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INSURANCE ADVISOR

2015 INSURANCE INDUSTRY PERFORMANCE

By Imran Makda

From data breaches to the "Cadillac Tax," 2015 proved to be a mixed bag for the insurance industry. Certain sectors outpaced the previous year's performance, while others stalled due to a combination of factors, ranging from an increasingly competitive marketplace, to a lack of natural catastrophes and low interest rates.

One overarching trend, however, was the proliferation of mergers and acquisitions across the industry, as a whole. This trend is likely to continue in the coming year and, with the rise of technological disruption and increased regulatory scrutiny, it's likely that 2016 will be unprecedented in the rate and scale of changes within the insurance environment.

In this article, we'll take a look back at the forces that shaped the insurance industry in 2015 and then shift our gaze forward to offer predictions for what the coming year may hold.

PROPERTY & CASUALTY (P&C)

P&C insurance in 2015 was a buyers' market, thanks in large part to more options and heightened competition. The P&C sector showed relative strength up to the third quarter of 2015, but gave back most of these advances in the fourth quarter.

At the end of 2015, net income for the P&C sector was down $6.7 billion, due to

DID YOU KNOW...

The Council of Insurance Agents & Brokers' fourth quarter Commercial P/C Market Index Survey showed that 2015 closed similarly to how it started– with continued decreases in commercial property casualty rates across small, medium and large accounts.

Two-thirds of individual insurance companies are specialists, accounting for about 56 percent of total direct premiums written, research firm Conning Inc. said in its 2016 report.

U.S. property & casualty insurers' operating earnings decreased by 7.2 percent in 2015, according to a report by Fitch Ratings.

Customer satisfaction with settlement amounts and service interactions for policyholders filing property claims dropped for the first time in five years according to the J.D. Power 2016 U.S. Property Claims Satisfaction Study.

Eighty percent of respondents to the Professional Insurance Agents of Connecticut, New Hampshire, New Jersey and New York State (PIA)'s annual Market Trends Survey said they've experienced minor or no increases in non-renewals in both personal- and commercial-lines policies, compared with a majority (63 percent) who reported minor to moderate increases in non-renewals last year.

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worsening underwriting results, coupled with a decline in both investment yields and realized capital gains. Net income for the P&C sector was $58.1 billion, compared to $64.8 billion in 2014. Both direct and net written premiums (NWP) grew slightly in 2015; gross written premiums (GWP) and NWP grew by 1.97 percent and 2.91 percent respectively in 2015, but the growth rate was anemic compared to the last four years, during which time GWP and NWP grew in the range of 3.64 percent to 4.55 percent each year.

Commercial P&C rates saw a drop of approximately 1 percent with the exception of commercial auto rates, which saw an increase due to underwriting concerns and poor loss experience. Workers' compensation rates showed a continued downward trend, but saw some rate strengthening in the third quarter of 2015. On a more positive note, personal lines saw an increase in both homeowners and private passenger auto insurance rates during the September renewal period.

Feeling the strain from stagnating premium growth, loss ratios (69.27 percent in 2015 vs. 69.03 percent in 2014) and combined ratios (97.87 percent in 2015 vs. 97.20 percent in 2014) both increased last year, resulting in lower underwriting gains. Net yield on invested assets also declined to 3.17 percent compared to 3.65 percent in 2014, contributing to lower net income. The main driver behind the reversal of gains in the fourth quarter was the unfavorable loss reserve development in commercial lines including AIG's pretax charge of $4.14 billion. Another major contributor to the decline in underwriting gains was State Farm, which posted an underwriting loss of $4.4 billion in its auto business—although this was offset by a $2.1 billion gain in its homeowners business. While the frequency of catastrophic events was at its highest since 1996, there was a notable decline in catastrophic losses ($14.3 billion in 2015 vs. $15.5 billion in 2014), according to Verisk Analytics. The average catastrophic event in 2015 resulted in insured losses of $360 million, down 26 percent year-over-year. Texas remained the state with the most losses, followed by California and Massachusetts.

