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INSURANCE ADVISOR

THE STATE OF THE (INSURANCE) UNION

Looking Back and Forward at Key Trends in the Insurance Industry

By Imran Makda

Overall, 2013 was a healthy year for the insurance industry. According to *SNL's U.S. Insurance Industry Index*, the industry is up 28 percent on a year-to-date basis and more than 50 percent compared to the last three years. Two out of three sectors of the industry showed improvement in 2013, compared to 2012, placing the insurance industry on solid footing for 2014.

THE STATE OF THE P&C INSURANCE SECTOR

The property and casualty insurance (P&C) sector performed well in 2013. Net premium written grew 3.89 percent year-over-year to approximately $478.8 billion in 2013, with growth in both personal and commercial business lines. Premium rates also rose over the last two years for nearly all personal and commercial lines.

Incurred losses improved slightly in 2013, with approximately $316.2 billion in 2013, compared to $336.8 billion in 2012. Due to the lack of a major catastrophe in 2013, the loss ratio for the sector also improved in 2013 (67.4 percent in 2013, compared to 74.3 percent in 2012). Overall loss reserves for the industry decreased by 1.9 percent ($591.8 billion in 2013, compared to $603.2 billion in 2012). The decrease in loss ratio and favorable loss reserve development is in part due to a continuing trend of prior reserve releases,

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DID YOU KNOW...

President Barack Obama is set to sign into law a bipartisan bill relieving homeowners living in flood-prone neighborhoods from insurance increases according to ***Insurance Journal***.

According to the ***Kaiser Family Foundation***, ACA enrollment in seven states hasn't significantly increased competition in health insurance markets.

Net probable maximum loss (PML) estimates for major catastrophic events came down significantly by Jan. 1, 2014, compared to the year prior, according to analysis by ***The Insurance Insider***.

Health and Human Services Secretary Kathleen Sebelius acknowledged that health insurance premiums are "likely to go up" in 2015, according to ***The Wall Street Journal***.

According to ***Moody's 2014 Global P&C Insurance Outlook***, property & casualty insurance premiums will grow at low- to mid-single-digit rates in North America and Europe and high-single-digit or double-digit rates in Asia and Latin America in the coming year.

According to ***SNL's U.S. Insurance Industry Index***, the insurance industry is up 28 percent from last year, and is up more than 50 percent compared to the last three years.

▶CONTINUED FROM PAGE 1

THE STATE OF THE (INSURANCE) UNION

which has been ongoing for the last five years. However, most industry participants believe this “cookie jar” is close to empty and the capacity for future reserve releases has seriously diminished.

The P&C industry as a whole has done a good job of maintaining the expense ratio, which has averaged around 28 percent for the last five years. The decrease in loss ratio, coupled with a steady expense ratio, led the industry to its first year-to-date underwriting gain since 2009. The combined ratio for the industry was 96.2 percent in 2013, which resulted in an underwriting gain of approximately $18 billion, compared to a combined ratio of 103 percent and an underwriting loss of $13.8 billion in 2012.

▶THE STATE OF THE LIFE INSURANCE SECTOR

According to the data collected so far, the life insurance sector did not perform as well as the P&C sector.

In 2013, the total premiums and annuity considerations for the life sector declined by 11.6 percent ($570.4 billion in 2013, compared to $645 billion in 2012). Life premiums declined by 6 percent in 2013, compared to 2012, and annuity premiums declined even more sharply by 25 percent in 2013, when compared to 2012.

Net policy reserves increased to $2.35 trillion in 2013, compared to $2.3 trillion in 2012. Net realized losses for the industry was $11.3 billion in 2013, compared to a loss of $9.5 billion in 2012.

▶THE STATE OF THE HEALTH INSURANCE SECTOR

On the other hand, the health insurance sector has enjoyed continuous growth for the last five years. This trend is expected to continue in 2014 resulting from the implementation of the Affordable Care Act (ACA).

Net premium written grew by 5.9 percent in 2013 ($433.2 billion, compared to $409.2 billion in 2013). Health insurers added approximately 10 million net new members in 2013 — 246.5 million members in 2013, compared to 236.6 million members in 2012. With only a slight decrease year-over-year, we expect this number to grow significantly in 2014 given the approximately 30 to 35 million uninsured individuals who will be required to enroll under ACA.

