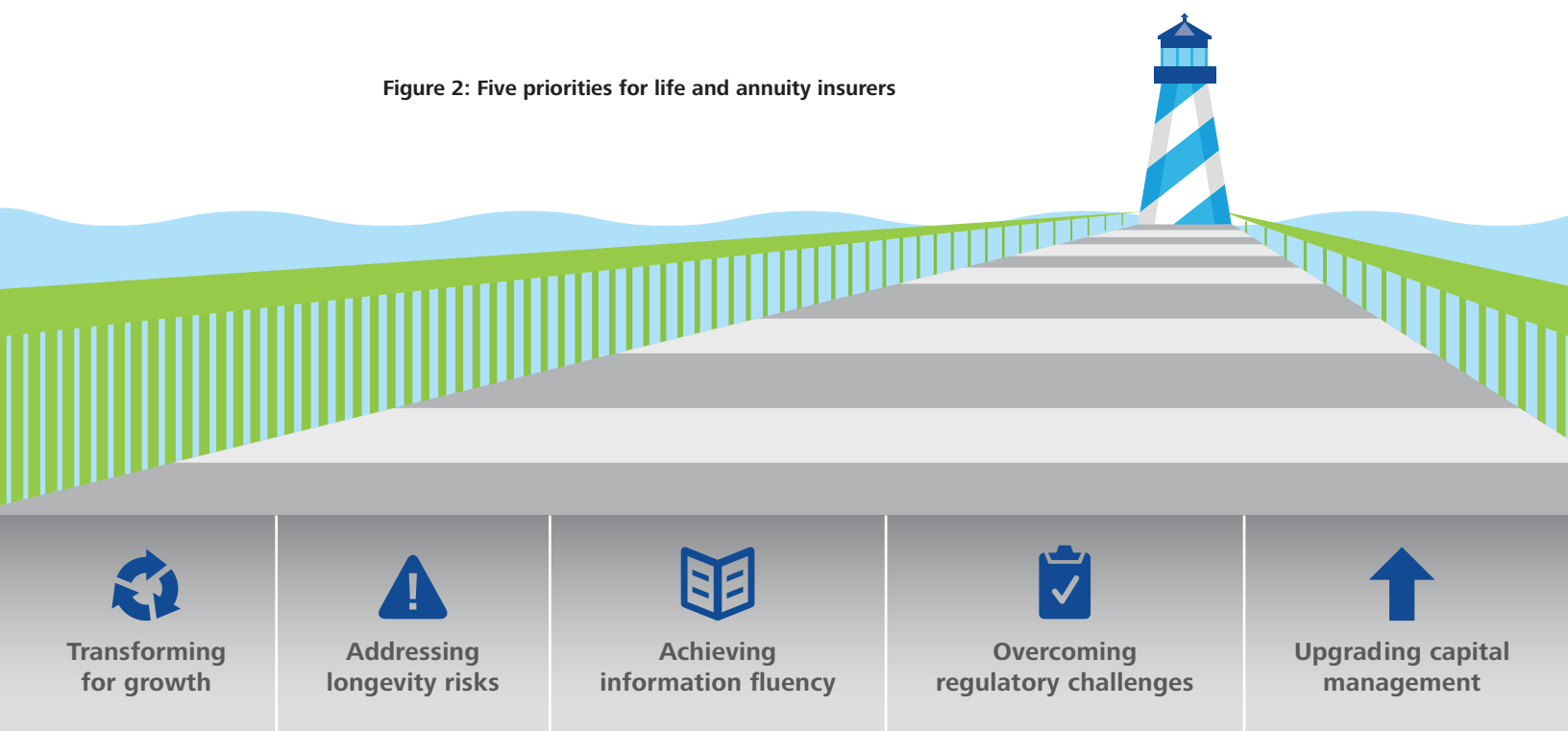
### Longer-term considerations

In this year's outlook, we're encouraging insurers to look beyond the short-term ups and downs of their own particular markets and the economy as a whole to consider the bigger picture. We focus on five pillars for long-term success that should rank high on insurer strategic agendas.

The agility with which carriers take on these challenges and convert them into opportunities for growth and performance enhancement will potentially determine which companies are most effectively positioned to lead the industry. They are:

- **Transforming for growth:** With low rates of life insurance ownership and complex annuity options still a mystery for many prospects, experimentation and innovation is called for in terms of insurers engineering products that are more consumer friendly, improving methods of attracting and engaging clients through traditional as well as new channels, as well as more effectively communicating the value proposition they offer.
- **Addressing longevity risks:** Given the aging US population, improved health care, and lengthening lifespans, helping consumers generate sufficient savings and income for retirement could turn out to be the biggest growth opportunity for L&A carriers. However, because of the long-tail nature of the risk and the uncertainty of investment markets, figuring out how to profitably design and underwrite longevity-related policies could also be their most formidable challenge. Carriers that have already made long-term commitments to policyholders may be prompted to modify the terms of their contracts or increase their investment returns to fulfill the terms of their policies. Enhanced creativity, risk management, and consumer communications will likely be key capabilities in serving this expanding market.