LIFE SECTOR

Life insurance sector results in 2015 managed to outperform 2014 levels, with pretax operating income totaling $54.2 billion (compared to $49.0 billion in 2014) and net income reaching $40.2 billion (compared to $37.6 billion in 2014). Premiums and annuity considerations declined by 1.58 percent year-over-year to $637 billion. This represents the third consecutive year of decline on a normalized basis.

Investment income also declined by $1.06 billion to $170.7 billion in 2015. Investment yields have been on the decline over the last five years, dropping from a high of 5.1 percent in 2011 to a low of 4.65 percent in 2015. The yields may get some relief as the Federal Reserve is likely to raise interest rates at least one more time in 2016.

Life insurance companies also experienced some exposure to the volatile oil and gas sector in 2015 and, as a result, recognized impairment charges, as well as fair value declines. To supplement the investment yield, the companies increased their exposure to the real estate sector, with industry exposure to this asset class reaching its highest level in six years. The ratio of mortgage loans to cash and invested assets topped 10 percent as of June 30, 2015, as insurance companies saw strength in the commercial real estate sector from improvements in the economy.

Capital and surplus grew to $366.8 billion, an increase of 3.6 percent or $12.8 billion over 2014. This marks the eighth consecutive year of capital growth since the financial meltdown in 2008. Return on the average equity was 11.17 percent in 2015, compared to 10.96 percent in 2014.

HEALTH SECTOR

Although full year 2015 results for the health insurance industry have not yet been published, the available data seems to indicate that 2015 will be at least on par with 2014. For the first nine months of 2015, the industry posted an underwriting gain of $12.7 billion, compared to a gain of $14.4 billion for full year 2014. Net income for the first nine months of 2015 was $8.5 billion, compared to $11.3 billion for full year 2014.

Net premiums written grew by 11.85 percent year-over-year in 2015, while claim loss ratios decreased slightly to 88.72 percent in 2015, down from 88.94 percent in 2014. The combined ratio for the industry was 99.08 percent as of Sept. 30, 2015, compared to 99.13 percent for the same period in 2014. Total members increased by 3 million to 289.5 million as of Sept. 30, 2015. The Centers for Medicare and Medicaid Services (CMS) reported that approximately 8.5 million consumers either signed up or renewed coverage during the 2016 open enrollment period.

Last year also saw some mega-mergers in the managed care space, as well as some spectacular collapses of nonprofit health exchanges in states, such as New York, Kentucky and Oregon. Questions about the risk of adverse selection on the exchanges still linger, as this population has proven to be sicker and more costly than original estimates indicated. CMS' decision to pay few cents on the dollar through the risk corridor program also added fuel to the fire. As a result, several well-known and well-capitalized insurers have pulled out of the exchange marketplace entirely. This move will create an opportunity for other insurers to enter the fray, which may prove attractive to some companies. United Health, for example, has taken measured steps to increase its participation in the exchange programs in the upcoming years with the expectation that the claim cost trends and premium pricing will improve.

WHAT TO EXPECT IN 2016

According to a survey conducted by Insurance Information Institute, the majority of P&C insurance executives expect no improvement in profitability in 2016, as a result of lower to flat premium growth and higher combined ratios. The abundance of the capital and surplus and lower-than-average catastrophe losses for the P&C industry as a whole will keep the downward pressure on pricing levels. This trend may be reversed, however, if a major catastrophe were to occur in 2016. Certain lines, such as workers' compensation, may see an increase as payroll and employment continue to rise. Cyber

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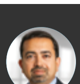
insurance will also be a growth leader for the industry as this product continues to expand and mature over the next few years.

For the life insurance sector, premiums are expected to grow modestly in 2016 as consumers will have to balance market volatility concerns against a meaningful rate of return. As such, indexed annuities may fare better in 2016, as opposed to variable annuities. Time Inc's *MONEY* magazine reported that only 36 percent of millennials have life insurance compared to 60 percent of Gen Xers. If this trend continues, it could be detrimental to the life sector. The life sector will need to innovate, design and deliver products more appealing to this new generation of consumers to stay afloat.

