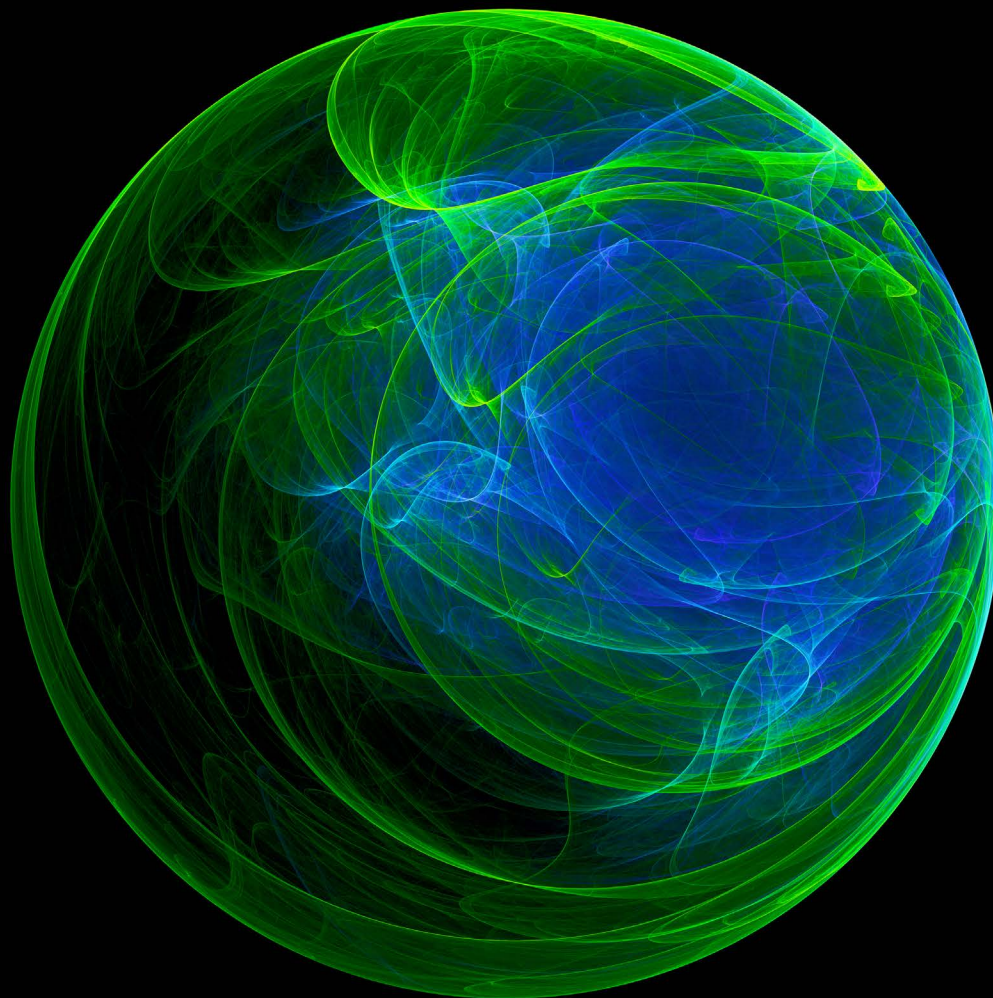


Deloitte.



2018 Insurance M&A outlook

The deal landscape continues to evolve

Overview and 2017 review

At the end of 2016, we correctly projected that 2017 insurance merger and acquisition (M&A) activity would start slowly but gain speed in the year's second half. Indeed, the number of insurer transactions announced during the second half of 2017 increased significantly—50 percent over the first half. The increase in broker transactions was a notable 25 percent. Seven deals valued at \$1 billion or more were announced—the same number as all of 2016. Both aggregate deal volume and value for insurer deals were down from 2016, 13 and 32 percent, respectively. This was the product of fewer large deals, with no announced deals reaching the \$5 billion threshold.¹

What's noteworthy about 2016 and 2017 is an evolving industry and M&A landscape that is setting the stage for a positive deal-making environment in 2018. Investor and consumer confidence is high; the US and global economies are improving in a synchronized manner; US tax reform has been signed into law; interest rates are moving in the right direction; organic growth remains elusive; and available capital remains at an all-time high. And while sources of uncertainty remain, they are not currently impeding M&A activity in a material way. Given these conditions, we expect 2018 deal volume and value to be largely consistent with 2016 and 2017. And although we don't anticipate any blockbuster deals along the lines of the ACE/Chubb transaction, we could see numerous smaller deals (\$1 billion to \$3 billion) as well as a handful of \$5+ billion deals as companies look to utilize M&A to achieve their strategic objectives.

This report looks back at 2017 and examines 2018 key trends to help insurance executives pinpoint M&A drivers and challenges, and plan their strategy accordingly.

2017 in review

Investor uncertainty leading up to and following the 2016 US election seemed to significantly restrain M&A through the first half of 2017 as insurers waited to see how policy and the economy would play out under the Trump administration and Republican-led Congress. Improved insurer stock prices as well as a scarcity of acquisition targets were additional factors that may have put a damper on the M&A market.²

July proved to be a noteworthy inflection point and the pace of M&A picked up. Despite the second-half surge, the number of insurance underwriter deals fell by 13 percent (from 97 to 84) YOY compared to 2016. Aggregate deal value was down even more—32 percent (from \$21.7 billion to \$14.8 billion). Average deal value increased 11 percent, from \$380 million in 2016 to \$422 million in 2017 (figure 1).³ Brokerage deal volume set a new record with 537 recorded transactions and a 53 percent increase in average deal value. Aggregate brokerage deal value was down, however, due to fewer \$1+ billion transactions versus 2016.

Figure 1. Insurance sector M&A activity, 2016-2017

	Number of deals			Aggregate deal value			Average deal value		
	2016	2017	YOY change	2016	2017	YOY change	2016	2017	YOY change
Underwriters	97	84	(13%)	\$21.7b	\$14.8b	(32%)	\$380m	\$422m	11%
L&H	27	31	15%	\$4.1b	\$6.6b	61%	\$291m	\$505m	74%
P&C	70	53	(24%)	\$17.6b	\$8.2b	(53%)	\$409m	\$372m	(9%)
Brokers	457	537	18%	\$7.3b	\$5.4b	(26%)	\$127m	\$194m	53%
Total	554	621	12%	\$29.0b	\$20.2b	(30%)			

In terms of aggregate value and volume, insurance M&A in 2017 remained largely consistent with most years since the financial crisis, with the exception of 2015. Most of 2017's transactions were on the smaller side, with only two exceeding \$2.5 billion in value. One of the year's biggest deals took place in the insurance broker space, when private equity (PE) firm KKR and Canadian pension fund Caisse de dépôt et placement du Québec acquired USI Insurance Services for \$4.3 billion.⁴ Other notable deals included Assurant's acquisition of The Warranty Group for \$2.5 billion;⁵ CF Corporation's \$1.8 billion acquisition of Fidelity & Guaranty Life;⁶ and Canada's Intact Financial Corporation's \$1.7 billion purchase of US specialty insurer OneBeacon Insurance Group. Notably, two deals in the first month of 2018—AIG's announced purchase of Validus Holdings Ltd. for \$5.56 billion⁷ and Lincoln Financial Group's announced acquisition of Liberty Life Assurance Company of Boston for about \$3.3 billion from Liberty Mutual⁸—have enabled the industry to match the total number of \$2.5+ billion deals for all of 2017.

Which factors and trends influenced industry M&A—for better or worse—in 2017?

- **An increase in uncertainty dampened investor confidence early in the year.** Lack of clarity about the direction of regulatory change, prolonged uncertainty around tax and health care reform, global geopolitical unrest, and general uneasiness about the implications of November 2016 election results on the economy and fiscal and monetary policy made companies more cautious about engaging in M&A during 2017's first half.
- **Foreign buyers remained largely sidelined, especially the Chinese.** While Chinese companies remained active shoppers in 2017, increasing deal scrutiny by US and Chinese regulators made it more difficult to construct and close deals than in previous years, a situation that is likely to persist in 2018.
- **New forms of institutional capital emerged.** Sovereign wealth funds, pension funds, and newly created closed-block (run-off) specialists that have materially lower cost of capital began to make their presence known as buyers in the US insurance space.
- **New types of noncontrol investors emerged.** Wealthy individual investors, PE firms, and venture capital (VC) funds, sometimes working individually and sometimes as an investor consortium, emerged prominently as willing providers of capital—but without the need to obtain operational control of the target.
- **The efficiency of global capital deployment continued to improve.** Relevant to insurance and across industries, the global low yield environment combined with the widespread availability of information and the improved means to deploy capital globally to its highest use made it less likely to have “lazy” capital languishing on balance sheets.
- **InsurTech minority investments and acquisitions continued to increase in strategic significance, if not deal value.** Insurance companies, PE firms, and VC funds continued to strategize about how to buy, partner, or invest in digital technologies—with the primary goal of enhancing the performance of their core businesses.
- **Valuations were viewed as rich.** Insurance companies were more fully valued in 2017 than in 2016. While richer valuations are good news for sellers, they also may make it more difficult to demonstrate to an acquiring company's board of directors that an acceptable ROI is feasible.
- **The US dollar declined in value by approximately 10 percent versus a basket of foreign currencies, effectively lowering prices for non-US buyers.** A decrease in the value of the dollar relative to select foreign currencies increased the attractiveness of US insurance properties as potential acquisition targets.