Figure 2: Five priorities for life and annuity insurers



- **Achieving information fluency:** Many insurers are not positioned to fully leverage the vast amount of data they already have, let alone the new sources of information and real-time analysis at their disposal. A new data management infrastructure and governance architecture should help many carriers break free of outdated, siloed systems, while turning data into both a strategic asset and a competitive advantage. The scope of these efforts should encompass client-targeting through service and supplemental sales. At the same time, carriers also should take additional steps to become more secure, vigilant, and resilient in the face of the rising threat of cyber attacks.
- **Overcoming regulatory challenges:** Insurers can rely on regulatory uncertainty as an ongoing way of life rather than a passing conundrum as multiple overseers — state, federal, and international — sort out new standards and launch probes of internal and external carrier practices. In addition, we see the potential for ongoing disputes and perhaps overlapping rules as regulators from different jurisdictions compete for supremacy. Meanwhile, even if

certain companies aren't technically subject to some new rules at first blush, they may be swept up into meeting these standards over time.

- **Upgrading capital management:** To start, insurers will probably need better frameworks and models to meet the increasing demands of stakeholders for more robust stress testing and scenario planning. Over time carriers will likely have to show an improved understanding of capital consumption among different products across insurance, asset management, and retirement planning to facilitate or justify capital deployment decisions and assess risk-adjusted returns. More effective capital management could also support growth needs, as insurers widen their product lines to meet evolving customer expectations.

The bottom line is that while macro- and microeconomic factors should continue to fluctuate and likely require ongoing adjustments, the five pillars explored in this outlook present tremendous opportunities to grow the business and make it more profitable and sustainable.

# Transforming for growth

## Insurers should rethink consumer approaches for more effective marketing and sales



Revenue growth continues to underperform, in large part due to the industry's lack of success in attracting new clients. The most recent life insurance market research by LIMRA found ownership of individual life insurance at its lowest level in a half-century at 44 percent of US households,<sup>5</sup> indicating a business model at risk of reaching the end of its useful life as it currently operates.

The good news is there is still plenty of room for L&A carriers to grow. However, to turn the tide and generate faster and more sustainable expansion, carriers should consider more innovative business models, policy designs, and marketing approaches to enhance and even replace those that have not evolved substantially to adapt to changing times. Rising to this challenge is becoming an imperative as digital-age consumers expect 24/7 access, more transparency, and greater ease of doing business.

Overcoming the general public's lack of awareness and understanding about the role and value of life insurance and annuities is a key component to improving penetration rates. Indeed, it's difficult to make a sale when 38 percent of those surveyed by Deloitte for its recent report, "Meeting the Retirement Challenge," said they didn't know anything about annuities or didn't understand how they worked. One quarter said the same about life insurance.<sup>6</sup>

However, awareness alone is unlikely to turn the tide. Carriers also will likely need to introduce a new generation of products and distribution options that resonate better and meet the evolving needs of the broader market.

### Focus for 2015

L&A insurers should think more creatively about how they market, design, and distribute their products, while becoming more customer-centric to excel in an increasingly technology-enabled, self-directed environment. A key component is to develop both precision around who the consumer is, and specificity with regard to their needs, while developing tailored, simplified, and perhaps more flexible niche products that correspond to those individual requirements. At the same time, customized delivery and service options should be offered that widen consumer choice while aligning with profitability expectations.

To lay the groundwork, carriers should rethink how they communicate with potential prospects. Too often, those outside the business, such as media financial pundits, are defining the industry's image and value, often to the detriment of insurers.

One way to change that may be for carriers to shift their emphasis from passive brand marketing to a proactive, informational campaign that more clearly explains the essential purposes and need for life insurance and annuities. The goal should be to create a more educated insurance consumer and thereby eventually shift the L&A market from products that have to be aggressively sold to those that are actively sought out by new buyers.

In the end, consumers of all segments and demographics expect greater choice these days with respect to how they want to engage and be served by any organization in any industry. Insurance is no exception, yet the L&A industry is behind the curve. Establishing more flexible and cost-effective business and operating models is table stakes for carriers not just to grow, but to survive in such a dynamic environment.

