

2012 outlook

Global Insurance Center



US life insurance industry outlook

Laying groundwork for future growth

Market summary

Life insurers in the United States face a conundrum as they head into 2012—managing both capital and risk in an economically and politically uncertain year, while continuing to lay the groundwork for future growth. The uncertain economic climate, compounded by ongoing concerns over US debt, continues to put pressure on life insurer ratings and capital levels.

Factors intensifying this pressure include:

- ▶ Low interest rates raising concerns over spread compression
- ▶ Volatile equity markets increasing hedging costs and reserve requirements
- ▶ Impacts of the unfolding euro zone financial crisis – particularly for multinationals
- ▶ Insistent investors wanting higher returns
- ▶ The changing regulatory environment

With these factors as a backdrop, management will need to maintain current credit ratings and capital levels in 2012, while simultaneously trying to improve earnings. However, the latter may prove potentially difficult through organic growth strategies. Continued unemployment creates competition for consumer's dwindling financial resources, which may affect new life insurance sales. Additionally, retirement account assets are still recovering from losses suffered in 2008, delaying further development of the retirement income market. Although variable annuity sales increased in the first half of 2011, the return of volatility in the second half has darkened the outlook for 2012. Potential regulatory changes also may challenge some insurers if capital requirements and distribution models are disrupted, as expected.

Consequently, US life insurers may need to improve earnings through such nonorganic means as an opportunistic acquisition, while building the foundation for organic growth after 2012. Nevertheless, larger and well-capitalized insurers may explore options outside the US for both organic growth and strategic acquisitions, although some foreign markets are becoming less attractive due to increased competition and their own changing economic circumstances. Multinationals with operations in the US may continue to feel ongoing impacts from the euro-zone crisis, and there could be secondary effects for US-based insurers as well.

Given these political, economic and regulatory qualms confronting the market, five broad themes are emerging to command management's focus in 2012:

1. Manage the company for the current low interest rate environment
2. Prepare for the impact of accounting and regulatory convergence
3. Invest in customer analytic tools to drive efficiency and improve risk management
4. Monitor developments in life insurance taxation
5. Embrace the Internet

With a presidential election looming in November 2012, insurers will confront a potentially deadlocked political climate during the year, possibly slowing down key regulatory changes. At the same time, efforts toward the convergence of accounting regulations and technical standards may decelerate, due to their complexity and impact on insurers and the need for further analysis in the uncertain economy. Looking ahead, life insurers may be challenged by efforts in Congress to reform the federal tax code, with implications for both corporate-level industry taxes and policyholder taxes.

Manage the company for the current low interest rate environment

In August 2011, the Federal Open Market Committee (FOMC) made an unprecedented announcement, locking in a low-interest rate environment until 2013. It has been a challenge for life insurers to manage through nearly two years of guaranteed low-interest rates at the short end of the yield curve. After the "official" end to the recession was announced, many insurers had hoped for a return to normalcy for rates. Adding to their dismay was the Federal Reserve's announcement in September 2011 of "Operation Twist," a stimulus plan aimed at lowering long-term interest rates further.

The relatively low-interest rate environment increases the risk of spread compression for existing products. At the same time, efforts to increase the sales of fixed annuities and universal life insurance are hampered by low crediting rates. This led some insurers earlier in the decade to chase yield at the cost of assuming greater risk, resulting in both realized and unrealized losses during the credit crisis of 2008. They may shy away now from taking on more risk, wishing to avoid replaying the events of that tumultuous time. Yet, simpler approaches to improving results, such as increasing the asset portfolio duration of the General Account, may achieve the desired intent, softening the FOMC's proposed actions.

A more sophisticated approach to interest rate and market risks to possibly protect an insurer's surplus position and simultaneously promote growth, is to improve the asset and

liability matching and management process, which can reduce variability in surplus and prepare for possible future interest rate changes. While interest rates are likely to remain low through 2013, they could climb rapidly after the current actions of the Federal Reserve come to an end. In such a situation, disintermediation risk can be a concern, as policyholders may lapse existing policies in favor of investing in new policies with higher credited rates. Understanding the interaction of the asset and liability cash flows under a variety of scenarios will help prepare insurers to weather these uncertain financial times.

