CHANGE AGENDA

The changing face of the insurance industry

Insurance and tax 2015
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The changing face of the insurance industry and the impact on the tax department

I am looking forward to welcoming you at Pennyhill Park on 1 July 2015. Our agenda is focused on change - to our industry, our stakeholders, our capital and the tax environment. As an outcome, I would like us to have a shared, considered view of the future of the tax department.

To start our thinking, I have prepared a set of insights on global trends that are impacting insurance. I hope this will be an interesting and useful document to read in advance of our event, and that it will enrich our discussions.

As always, please do let me know if you would like to discuss this document in more detail before we meet in July.

Jeff Soar
European Insurance Tax Leader
We have identified six global megatrends that will impact our working world:

1. **Digital future**
2. **Entrepreneurship rising**
3. **Global marketplace**
4. **Urban world**
5. **Resourceful planet**
6. **Health reimagined**
The six global megatrends

Megatrend 1

Digital future

Fueled by the convergence of social, mobile, cloud, big data and a growing demand for anytime, anywhere access to information, technology is disrupting all areas of the business enterprise.

Enormous opportunities exist for enterprises to take advantage of connected devices enabled by the “Internet of Things” to capture vast amounts of information, enter new markets, transform existing products, and introduce new business and delivery models.

However, the evolution of the digital enterprise also presents significant challenges, including new competition, new communication channels, changing customer engagement and business models, unprecedented transparency, privacy concerns and cybersecurity threats.

Almost 80% of companies say their customers are changing how they access goods and services. More than 51% of these companies are changing their pricing and delivery models.

Source: Supply on demand: Adapting to change in consumption and delivery models, Economist Intelligence Unit, 2013.

Megatrend 2

Entrepreneurship rising

The growth and prosperity of all economies, rapid-growth and mature, remain highly dependent on entrepreneurial activity.

While some entrepreneurial activity around the world is still driven by necessity, “high-impact” entrepreneurship, once largely confined to mature markets, is now an essential driver of economic expansion in rapid-growth markets. In some cases, these high-impact entrepreneurs are building innovative and scalable enterprises that capitalize on local needs and serve as role models for new entrepreneurs.

The face of entrepreneurship is also changing – across the world, entrepreneurs are increasingly young and/or female. Many of these new enterprises are digital from birth. Access to funding remains the primary obstacle for entrepreneurs from all markets.

Megatrend 3

Global marketplace

Faster growth rates and favorable demographics in key rapid-growth markets will continue to be a feature of the next decade or so.

The gulf between “mature” and “rapid-growth” countries continues to shrink. A new tier of emerging nations, driven by their own nascent middle classes, will draw global attention. Innovation will increasingly take place in rapid-growth markets, with Asia surfacing as a major hub.

The economies of the world will remain highly interdependent through trade, investment and financial system linkages, driving the need for stronger global policy coordination among nations and resilient supply chains for companies operating in this environment.

China and India will become the world’s largest investors. By 2030, rapid-growth markets will account for 47% of gross global inflows, up from 23% in 2010.


Megatrend 4

Urban world

The number and scale of cities continue to grow across the globe – driven by rapid urbanization in emerging markets and continued urbanization in mature markets. The United Nations (UN) reports that 54% of the world’s population currently live in cities, and by 2050, this proportion will increase to 66%.

In order to harness the economic benefits of urbanization, policy-makers and the private sector must do effective planning and attract sustained investment in railroads, highways, bridges, ports, airports, water, power, energy, telecommunications and other types of infrastructure.

Effective policy responses to the challenges that cities face, including climate change and poverty, will be essential to making cities of the future competitive, sustainable and resilient.

The world’s 750 biggest cities account for 57% of global GDP. By 2030, they will contribute 61% of total world GDP – close to US$80t (in 2012 prices).

The six global megatrends

Megatrend 5
Resourceful planet

Absolute population growth, economic development and more middle-class consumers will drive increasing global demand for natural resources – both renewable and non-renewable.

While the world’s supply of non-renewable resources is technically finite, new technologies continue to impact the future supply picture by allowing access to formerly hard-to-reach and valuable oil, gas and strategic mineral reserves.