The medical cost ratio for the industry also ticked up to 85.9 percent in 2013 from 84.9 percent in 2012, which resulted in pushing up the combined ratio to 97.7 percent in 2013, compared to 96.8 percent in 2012. This also decreased the underwriting gain in 2013 ($16.8 billion in 2013, compared to $19.2 billion in 2012).

Total capital and surplus for the health sector increased to $122.9 billion in 2013 from $89.8 billion in 2012. This increase primarily represents new investment in the health sector as companies get ready for the ACA.

▶THE STATE OF INSURANCE M&A

Looking at the insurance industry as a whole, 2013 was a slow year from a mergers and acquisitions (M&A) standpoint, compared to recent history. Deal activity in the insurance sector saw a marked decline in both the number and size of transactions in 2013, compared to 2012. In terms of deal flow, 110 deals were made between 2010 through 2012, compared to only 63 in 2013. Deal volume also dropped in 2013. Between 2010 and 2012, average deal size was approximately $319.4 million. However, in 2013, average deal size dropped significantly to just $166.5 million. This reflects a lack of mega or blockbuster deals in 2013 and a deal market that favored selective acquisitions by companies to bolster their existing niches or to expand in strategic markets.

Breaking it down by sector, M&A activity in the life and health segments was particularly slow in 2013. The majority of life and health deals focused on the annuity business, which has long been impacted by the low interest rate environment. The pace of managed care deals also slowed in 2013 dropping to a total of just 12 deals, compared to 16 in 2012. Additionally, aggregate deal value dropped significantly from $10.9 billion in 2012 to $271.5 million in 2013. This drop reflects a decrease in mega deals seen in 2012 in the managed care space as larger investors took advantage of opportunities related to the pending ACA.

In the P&C sector, the number of deals in 2013 dropped by 36 percent in 2013. Some of this drop in activity can be attributed to Hurricane Sandy as well as newsworthy events regarding deficient loss reserve carried by some P&C companies. Such events kept many investors on the sidelines until the loss exposure matured and the dust settled.

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▶CONTINUED FROM PAGE 2

THE STATE OF THE (INSURANCE) UNION

▶WHAT'S IN STORE FOR 2014?

While the 2013 insurance deal market saw slow activity, 2014, so far, looks to be promising. At the close of the first quarter, 17 deals with an aggregate deal value of $2.7 billion were announced, of which Warranty Group, Inc. and Wright Insurance Group, Inc.'s acquisitions account for approximately $1.9 billion.

Ultimately however, whether we will see M&A momentum return to pre-2013 levels largely depends upon macro factors such as economic growth, the interest rate environment, stock market performance and natural disasters.

If the economy continues its upward trajectory it will bring top-line growth to the insurance industry, leading fewer companies to look for M&A opportunities. Additionally, the trend of rising premium rates is likely to flatten as excess underwriting capacity may be a catalyst for market competition. However combined ratios will likely benefit from the recognition of recently favorable prices into earned premiums in 2014.

The Federal Reserve's stance on interest rates and quantitative easing policies have a direct effect on insurance industry valuations; in particular, on the life insurance sector. These interest rates are likely to rise modestly in 2014, which would make it more difficult for potential buyers to model improved results after an acquisition, thereby making premium valuation difficult to predict.

In 2013, the lack of significant natural disasters was welcomed by the insurance industry. However, it is of course impossible to predict if such luck will continue in 2014. While absence of a major catastrophe can increase M&A activity, one or more significant natural disasters can result in a serious drain on insurance industry capital, thereby reducing companies' ability to enter into M&A transactions.

Data source: SNL

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INSURANCE REGULATION

The Debate Continues

By John Green, Assurance Partner

In December 2013, the Federal Insurance Office (FIO) issued its report entitled, "How to Modernize and Improve the System of Insurance in the United States." This 65-page report, mandated by the Dodd-Frank Act of 2010, which was delayed by nearly two years, is notable in that it continues the long-running debate of federal vs. state regulation of the insurance industry. In addition, the report outlines the need for the United States to address international regulatory concerns. This article will explore a brief history of regulation in the United States, and the regulatory challenges insurance companies in the United States will face in the coming years.

▶A BRIEF HISTORY OF INSURANCE REGULATION IN THE UNITED STATES

State insurance regulation can be traced back to at least 1851, a period when states' rights were under intense debate, and the year New Hampshire appointed its first insurance commissioner. By 1871 all states had an insurance regulator and the National Association of Insurance Commissioners (NAIC) was formed for the purpose of developing uniform insurance law and regulations among the various states.