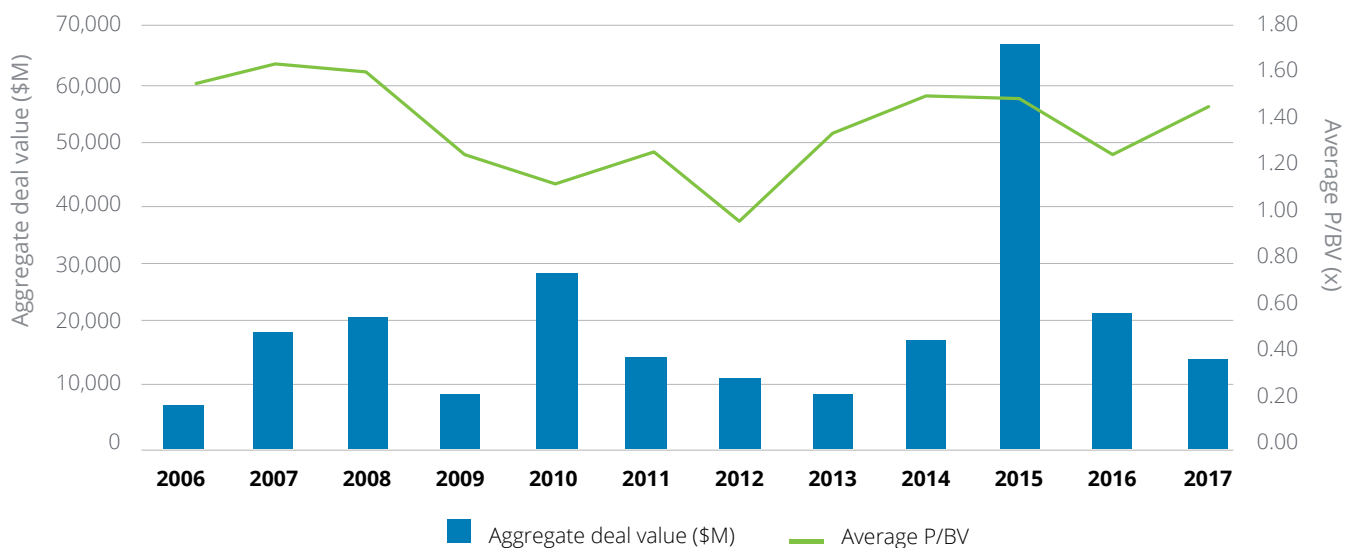
Insurance underwriters

The number of underwriter deals decreased by 13 in 2017, from 97 to 84. The largest closed transaction during the year was valued at \$1.9 billion—this was the lowest figure since 2013 and the fourth-lowest figure for any year over the past 12. Aggregate deal value, while down from 2016, remained largely consistent with the aggregate valuation range we’ve seen going all the way back to 2006 (with the notable exceptions of 2016 and 2010). Figure 2 illustrates

that average valuations increased significantly in 2017. However, the aggregated valuation figures are a product of very few data points and, therefore, may not be reliable. Only four of the 53 announced property and casualty (P&C) deals and five of the 31 announced life and health (L&H) deals reported price-to-book value (P/BV) multiples.

Figure 2. M&A trends for insurance underwriters

Insurance underwriter transactions Price-to-book value multiples



Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of deals	84	99	95	83	107	99	98	88	82	79	97	84
Size of deals (\$M)												
Low	0.4	0.4	1.3	0.0	0.3	0.48	0.1	0.1	1.3	0.3	0.3	0.01
High	1,120.9	2,744.0	6,225.0	1,900.0	15,545.1	3,534.6	3,100.2	1,125.0	5,579.6	28,240.3	6,303.8	1,906.2
Average	94.1	229.5	288.9	162.0	395.6	222.5	195.5	136.4	277.3	1,317.4	379.8	421.6
Observed P/BV deal multiples												
Low	0.75x	0.79x	0.48x	0.77x	0.55x	0.54x	0.31x	0.68x	0.14x	0.10x	0.18x	0.64x
High	6.19x	2.34x	2.81x	2.98x	1.70x	5.81x	5.99x	4.11x	2.83x	2.53x	4.97x	2.88x
Average	1.54x	1.63x	1.60x	1.20x	1.12x	1.24x	0.91x	1.34x	1.48x	1.45x	1.19x	1.47x
Median	1.66x	1.65x	1.59x	0.89x	1.06x	1.01x	0.81x	1.55x	1.39x	1.26x	1.14x	1.28x

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.
- Insurance underwriters include P&C, L&H, multiline, title, mortgage guaranty, and finance guaranty sectors covered by SNL Financial.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x.
- Analysis as of 12/31/2017.
- SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

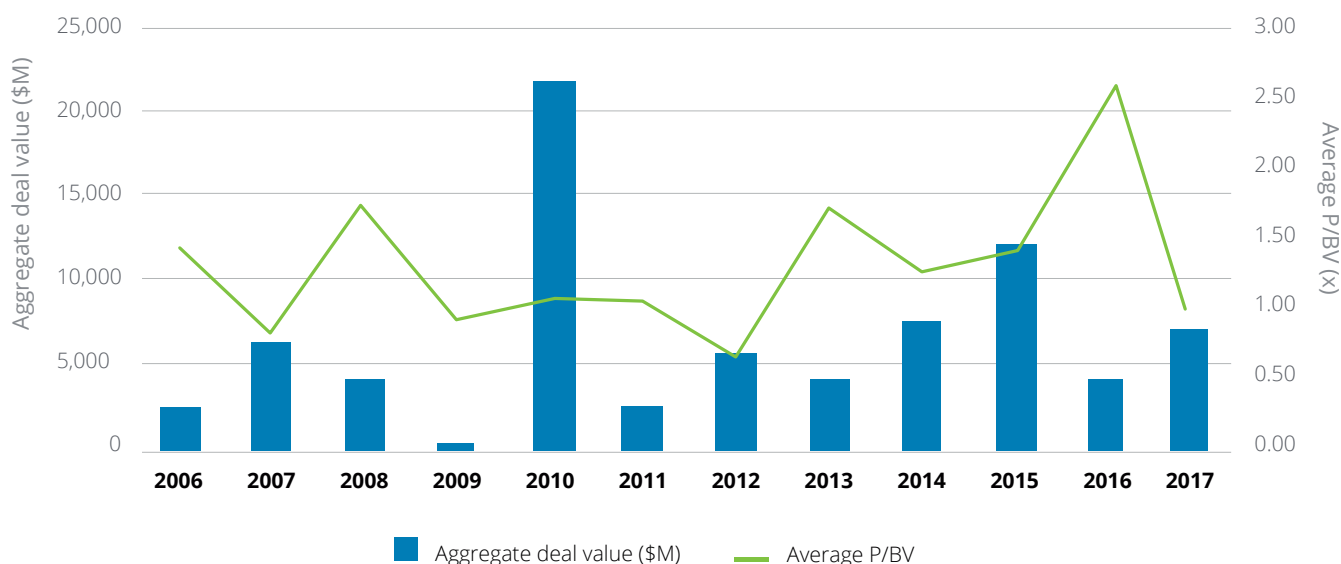
Life and health

2017 L&H M&A deal volume remained generally consistent with 2016 and most years going back to 2006. And like 2016, L&H experienced far less volume than the P&C subsector. Scarcity of targets, a low-yield environment, and sizable bid-ask spreads all contributed to the relatively muted action. Two relatively large deals were responsible for increasing average deal value by 74 percent and aggregate deal value by 61 percent over 2016. Figure 3 illustrates that average valuations

decreased significantly in 2017. However, the aggregated valuation figures are a product of very few data points and, therefore, may not be reliable. Only five of the 31 announced L&H deals reported P/BV multiples.

