NOVARICA

EXECUTIVE BRIEF

JANUARY 2017

FIVE POTENTIAL CHANGES IN 2017 FOR INSURANCE

Topics

- **Product innovation,** driven by market and technology evolution
- **Predictive analytics** impact
- **Cyber-Security** risks from new quarters
- **Digital distribution** starting to affect traditional insurers
- **Regulatory** changes driven by political pressures

Summary

Most of the insurance industry admits the potential for real change to occur in the industry, but few expect it in the short-term. Nonetheless, some insurers do see the demand for different product types, the impact of predictive analytics, and the threat of digital competition and cyber-security as areas where real change is likely in 2017, and are taking steps to prepare.

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TABLE OF CONTENTS

FIGURES & TABLES

INTRODUCTION

The past few years have brought incremental rather than discontinuous change to the insurance industry. There has been a steady ratcheting up of pressure for more digital capabilities, better data and analytics, and more flexible and modern core systems. Novarica has documented and analyzed these trends in our *Insurer IT Budgets and Projects* reports, our annual *Hot Topics for Insurers* reports, and our *Novarica New Normal 100 reports*.

Bill Gates famously wrote in 1996, "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten." But the insurance industry may be flipping this dictum on its head. If one compares the rhetoric of most senior executives in insurance and the strategic plans of their companies, it's clear that they believe significant change is likely in the 10-year timeframe, but that the next 12 months will look a lot like the last 12. Nonetheless, there is a widely accepted risk of significant change within the coming year.

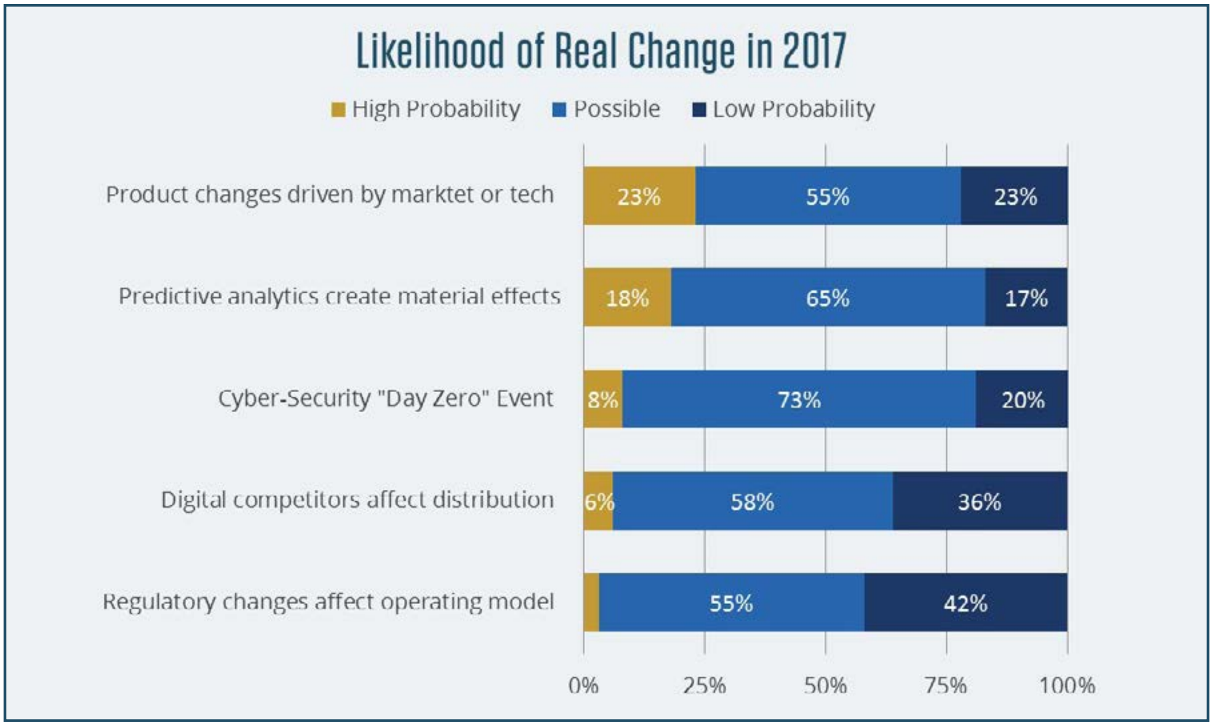
Some of the possible changes that insurers may face in 2017 include the risks that:

- **Distribution** could be materially affected by digital competitors
- **Products** could need to be launched that are substantially different than those currently offered, driven by the realization of changing market needs or the availability of new technology
- **Predictive analytics** could have a material effect on underwriting or claims results
- **Security** strategy could have to be completely rethought due to a "Day Zero" Cyber Security Breach somewhere in the economy
- **Regulatory** changes could occur that would require substantial changes to operating models

Based on a quick snap poll of more than 60 insurer CIO members of the *Novarica Research Council*, it appears that most of the industry admits the potential for change, but doesn't really expect it.

Participants included a broad cross-section of Council members, which includes both large and midsize insurers (over/under $1 B) across personal, commercial, specialty, workers comp, life, annuity, and group benefits. The results of this poll are shown in the figure on the following page. Members were asked to rank the likelihood of each of the changes above on a scale of 1-10. Responses of 9 or 10 are shown as "High Probability" and responses of 1 or 2 are shown as "Low Probability." Responses of 3-8 are shown as "Possible."

FIGURE 1: Likelihood of Real Change in 2017



Source: Novarica Snap Poll of 66 Insurer CIOs, 2016Q4

In general, the insurer CIO community is expecting continuity rather than change in 2017. Between one-fifth and one third think any change in any of these areas is highly unlikely.

Only about one in five firmly expect product changes driven by the kinds of changes in technology capabilities and customer expectations that are driving massive investment in InsureTech. Similar numbers expect real significant impact on underwriting and claims from predictive analytics.

Fewer than one in ten firmly expect digital competitors to materially affect their distribution, or a truly disruptive cyber-security or regulatory event.

However, more than half of the group believes that real change is at least possible in all of five of these areas.

The following sections of this brief look at each of these five areas in more detail.

PRODUCT CHANGES

Given a history of continuous product changes, it's not surprising that 23% of insurers believe it's highly probable that they will have launched substantially different products than they currently offer.