The Federal Reserve's inclination to revise interest rates at least once in 2016 may improve investment yields slightly, but this improvement may be offset by weaknesses in certain sectors, such as oil and gas. Insurance companies need to actively manage these exposures moving forward to see meaningful improvement in investment yields.

As discussed earlier, commercial lines saw significant adverse loss development toward the end of 2015, and personal lines showed signs of rising frequency. To reverse these trends, insurance companies will be actively seeking cost containment by investing in infrastructure and technology, which may take a few points off of their combined ratios.

With an economic growth forecast of less than 2.5 percent for 2016, insurance companies have to look at other avenues to create shareholder value and increase return on equity. New technologies, such as data analytics, robotics and telematics, can be both innovative and disruptive. The use of digital technologies is redefining the landscape and impacting the entire business cycle—everything from marketing and distribution to pricing and loss mitigation to accounting.



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5 KEY ISSUES INSURERS MUST ADDRESS IN 2016

By Imran Makda and Richard Bertuglia

With the arrival of spring come annual shareholder meetings—a reminder for companies (including those without public shareholders) to take heed of emerging concerns and corporate governance issues.

While there is no shortage of challenges facing the insurance industry vying for the C-suite's attention, we believe the five issues below deserve a special spotlight in management discussions this year.

1 CONSOLIDATION

Moody's 2016 outlook for the insurance industry notes that merger and acquisition (M&A) activity in the sector hit record levels in 2015 and is expected to remain strong this year. The report notes that the challenging economic environment, need for scale and regulatory changes are strong drivers of deal activity. The healthcare insurance market has been particularly active, as insurers wrestle with new strategies to address the changing reimbursement environment and compete in new insurance exchanges.

Technology advances, such as telematics and data analytics, are driving innovation across the insurance sector and giving rise to specialty players that are opening doors to new areas of strategic growth. As BDO highlights in its 2016 Shareholder Management Alert, management has the responsibility to be thoughtful and strategic in seeking out opportunities for growth and conducting proper due diligence on potential targets. Further, boards should ensure their companies have sound integration policies for assimilating target businesses and continuing strong governance following an acquisition.

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5 KEY ISSUES

2 DATA MANAGEMENT

Insurers are swimming in a sea of data. Telematics, social media, wearable devices and other new digital developments are enabling insurers to tap into an even greater wealth of data about their customers. Sorting through data sets to get meaningful information will be a growing challenge. Outdated systems have hindered many insurers' ability to maximize data to its full potential and take advantage of new opportunities. Sophisticated data analytic capabilities will increasingly give insurers an advantage and have pushed non-traditional competitors onto the scene.

At the same time, insurers must have proper governance mechanisms in place to ensure the right data gets into the hands of the right decision makers at the right time. Evolving reporting and compliance issues must be properly managed, and elevated risks need to be addressed. Shareholders and regulators alike are increasingly asking questions about how companies are gathering, storing, protecting and using customer data.

3 CYBERSECURITY

Cybersecurity is an increasingly worrisome threat facing all businesses today, but particularly so for insurance companies that handle large amounts of Personally Identifiable Information (PII) and Protected Health Information (PHI). Allianz Global Corporate & Specialty reports that cyber crimes cost the global economy $445 billion annually. As these attacks become increasingly sophisticated and damaging, investors want assurances that insurers are proactively taking measures to improve IT and data security and developing response plans in the event of a breach.

Cybersecurity is getting increased regulatory attention as well; although no federal oversight currently exists for insurance companies, state regulators are giving the industry closer examination. In November 2015, the New York Department of Financial Services issued a letter highlighting findings from its cybersecurity risk assessments of the industry and key regulatory proposals it is considering. Among concerns listed in the letter are third-party vendor relationships that serve as a frequent entry point for hackers.

Insurers are, in large part, still working to modernize their IT systems; there will be renewed urgency to move these efforts forward more quickly to ensure proper actions are being taken to mitigate security risks. For property/casualty insurers, cybersecurity pressures are even greater, as more companies look to purchase cyber liability insurance policies. Allied Business Intelligence Research estimates that U.S. businesses spent over $2 billion on cyber insurance policies in 2014 and projects that it will reach $10 billion by 2020.