Figure 3. M&A trends for life and health

Life and health transactions Price-to-book value multiples



Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of deals	26	33	25	21	28	27	30	25	17	28	27	31
Size of deals (\$M)												
Low	1.8	0.4	1.3	0.5	0.3	0.5	0.1	0.1	3.0	1.5	6.8	0.01
High	893.0	2,400.0	2,400.0	126.5	15,545.1	917.3	1,550.0	1,056.0	5,579.6	5,001.9	2,750.8	1,835.2
Average	92.2	227.1	188.8	28.7	1,026.2	122.3	299.6	204.6	544.5	698.8	290.7	505.3
Observed P/BV deal multiples												
Low	0.75x	0.79x	1.21x	0.88x	1.06x	0.54x	0.31x	1.73x	1.29x	0.10x	0.18x	0.64x
High	2.41x	0.79x	2.28x	0.88x	1.06x	5.81x	5.99x	1.73x	1.29x	2.17x	4.97x	1.28x
Average	1.44x	0.79x	1.73x	0.88x	1.06x	1.05x	0.67x	1.73x	1.29x	1.40x	2.58x	0.99x
Median	1.17x	0.79x	1.71x	0.88x	1.06x	0.94x	0.67x	1.73x	1.29x	1.13x	2.58x	0.96x

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- For years 2007, 2009, 2010, 2013, and 2014 there is only one deal with data, respectively.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x, except in 2016
- Analysis as of 12/31/2017.
- SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

Property and casualty

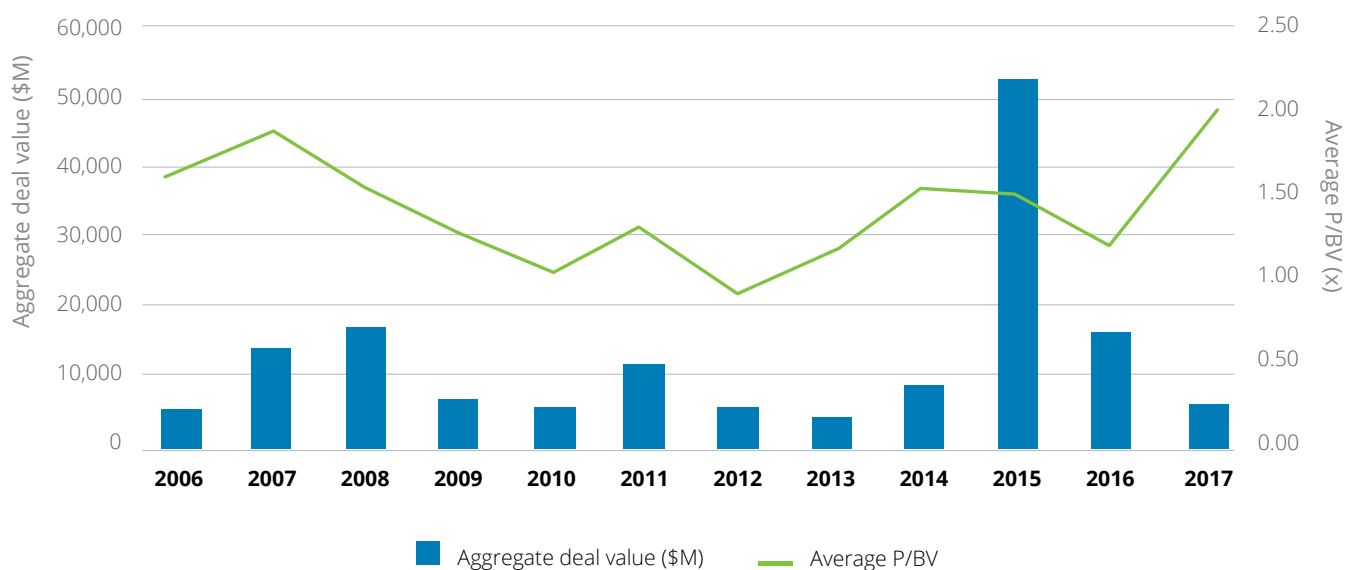
2017 P&C M&A deal volume was down notably from 2016—a 23 percent reduction from 70 deals to 53. There were only two P&C deals valued at \$1 billion or more. They generated \$3.6 billion or 28 percent of the total value of deals announced. In 2016, there were four P&C deals above \$1 billion, with aggregate deal value of \$14 billion or 65 percent of the total

value of deals announced. Figure 4 illustrates that average valuations increased significantly in 2017. However, the aggregated valuation figures are a product of very few data points and, therefore, may not be reliable. Only four of the 53 announced P&C deals reported P/BV multiples.

Figure 4. M&A trends for property and casualty

Property and casualty transactions

Price-to-book value multiples



Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of deals	58	66	70	62	79	72	68	63	65	51	70	53
Size of deals (\$M)												
Low	0.4	1.0	1.8	0.0	1.20	0.5	0.8	0.4	1.3	0.3	0.3	1.4
High	1,120.9	2,744.0	6,225.0	1,900.0	1,318.5	3,534.6	3,100.2	1,125.0	1,671.3	28,240.3	6,303.8	1,906.2
Average	95.1	230.6	323.5	196.9	145.7	266.8	148.5	110.3	199.4	1,636.1	408.8	372.2
Observed P/BV deal multiples												
Low	0.92x	1.23x	0.48x	0.77x	0.55x	0.73x	0.57x	0.68x	0.14x	0.99x	0.21x	1.50x
High	6.19x	2.34x	2.81x	2.98x	1.70x	2.69x	1.52x	4.11x	2.83x	2.53x	1.45x	2.88x
Average	1.58x	1.72x	1.56x	1.30x	1.13x	1.34x	0.97x	1.24x	1.50x	1.48x	1.19x	2.08x
Median	1.66x	1.73x	1.51x	0.99x	1.06x	1.16x	0.90x	1.38x	1.43x	1.29x	1.14x	1.97x

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda. Property and casualty includes P&C, multiline, title, mortgage guaranty, and finance guaranty sectors covered by SNL Financial.
- Transactions grouped by the year they were announced.
- Deal multiples represent closed multiples, unless the transaction is still pending close.
- For 2004, there is only one deal with data.
- Outliers have been removed from the average deal multiples. Outliers include all deals with a P/BV multiple smaller than 0.5x or greater than 3.0x.
- Analysis as of 12/31/2017.
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Insurance brokers

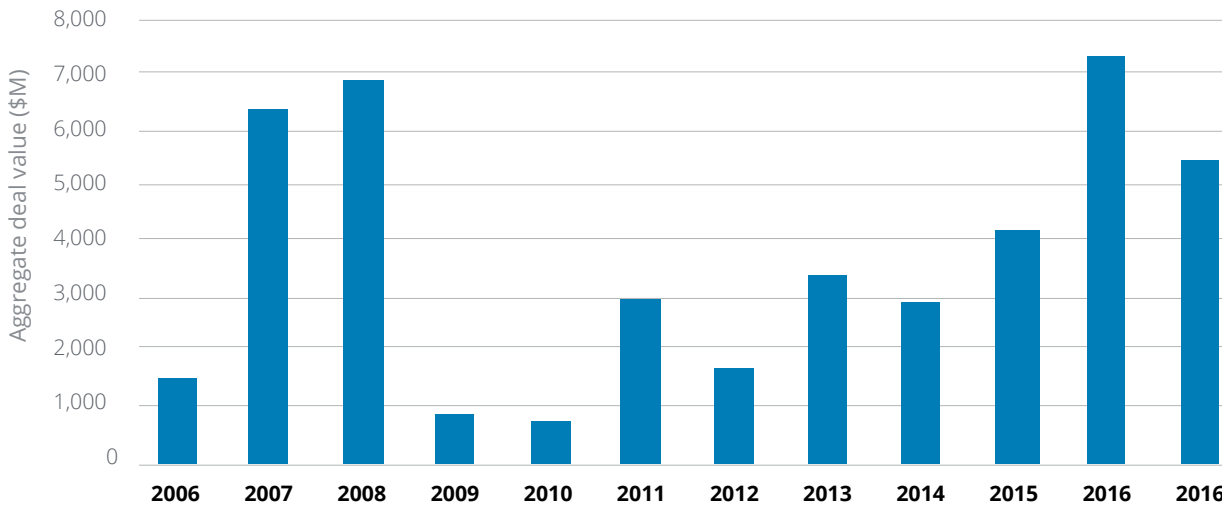
2017 broker deal volume set a new record: With 537 announced transactions it was the most active year ever recorded. Aggregate 2017 deal value dropped 26 percent (to \$5.4 billion from \$7.3 billion) from the previous year (figure 5). Average deal value would have dropped as well had it not been for the one large deal in 2017: KKR and Canadian pension fund Caisse de dépôt et placement du

Québec’s acquisition of USI Insurance Services for \$4.3 billion. This deal represented 80 percent of the year’s total announced deal value.⁹

Figure 5. M&A trends for insurance brokers

Insurance broker transactions

Aggregate deal value



Year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Number of deals	220	267	293	183	240	304	344	239	351	492	457	537

Source: SNL Financial

- Transactions represent US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda.
- Transactions grouped by the year they were announced.
- Analysis as of 12/31/2017.
- SNL has noted that some numbers may not reconcile to prior years as there may be a lag between deal public announcement and disclosure.