For example, more L&A carriers are likely to explore direct-to-consumer options, particularly to target younger, lower-income, and other underserved segments. While many will probably prefer to launch direct platforms on their own, some may choose to explore a partnership with an existing online advisory service or major Web-based retailers to leverage their existing technology platforms and online customer relationships.



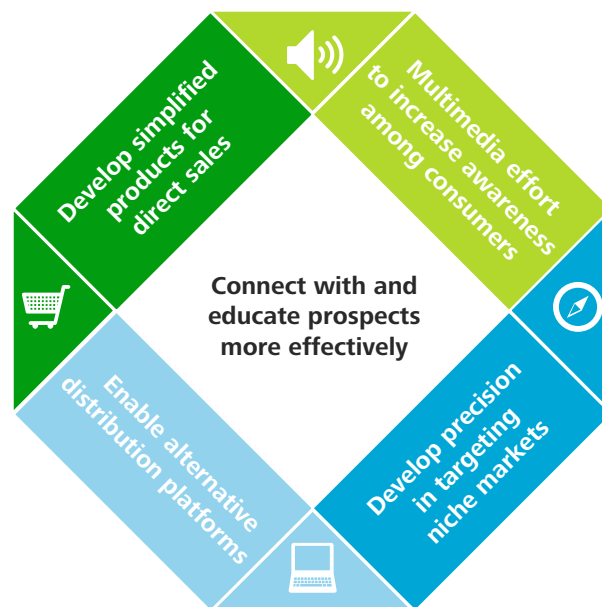
### The bottom line

Carriers should move more aggressively in 2015 to reassess their products, distribution platforms, communication options, and consumer outreach campaigns with the goal of connecting with and educating prospects more effectively.

Beyond specific actions such as product simplification or perhaps direct sales, L&A carriers should refocus marketing and advertising strategies to rebrand the business. Insurers should be portrayed not just as product sellers, but as a long-term partner on whom consumers can count to help them meet evolving financial needs over time.

Consider the example set by pharmaceutical makers, which in the 1990s started bypassing their intermediaries — doctors, hospitals, and health insurers — to take their message straight to the public. Rather than waiting passively for distributors to suggest medications to patients, pharmaceutical companies sought to generate demand at the source by better educating the public and prompting them to ask doctors for specific drugs. A similar effort might create more demand for L&A products as well.

Figure 3: Avenues for L&A growth



# Addressing longevity risk

## Aging population and new regulations expand opportunities for guaranteed lifetime income coverage



Life spans are being extended thanks to medical advances, and greater access to health insurance under the Affordable Care Act should bolster this trend. Fewer and fewer people are covered by defined benefit retirement plans, just as future benefits paid by Social Security may become increasingly uncertain given that current payments have already started to exceed contributions to the nation's biggest retirement program.<sup>7</sup>

As a result of this confluence of trends, consumers are increasingly worried about the possibility of outliving their assets. Half of those responding to Deloitte's "Retirement Challenge" survey said they have not saved enough to cover them through retirement. In fact, a sense of helplessness had set in among four in 10 respondents, who said: "I believe no matter how much I save, the returns I can expect on those investments will not be enough to provide me with sufficient retirement income."<sup>8</sup>

Given these concerns, and considering that roughly 10,000 Baby Boomers will turn 65 every day between now and 2030,<sup>9</sup> longevity risk could perhaps be the biggest growth opportunity for annuities carriers.

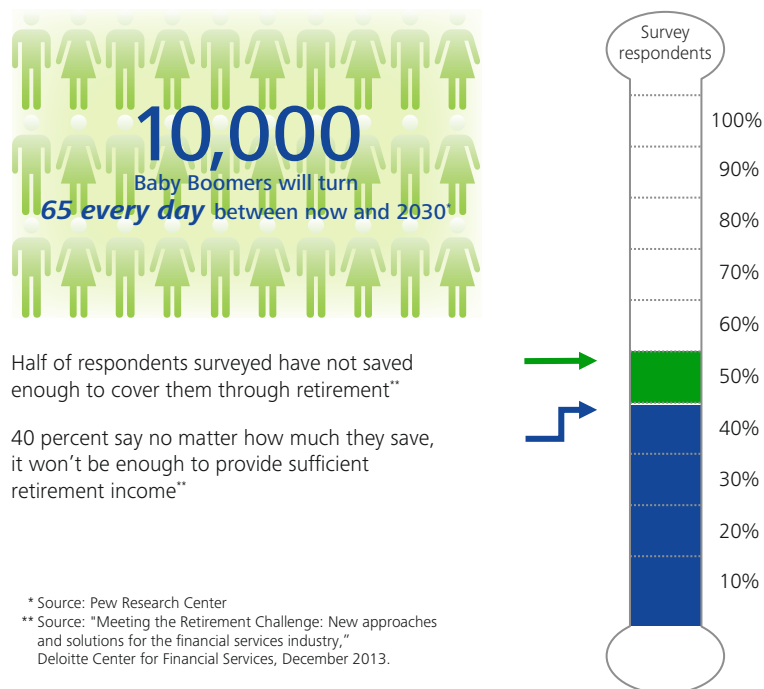
Some carriers have entered the market for longevity risk on a mass scale via pension risk-transfer deals, in which insurers take over defined benefit plans being run off by employers. This trend should continue for the next few years as more employers look to offload retirement obligations from their balance sheets.

