

“Interesting Times” in the Insurance Industry

How the New Normal is Challenging Insurers While Creating Huge Opportunities

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Like almost every industry, insurance was hard hit by the economic decline that began in 2007 and exploded in 2008. Several companies peered into the abyss; few escaped significant losses in investment portfolios, declines in premium volume, significant write-downs and diminished shareholder equity.

Still, the industry as a whole showed impressive resilience, with the vast majority of companies weathering the storm – chastened, perhaps, but the wiser for it. The past two years have brought some relief: economic conditions have been strengthening, albeit slowly, and stock prices have been ascending steadily since 2009. Today, most insurers are on relatively sound footing.

But this is no time for the industry to let its guard down. The economy remains fragile. Energy markets are being roiled by uprisings throughout the Middle East. A continued low interest rate environment is making it difficult to balance investment risks and returns. And the passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act has intensified regulatory uncertainty, along with concerns about the potential for a greatly expanded role for the federal government.

Perhaps the most daunting challenge is the sheer pace of change, which is accelerating dramatically and creating stress for virtually every type of business. Some are calling these unprecedented conditions “the new normal.” In short, we are living in what the ancient Chinese proverb calls “interesting times.”

But amidst this breathtaking tumult, it’s important to remember a crucial truism: adversity creates opportunity. Those companies able to devise innovative solutions to today’s myriad challenges will not merely survive.

They will triumph.

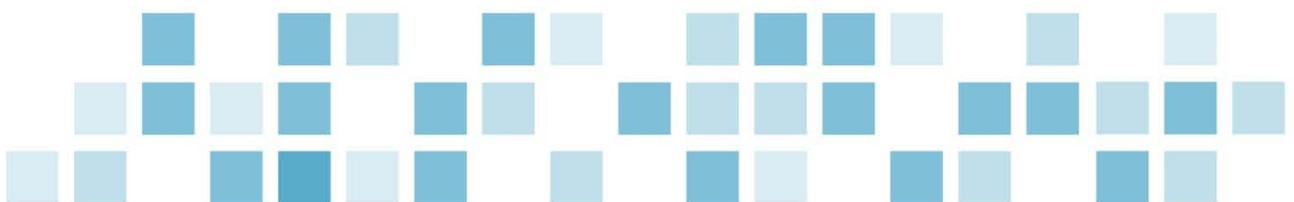
While companies have no control over external factors such as interest rates or economic conditions, they can take steps to strengthen their position and adapt to a fluid, dynamic environment. Insurance industry leaders need to continually assess their operations and strategies by asking some critical questions:

- How well is our company prepared for this new era?
- Are we developing and initiating strategies that will guide us through the rocky shoals of change?
- Are we taking steps today to position our company for the future?

Executives in our insurance practice communicate regularly with industry executives and regulators to gain a better understanding of their perceived challenges and opportunities. Their insights, combined with our ongoing analysis, convinced us that several crucial issues will continue to be top-of-mind concerns for industry leaders in the coming months and years:

1. **Market position.** Each company will need to carefully assess its resources, strengths and weaknesses to determine its competitive position. In many cases this will include evaluating the costs and benefits of combining with other companies, either through a strategic partnership, a merger or an acquisition.
2. **Regulatory environment.** Insurers not only should carefully examine the regulatory environment to ensure they are keeping up with changing regulations; they also should assess the status of their relationships with regulators and, if necessary, take steps to strengthen those relationships.
3. **Information Technology (IT).** IT has become a critical factor in the industry; companies that fail to keep up with the dizzying pace of change will find themselves at a competitive disadvantage. Companies should rigorously assess their IT capabilities to determine whether they are taking full advantage of its potential in areas such as operations, marketing and client service.
4. **Changing demographics.** Insurers need to understand how the nation's rapidly evolving demographics are altering their customer profiles, and then determine how best to reach and interact with these various customer segments.

We don't claim to be offering unique insights here; industry executives have been grappling with these issues for some time. However, we're convinced that succeeding in this environment will require maintaining intense focus on issues such as these. They will have significant influence on the industry for the foreseeable future.



Examining corporate assets, liabilities and resources: Is there a merger in your future?