New asset classes and more complex financial instruments also may assist in improving financial results. To avoid the dangers seen in the recent financial crisis, insurers need to more fully comprehend the structure and safeguards among these assets. Utilizing a variety of stress scenarios to understand counterparty risks, correlations in credit risk, capital requirements and cash flows can help insurers better evaluate investment opportunities. Looking through the lens of risk-adjusted returns can give confidence as to whether or not the insurer is receiving a sufficient return for the asset risks being absorbed.

Prepare for the impact of accounting and regulatory convergence

Regulatory uncertainty more than likely will persist through 2012, given the present contentious reform efforts and attempts by competing interests to converge systems in divergent directions. Changes are being implemented at all regulatory levels, and navigating these changes will yield challenges as well as opportunities for insurers.

Although the Dodd-Frank legislation has passed its first anniversary, many key rules have yet to be formalized, several of which are expected to have an impact on insurers. Already, the Federal Insurance Office (FIO) has been established, and its mandate covers a wide variety of topics, from expanding access to insurance coverage for under-served populations to considering how (or if) insurers contribute to systemic

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risk. Challenging the traditional sphere of the National Association of Insurance Commissioners (NAIC) and its respective state departments of insurance, the FIO may create a federal supervisor of insurance on top of existing state-based regulation of the industry.

One area where the FIO may come into contention with the NAIC involves Solvency II, which is slated to become effective in January 2014. The issue is over "equivalency" for US insurance regulation. In its Solvency Modernization Initiative, the NAIC has endeavored toward a standard that conforms to Solvency II principles, albeit with one possible exception – national-level insurance supervision. The NAIC itself does not have supervisory power, and Solvency II equivalence is based on the existence of a national supervisory body.

Should the US not have a regulatory system that is recognized as equivalent when Solvency II goes in effect, a variety of issues will arise for both US subsidiaries of European insurers and US insurers with business in Europe. For instance, insurers may need to restructure operations. Merger and acquisition opportunities may arise if European insurers decide the capital requirements for US operations are too high, assuming they have to hold the amounts as required by Solvency II. With regard to equivalency status for the US, potentially affected companies may want to prepare strategies for either possibility.

Leaving equivalency aside for the moment, both the NAIC Solvency Modernization Initiative and the EU's Solvency II require companies to develop a full understanding of their material risk profile. Under this principle, management must understand the models used for calculating required risk capital and use these models in their decision-making. This will require a robust vetting of the models, as well as more thorough communication of the risks to stakeholders. Insurers should leverage these regulatory changes to improve their business decisions, acquiring a better understanding of their risk profiles, while optimizing performance against assumed risks.

In addition to global regulatory developments on a macro-economic scale, insurers may

also want to consider specific regulatory changes at the micro-economic level, which may be leveraged to optimize performance. Specific developments in valuation changes may pose an impact for certain product types, among them universal life with secondary guarantees and indexed annuities with guaranteed living benefits. In principles-based approaches to capital and reserving, some products and product features may have smaller requirements in capital and reserves, while others may have greater requirements. Insurers will need to adapt their product features and pricing to these new approaches, repositioning certain products to take advantage of this new environment.

At the micro level, expectations are for increased competition among some US states deriving from their respective regulatory environments. Some states, for instance, have actively attracted insurers to form captive reinsurers within their borders. Consequently, insurers may want to consider both international and national regulatory differences insofar as adjusting their corporate structure and capital allocation priorities to capture regulatory arbitrage opportunities.

While insurance accounting standards may eventually converge globally, we anticipate deliberation and slow movement with the Financial Accounting Standards Board (FASB) and International Accounting Standards Board. It is quite likely that we will see a FASB Exposure Draft in the summer of 2012, and industry debate thereafter. However, understanding the effects of the proposals remains critical to insurers if they want to shape the discussions and eventually gain competitive advantage.

Invest in customer analytic tools to drive efficiency and improve risk management

Analytical and predictive modeling techniques continue to improve, creating opportunities for increased sales, improved efficiency and expanded capabilities.

Life insurers are looking to use predictive modeling to improve their underwriting speed and accuracy. Traditional life

underwriting requires a broad array of medical tests and is both time-consuming and expensive. The delay between application and acceptance reduces the number of policies that ultimately are issued. Automated underwriting and straight-through processing are partial solutions to this delay, eliminating many manual and duplicative processes. Predictive modeling goes further, automating underwriting by applying business rules and tapping additional external information to effect underwriting decisions more quickly.