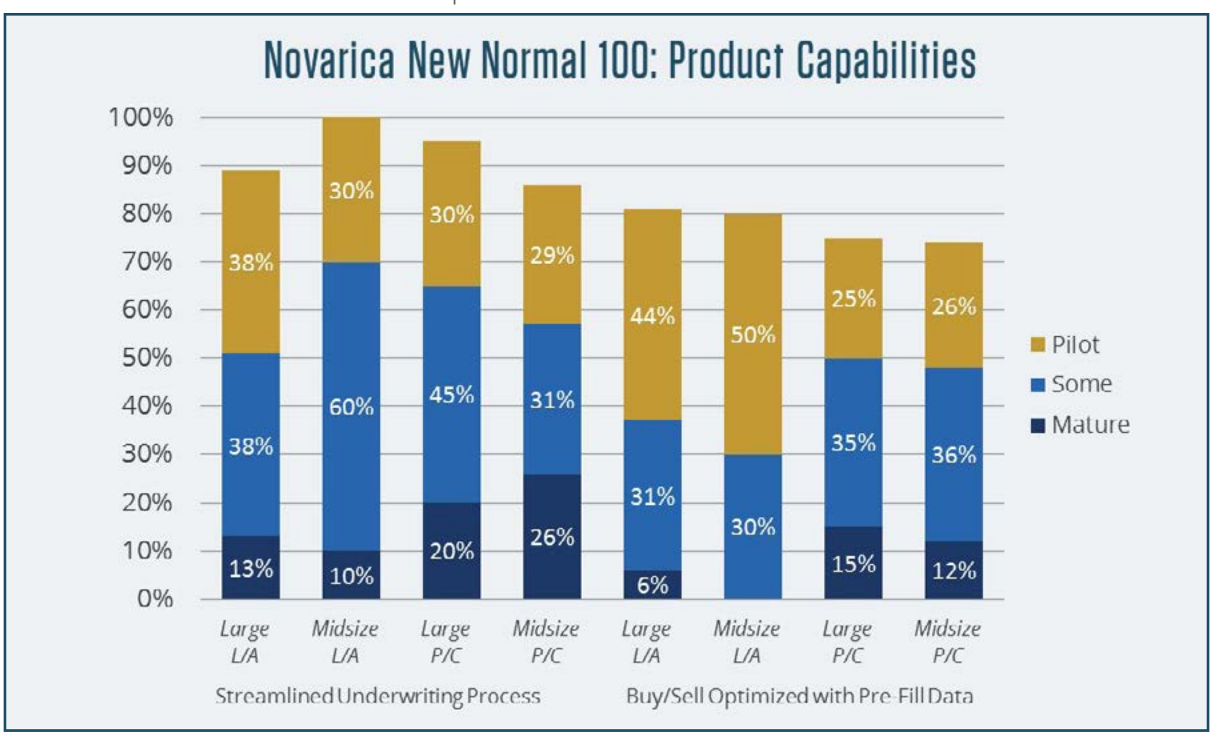
Insurers are always evolving and modifying products, but the changing expectations of customers and the changing capabilities of technology are combining to accelerate this change. InsureTech "Creative Carriers" like Trov and Slice are offering innovative micro-insurance products and others like Lemonade and Hiscox are offering simplified, streamlined versions of renters insurance and small business insurance (for more on Creative Carriers and other classes of InsureTech, see *The ABCs of InsureTech for Incumbent Insurers*, *November 2016*)

In this sample, one midsized life insurer noted that they're planning to offer a simplified digital product to address the adult millennial market, and a super-regional P/C insurer plans to offer a mobile-optimized, completely paperless offering that heavily leverages third party data for underwriting, but which will be sold through traditional agent channels.

New products often leverage pre-fill third-party data in underwriting, and are designed with the streamlined underwriting process in mind. The *Novarica New Normal 100* (*June 2016*) showed that small numbers of insurers already have mature capabilities in both of these areas, and pilot activity is widespread.

As shown in the figure below, more than 20% of P/C insurers both large and midsize (over/under $1 B in DWP) consider themselves to have mature capabilities in developing products specifically to support a streamlined underwriting process, and about half of insurers in all size/sector groups have at least some capabilities in this area. Designing products that are optimized to improve the buying process by leveraging pre-fill (a key focus of many InsureTech players) is less mature across incumbent insurers.

FIGURE 2: Novarica New Normal 100: Product Capabilities



Source: Novarica Survey 2016Q2. Large L/A n=16, Midsize L/A n=10, Large P/C n=20, Midsize P/C n=42

PREDICTIVE ANALYTICS

Predictive analytics has been increasingly widespread in insurance over the past five years, and the impacts are already being felt, especially in terms of underwriting results and managing claims.