In the early 20th century President Theodore Roosevelt floated the idea of federal insurance regulation. Various bills were introduced in congress at that time calling for federal regulation under the theory that the insurance industry was at least as important as the railroads and banks, which were already federally regulated. However, none of these initiatives succeeded.

In 1944, the Supreme Court ruled that insurance could be regulated by the federal government. Although there were several congressional proposals to federally regulate the industry over more than 60 years since, no meaningful legislation was passed into law until the Dodd-Frank Act of 2010, which mandated the creation of the FIO.

▶THE ROLE OF THE FIO

The FIO, headed by Michael McRaith, a former state regulator, is a part of the U.S. Treasury Department. The FIOs role is to gather information regarding the U.S. insurance industry; monitor all aspects of the insurance industry; participate as a member of the Federal Stability and Oversight Committee (FSOC); make recommendations to improve the insurance industry; and serve as the U.S. representative to the International Association of Insurance Supervisors (IAIS). FIO performs these duties with minimal staff.

Insurance regulation is comprised of two broad areas, prudential regulation and marketplace regulation. Prudential regulation involves the oversight of an insurer's financial position and the ability to pay claims or benefits. Marketplace regulation involves the insurer's business practices such as pricing of premiums, licensing of insurers and agents, and consumer protection. The proponents of federal regulation believe that the current state-based system is not efficient because it does not promote uniformity. State regulation can be inconsistent with duplicative requirements and legal authority limited within each state. Proponents of state regulation, led by the National Association of Insurance Commissioners (NAIC), point to the fact that no insurance company became insolvent during the 2008 financial crisis, much of the industry is local in nature, and state regulation better addresses consumer complaints.

The FIO report stops short of proposing a comprehensive system of federal regulation to replace the current state system or the option of a federal charter (similar to the banking industry). Instead, the report proposes that state regulators adopt some initiatives to improve efficiency and suggests areas where direct federal involvement in insurance regulation is warranted. This recommendation is for a hybrid system of regulation.

▶ Read more

▶CONTINUED FROM PAGE 3

INSURANCE REGULATION

The 18 recommendations to state regulators essentially suggest that regulators should find ways to work together to improve efficiency by: communicating better; adopting uniform standards in the areas of risk transfer; adopting uniform rules about the character and fitness of officers and directors; coordinating payments from guaranty funds; and establishing uniform marketplace rules.

According to the FIO report, areas where direct federal involvement is warranted include: national standards for mortgage insurers; uniform treatment of reinsurers; regulation of large national and international insurers; and regulation of registered agents and brokers.

▶INTERNATIONAL INITIATIVES

While the debate continues in the United States, global regulatory initiatives could emerge in the next several years. The International Association of Insurance Supervisors (IAIS) issued two papers in the fall of 2013. The first deals with the development of a common risk-based global capital standard for insurers. The second involves the development of a Common Framework (ComFrame) for global insurance regulation based on the IAIS core principles. The capital standard project is slated to be completed in 2016 with standards being adopted in 2019. The timetable for the ComFrame has not been formulated.

IAIS is a voluntary membership organization comprised of insurance regulators from over 200 jurisdictions and approximately 140 countries. Essentially, the IAIS is the international version of the NAIC – an association with no direct regulatory power that can only recommend common standards and principles which members voluntarily adopt or not. Interestingly, the FIO, the NAIC and the Federal Reserve Board are all members of the IAIS.

▶NEXT STEPS

The release of the FIO report was met with little fanfare. Because the FIO has no power to enact any of the recommendations, the current regulatory system in the U.S. will remain status quo. Any meaningful federal initiatives can only be accomplished through acts of Congress, which undoubtedly will take time and will likely be challenged by various stakeholders. In the meantime, the FIO will continue to monitor the industry.

While the threat of federal regulation is not imminent, U.S. state legislators are pushing for more influence over global regulatory efforts. Recently the National Conference of Insurance Legislators (NCOIL) formed a task force of 21 state lawmakers for the purpose of lobbying both domestic and international agencies to ensure that efforts to change the current system are defeated.