Longer term, however, with the transition from defined benefit to defined contribution plans accelerating, the 401k system should provide a natural platform for longevity solution marketing, reaching prospects who are prime candidates for guaranteed lifetime income products.

Recent federal advisories should help facilitate the use of this channel for annuity sales. In July, the Internal Revenue Service (IRS) issued new rules allowing individuals to buy longevity annuities in both their 401k and Individual Retirement Accounts (IRAs). In October, the IRS put out a notice allowing employers to include annuities in target-date mutual funds that often serve as a default investment option in 401k plans. The Department of Labor followed up with a letter of its own confirming that possibility.<sup>10</sup>

"As boomers approach retirement and life expectancies increase, income annuities can be an important planning tool for a secure retirement," said J. Mark Iwry, Deputy Assistant Treasury Secretary for Retirement and Health Policy. "By encouraging the use of income annuities, [Treasury's] guidance can help retirees protect themselves from outliving their savings."<sup>11</sup>

**Figure 4: Longevity risk looming larger each day**



## Focus for 2015

Annuity carriers are in a prime position to better educate consumers about the need for reliable retirement income streams, as well as the potential for their products to meet that demand as part of a 401k or IRA distribution.

Ideally, 401k and IRA statements could routinely report not just how many total dollars are in an account, but show how this nest egg could be parlayed to generate a regular income over the long term, to plant the seeds for an annuity transaction.

Eventually, carriers and consumers alike might benefit from having a requirement in place that 401k and other defined contribution plans offer a lifetime income option — with annuities being a natural product to offer such longevity coverage — but that would require additional changes in current regulations.

However, while opportunities for growth in this market are expanding, the challenge remains as to how carriers will be able to fulfill their longevity income commitments and still remain profitable.

Insurers that have previously sold products such as variable annuities with living benefit riders might find that they were underpriced for the investment risk assumed. Several have tried to limit their potential losses by offering buyouts to consumers, providing increased cash value today in exchange for a waiver of the policy's increasing future value benefit. If too few policyholders take carriers up on such an offer, insurers might consider selling that book of business to at least lock in a definitive loss. As an alternative, they could go in the opposite direction and increase their bet on mortality exposure, but at more favorable terms to the insurer to offset any potential future losses on older business.

More recently, annuities carriers in the longevity market have reduced contractual benefits and increased associated fees in their newer products to reduce their potential exposure.

## The bottom line

The demand for longevity coverage is likely to soar given demographic and macroeconomic trends, while the ability of annuity providers to capitalize on that need should be enhanced by recent regulatory changes encouraging the product's inclusion in individual retirement plans.

However, carriers going after this market segment should carefully consider how they design, model, and distribute such products to meet economic targets and reduce downside risk over the long term. They should also stay engaged with the customer to manage their expectations and product features as mortality trends play out, rather than just treat longevity policies as a one-time product sale and hope their assumptions turn out to be profitable.

Insurers could perhaps craft more hybrid products that account for a wider variety of senior citizen needs, such as combining life insurance, retirement income, and long-term care coverage in a single policy, while limiting longevity exposure by capping lifetime income benefits. The development of such multipurpose policies could be driven by longevity trends that might make stand-alone life insurance policies less attractive if life spans continue to steadily increase, as expected.

# Achieving information fluency

## More integrated, accessible data management systems can differentiate carriers



Data is the lifeblood of L&A insurers — more so as the availability, variety, and velocity of information continue to increase. Yet the full value of data is rarely optimized by insurers because information often remains isolated in siloed, legacy technology systems and operating structures. So, while carriers may be information rich, many remain to a large extent knowledge poor.

The objective should be to develop information management capabilities so as to better understand consumer behaviors and preferences, support more effective design and distribution of products, and deal more adeptly with evolving regulatory requirements. Indeed, “information fluency” is a foundational element of efficient compliance reporting and effective enterprise risk management.