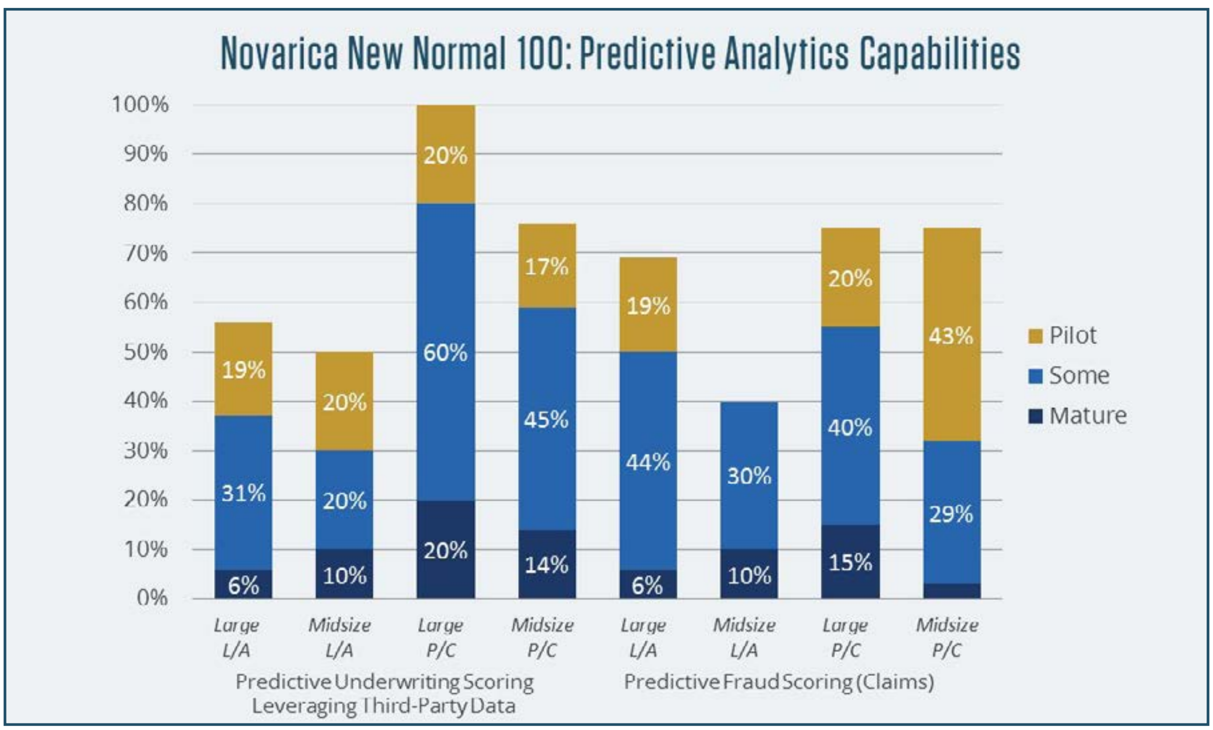
As noted on Novarica's ***blog*** in September, while most of the external entrants to the insurance industry from Silicon Valley focus on customer experience or distribution as the opportunity to differentiate from incumbent players, new entrants from Wall Street – especially those from quantitative hedge funds – see their superior abilities in predictive analytics as the key to outcompeting incumbents.

18% of insurers in this study group believe it's highly probable that the use of predictive analytics will have had a material effect on their company's underwriting or claims results by the end of 2017, but an equal number believe it's highly improbable.

Among the true believers are a specialty lines insurer and a workers comp insurer who noted they're already seeing impact from previous investments. The skeptics are more likely to include life/annuity insurers

This split was also seen in our *Novarica New Normal 100* research, where about half as many life/annuity as property/casualty insurers reported current use of predictive analytics in underwriting. However, predictive analytics for fraud detection deployment rates were comparable between the sectors. The figure below show the current maturity levels of insurers by size (over/under $1B in DWP) and sector.

FIGURE 3: Novarica New Normal 100: Predictive Analytics Capabilities



Source: Novarica Survey 2016Q2. Large L/A n=16, Midsize L/A n=10, Large P/C n=20, Midsize P/C n=42