2018 Outlook

We anticipate that 2018 insurance M&A aggregate deal volume and value will remain generally consistent with what we've experienced since 2011 (with the exception of 2015) and be comprised primarily of smaller transactions valued at less than \$2 billion. That said, we do expect to see a handful of deals announced with a value of \$5 billion or more given the sheer number of CEOs of large, global companies who are speaking publicly about initiatives that will either directly or indirectly spur strategic M&A. Below the surface of the big headline numbers we anticipate an active insurance M&A marketplace that will continue to evolve in a number of ways, as discussed below.

L&H growth. From a subsector perspective, L&H businesses should continue to grow through acquisition, as lagging consumer demand for life insurance and annuity products continues to inhibit organic growth. While demand remains high for acquisitions, especially within the group insurance space and for closed blocks of life and annuity business, limited supply and other constraints will likely keep transaction volume muted—especially when compared to the P&C subsector.

P&C impacts. 2017's major hurricane season, West Coast forest fires, and other catastrophes may impact P&C carriers' 2018 income statements in certain markets and lines of business, but we don't expect they will raise rates enough to materially improve margins organically or lead to a significant hardening of the P&C market in the coming year. Due to this lack of organic growth, M&A will continue in the P&C subsector with small-to-medium-size specialty carriers, in particular, as they are appealing acquisition targets, especially for overseas players.

Uncertainty in reinsurance. The reinsurance market, which has been dealing with persistently soft rates for almost a decade, faces significant uncertainty on whether it can secure notable rate increases in 2018, despite 2017 being the costliest catastrophe year on record. Increasing their rates in the wake of the various storms has not been possible for many reinsurers given a muted increase in demand and alternative capital pouring into the sector. This dynamic has been eroding the long-term profitability of reinsurers, reshaping the landscape, and stimulating more M&A. American International Group's \$5.56 billion acquisition of Validus Holdings Ltd. in January 2018¹⁰ is the most recent example of this trend. By driving up the stock prices for several reinsurers after news of the transaction became public, the market signaled its view that more deals may follow.

Managing general agents (MGAs). Brokers interested in alternative distribution opportunities may look to acquire digital MGAs in 2018. MGAs are authorized to perform certain functions ordinarily handled only by insurers—binding coverage, underwriting and pricing, appointing retail agents within a particular area, and settling claims¹¹—which are attractive to small-to-medium businesses that don't want to buy insurance through traditional brick-and-mortar brokers. Acquiring an MGA can be a less expensive way for a broker to offer these services than developing them in house.

Increase in run-off transactions. The transfer of long-tail legacy liabilities for companies that have stopped writing a type of business (e.g., insurance and reinsurance of asbestos, environmental, construction defects) are becoming an increasingly active and impactful part of the insurance M&A marketplace. The viability of the run-off business model was reinforced in 2017 when a number of highly credible investors with extensive experience in the insurance industry created entities designed to accumulate specific types of run-off business. This increased the capital available specifically for this type of transaction and suggests we will see continued growth in the market in 2018 and beyond.

InsurTech investment. Pressure will continue to build on insurance companies to invest in InsurTech, either by acquiring a technology startup, becoming a minority owner, or investing in the portfolios of VC/PE funds or incubators. InsurTech-oriented investments may have totaled only two percent of insurance companies' invested capital from 2012–2017¹² but the need to innovate—especially from a digital perspective—will continue to fuel companies' interest in gaining access to InsurTech capabilities.

US tax reform. Comprehensive US tax reform legislation may stimulate insurance M&A in 2018 and beyond by improving the attractiveness of the US market to foreign investors. This could create an environment where more capital will be available for acquisitions, and level the playing field between domestic and foreign-based insurers (which previously enjoyed a competitive advantage through lower tax rates in their home countries).

Change at the top. The global insurance industry has experienced a lot of change at the top in the last 18 months or so. Multiple globally prominent insurers have announced new global and/or regional CEOs. In several cases, these individuals have spoken publicly about their intentions to pursue initiatives that would, either directly or indirectly, stimulate M&A activity in the industry. Examples include revisiting corporate strategy, reviewing business portfolios to identify noncore assets or key business gaps, reviewing geographic priorities, and using acquisitions to support efforts to digitize and/or fill specific talent gaps. Insurance M&A in 2018 could be given a boost as these new CEOs execute plans to grow their organizations and enhance performance.

Insurance M&A drivers and trends for 2018

Insurance company executives contemplating M&A in 2018—whether that means selling, buying, or partnering—should consider planning for and addressing seven trends that are evolving the insurance M&A market over time and may either help or hinder their ability to execute on their plans:

- Modularization of the insurance value chain
- Tax reform and regulatory policy
- Valuations
- Emergence of new buyer types
- Continued demand by foreign buyers to invest in the US market
- InsurTech: Buy, invest, or partner?
- Divesting noncore business

Modularization of the insurance value chain

Given the need to enhance ROE in a low-growth, low-margin industry that is awash in excess capital, insurance companies are examining their operating models and rethinking if and how they play within various components of the value chain. The realization that distribution, underwriting/servicing, and the sourcing of capital are separable chain components (each offering a platform for differentiated competitive advantage) is certainly not a new development. However, technology is significantly enhancing the ability of organizations to specialize in only the components of the value chain where they believe they can create a competitive advantage. Moving forward, we expect to see more instances of transactions being done specifically to implement strategic decisions around value chain participation.

The distribution component of the value chain is particularly susceptible to modularization as well as modernization. Travelers' acquisition of UK-based Simply Business¹³ is a case in point. Simply Business is positioned as a technology company offering products online on behalf of a broad panel of carriers. Its principal focus is enhancing the insurance buying experience for microbusiness owners by simplifying the small commercial insurance transaction and making it more efficient. Travelers saw an opportunity to potentially leverage this distribution platform in the United States as well as other countries.

MetLife's sale of its US retail advisor salesforce to MassMutual¹⁴ and its subsequent spin-off of Brighthouse Financial¹⁵ are other prominent examples. MassMutual, MetLife, and Brighthouse Financial each made deliberate value chain participation decisions in executing the two transactions: MassMutual deepening its commitment to exclusive distribution; MetLife becoming a simpler, more efficient, and less capital-intensive company

focused on employee benefits, asset management and protection, and fee-based retail products outside of the United States; and Brighthouse focusing on manufacturing annuity and life insurance solutions.¹⁶

Transactions of this nature are a new development for the industry and are likely to become more common as the pressure to enhance ROE intensifies and technology makes a wider range of strategic value chain choices more possible from an operational perspective.

Tax reform and regulatory policy

Tax reform

Congress approved and President Trump signed comprehensive US tax reform legislation—officially known as *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018* ("the Act")—that reduces the corporate tax rate from 35 percent to 21 percent effective January 1, 2018; provides other tax relief for corporations, pass-through entities, and individuals; moves the US toward a participation exemption-style system for taxing foreign-source income of domestic multinational corporations; and eliminates or modifies a number of well-known business and individual deductions, credits, and incentives.¹⁷

From a corporate perspective, a goal of the overhaul was to reduce the corporate tax rate and redesign the taxation of international operations to make US companies more competitive globally. To partially offset the decrease in revenue from these measures, the Act broadens the tax base. To that end, the bill involves substantial changes to the overall corporate tax rate structure and a host of changes specific to the insurance industry. The latter changes, in particular, will require evaluation and planning during the course of M&A activity. However, on a net basis, the reduction of the corporate tax combined with the ability to repatriate cash from overseas operations at a significantly reduced rate could create additional capital for strategic deployment, including through acquisitions.

Aside from the corporate tax rate reduction, some of the most significant tax reform provisions and their M&A implications include the following:

A major overhaul of the international tax rules will impact the global operations of many multinational insurance companies and groups.

- For foreign-parented groups, the Act significantly curtails—through the new Base Erosion and Anti-Abuse Tax—the efficiency of certain business operating models having a material cross-border component (e.g., reinsurance from a US direct carrier to a foreign related-party reinsurer) that is deemed to erode the US tax base. Such operating models may require substantive restructuring to retain tax efficiency.
- Most significantly for US-parented groups, while the Act retains subpart F (including the exception for active financing income) and creates a new category of foreign income loosely derived from intangibles that generally cannot be deferred (so-called GILTI income), the Act also creates a new participation exemption system for earnings derived by qualifying foreign subsidiaries (income from foreign branch operations continues to be subject to US tax on a current basis). Additionally, the Act results in changes to the tests for evaluating subsidiaries of US parents as controlled foreign corporations or passive foreign investment companies. The breadth and complexity of this international tax overhaul creates a fresh opportunity to optimize global structuring, while also creating a need to thoroughly evaluate any M&A activities between US and non-US organizations.

The Act also provides a number of general changes and changes specific to taxation of the insurance industry, which will impact insurers and require evaluation during the M&A process.