While some carriers have taken steps to improve data fluency by making information more easily accessible and translatable across the enterprise, many continue to struggle to get the return on investments they seek. Insurers could find themselves at a distinct disadvantage if they pursue a slow, continuous improvement path instead of taking a more transformative approach to make information management a differentiator and a competitive strength.

**Figure 5: Turning data into a strategic asset**



## Focus for 2015

Insurers are increasingly looking to leverage data as a strategic asset across the company for enhanced business performance and compliance capabilities, but the technological, organizational, and operational obstacles to achieve fluency across lines and functions can be formidable. To date, few are equipped to harvest and harness data to its fullest value.

The need to improve enterprise-wide information management is likely to become more prominent in 2015. More and more carriers will likely begin to strategically transform the way they amass, store, define, govern, analyze, and disseminate information to meet internal demands for enriched insights into the behaviors and needs of customers and stakeholders.

On the flip side, insurers' increasing digitization of marketing, sales, and communication raises the vulnerability level of their proprietary information to cyber-hacking risk. At the same time, pressure is also growing for insurers to contend with ever-more daunting challenges to protect consumer-data privacy and security, especially as the use of non-traditional information sources proliferates. This task is even more formidable for carriers with global footprints, which need to establish data management systems that comply with local privacy and security laws.

## The bottom line

Data management has become more of an ongoing journey rather than a final destination, as internal systems need to be constantly reassessed and revamped to process new types of information from additional sources, while better capitalizing on data already in their various systems.

Insurers that are anxious about initiating a comprehensive information fluency strategy across their organizations could implement such a project over multiple stages, while establishing short-, medium-, and long-term objectives with definitive milestones.

Strong executive buy-in, robust change management programs, and dedicated data champions should be the foundation of information management initiatives. Through an effectively communicated shared vision and commitment to collaboration and change, both at the top of the organization and across its ranks, information can be shared and leveraged over multiple business units, functions, and geographies.

The potential payoff for such an investment is significant: improved market competitiveness, better customer relations, added responsiveness and reliability in compliance reporting, more insightful enterprise risk management and decision-making, as well as enhanced business growth and a better bottom line.

Those carriers that achieve information fluency will likely have a competitive advantage in their ability to more nimbly react to the evolving needs and demands of consumers, regulators, and intermediaries.



# Overcoming regulatory challenges

## Prepare for some major changes, as well as ongoing uncertainty



While uncertainty remains the norm when it comes to assessing the regulatory outlook for L&A insurers in 2015, the crystal ball is becoming slightly less cloudy, at least as a directional prognosticator.

On group capital standards, for example, it is increasingly obvious that the threshold question — should there be group capital standards? — has been resolved, and not in favor of the US status quo. US regulation is legal entity-based, so both industry officials and domestic regulators have been voicing opposition to group capital standards. However, as group capital regulation gains currency internationally, US insurers operating in other jurisdictions will have to comply with group capital requirements. US regulators and industry officials are working to develop standards suitable for the US market that may help provide a safe harbor for domestic carriers.

While the details of new standards and regulations are still being developed, one commonality is the need for timelier, more accurate, more relevant information to respond to regulators, to demonstrate policyholder protection, and to substantiate solvency standing. That may mean increased costs in the short run, but could also translate into more efficient management long term if the right structure is used and the correct tools properly deployed.

On a related front, a host of tax issues may share the spotlight for L&A insurers in 2015, including the regulation of affiliated captives, the potential elimination of the interest deduction related to the purchase of company-owned life insurance, a modification of the deferred acquisition costs rule (which should mean essentially more capitalization), and a new method of computing the separate account dividend-received deduction that would reduce the benefit.

On the plus side, the IRS released a directive on variable annuity contracts, addressing when to take deductions related to hedging and to the actual product. This could be considered a beneficial ruling as it may allow companies to take significant losses earlier.

### Focus for 2015

This looks to be an active year on the compliance front as insurers adapt to a host of regulatory changes.

For one, 2015 will see the first Own Risk and Solvency Assessment (ORSA) summary filing. ORSA reflects the new wave of insurance regulation, where static examinations conducted every five years are replaced by an ongoing dialogue between regulators and the regulated, engineered on a framework of real-time, in-depth, customized, relevant information.

Increased consumer protection activity is likely to continue, as witnessed most recently in New York State's investigation into indexed universal life sales practices. This may affect insurers that need to adjust policy design, product mix, or processes in response to economic conditions and regulatory changes.