4 GLOBAL ECONOMIC CONCERNS

A slowing Chinese economy, declining energy prices and low interest rates are arguably the biggest global risks facing the insurance sector in the year ahead. A healthy level of cross-border M&A activity has been driven by buyers in China and Japan, but some Chinese investors have stepped away from overseas expansion plans due to the country's recent economic woes and pressures to invest at home. The Chinese government is also taking more aggressive measures to boost domestic spending, announcing plans in early February to tighten restrictions on the purchases of insurance policies overseas.

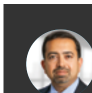
Still, some argue the industry's growth momentum will remain strong. Shareholders want to know how companies are preparing for these negative exposures and mitigating the downside risks of international growth and/or financing opportunities.

5 SHIFTING WORKFORCE DYNAMICS

The number of workers entering into temporary agreements with on-demand companies like Uber is growing, raising questions about what kind of traditional labor protections and benefits they are afforded.

A June 2015 report from McKinsey Global Institute estimates that less than 1 percent of U.S. workers are contingent workers operating through "digital marketplaces for services," although quantifying the growth of this job category has been challenging given the broad range of definitions. Congress is working to get greater clarity about this emerging sector of the economy. The last time the Bureau of Labor Statistics surveyed the number of "contingent workers" (those employed in temporary arrangements) was in 2005; they recently announced plans to repeat the survey again in May 2017.

In the meantime, the Congressional Research Service issued a report on the gig economy in February 2016, defining it as "the collection of markets that match providers to consumers on a gig (or job) basis in support of on-demand commerce." The report raised a number of concerns for further examination, including the potential impact on how and where these employees get health insurance and retirement benefits that are traditionally offered through employers. It suggests that "new mechanisms such as portable benefits or risk-pooling" might need to be considered to provide benefits to gig economy workers. Boards and the C-suite must consider the potential impact to current and future business as new workforce dynamics take hold.



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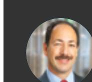

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PErspective in **INSURANCE**

Insurance agency M&A reached a record high in 2015, with 451 deals announced or reported in the US and Canada—up from 357 in 2014, according to *Insurance Business America*.

While a majority (57 percent) of sellers were property and casualty (P&C) agencies, private equity firms did much of the buying, demonstrating a shift in buyer dynamics. PE firms were involved in 242 deals, up 50 percent year on year. The top PE-backed buyer was Genstar Capital-backed Acrisure, which made 56 acquisitions.

For insurance underwriters 2015 will be remembered as the year of multibillion dollar mergers, with announced deal value for insurance underwriters totaling $141,357 billion, according to data from SNL. To put this figure into perspective, the total deal value from 2010 to 2014 *combined* was approximately $82.5 billion. The largest P&C deal of 2015 was ACE Ltd's $28.3 billion acquisition of The Chubb Corp. last July. The merger of giants created the world's biggest P&C company, to be called Chubb Ltd.

The managed care sector saw the highest total transaction value, totaling $91.8 billion, despite representing the smallest fraction of total deal volume, with just two mega-deals amounting to a staggering $83.6 billion in deal value. These mega-deals occurred because companies wanted to take advantage of the favorable debt market while creating a more efficient enterprise that is better-equipped to deal with regulatory challenges, as well as changing healthcare reimbursement models. The ACA has put tremendous pressure on operative and profit margins and the companies and their boards saw this as an opportunity to create an efficient, integrated and profitable enterprise through M&A.

The acceleration in M&A was caused by a variety of factors, including domestic and global macroeconomic shifts, changes in the regulatory environment, strategic positioning or repositioning of companies and good market conditions. Valuations were further buoyed by positive deal speculation and the strong stock market through most of 2015, making potential targets more expensive.