Now that the crisis phase has passed, insurers need to carefully examine their operations to objectively assess their organization's competitive strengths and weaknesses. They may uncover issues they cannot afford to ignore.

For example, the recent economic meltdown made it clear that many companies failed to understand the risks associated with their investment strategies. While this became painfully obvious in banking and other segments within financial services, the insurance industry was not immune. Some insurers, primarily smaller enterprises, chased yield without the expertise to adequately evaluate risk. Many paid a dear price for it.

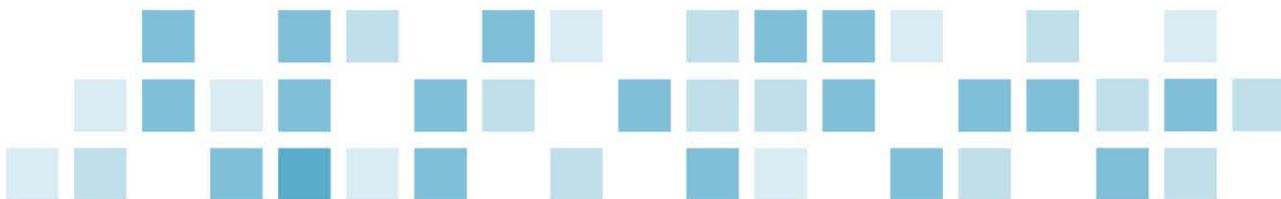
While the decline in housing values has had a significant impact on insurance companies, most insurers were not unduly exposed to asset classes, such as mortgage derivatives, that triggered the economic downturn. No doubt some of the credit goes to cooler heads among senior leadership teams, along with industry business models requiring the provision of reserves greater than the probability of occurrence.

But one shouldn't underestimate the crucial role played by regulators in limiting insurers' freedom to manage their asset portfolios. Many in the industry chafe about intrusive regulatory oversight, but state-based regulatory agencies played an essential role in helping prevent widespread calamity.

Simply put, companies need to determine whether they have the resources and skill sets to compete successfully in today's "new normal" environment. With some exceptions (breakthrough innovation can be a game changer in any industry), insurance companies are increasingly requiring size, scale and investment acumen if they are to compete successfully. Some smaller companies, lacking the necessary resources to make critical investments in areas such as IT, may need to partner with other companies offering complementary strengths.

Alternatively, such companies' best option may be to seek a buyer with the wherewithal and interest to acquire them. We believe the challenges presented by today's environment could lead to significant consolidation within the insurance industry. Strong, well capitalized companies may use this opportunity to acquire some of their smaller competitors, as well as firms with noteworthy competencies in areas such as product innovation, marketing and sales, client service and customer relations.

Heretofore, most M&A activity in the insurance industry has been concentrated in the brokerage segment, with firms such as Arthur J. Gallagher, Brown & Brown and Hub International pursuing acquisitions vigorously. We may see a noticeable increase in M&A activity among insurers themselves.



Adapting to an Evolving Regulatory Environment

Few doubt that compliance, always a significant challenge for the industry, is only going to become more demanding with the passing of the Dodd–Frank Act. The Act is both long (it comprises 2,300 pages) and complex, and much of its impact will remain unknown until regulators craft specific regulations and companies seek to implement them.

While Dodd-Frank is primarily targeted toward investment banks and commercial banks, the Act will still have far-reaching impact on the insurance industry. Unanticipated — and unintended — consequences are virtually assured. A major theme coming out of the legislation is that risk, by definition, is bad. Moreover, the legislation seems to imply that a zero-risk regulatory environment can be established, if only the right rules can be crafted.

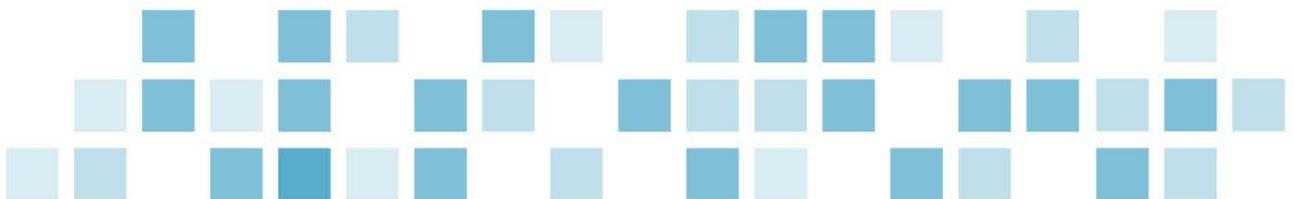
In reality, eliminating risk is impossible, and there are almost always negative consequences when lawmakers attempt to do so.