The application of new technologies, as well as the shifting supply environment, will drive business model adaptation and innovation in multiple sectors – as well as impact the geopolitical balance of power.

Increase in global energy demand by 2035. The majority of demand will come from China, India and the Middle East.


Megatrend 6
Health reimagined

Health care – which already accounts for 10% of global GDP – is embarking on a once-in-a-lifetime transformation.²

Health systems and players are under increasing cost pressure – driving them to seek more sustainable approaches, including incentives that emphasize value. These cost pressures are exacerbated by changing demographics, rising incomes in rapid-growth markets and an imminent chronic-disease epidemic.

An explosion in big data and mobile health technologies is enabling real-time information creation and analysis. Companies beyond health care as traditionally defined are entering the fray, providing new sources of competition and partnering.

More widely, the ageing population is a key trend. Social security systems and pension schemes are under pressure. Governmental systems are shifting responsibility into the private sector. Longevity and low interest rates remain a challenge regardless of this shift.

Noncommunicable diseases account for 75% of health care spending and will cause a loss of US$47t to world GDP by 2030.

The impact of these trends is already being felt in the insurance industry

Data analytics

The explosive growth in data provides insurance carriers with an increased level of information with which to generate insights into customer preferences and behaviors, individual risk patterns and greater insights into operational performance and risk levels across the organization.

Investing substantial amounts in gathering and analyzing information on the performance of the risks they place across class, line, product, geography and industry. Some brokers are already successfully monetizing this insight by providing it to insurers on a paid-for basis.

Competitive advantage will pass to the insurers and brokers who can most effectively communicate actionable insight from their new data and analytics techniques to underwriters, sales and operations teams. Value can only truly be driven by these front-line staff.

The increasingly digital world we face also provides new opportunities to expand beyond traditional sales and servicing channels, in some cases even blurring the lines between product and delivery. As the success of telematics in the personal motor market continues, insurers are now experimenting with new forms of usage-based insurance (for example, in workers’ compensation).

Insurance intermediaries are repositioning themselves as “analytical brokers,”
Small- and mid-market squeeze

From an insurance perspective, growth in this sector represents a significant opportunity for commercial P&C carriers worldwide.

As many of the world’s largest organizations turn to alternative risk transfer programs, due in part to the increased sophistication among risk managers and the impact of prior year hard market cycles, the demand for traditional commercial insurance products has declined. As a result, commercial carriers and brokers have been focusing on the SME marketplace as an avenue to generate top-line growth.

This creates a challenge in equal measure. As each “end” of the market — from specialty lines to personal lines — focuses on SME, the squeeze on this segment has become apparent. There is a strong need to commoditize a differentiated proposition in order to drive successful profitable growth - yet very few insurers and brokers have achieved this goal.

Overall climate for fostering entrepreneurship among the G20 in 2013

Countries ranked at the top were all mature markets.

Countries ranked at the top were rapid-growth markets.
The impact of these trends

Growth in new markets, using new sources of capital

While emerging economies have been an important contributor to insurance industry growth for the past several decades, their significance has recently accelerated.

The share of worldwide premium income concentrated among emerging market countries has grown from 12% in 2008 to 17% in 2013. Over this time period, premium income grew at a compound annual rate of 8.8% versus just 0.6% for mature markets.

Within Asia, China was the primary driver of emerging market growth, improving its global ranking from 6th in 2008 to 4th in 2012. In Latin America, Brazil rose from 17th in 2008 to 12th in 2013 and now accounts for nearly half of all premium generated in Latin America.3

Our European insurance clients tell us that the Middle East and Africa are becoming key targets for growth initiatives, in addition to the more traditional focus areas of Latin America and Asia.

A number of initiatives have recently been launched to further support the fledgling insurance industry in Africa, including the West African Insurance Association; Globus, a network of 30 African insurers; and the African Insurance Organization. While the market remains very small, several insurers have sought to jump-start the pace of growth with the introduction of micro-insurance and Takaful products. The recent acquisition of Gras Savoye by global broker Willis means that, for the first time, a major intermediary will have a wholly owned network across north and central Africa.