- Changes to the net operating loss (NOL) carryback and carryover rules, coupled with the retention of the complex life/nonlife insurance subgroup consolidation rules, require detailed evaluation for operating loss utilization when structuring an acquisition. The Act harmonizes the NOL rules for life companies and noninsurance corporations by significantly changing the treatment of both. For operating losses generated in a post-2017 tax year, life insurance and noninsurance company NOL rules provide for an unlimited carryforward period, but no longer allow for a carryback of losses. In addition, those NOL carryforwards will be subject to an annual utilization limitation of 80 percent of current year taxable income. However, nonlife insurance NOLs will retain their current two-year carryback, 20-year carryforward periods under the Act and will not be subject to the 80 percent

limitation applicable to life insurance and noninsurance NOLs. These various classes of operating losses are especially nuanced to the insurance industry.

- Limitations on the deductibility of interest at a consolidated level as well as the reduction in the corporate tax rate may result in modifications to the approach for evaluating acquisition financing. The Act further limits the deductibility of net interest expense to 30 percent of EBITDA (EBIT after 2021). Any limited interest expense is carried forward indefinitely. Generally, any business interest income and interest expense is considered active trade or business interest. This provision generally allows insurance companies to fully offset their interest expense by interest income, which may mitigate the impact of the new limitation for many taxpayers.
 - Note that the Conference Report explanation of the provision states that the calculation should be performed at the consolidated tax return group level. This may impact structuring under the life/nonlife consolidated return groups that include ineligible life companies. In this situation, netting of life company interest income and nonlife interest expense potentially could be limited.

A few other Act takeaways of note to the insurance industry may play a role in evaluating targets for acquisition.

- Changes to the calculation of life insurance reserves, deferred policy acquisition costs, net operating losses, changes in basis of computing reserves, and changes to a company's share of certain tax-favored investments are the biggest revenue raisers relative to the taxation of life insurance companies.
- Changes to reserving methodologies will impact virtually all policy lines, particularly decreasing the after-tax profitability of certain long-tail P&C lines and shorter-tail life policies with low cash surrender values.
- A reduction in the dividends received deduction for all corporations, coupled with changes to the life company share calculation and proration rules for P&C companies, will impact investment mix decisions for insurance companies of all types.

The insurance industry spent time evaluating the potential implications of tax reform over the last months of 2017, including the impact on regulatory capital. Although stakeholders are still digesting in detail the impact of the Act's specific provisions, we anticipate that the overall expected net positive impact of tax reform will spur activity in M&A during the first half of 2018 as companies move quickly to evaluate potential acquisition targets or divestitures.

Regulatory policy

Entering 2017, potential acquirers faced an important regulatory question: If you buy an insurance company and you're not currently on the Financial Stability Oversight Council's (FSOC) list of systemically important financial institutions will the purchase make you exceed the statutory asset threshold and put you on it?

A year later, regulators are shifting their focus from an entity's size to its activities as an indicator of systemic risk. This changes the focus from a domino effect, in which one institution falls and others follow, to a tsunami effect where all institutions may be impacted by an economic event.

Various regulatory entities are expected to weigh in with definitions of systemically risky activities, including the International Association of Insurance Supervisors (which is tasked by the G-20's Financial Stability Board with managing global insurer systemic risk), FSOC, and the Treasury Department. As regulators move from an exclusively entity-based to an activities-based systemic risk management system, we expect to see some insurance companies divest assets to avoid systemic risk designation.

Meanwhile, uncertainty remains about compliance demands under the US Department of Labor (DOL) Fiduciary Duty Rule for the sale of retirement-related products. However, many insurers didn't wait for fiduciary rule challenges to play out before repositioning themselves to comply. Nearly all of the 21 members of the Securities Industry and Financial Markets Association (SIFMA) surveyed by Deloitte reported making changes to retirement products in response to the fiduciary rule, including limiting or eliminating asset classes and certain product structures.¹⁸ The study also indicated an accelerating shift of retirement assets into fee-based or advisory programs rather than commission-based sales.¹⁹ Some SIFMA members cited "significant operational disruption and increased costs" for compliance, and indicated they expected "additional real costs as well as ongoing opportunity costs,"²⁰ even before it was announced that implementation of some of the fiduciary rule's components would be delayed for further review until July 2019.

With lessening federal regulatory focus under the Trump administration, state regulators may step into the breach. For example, larger states (California, New York) could toughen their scrutiny of incoming M&A activity, especially from countries such as China. Adding to the uncertainty around the DOL fiduciary rule, various other regulators are addressing the issue: The Securities and Exchange Commission (SEC) is working on its own version,²¹ the National Association of Insurance Commissioners expects to issue its

model based on a best interest standard in 2018, and New York has already proposed its new standards, broadened to include sales of life insurance.²²

These changes could lead to increased compliance requirements, which may prompt some insurers to consider the desirability of continued engagement in some markets. In states such as Pennsylvania, companies are already able to split blocks of business for sale or runoff, and a Connecticut law²³ went into effect in October 2017 allowing insurers domiciled in that state to do the same.²⁴

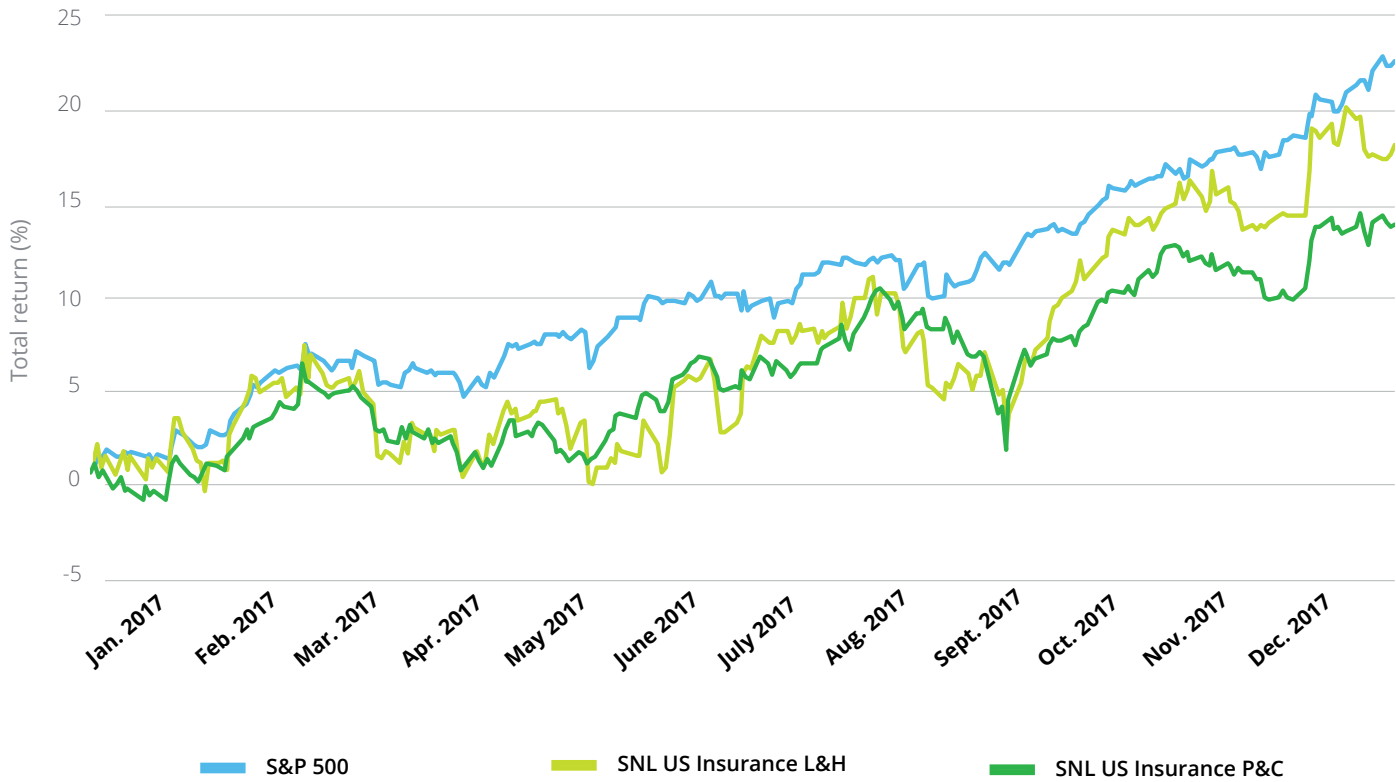
Many insurance firms already have invested considerable money and effort in key regulatory-related activities, such as enhancements to risk management and compliance frameworks. Executives expect these investments to deliver long-term business benefits regardless of the specific regulations that are enacted.²⁵

Valuations

While current insurance industry equity valuations are not extreme by historical standards, industry observers would likely agree that they are generally viewed as being more fully valued than they were at this time last year. The data, however, tell a different valuation story. In terms of stock prices, insurance companies had a good year. While not as strong as the S&P 500's 22 percent increase, insurers benefitted from the 2017 stock run-up (figure 6, next page), as illustrated by SNL's L&H and P&C indexes increasing by 17 and 14 percent, respectively, during the year. In terms of price/earnings (P/E) ratios, the S&P 500 P/E increased by nine percent to approximately 17.1. The P/E ratio of the L&H index lags the overall market significantly and actually decreased four percent over 2017 to 12.8. The story is significantly different in P&C: The P/E ratio of the P&C index finished the year at 22.1, a significant premium to the market and up 28 percent from the start of 2017. P/E ratios within most P&C subsectors are collectively approaching their highest point in the past 15 years.²⁶

A continued upward trend for valuations in 2018 could have diverging implications for insurance industry M&A: Richer valuations may increase overall deal value for sellers (an incentive for companies to put properties on the market) but it also may widen existing price gaps, making offered properties less attractive to potential buyers.