Predictive modeling has benefits beyond underwriting, as well. The information it produces on policyholder behavior can be used to target a marketing message to the individuals who are most likely to purchase the product. There is some history to this: banks have long aimed their products at people who have recently purchased a home, and producers of baby products are especially adept at putting advertising material in the hands of new parents. Insurers can learn from these experiences, targeting their life insurance information at a more precise and opportunistic time, when a person's life events create a need for a particular insurance solution. Combined with social media and other Internet strategies, predictive modeling can help reach out to new customers, such as the young and middle market consumer.

An insurer also can improve its back office through the use of predictive modeling. Given the extensive modeling of multiple scenarios required by the developing principles-based regulations, an insurer can improve its risk management processes by gaining insight into the range of outcomes that can occur in the current volatile environment. This information can then be used to prepare accordingly for the more-likely outcomes, while developing contingency plans for the less-likely outcomes. The proposed principles-based regulations require extensive data collection and modeling capabilities before a company can tap its own experience for regulatory purposes. Companies leveraging their own experience nonetheless can set reserves and capital levels that appropriately reflect their products, underwriting skill, mix of business and customer base.

Monitor developments in life insurance taxation

As we peer into the future, insurers may be challenged by efforts in Congress to reform the federal tax code. Possible implications exist for both corporate-level industry tax and policyholder tax issues. Budget deficits and taxation are serious concerns, yet they will be in flux because of the economic and political changes underway. The presidential and congressional elections in 2012, with the health of the economy as a central political issue, could set the stage for changes in the tax code, with significant repercussions for the life insurance industry.

As Congress grapples with budget deficits and how to make the tax code more pro-growth and competitive on the international stage, both political parties are focusing on "tax expenditures" as a way to finance deficit reduction and tax reform. Under the current tax system, the buildup of value in an annuity or a life insurance policy is not taxed until the policy is surrendered. Life insurance death benefits also are not taxable to the beneficiary. This inside buildup in life insurance and annuities, retirement savings, small life insurance company deductions and the tax treatment of life insurance company reserves are among the many items that are included in the "tax expenditures" under consideration. The Obama Administration's Deficit Reduction Package, recently recommended to the Super Committee of a dozen lawmakers working out a compromise on deficit reduction, calls for US\$1.5 trillion in increased revenue. In the package are the Administration's FY 2012 budget proposals (also proposed in previous budgets) and various propositions, such as modifying the dividends-received deduction for life insurance company separate accounts. The package also calls for eliminating corporate-owned life insurance (COLI), by expanding the pro rata unrelated interest disallowance for COLI. These politically charged issues will heat up in the months ahead.

Embrace the Internet

Some sectors readily lend themselves to transacting on the Internet. Brick and mortar stores like Best Buy, for instance, can capture additional sales online, while still driving in-store sales from customers who want a more personal interaction. Companies whose services are in high demand, such as television, radio and newspaper, also report high-transaction volume on the Internet. Then, of course, there are retailers like Amazon that only sell online.

Insurance companies, on the other hand, have historically operated via a very traditional sales model. An agent typically solicits information about a family's needs and presents both advice and products addressing these needs. An application is written at the home or office and the paperwork is sent to the insurance company, which then issues a policy. While other sectors have been nimble in adapting to the Internet and leveraging its opportunities, life insurance companies have lagged behind. Perhaps this is due to the nature of the sector's products and services, and the complexities and subjectivity of underwriting.

At present, the extent of life insurer presence on the Internet largely consists of financial calculators of insurance needs, sales lead-generating activity like educational materials and product information and proprietary Internet applications that support the sales force through online insurance application forms and illustrations.

The newest generation of insurance buyers is young, Internet savvy and transactionally self-sufficient. Such consumers have grown up in a "do it yourself" culture, and spend a significant portion of their time transacting online. While insurance in its current form does not lend itself well to Internet sales, life insurers can leverage the Internet to develop stronger ties to customers and build a better brand.

In the future, it will be possible for a consumer to submit applications to several insurers, receive competitive quotes, and be educated by Web-based information on the insurers, decide which insurer best suits his or her needs and wallet. Creating incentives for consumers to transact online, much in the way many airlines do, could guide lower premium options, versus purchasing insurance solely through an agent.

Social media also continues to play an ever-increasing role in our personal and professional lives and in our personal and business decisions. Most companies can now be followed on LinkedIn, Facebook and Twitter. We predict these and other similar sites present the next major opportunity for insurance company sales.

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EYG no. EG0075

1111-1306870 NY

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