Group supervision is likely to undergo further strengthening. Model acts covering corporate governance and holding company supervision will either be in the National Association of Insurance Commissioners (NAIC) approval process and/or put before state legislatures for adoption. Supervisory colleges — designed to facilitate oversight of internationally active insurance companies at the group level — will likely grow in importance, increasing demand on compliance staff.

Perhaps nowhere will the challenge to L&A insurers be more evident than with capital standards. The regulatory structures at the federal level remain formative. Internationally, Solvency II-influenced regulation seems to have gained dominance. All this leads to greater opportunities for friction with state regulators, and a toughening regulatory climate that may manifest in greater restrictions on capital.

The few carriers designated as global systemically important insurers will be the first directly affected by the upcoming wave of capital standards, with the Basic Capital Requirement (BCR) adopted by the International

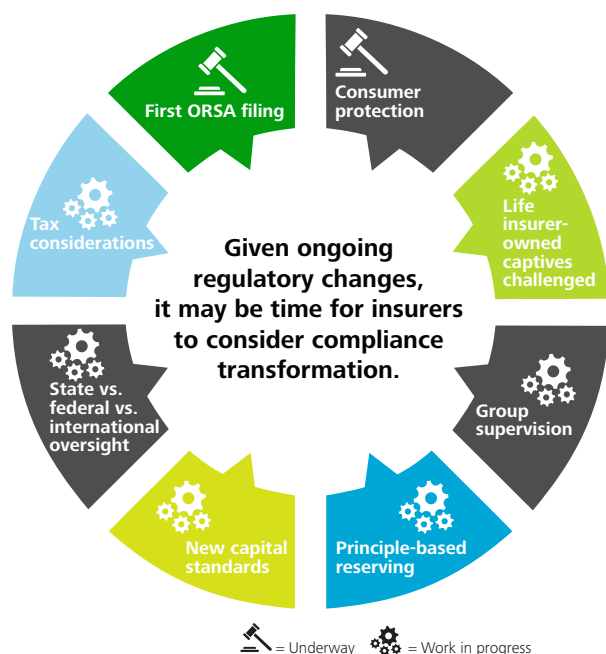
Association of Insurance Supervisors (IAIS) in October. The BCR will be reported on a confidential basis to group-wide supervisors and shared with the IAIS beginning in 2015. Also in 2015, work will likely accelerate on other capital standards, including those for internationally active insurance groups.

The NAIC, which is working with the FIO and the Federal Reserve to support a US standard, unveiled its own capital framework. Of the two options proposed, one is RBC-plus-based, while the other uses an accounting agnostic cash-flow testing approach. The valuation method selected for capital standards could have significant repercussions for life insurers, whose long-tail claims may not match up well with the volatility that could be introduced by market-based valuation.

One positive for insurers at year-end 2014 was the Congressional adoption of a clarification to the Collins Amendment to Dodd-Frank. This reduces capital concerns by allowing the Federal Reserve discretion in setting capital requirements for systemically important financial institutions that are also regulated by state insurance regulators. In addition, it prohibits the Federal Reserve from requiring insurers using only statutory accounting principles to use generally accepted accounting principles.

Even purely within the United States, regulatory pressure driven in whole or in part by non-state actors will likely have an effect. Principle-based reserving (PBR) may be the NAIC's number one priority, but loud resistance by some influential state regulators, consumer advocates, and the FIO may slow its acceptance by state legislators, and thus defer any capital relief PBR might have been expected to provide.

**Figure 6: L&A regulatory hot spots**



The regulation of life insurer-owned captives may also be expected to increase compliance and capital costs for carriers that go that route. While the NAIC has adopted the framework suggested in the Rector Report on treatment of captive reinsurance transactions, New York remains firmly opposed. The FIO echoed New York's objection in its September 2014 annual report.

In its November 2014 report to Congress on systemic risks, Treasury's Office of Financial Research called "the migration of financial activities toward opaque and less resilient corners of the financial system" one of the three most important, increasing risks to financial stability. The report cited this use of captives as one example "of migration and innovation that may require monitoring for their potential to pose financial stability risks."<sup>12</sup>

The captive issue may have tax implications as well. The IRS is examining whether there is actual risk transfer to affiliated captives, which is required to qualify for tax deductions, as well as the issue of possible excessive premiums being charged by such captives.

Affiliated captives are also once again targeted on a federal level with H.R.2054. Rep. Richard Neal, D-Mass., the bill's sponsor and ranking member of the House Ways and Means Select Revenue Subcommittee, said his proposal "effectively defers any deduction for premiums paid to foreign affiliated insurance companies if the premium is not subject to US tax." The legislation is primarily aimed at affiliated reinsurers operating in jurisdictions such as Bermuda and the Cayman Islands.