Figure 6. SNL US Insurance and S&P 500 index YTD total return (%)



Source: <https://platform.mi.spglobal.com/web/client?auth=inherit#markets/marketCharts?keyIndex=73SNL>

Notes:

- Data as of December 19, 2017.
- SNL US Insurance L&H: Includes all insurance underwriters in SNL's coverage universe in the Life & Health sector whose primary shares trade on a US exchange (NYSE, NYSE MKT, NASDAQ, OTC).
- SNL US Insurance P&C: Includes all insurance underwriters in SNL's coverage universe in the Property & Casualty sector whose primary shares trade on a US exchange (NYSE, NYSE MKT, NASDAQ, OTC).
- SNL US Insurance: Includes all insurance underwriters and insurance brokers in SNL's coverage universe whose primary shares trade on a US exchange (NYSE, NYSE MKT, NASDAQ, OTC).

Rising interest rates also may impact valuations and influence 2018 M&A. There was little surprise for markets when, on December 13, the Federal Reserve (the Fed) raised interest rates for the third time in 2017. The Fed also projected three more increases in 2018, as most of its officials expect inflation to gradually increase in the medium term.²⁷ Increasing rates improve insurance company investment returns, boost stock prices, and make it easier for companies that are considering a transaction to model a favorable economic scenario in their deal pricing.

There is considerable speculation about the impact of 2017's high incidence of major catastrophes on P&C and reinsurance market valuations, which have softened over time. Will the disasters raise rates and harden the market or will an excess of available capital continue to keep the market soft? If the market does harden, will it generate more M&A or will companies refocus on generating organic growth? A pricing reset in property-catastrophe premiums, particularly for reinsurance, is hoped for, but we don't anticipate any dramatic changes; in addition, P&C companies have robust reserves and pension funds and other competitive buyers are injecting new capital into the sector.

The combination of target scarcity and full valuations can make it difficult for buyer and seller to bridge the bid-ask gap. How many available assets take a unique approach to the marketplace and would materially add to an acquirer's portfolio to justify paying a significant premium? Executives should have a strong, strategic rationale for how they are going to create incremental value for such deals; they also should set a payment ceiling for a business or capability, especially since a shortage of high-quality targets and foreign buyers' willingness to pay a premium may drive sale prices to prohibitive levels.

Emergence of new buyer types

Sovereign wealth funds, pension funds, closed-block specialists, and special purchase acquisition companies (SPACs) that have materially lower cost of capital are emerging as highly competitive buyers in the US insurance space. Already prominent in Europe's life insurance market, these investors buy books of business that insurers want to dissolve or reinsure. The process is more complicated in the United States due to regulatory concerns around legal and financial finality and backstops for policyholders. Still, we expect the trend to stimulate M&A going forward as an example of new buyer types joining forces to transact deals, management seeking to improve a poor ROE via M&A, and divestments to exit certain lines of business.

For instance, an investor group led by affiliates of Apollo Global Management LLC announced in late December 2017 that they have entered into a definitive agreement to buy Voya Financial Inc.'s Closed Block Variable Annuity business.²⁸ Smaller investors are also making similar plays. As another example, FGL Holdings (a SPAC initially named CF Corporation) announced the completion of its \$1.835 billion acquisition of Fidelity & Guaranty Life in November 2017.²⁹ CF Corporation raised \$600 million via a 2016 initial public offering (IPO), making it the largest blank check IPO in over a decade.³⁰

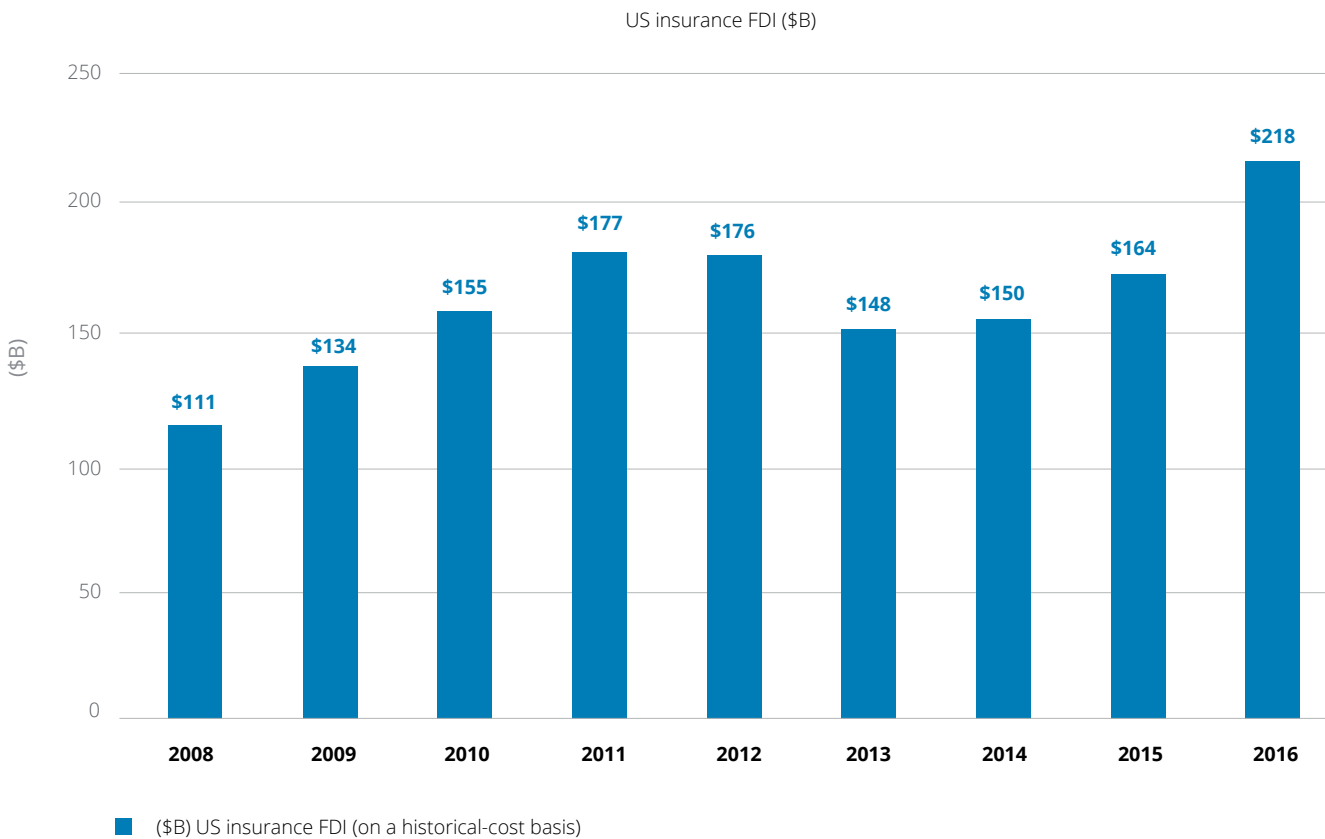
Typical competitive buyers have neither the expertise to underwrite nor the desire to distribute, but they may be part of an investor group looking to capitalize on another entity that does want to underwrite and distribute. Or they may want to aggregate various closed blocks, make them "lean and mean," and divest them in a run-off deal. In fact, demand for such run-offs may exceed supply, potentially leading to higher prices. That shouldn't be a deterrent to these competitive players; they have plenty of investment capital, are willing to pay more for certain assets, and may be prepared to accept a lower rate of return in exchange for predictability. A lot of this alternative capital is flowing into reinsurance, which investors like for the sector's mix of good yield, better interest rates, and relative safety.

Continued demand by foreign buyers to invest in the US market

The US insurance market continues to attract the interest of foreign investors, especially Chinese and Japanese companies seeking to diversify and grow outside their home country at a time when capital

is plentiful and debt is cheap.³¹ In fact, foreign direct investment from all countries into the US insurance industry has increased by \$70 billion since 2013, a 47 percent rise (figure 7).