CYBER-SECURITY

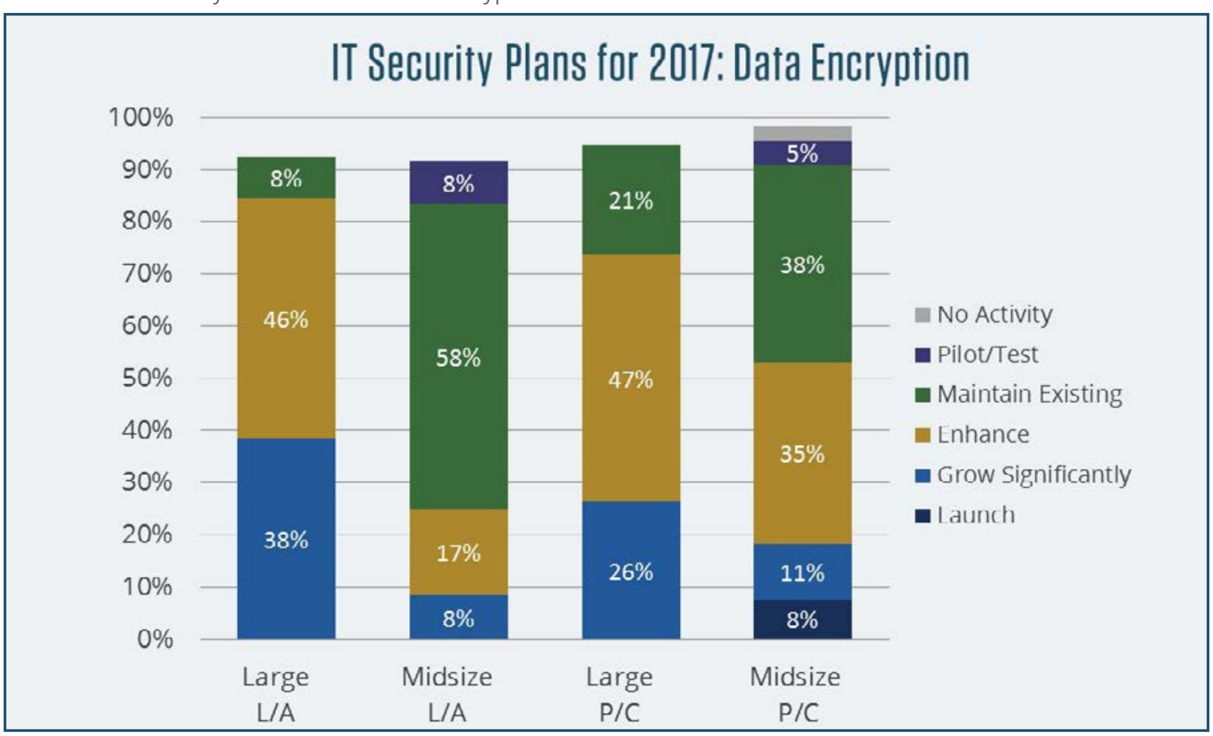
A "Day Zero" breach is one that exploits previously unknown vulnerabilities, and therefore is unanticipated by current security practices.

Only 7% of insurers believe it is highly probable that there would be a "Day Zero" cyber-security breach somewhere in the economy that would force them to completely rethink their security strategy. On the other hand, only 18% believed it is highly improbable. Some of those skeptics didn't believe that anything was likely to change their strategies, since they were already devoting significant resources to security.

While insurers have long focused on application security and network defense, fewer have focused on encrypting data at rest. Based on another recent Novarica survey, this may be changing, especially for larger companies. Our research shows that more than 70% of large insurers are growing or enhancing their capabilities in this area.

The figure below shows data collected in Q4 on insurers plans for data encryption in 2017 by size (over/under $1B in DWP) and sector. This will be further examined in an update to our *US Insurer IT Security Update* report next quarter.

FIGURE 4: Insurer Security Plans for 2017: Data Encryption



Source: Novarica Survey 2016Q2. Large L/A n=13, Midsize L/A n=12, Large P/C n=19, Midsize P/C n=66

DIGITAL COMPETITORS AND DISTRIBUTION

Despite the billions of dollars being poured into Digital Distributor *InsureTech* plays, only 6% of insurers in this group believe there's a high probability that their own distribution will be materially affected by digital competitors. 37% believe it's highly unlikely.