The impact of Dodd-Frank and the federal government’s role in regulating the insurance industry is still in question, since insurance has long been regulated on the state level. State-based regulatory regimes performed well during the recent financial crisis, arguably helping the industry avoid many of the problems that devastated the banking industry.

Though there have been few complaints about the performance of insurance industry regulators, state regulatory regimes remain under threat of federal usurpation. We believe this is unfortunate, and hope the demonstrated success of the state-based model will limit federal regulatory encroachment.

Many insurance industry executives report improved relationships with their state regulators, partially in response to recent crisis. The industry should continue its efforts to work cooperatively with regulators while keeping lines of communication open.

Of course, there always will be some tension between the regulated and the regulators – as it should be. But insurers should try to work cooperatively with regulators by providing them the information they require and helping them understand business model, plans, strategies and challenges. Regulators also should seek cooperative, less adversarial relationships with insurers and even look for ways to help them – without, of course, compromising the needs of constituents such as policyholders. For example, they should take an open-minded attitude to updating rules regarding technology use. Allowing insurers to engage consumers through social media is likely to benefit all parties. Regulators should not be an obstacle to such innovative approaches to communications.



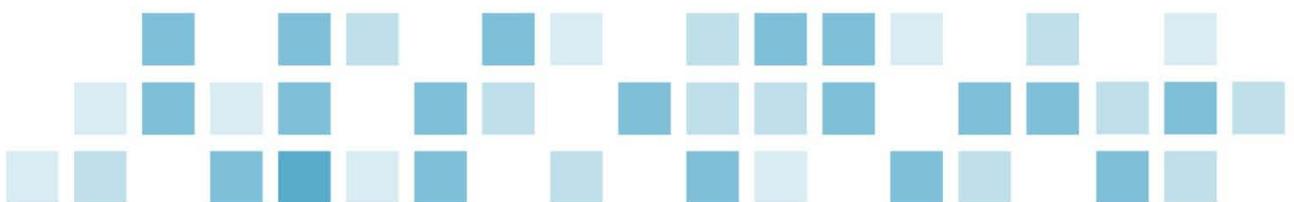
Are your IT systems enhancing your competitive position?

Being saddled with outdated, inefficient IT systems is a painful reality for many insurers; some of the industry's most significant players have systems dating back to the 1970s. While a number of companies have been able to remain competitive by tinkering with their systems, the failure to stay abreast of the rapid evolution in IT has now become an inescapable problem for many insurers and their distribution channels. Unfortunately, upgrading a major IT system is an expensive proposition. Companies that have steadfastly managed and updated their IT systems will enjoy an increasingly significant competitive advantage.

The emergence and rapid growth of cloud computing – in which major IT functions are outsourced to a third-party provider and then accessed via the Internet – might offer an attractive alternative to huge investments in on-premise IT. In addition, cloud computing may provide a way for companies to technologically leapfrog competitors with antiquated legacy systems and sunk costs in hardware, software and staff. The cloud option also enables companies to take advantage of their provider's economies of scale, as well as their continual investments in the latest hardware and software. The cloud model further permits companies to scale their IT requirements up or down, depending on need.

Before migrating their IT capabilities to the cloud, companies need to consider a variety of issues, including those associated with regulatory compliance; after all, insurers cannot completely outsource their compliance responsibilities. Companies also should perform intensive due diligence to confirm the prospective vendor's stability, as well as its ability to keep sensitive information utterly secure. In addition, Insurers should learn how their cloud service providers prevent outages, such as the one that recently affected Amazon Web Services, and their plans for responding to such an outage. IT considerations should definitely be incorporated into the company's disaster recovery plan.