### **The bottom line**

The pace of regulatory evolution is unlikely to slacken soon, so it may be time for insurers to consider the process of compliance transformation. This may include enterprise-wide aggregation of core regulatory change activities, the creation of a coordinated response for foreseeable regulations, and the utilization of scenario planning techniques for the unknowns, along with the formation of rapid response teams. Such a revision may help the ongoing process of planning for change and create differentiating value from mandatory regulatory exercises.

In addition, we expect the bar to continue to be raised as state, federal, and international regulators battle for supremacy in terms of which standards and regimes must be followed. Even if certain companies aren't technically subject to new regulations at first, they may very well get swept up in having to meet these higher standards over time.

In any case, carriers should expect ongoing regulatory uncertainty as the various regulatory authorities jockey for position and debate whose set of rules the industry must ultimately follow.

# Upgrading capital management

## Insurers look to integrate internal, external capital frameworks for more effective decision-making



The challenge of satisfying the diverse interests of a wide variety of stakeholders, both internal and external, has often induced insurers to employ more than one approach to capital management — at times seeming to operate independently of one another — to cover the economic, accounting, and regulatory aspects of their businesses.

In an effort to better assess the return potential offered by various businesses, many insurers have developed some form of internal framework based on the economic capital approach, defined by in-house assessments of the amount of capital needed to sufficiently cover all major business risks. These range from primary factors, such as insurance, market, operational, and liquidity risks (which are more quantifiable and can be mitigated to a certain extent) to secondary factors, such as strategic, modeling, and reputational risks (which are less quantifiable and generally considered more difficult to mitigate).

However, insurers have often tended to use internal capital frameworks on a limited basis, such as allocating capital notionally to business units for the purpose of performance benchmarks, rather than utilizing them for day-to-day operational decision-making, potentially causing disconnects with pricing and risk management functions and limiting their efficacy.

In addition to managing capital utilization internally, insurers also have to be constantly cognizant of external capital frameworks mandated by regulators and those advocated by rating agencies. Regulators have imposed a variety of statutory capital requirements on carriers designed to protect consumer interests under different scenarios. Likewise, rating agencies as well as analysts tracking listed insurance companies use proprietary capital models to evaluate an insurer's financial strength and stability, along with its preparedness to withstand varied stress situations.

Several regulatory enhancements — including the NAIC's Own Risk and Solvency Assessment, the federal systemically important financial institution designation, state enterprise risk management standards, and continuing influence from international developments such as Solvency II and IAIS's

global capital standards — are pushing carriers to embrace a more rigorous and holistic process. This includes the formal approval of annual capital sources, stress testing, formalizing risk appetite and risk tolerance statements, as well as robust reporting tied to risk-adjusted capital.

Rating agency capital frameworks have also undergone changes, with an increasing trend of agencies viewing capital on a "look-through" basis that does not give as much credit for on- or off-shore captive/reinsurance solutions or structures in their assessment of capital adequacy.

Such changes in external capital standards are prompting insurers to embrace processes that enhance collaboration among capital management and associated functions, while also pushing them to reassess the way they incorporate external frameworks in their operations.

As investment yields continue to languish in this low interest rate environment, L&A insurers have had to review the return potential and pricing of most of their products, especially for those that are more capital-intensive (such as annuities), underscoring the need for carriers to reexamine their capital management approach.

Finally, advancements in technology — ranging from analytics to modeling to information management — have made projection of capital requirements and understanding of the intersection of different capital frameworks more manageable and efficient.

These converging factors spotlight the need for a more robust internal risk-adjusted capital framework that incorporates different approaches, including economic, accounting, and regulatory capital management, while at the same time providing clarity to other functions within the company on how capital is deployed and measured.

### Focus for 2015

A growing number of insurers will likely look to follow the lead of other institutions in the financial services industry, such as banks, by implementing an internal risk-adjusted capital adequacy framework that accounts for economic as well as regulatory factors under one integrated capital management system.

Having a combined view of capital should enable insurers to conduct a thorough bottom-up analysis of their risks by product line and risk type, and apply the approach that is most meaningful for mitigating the particular exposures to each, leading to more transparency and consistency in pricing and underwriting.

At the same time, an integrated framework allows those in capital management — both directly and indirectly through related functions such as pricing and asset liability management (ALM) — to better collaborate with other core functions including actuarial, corporate planning, and investment management, with a clearer appreciation of the impact their individual strategies might have on one another.

Such a strategy should also help insurers to better understand the capital consumed by different business units, including core insurance and annuity products, asset management, retirement products, and any affiliated banking operations. This would enhance the return on risk-adjusted capital assessment by insurers, allowing them to more effectively differentiate between businesses that generate high levels of absolute profits but consume more than a commensurate capital requirement and those that seemingly deliver low gross profits but can provide higher risk-adjusted returns.