With all the lobbying in the United States, it's safe to say there will be no major regulatory changes on the horizon. However, Dodd-Frank and the international initiatives have already had an impact on the large national and international insurers. Those companies have the unique pleasure of having triple regulation – state regulation among the 50 states; federal regulation through the Consumer Financial Protection Bureau and the Federal Reserve for those companies that are deemed Systemically Important Financial Institutions; and international regulation, be it country-based or through the IAIS. With the cost of all this regulation, it's no wonder the returns on equity are so paltry (14.34 percent for property/casualty and 6.8 percent for life) in relation to other industries (NYU Stern School of Business Report, January 2014).

Taking a step back, it would be difficult to argue that the current systems are efficient, but it does provide for interesting meetings and conferences throughout the globe for regulators, lobbyists and legislators.

For more information, please contact John Green, Assurance Partner at jgreen@bdo.com.

FASB ANNOUNCES NEXT STEPS ON INSURANCE STANDARD

On Feb. 19, 2014, the Financial Accounting Standards Board (FASB) issued an update regarding the new accounting standard for insurance companies. After seven years of deliberations with the International Accounting Standards Board (IASB) to create a joint insurance standard, FASB has decided to discontinue deliberations on the comprehensive insurance project and instead move ahead with targeted improvements to General Accepted Accounting Principles (GAAP).

FASB's focus will be on specific changes to long duration contracts and improved disclosures for short duration contracts. Board members indicated that the likelihood of reaching consensus on the joint standard in the near future was not good and the preference is to make improvements now as opposed to waiting for the IASB. FASB indicated that the number of scope exceptions that emerged during the joint deliberations combined with different IASB goals made it impractical to continue joint deliberations.

While the project began with high hopes that a new joint insurance standard would set the table for further convergence of GAAP and International Financial Reporting Standards (IFRS), at this time, it remains to be seen whether FASB and IASB can complete a joint standard at all.

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PErspective in Insurance

After an unprecedented number of insurance merger and acquisition (M&A) deals two years ago, insurance deal volume dwindled in 2013, resulting in the slowest activity the industry has seen in years. According to data from *SNL Financial*, in 2010, a total of 336 insurance deals were announced in the U.S., 401 in 2011 and 416 in 2012. Through the end of September 2013, however, only 168 insurance M&A transactions were announced. Despite 2013's significantly lower deal volume, industry experts are gearing up for a robust 2014, prompted, in part, by increased activity and interest in the annuities market from private equity funds.

While historically, strategic buyers accounted for nearly 90 percent of the insurance industry's deal volume, private equity funds are demonstrating interest by stepping up their activity in this space, particularly in the area of annuities. According to *Business Insurance*, there were 94 deals in 2013 that involved 16 private equity-backed buyers. Three private equity-backed firms in particular — Hub International Ltd. (backed by Apax Partners), Confie Seguros Insurance Services (backed by ABRY Partners) and AssuredPartners Inc. (backed by GTCR) — led more than 10 transactions each in 2013.

Among the factors drawing private equity to the insurance industry include the sector's relatively low risk environment and fee-based service nature, which typically deliver stable cash flows. Annuities are particularly attractive to private equity buyers because of the assets that back the debt. Given private equity's investment expertise, private equity firms can invest these assets toward options that offer a higher return compared to the type of investments insurers typically make.

While such investments have prompted regulatory scrutiny, private equity buyers have worked to address such concerns. In December 2013, executives of Athene Holding Ltd. and its affiliate Apollo Global Management, appeared before a Private Equity Issues Working Group set up by the National Association of Insurance Commissioners (NAIC), and announced they support more regulation and disclosure from life insurers that are backed by investment firms, as long as such regulation is also applied across the industry, according to *The Wall Street Journal*.

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

MARK YOUR CALENDAR…

APRIL

April 27-30
The 15th Annual NAIC/NIPR E-Reg Conference
Kansas City Marriott Downtown
Kansas City, Mo.

April 27-30
RIMS '14 Annual Conference & Exhibition
Denver, Colo.

MAY

May 4-6
ACORD LOMA 2014
Rosen Shingle Creek
Orlando, Fla.

May 4-7
Association of Home Office Underwriters (AHOU)
JW Marriott
Indianapolis, Ind.

May 7-9
NALC Spring Meeting
Sandestin Golf & Beach Resort
Destin, Fla.

JUNE

June 8-11
IASA Annual Conference
Indianapolis Convention Center
Indianapolis, Ind.

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BDO INSURANCE PRACTICE

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