In addition to assessing costs and benefits, insurers should conduct a risk-reward analysis, and then establish clear policies regarding the use of IT and the protection of sensitive information. Developing such policies should not be the exclusive purview of the IT department; risk management and compliance specialists should also play a central role in the process. While upgrading IT systems to improve operational efficiency and customer service (among other benefits) is crucial, insurance companies should also carefully consider how they might exploit the volumes of information their systems are able to aggregate and organize. Historically, insurers have been notoriously "data rich, but information poor." There are a variety of ways insurers can exploit solid, well organized information, from strengthening actuarial capabilities to enhancing their ability to objectively evaluate distribution channels, brokers and agents. Those companies best able to convert



their voluminous data into actionable intelligence will gain a powerful competitive advantage.

Although companies skilled at gathering, organizing, analyzing and exploiting information will reap huge rewards, most will find getting there requires overcoming some significant challenges. For example, many insurers don't aggregate their information in a central repository, but instead segregate it into silos such as billing, administration, claims, personal policies, commercial policies, etc.

Well managed insurance companies will use technology to streamline operations, improve customer service and provide management with valuable metrics and other intelligence. The most successful businesses will also use technology innovatively to reach younger consumers and others who are becoming difficult to influence through traditional media. Engaging consumers who do not currently appreciate the value of most insurance products will be a hallmark of the highest achieving companies.

Reaching New Customer Segments

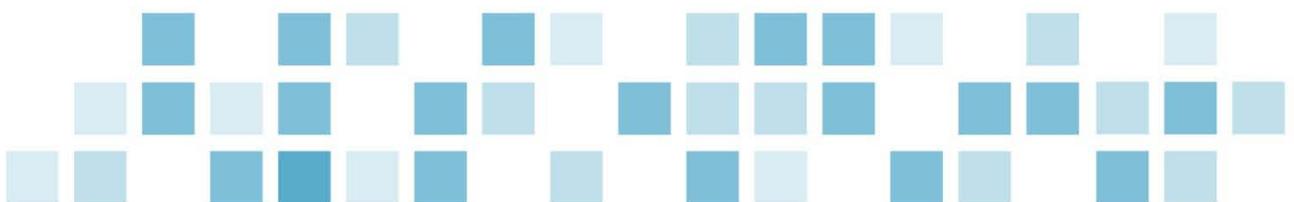
Demographic shifts, which are already beginning to affect the insurance industry, will become pronounced over the next several years. Those insurers best able to meet the needs of evolving consumer segments will gain a significant competitive advantage.

For example, while men have been core buyers for much of the industry's history, women have become extremely active and influential consumers of financial products and services, including insurance. Similarly, the United States is becoming increasingly diverse, with the Hispanic population growing particularly quickly. Reaching these audiences will likely require different approaches than those that worked in the past.

Another crucial audience will likely necessitate even greater changes in the way insurance companies recruit employees, build distribution networks and market and sell products: young people.

Members of the "millennial" generation already represent a crucial segment of the insurance industry's customer and employee audience, and their importance will only grow in coming years. Also known as Generation Y, Echo Boomers and the Net Generation, millennials are the approximately 75 million people born in the United States between 1983 and 2001. This generation's distinct values, interests and behaviors are already compelling U.S. corporations to adapt new ways of doing business. Millennials are a technology savvy cohort that considers Twitter, Facebook, LinkedIn and YouTube routine forms of communication. They are driven by convenience, yet they show notable interest in issues such as environmentalism and corporate social responsibility.

Effectively reaching this audience can be challenging and likely will require sales, marketing and communications strategies unfamiliar to many insurance industry



professionals. Millennials can be difficult to influence through traditional mass marketing tactics. They don't like to be "sold," and they're remarkably skilled at ignoring sales pitches. Aggressive, "in-your-face" approaches are quickly and easily dismissed.

Yet, when done correctly, advertising can be effective. Authenticity is essential; perhaps the worst thing an advertiser can do is to come across as "slick." Millennials are much more willing to buy when they are referred by someone they trust.