Below are some of the most notable insurance deals of 2015:

Target / Buyer	Announcement Date	Announced Deal Value ($M)
Cigna Corporation / Anthem, Inc.	7/24/2015	48,088.99
Humana Inc / Aetna Inc.	7/3/2015	35,474.88
Chubb Corporation / ACE Limited	7/1/2015	28,240.30
HCC Insurance Holdings, Inc. / Tokio Marine Holdings, Inc.	6/10/2015	7,497.10
PartnerRe Ltd. / Exor SpA	8/3/2015	6,606.01
Health Net, Inc. / Centene Corporation	7/2/2015	6,258.75
StanCorp Financial Group, Inc. / Meiji Yasuda Life Insurance Company	7/23/2015	5,001.86
Symetra Financial Corporation / Sumitomo Life Insurance Company	8/11/2015	3,726.89
Sirius International Insurance Group, Ltd. / China Minsheng Investment Corp.	7/27/2015	2,235.00
Ironshore Inc. / Fosun International Holdings Ltd.	5/3/2015	2,098.01
Fidelity & Guaranty Life / Anbang Insurance Group Co., Ltd.	11/9/2015	1,582.71
Voya Financial, Inc. / Undisclosed buyer	3/4/2015	1,415.20
Montpelier Re Holdings Ltd. / Endurance Specialty Holdings Ltd.	3/31/2015	1,393.99

Overseas buyers made a splash, with significant dealmaking activity from Japan and China-based buyers. Some Asian insurance firms see overseas acquisitions as a way to boost their brand profile at home—it will be easier for them to grow their domestic insurance market if they can present themselves as an international insurer, according to *Lawyers Weekly*. Better growth prospects in other markets, as well as a governmental push for financial services firms to diversify their portfolios have also played a role in increasing Chinese outbound M&A. In Japan, an aging population, declining domestic market and increasing competition from China are driving a general overseas acquisitions boom—outbound dealmaking topped approximately $90 billion in 2015, including $25 billion of insurance deals, according to the *Financial Times*. The second largest deal of the year was Tokyo-based Tokio Marine Holdings' $7.5 billion acquisition of Houston, Texas-based HCC Insurance Holdings, which owns Houston Casualty Company.

The hot dealmaking environment looks set to continue through 2016, as insurance companies experience pressure from various sources. Commercial insurance rates fell 4 percent year-over-year in February this year, according to insurance exchange MarketScout. Organic growth in the independent insurance agents and brokers sector slipped to 4.4 percent during the third quarter of 2015, down from 6 percent in Q3 2014, according to *Insurance and Financial Advisor*. This was the first time in more than three years it went below 5 percent. Profitability is also down—measuring 21.9 percent in Q3 2015 compared with 22.4 percent in Q3 2014 as measured by EBITDA.

A.M. Best predicts that P&C underwriting will produce profits in 2016, but net income and surplus growth will slow. The ratings agency describes the overall outlook for the commercial P&C segment as "negative," according to *Insurance Business America*. This environment may drive more agencies and brokers to sell assets or to boost their top line growth through acquisitions.

PErspective in Insurance is a feature examining the role of private equity in the insurance industry.

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APRIL

April 24-26
2016 AAIS Main Event Conference
Ponte Vedra Inn & Club
Ponte Vedra Beach, Fla.

MAY

May 16-18
LOMA Financial Inforum 2016
Grand Hyatt Tampa Bay
Tampa Bay, Fla.
May 17-20
AAMGA 90th Annual Meeting 2016
JW Marriott Phoenix Desert Ridge Resort
Phoenix

May 19-20
NAIC 2016 International Insurance Forum
Capital Hilton
Washington, D.C.

JUNE

June 12-15
IASA's 2016 Annual Educational Conference and Business Show
Henry B. Gonzalez Convention Center
San Antonio

June 12-15
IIS Global Insurance Forum
Shangri-La Hotel
Singapore

JULY

July 11-13
ACLI's Compliance & Legal Sections Annual Meeting
The Fairmont Copley Plaza
Boston

July 14-17
NCOIL 2016 Summer Meeting
Portland Marriott Downtown Waterfront
Portland, Ore.

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