Figure 7. US insurance foreign direct investment (FDI) position



Source: <https://www.bea.gov/international/di1fdibal.htm> Industry detail (includes all industries); <https://data.oecd.org/united-states.htm>

We anticipate that 2018 will see a continuation of inbound M&A interest and activity focused more on the P&C and specialty insurance segments than on L&H. Available capital remains abundant in Asian countries including China, Japan, and Taiwan. The US dollar has been falling relative to the euro, the pound, the

yuan, and the yen over the past year. And even though current insurance company valuations may be considered somewhat rich, sophisticated investors such as the Japanese are known to pay preemptive valuations for the right investment.

Market trends also suggest the potential for heightened interest by European buyers as they reevaluate the role the US market will play in their business portfolios. The scale and growth (in absolute dollars) that make the US market attractive, combined with the perception of favorable trajectories in economic growth, taxes, regulation, and interest rates, are triggering renewed interest in acquisitions. In addition, a historic deterrent—valuation—is being mitigated. Previously, any kind of material acquisition by a European buyer likely would have had to use stock (at least partially). With the European economy generally depressed versus the United States, companies would be using underappreciated shares to buy appreciated ones, which is quite difficult to justify financially. However, many non-US markets outperformed US markets in 2017, boosting underappreciated shares and renewing European interest in US targets.

Still, inbound deal activity will need to overcome some hurdles in 2018:

- Recent and continued interest rate increases may cause the dollar to strengthen, making deals more difficult for foreign buyers to execute.
- Japanese buyers are still digesting the large US purchases they made a couple of years ago. While they likely are looking for acquisition opportunities, they may not be ready to move into buying mode.
- The US Treasury Department's Committee on Foreign Investment in the United States (CFIUS) and state-level regulators continue to closely examine any proposed acquisition of US insurance assets by Chinese companies that have not provided enough transparency into financing and ownership structures. For example, Fosun drew CFIUS' interest after it paid more than \$2 billion for Ironshore, which owns a subsidiary that provides professional liability insurance to government employees including the Central Intelligence Agency.³² Such scrutiny can delay or even scuttle a deal. For example, China's Oceanwide Holdings is proceeding with its announced \$2.7 billion acquisition of US insurer Genworth Financial, which has stalled over concerns about Chinese access to sensitive US personal data.³³ Genworth, which in November 2017 extended its deadline to complete the deal to April 1, 2018, and Oceanwide are working to amend the proposed deal in hopes of winning CFIUS' approval.³⁴
- For a large part of 2017, the Chinese Insurance Regulatory Commission and China's Ministry of Finance encouraged companies to be more cautious in their outbound purchases, especially as some Chinese insurance companies were considered to be overleveraged. This action followed the Chinese State Council's 2016 ban on outbound investment deals worth more than \$10 billion or M&A transactions above \$1 billion if they are not within the Chinese investors' core business.³⁵ The Chinese government continues to constrain outbound deals going into 2018.

InsurTech: Buy, invest, or partner?

Although aggregate InsurTech M&A and minority investment transactions comprised just two percent of insurance company capital expenditures from 2012–2017,³⁶ InsurTech continues to garner considerable industry attention, given the overall strategic importance of technology investments. As detailed in the Deloitte report, *The state of the deal: M&A trends for 2018*, a survey of over 1,000 executives, including some insurers, reveals that acquiring technology assets now ranks first as a strategic driver of M&A deals.³⁷

In addition, insurers are increasing their focus on the technology and/or digital capabilities of their traditional M&A target—other insurance companies—as a key driver of these transactions.

Insurance companies in L&H, P&C, and reinsurance—as well as PE and VC funds—are strategizing how to leverage digital technologies including sensors, aggregators, and business process enablers (e.g., robotic process automation) to enhance business performance and customer engagement. Underwriting and distribution are also ripe for digitalization (see sidebar).

Digitalizing L&A underwriting and distribution

Insurers and InsurTech startups are experimenting with digitalization to shorten the L&H application-to-closing process from weeks to minutes, lower onboarding costs, and minimize the consumer dropout rate. Accelerated underwriting metrics—based on digitally available medical data, drug prescription information, and potentially even facial analytics technology—can be used to estimate an applicant's life expectancy and reduce or eliminate traditional medical tests.³⁸

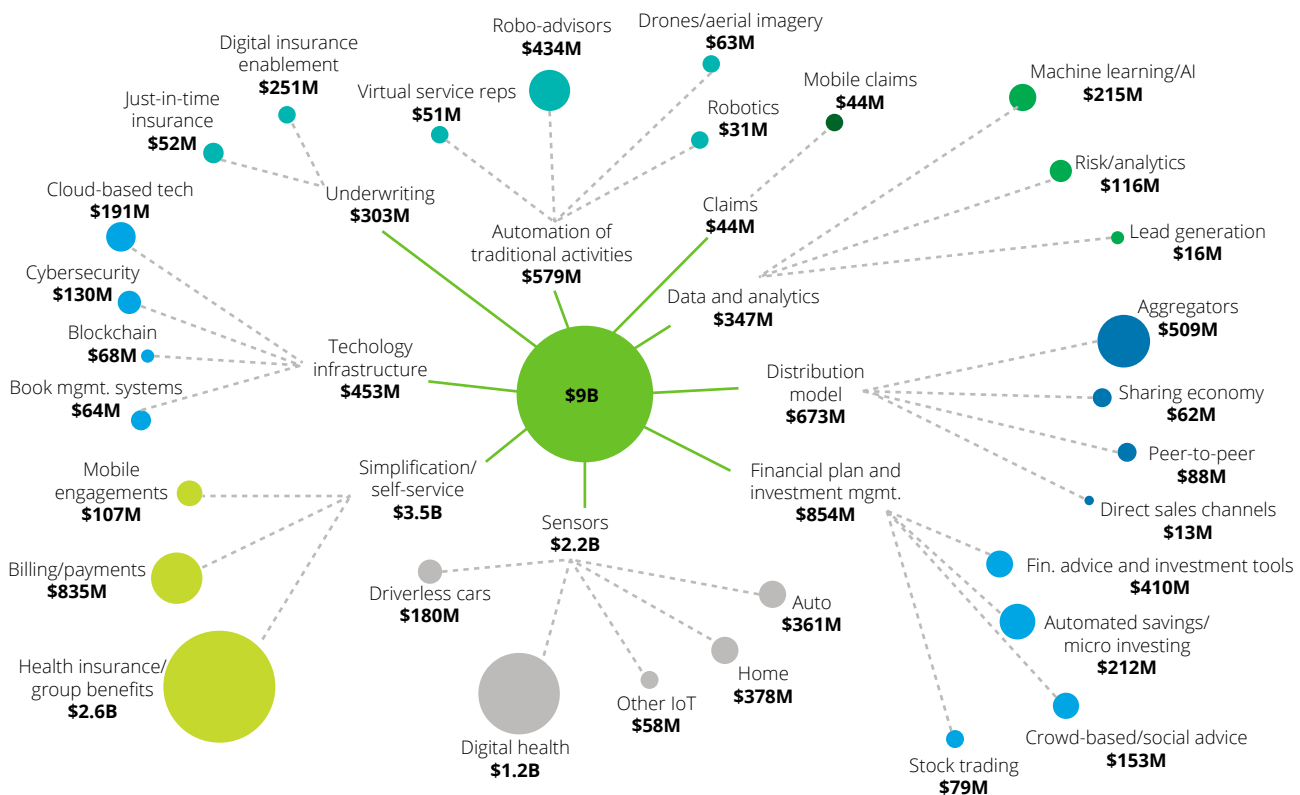
Digitalization may also enhance annuity and policy distribution. For example, Abaris, an InsurTech startup, has launched a direct-to-consumer online platform for deferred income annuities. Ladder, another startup, offers direct-to-consumer life insurance policies within minutes, particularly targeting younger consumers who may often avoid purchasing such coverage because of the time it traditionally takes to do so.³⁹

Some InsurTech deals will be outright purchases, as seen in American Family Insurance's December 2017 acquisitions of data and analytics software company Networked Insights and home inspection software company HomeGauge. Via its press release, American Family said that the acquisitions are part of an enterprise-wide focus on investing in technology platforms, data and analytics, and artificial intelligence (AI).⁴⁰ Many insurers have been using corporate venture capital (CVC) funds to make minority investments within the InsurTech space. We expect this trend to continue as insurers seek to obtain capabilities and/or talent to

positively impact their core businesses. Figure 8 highlights the technologies that have attracted the most investment interest during 2012 to 2017.

Insurance companies are realizing that investing gets them a seat at the table so they know what is going on in the tech space. In fact, insurers appear to be interacting smoothly and comfortably with InsurTech disruptors, with most recognizing these new players as potential collaborators rather than competitors, and vice versa.⁴¹

Figure 8. Investment in InsurTech startups across trend areas 2012–Q1 2017



Source: Deloitte analysis using CB Insights data. Numbers do not include companies for which funding was undisclosed. Funding values are rounded.