The strengthening of such capabilities should help carriers better assess the effect of product design as well as pricing on enterprise risks and the capital required to back them under different scenarios. This should also facilitate the engineering of products that are better aligned with the strategy that articulates how the firm balances policyholder capital needs with return on equity targets.

In addition, companies that are looking to commit capital to large initiatives such as mergers and acquisitions, technology investments, distributions deals, product or geographic expansion, or similar significant moves should be able to make more informed decisions based on this approach.

Implementing an integrated capital framework would require a multipronged effort, including improved information management and advanced analytics, more holistic capital management processes, and a governance mechanism that enables a more granular, real-time assessment of capital deployed.

Carriers should also take a fresh look at how to better integrate capital and risk management with their particular operating model and strategic decision-making process.



### The bottom line

Driven by regulatory pressures, institutions in the banking sector are ahead of many insurers in terms of creating sophisticated capital models that allow them to analyze risk-adjusted returns at a granular level and effectively utilize such data in making operational and strategic decisions. But many insurers are looking to catch up by adopting a similarly holistic approach to capital management.

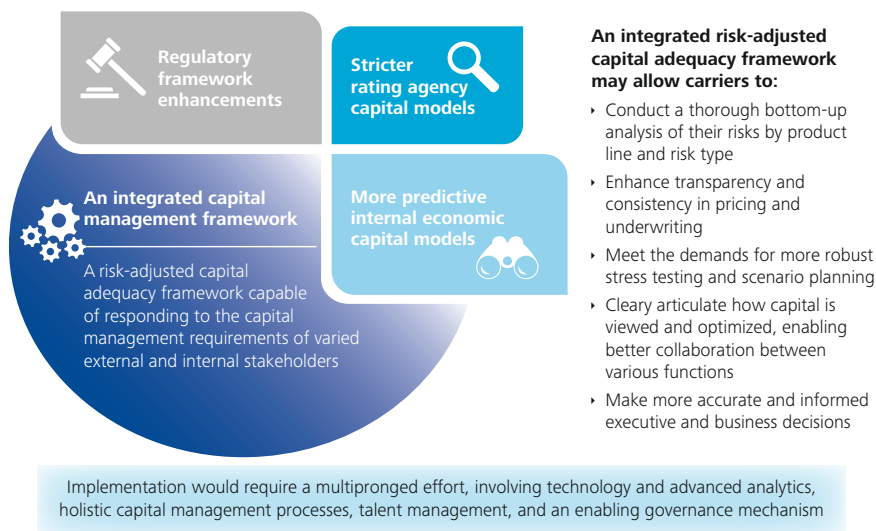
Insurers that invest in a more integrated internal capital framework, in conjunction with an enabling mechanism that effectively integrates people, process, technology, and governance, can expect greater clarity for internal as well as external stakeholders.

Internally, product development, treasury, investments, ALM, and other related functions can operate more effectively with a clearer articulation of how capital is viewed and optimized. Externally, the differences among various accounting and capital bases can be more effectively explained, with the firm's view and objectives — rather than external benchmarks — driving stakeholder communications.

Such an integrated capital management framework could form a strong base for meeting the increasing demands of a variety of stakeholders for more robust stress testing and scenario planning, while facilitating more accurate long-term executive decisions and enhancing product pricing, reinsurance strategies, and other day-to-day operational business decisions.

Figure 7: Capital management transformation

Insurers look to integrate internal, external capital frameworks for more effective decision-making



# Next steps

## Where do insurers go from here?



The five pillars we've covered in this outlook are often tackled by insurers in isolation — the result of a silo mentality all too prevalent in the industry that has hindered operating efficiency and hampered growth potential.



In fact, these pillars are interconnected and should be addressed as part of a multipronged effort to reshape an insurer's business model to remain competitive and stay ahead of the curve in a rapidly evolving market.



While the exact methods of adaptation are subject to debate, what's clear is that the world is changing in ways that require a different focus from the industry, emphasizing products and services that are more flexible, easily customized, and consumer-driven to satisfy a widening range of needs and expectations.



In essence everything we've discussed revolves around enhancing existing capabilities and adding new ones to drive healthy, sustainable growth, while producing more satisfactory returns for shareholders at publicly held carriers and better dividends for mutual policy owners.

To accomplish this, insurers should reexamine the way they do business internally and externally through a transformative lens — one that's wide enough to allow them to synchronize and coordinate their efforts across the organization.

# Endnotes

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