New capital continues to flow into the insurance market, driven by a desire for diversification by a range of capital providers from hedge funds to pension funds and sovereign wealth to Asian reinsurance. Whilst this new capital has softened premiums in some lines of business - particularly reinsurance - it nevertheless provides greater options for insurers to underwrite in new markets and new types of risk.
The impact of these trends

Changes to insurance distribution

In response to threats to their own business models, intermediaries are investing heavily in their own capabilities to remain relevant to their clients and to insurers. Their focus is moving towards better understanding and serving their clients as true risk advisors, rather than simply the gateway to the insurance market.

This means that intermediaries are:

- The driving force behind market investments into data analytics
- Generating more insight for their clients and the insurers with whom they trade, including benchmarks and advisory services
- Focusing on industry specialization
- Developing structured products that can be traded on a portfolio basis, whilst ensuring these offer preferential terms for their clients
- Investing in their own electronic trading capabilities

These are disruptive actions that intermediaries consider necessary to remain a fundamental part of the insurance value chain for commercial and specialty risk. Their impact on insurers will be significant, as the market moves towards a renewed emphasis of exclusivity and service and new capabilities are required.
Segmentation

In the future it will be even more important to distinguish between commodity retail products and bespoke insurance solutions for larger and more complex risk.

The insurance industry needs to clearly segment retail business and use digitalization and industrialization techniques in order to survive in this market. Commodity products will be sold through a digital channel or will be embedded in other products through greater use of affinity (e.g., car insurance as a part of the car you buy). For bespoke products the broker and IFA channel will continue to be the channels of choice.
The impact of these trends

New types and concentrations of risk

Concerns about the impact of climate change on the global insurance industry continue to grow as extreme weather events grow more frequent and severe from year to year.

In 2014, there were 980 natural catastrophe events worldwide resulting in more than US$31b in insurance claims. Recent studies suggest that the trend toward more severe weather appears to be worsening. Boston-based Karen Clark & Co., a hurricane modeling consulting firm, released a report indicating that global warming has the potential to increase peak hurricane wind speeds 2% to 5% over the next 20 years, resulting in a 30% to 40% increase in property insurance losses.

New severity of existing risk is combined with new types of risk that present substantial opportunity to insurers. The growth of the cyber-risk market, led by innovations amongst Lloyd’s Managing Agents and Brokers, is an example of this - as is agricultural and resource-related risk in developing markets.

Much of this cannot be modeled robustly, leading to downstream implications which are not yet fully understood. The impact of the Thai floods in 2011 is an important example of how previously unmodeled risk concentrations can have a dramatic effect on the insurance industry.

4 Munich Re, Insurance Information Institute
The impact of these trends

Transformation of private health insurance

Expenditures on health care currently exceed 12% of GDP across advanced economies, placing pressure on public programs and forcing governments around the world to seek alternative funding mechanisms.

Over the past 10 years, government expenditures on health care increased at a compound annual rate of 7.2% per year. More recently, from 2010 to 2013, this rate has slowed to 3.9% while the rate of private expenditures, including insurance and out-of-pocket costs, has grown 5.2%.

Private health insurance stands to gain from revenue growth, as consumers become more involved in the decisions involving the funding of their health care needs. Currently, health insurance premiums around the world are growing at a compound rate of around 4.5%, a rate that is expected to continue for at least the next 10 years.

At the same time, health insurers are facing rising claims costs and increasing pressure on underwriting. The incidence of chronic diseases, including diabetes and heart disease, is on the cusp of becoming an epidemic and is one of the biggest drivers of global health care spending, accounting for about 75% of costs.

For non-life insurers, the continued expansion of health care will increase the demand for property and liability insurance as well as other risk management products and services. A key challenge for the insurance industry will be how they will respond to the impact of provider consolidation. Higher levels of concentration will create a more sophisticated buyer group with greater access and resources to alternative risk programs including self-insurance, risk retention groups and captives.

Currently, health insurance premiums around the world are growing at a compound rate of around 4.5%, a rate that is expected to continue for at least the next 10 years.
Pensions and retirement systems may become more robust

Most countries and stakeholders have been struggling to varying degrees with the financial aspects of longevity and financial well-being during retirement.