Most insurers are focusing on leveraging capabilities offered by InsurTech organizations to enhance operational efficiencies, customer value, or revenue growth within their core businesses. For the most part, they're achieving this by becoming customers of and/or by making minority investments in those InsurTech

organizations. There have been many fewer examples of outright acquisitions, as it is rare to see an innovation so unique with barriers of entry so high that a carrier will want to buy the startup. This may change as InsurTech organizations mature their value propositions.

Technology's rapid evolution is also influencing insurance companies' decisions whether to acquire, partner, or invest in specific capabilities. Options include:

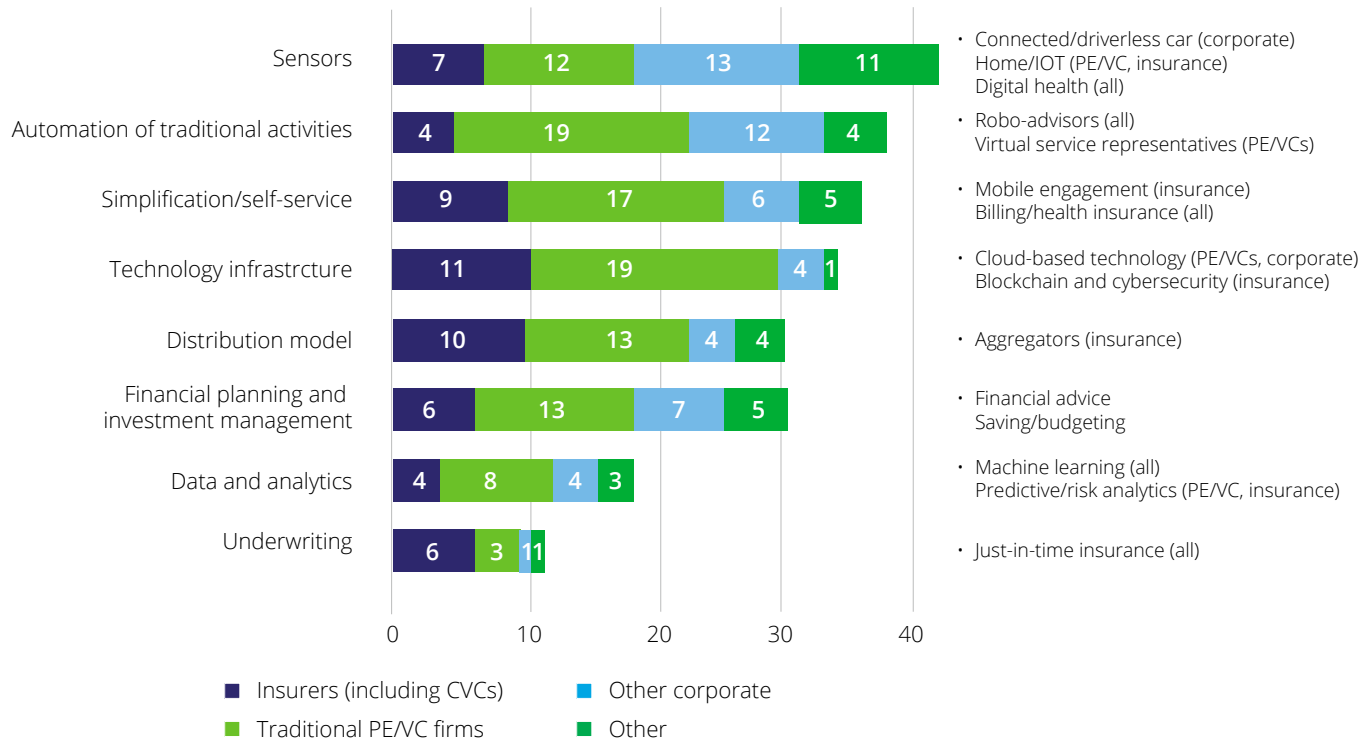
- Making outright acquisitions of InsurTech assets
- Standing up InsurTech venture funds to make an off-balance-sheet financial investment
- Making an on-balance-sheet equity investment to test/incubate a business opportunity or capability that may benefit the investor's core business
- Making indirect investments (which may evolve into equity investments) to work with InsurTech startups on specific projects and proof-of-concept initiatives⁴²

For insurance companies that choose to invest, trending areas include technology infrastructure, distribution models, and simplification/self-service features (figure 9).

Might some insurance companies decide to build versus buy? The choice is likely to be technology or product specific. If a carrier has a very specialized offering and wants to gain a first-to-market advantage, it may elect to build; if not, partnering with a startup is more likely.

Figure 9. 2016-17 investments by trend areas and investment source

Number of companies



Source: Deloitte analysis utilizing CB Insights data. Excludes all acquisitions for which funding was not disclosed.

Divesting noncore business

Years ago, many insurance companies sought to grow their revenues and customer base by casting their net wider—building and acquiring capabilities to amass large product and/or geographic footprints or become more like full-service financial institutions. However, a lot has changed in the last decade: Competition is tougher, regulations are tighter, the pace of technological change continues to accelerate, customer expectations are growing, loss reserve releases are slowing, and some added services are proving to be more burden than revenue booster. In response, many insurance companies are considering pulling in their nets, focusing on what they do best, and divesting noncore assets for both competitive and regulatory reasons.

Some divestments complement the modularization trend discussed earlier. We can see, for example, group life companies naturally disaggregating benefits enrollment, benefits administration, and other related functions. The challenge is that many companies are wrestling with the idea of what is “core.” Do they want to focus on product selling and customer acquisition, certain specialty insurance products, or digital-enabled customer relationship management? As insurance company growth strategies come into focus, we expect to see more lines of business being shed.

Some insurance companies are preparing to divest assets in anticipation of regulatory changes to the activities-based risk designation. We also see companies changing the way they transfer capital in preparation for tax reform. A lowered US corporate tax rate may drive some divestitures of assets set up or reinsured to recognize revenue in Bermuda or other low- or no-tax domiciles.

The increasing impact of run-off insurance deals

Insurance companies looking to unlock capital supporting legacy liabilities are turning with regularity to run-offs. To illustrate, 2017 saw a significant increase in insurance run-off transactions, with deal types taking the form of complete portfolio sales or reinsurance transactions such as loss portfolio transfers, adverse development covers, and hybrid solutions (figure 10).

Many run-off transactions are acquisitions themselves. Target companies can be cleaned up ahead of the sale to increase valuations by removing the drag from run-off business. The run-off structures can be used in conjunction with active company transactions to provide a buyer with the desired portion of the business.

Although run-off deals can protect a company's balance sheet from certain long-term, risk-attaching agreements, they don't necessarily give the seller complete finality; if the reserves deteriorate badly enough, the seller will remain on the hook.

Investor interest in run-off business has been evidenced by several recent deals in which highly credible investors with significant experience in the insurance industry launched new entities designed to execute run-off business models. As mentioned earlier, a consortium of investors announced in December 2017 that they entered into an agreement to acquire the Voya Financial Closed Block Variable Annuity business. The investment was made through a newly formed standalone entity named Venerable Holdings Inc. The investors anticipate using Venerable as a platform for an ongoing effort to consolidate variable annuity blocks from across the industry.⁴³

We anticipate a continued increase in run-off deals as companies look to unlock capital and shed “dead” businesses. Deal-making should be aided by increased investor interest in run-off businesses and the use of new regulations in Rhode Island and Vermont to make run-off deals cleaner.

Figure 10. Representative examples of recent P&C run-off deal activity

Company	Runoff company	Deal type	Limit provided	Reserves transferred
AIG	Berkshire Hathaway	Hybrid LPT/ADC	\$20B	\$7B
AmTrust	Premia	Hybrid LPT/ADC	\$1B	\$625M
RSA (UK)	Enstar	LPT	NA	\$1.2M
QBE	Enstar	LPT	NA	\$900M

Source: Deloitte, Mid-year market update: What M&A issues are reshaping the insurance industry?, August 10, 2017, accessed January 21, 2018, <https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/series/financial-services/insurance.html>.

Moving forward on 2018 insurance M&A opportunities

While 2018 aggregate deal volume and value will likely be consistent with 2016 and 2017, we expect to see continued evolution in the insurance M&A landscape during 2018, setting the stage for an active deal-making environment. To move forward with confidence and make optimal use of available capital, executives should link M&A efforts to their overall growth strategy—investment options may be organic, inorganic, or both. Start by confirming that proactive target screening efforts are aligned with overall strategy. In addition, executives contemplating M&A should examine the company's existing business portfolio, consider divesting assets that may no

longer be core, and think about acquisitions or investments in businesses or capabilities that will improve positioning in core markets. And deal team members should focus on conducting thorough due diligence and effectively planning for integration at the beginning of the process, not after the transaction closes.



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