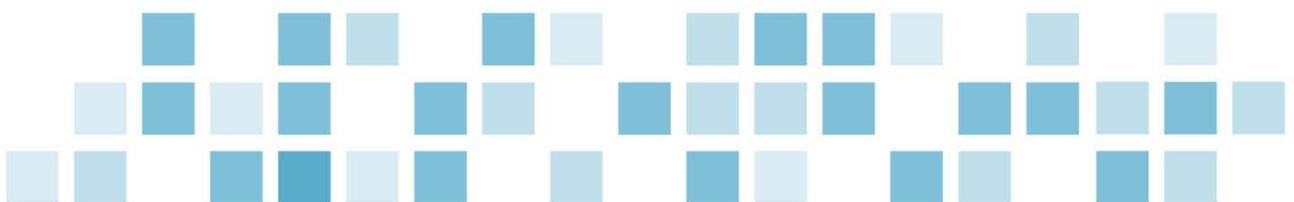
Since millennials get most of their information online, often via mobile computing devices, insurers should — at the very least — make sure their websites are accessible via smartphones and other mobile devices. Smartphone apps are another tool that will prove increasingly valuable to insurance companies; Nationwide, USAA, State Farm, Farmers and GEICO are among the companies that have already introduced mobile computing apps. While most existing insurance apps are related to the claims process (enabling the user to report an automobile accident, upload photos from the scene, identify their location for tow trucks, etc.), an innovative new app from USAA allows policyholders to pay a premium by uploading a photo of a check.

Social media has become an essential platform for many businesses trying to market to millennials (and other consumers). Insurers do not have the luxury of delaying the development of social media policies, strategies and campaigns. Some companies are already using social media such as Facebook as a tool for investigating fraudulent claims. However, the most successful companies will use social media to communicate innovatively with consumers (as well as employees, brokers, agents and others), engage them, and build relationships with them.

It won't be easy. Today more than half of U.S. consumers own neither life insurance nor annuities. These consumers apparently have little or no appreciation for how these products might benefit them.

But we're convinced that YouTube, Facebook and other platforms will prove to be excellent vehicles for promoting consumer education.

While social media's increasing influence seems inexorable, one issue may slow adoption within the insurance industry: regulatory compliance. A variety of regulations could make the pursuit of an aggressive social media strategy difficult, including those associated with advertising, client testimonials and records retention. Such compliance issues can be murky. For example, most states have detailed regulations specifying how insurers must handle customer complaints. Might a consumer's negative Facebook post or an unfavorable tweet be considered a "complaint" and thus subject to these regulations? Companies will also need to carefully examine how their social media efforts could generate risks in the area of errors and omission.

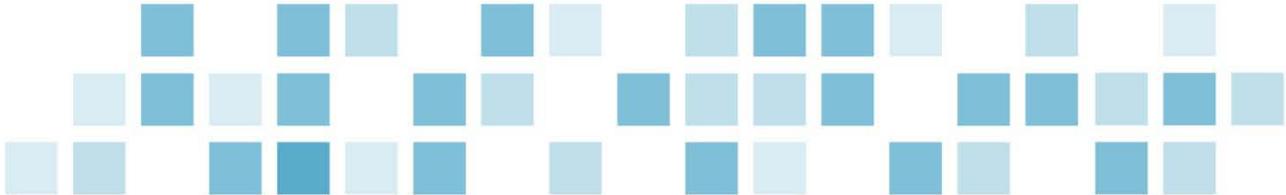


Still, we are convinced companies need to evaluate how they can use social media to reach a variety of stakeholders. This will require developing carefully considered, well articulated policies. Such policies should not be developed solely by the marketing or communications departments; legal, regulatory/compliance and risk management departments should also be active participants in such policy development.

The industry will also likely require some progressive thinking from regulators.

With all this change, a fundamental question for the insurance industry is whether the current generation of executives and salespeople will be able to successfully adapt to these new approaches. The business models and paradigms familiar to many of the industry's leaders may be becoming outdated. If so, there likely will be a need to recruit new types of salespeople and develop new ways to train and manage them.

The past several years have been challenging for the insurance industry, and the next several years will likely prove to be equally challenging. However, adversity has a way of stimulating people's creativity and ultimately generating remarkable advances. We're now are in the midst of an era characterized by innovation and experimentation, tempered by discipline. No doubt we'll face stressful times ahead. But we are just as likely to witness one of the most exciting times in the industry's history.



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