In the aftermath of the global financial crisis, governments, public and private sector employers, and pension funds are reassessing their current solutions. As they build towards more robust pensions and retirement systems, policymakers and industry leaders are considering key aspects including financial adequacy, sustainability and performance of investments and retirement assets.

They are also building more efficient and effective pension and retirement systems, to deliver promises whilst meeting service expectations. This is ultimately a political challenge as the level of investment in these capabilities will be very significant. Bold decisions will be required to build a better retirement world.
Tax changes are having a significant impact on the industry

There is a general increase in the required level of transparency globally in almost all areas of tax.

The US's FATCA regime has shown how one country's desire for data regarding their citizens can have an impact in almost all corners of the globe. Financial institutions are being asked to take on responsibilities which would previously have rested with the tax payer and are becoming virtual revenue enforcement agencies by declining new business which cannot fit within the transparency rules. Transparency is a global phenomenon; FATCA was created by the US but has been copied globally.

The Common Reporting Standards have now been agreed by over 100 countries, with reporting to start in 2017.

The drive for transparency is not limited to personal taxes and individual tax payers. Corporates are also having to open their tax affairs up to a greater degree of scrutiny as a result of the country-by-country reporting (CBCR) rules coming into force as part of the OECD’s Base Erosion and Profit Shifting (BEPS) review. For insurers, the requirement to disclose the allocation of revenues between the countries a group trades in alongside profits, headcount, capital and taxes paid is likely to lead to increased challenge from tax authorities. This is because few tax authorities currently understand insurers’ business models therefore comparing these metrics with other sectors could reflect negatively on insurers. Insurers are continuing to lobby the OECD and governments in order to educate them on the industry and in particular the importance of risk and capital. The march towards transparency is unlikely to stop anytime soon as tax authorities around the world want greater detail and more information to check that they are getting their fair share.

However it is not just tax authorities who are pushing the tax transparency agenda. The media, consumer groups, charities and “tax activists” are also demanding information on multinationals' tax affairs and it is therefore feasible that the CBCR template could become a public document in future. The press offices of several UK insurers have already received requests for the CBCR template on the grounds of corporate social responsibility.

The need to provide this information is driving change within the tax departments of insurance groups as systems need to be updated and additional information requested and processed. Many insurers do not have this information easily available either centrally or locally.

Reporting it accurately and frequently will be a significant challenge – and expense – requiring system and process change. The concerns of the industry have not prevented tax authorities from continuing to pursue their hunger for new data sources. It is also driving behavioral change across all classes of tax payers who are considering their approach to the management and presentation of their tax affairs.
Globalization and localization of taxation

The work of the OECD through their BEPS program is trying to achieve a level of global consistency in taxation regimes that has never before been attempted.

The BEPS project is pushing for consistent guidance to be issued in many areas which could have a significant impact on insurers. Guidance is to be issued on the taxation of risk transfer, hybrid instruments, interest, intangibles and digital, as well as broadening the tax basis for cross-border activities. This is likely to mean that the majority of the world’s major economies, as well as emerging markets, introduce rules that limit taxpayers’ ability to manage tax affairs in the most efficient manner.

However this may also lead to more tax disputes as the various countries in which a group trades will still need to make decisions as to what taxes they need to raise and may make alterations to the global standards accordingly. This tax globalization is happening at a time when the world’s economies are recovering from a period of sustained challenge and the need to raise money to balance the books is greater than it has been for decades. This need for tax revenue could drive localization in tax which seems at odds with the globalization driven by the OECD but without a significant increase in global economic growth rates it would seem likely to continue.

The VAT rules are a good example of how difficult it can be to achieve consistency across borders. Even though the general principles of VAT are set out in EU law each of the Member States applies them slightly differently. If this can happen where the basis of the rules is enshrined in legislation the application of a general set of principles will offer a far greater challenge.

We have already begun to see jurisdictions’ differing responses to BEPS, some of which could potentially impact insurers inadvertently. For example some countries have introduced withholding taxes on payments made to “tax havens” which could include reinsurance. The UK’s Diverted Profits Tax is an example of a country taking unilateral action to legislate BEPS early. This could impose a punitive tax on certain outbound intra-group reinsurance arrangements, or on operating models where UK activities (for example, brokerage, marketing, sales) result in profits in an overseas affiliate (for example business sold on a Freedom of Services basis, including off-shore bond business and brokerage structures).

The drive for localization and globalization at the same time causes, and will continue to, a greater degree of uncertainty for tax payers as to how to manage their affairs at a time when their business models are already under pressure from economic and regulatory change.
The right messaging is critical to avoid reputational risk

“Fairness” is now a key theme for tax. Those companies who are perceived as acting contrary to this principle receive sustained negative media and public attention which causes substantial reputational damage.

Communication has become an important enabler for successful tax departments. As tax considers how to present the total tax position, for example, or explain the capital rationale behind complex structuring, it is vital to consider these new audiences.

Multinationals should consider public perception and associated reputational risk when reviewing or implementing operating models, restructuring or transactions as authorities, governments and the general public become increasingly critical.
Profits-based taxes, consumption taxes and operational taxes

The role of the tax department is changing. Traditionally most tax teams focused most of their efforts on profits-based taxes with a small proportion of the team focusing on consumption or indirect tax.

Notwithstanding the drive for international consistency of corporate taxes, as outlined earlier, it could be argued that the drive to globalization and localization will render profits-based taxes as a thing of the past. Increasingly commentators are taking the view that the only way to ensure fairness of allocation of tax revenues to countries in international trade could be taxing the consumption where it happens. Whether or not there is agreement to that view, there is no doubt that consumption-based taxation is likely to grow in importance and that will lead to a shift in the focus of the tax department.

Operational taxes such as FATCA and CRS, and the localization of tax via withholding taxes has also resulted in a significant increase in tax being involved in the day-to-day operations of the group. This will mean a change to the role of the tax function whether this manifests itself in the gathering and distribution of data direct to authorities, or the need to provide customers with information so that they can fulfill their own requirements.

Management of operational taxes relating to investments and the day to day running of the business will also become more important and require a greater level of focus.
The following points of intersection will be of critical importance to tax departments

The availability and use of new data sources to inform tax decisions and enable compliance

Many insurers and brokers are already investing in new Data Warehouse and MI capabilities to provide internal data in a more timely and robust manner to a range of stakeholders including tax.

As these organizations move additionally to gather and leverage new external data sources, tax should seek to leverage these where possible to support enhanced reporting requirements.

Looking to the future, digital tools and software robotics are likely to be key enablers of providing this data in a structured and accurate manner to multiple interested external parties.
The tax implications of new markets and operating models

This year insurers and brokers are particularly active in seeking to deliver stretching growth ambitions by exploiting new market opportunities. They are also transforming their operating models, to allow for greater agility, efficiency and profitable growth.

As tax requirements and business models become more globalized in parallel, it will be critical for tax to be at the center of growth and efficiency decisions.

Consultation “after the event” is not sufficient to minimize the new reputational and financial risks presented by tax authorities and the media.

The need for qualitative communications

Tax has become qualitative and quantitative – effective communication of tax matters has become as important as technical ability.

The impact of broker and insurer innovations

The global insurance market is becoming increasingly innovative.

As new types of risk, capability and capital are traded, the tax risk may change for the entire value chain.

Just as insurers look actively to new markets and models, tax departments can no longer assume the status quo in terms of insurance products and services.
Look to the future

By 2025 we predict the following for tax departments:

- Global tax authorities will become truly able to share and analyze the “big data” they are gathering ... and begin to respond with further regulations

- Global real-time reporting becomes the norm

- Publicly available reporting of total tax contributions for all jurisdictions in which the group operates

- Every tax department includes a dedicated tax communications role

- The level of local country knowledge available differentiates good and great tax teams

- Boards consider it imperative to include tax in every major decision

- Tax technical capability becomes constrained – unless investment takes place now to bring in new talent
The Tax Directors’ event will focus on the key changes that are impacting our industry and tax departments

Global changes in the insurance industry

The changing stakeholder landscape for tax

Tax challenges of globalization

The changing capital landscape

The future of the tax department

We look forward to the opportunity to share, discuss and build consensus on these topics amongst the senior insurance tax community.
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