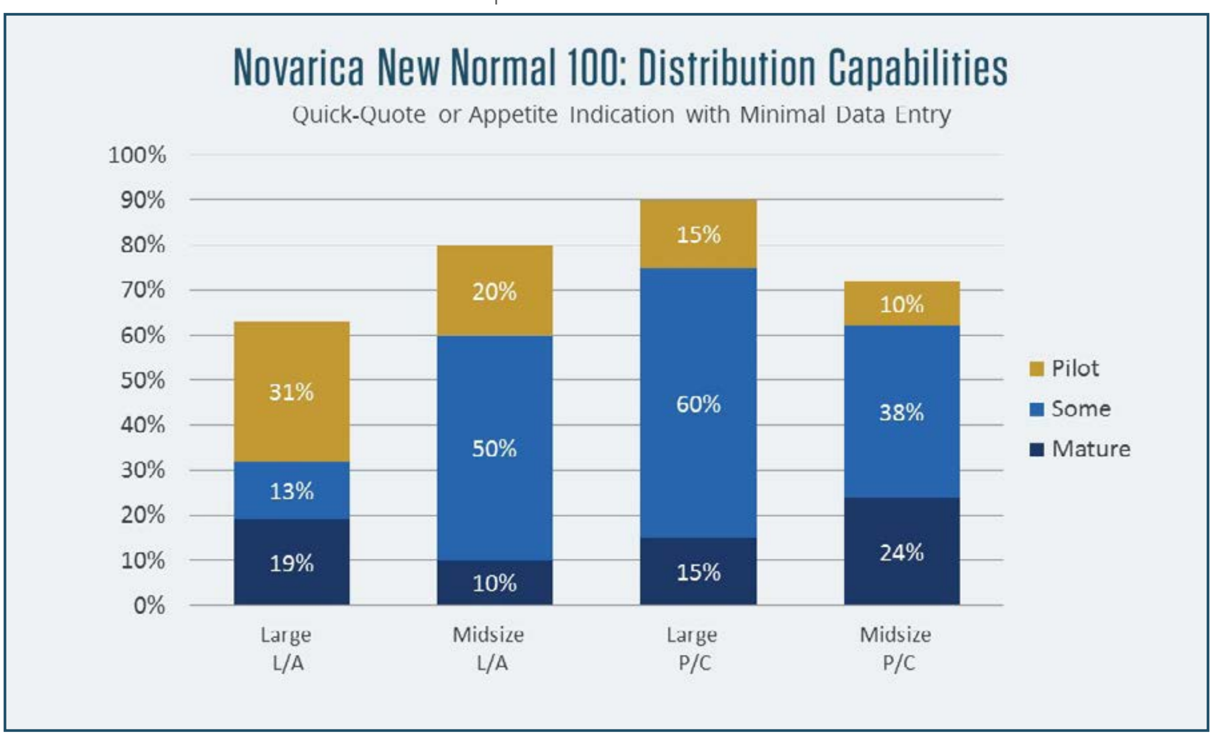
The true believers cross all different lines of business, from HNW personal lines to specialty commercial to annuities and group benefits. Interestingly, one of the true believers cited major direct personal auto insurers (e.g. GEICO and Progressive) as the "Digital Distributors" he most fears. This underscores the point that digital distributors are nothing new, despite the level of media attention that start-ups in this space attract.

One of the things that digital distributors focus on, whether they are start-ups or incumbents, is ease of transactions for buyers. This ties back to the other capabilities mentioned in this brief — leveraging third-party data, analytics, and streamlined underwriting to be able to provide a quote or indication of interest with minimal data entry from the customer or agent.

The figure below shows insurers' capabilities in this area by size (over/under $1 B in DWP) and sector from the Novarica New Normal 100 reports. With the exception of large life/annuity insurers, about 60% of insurers have at least some capabilities here.

This is a continued area of investment, and a critical one for insurers to be able to capture agent and customer activity in a world of ever-increasing standards for user experience and convenience.

FIGURE 5: Novarica New Normal 100: Distribution Capabilities



Source: Novarica Survey 2016Q2. Large L/A n=16,Midsize L/A n=10, Large P/C n=20, Midsize P/C n=42

REGULATORY

Only 3% of those polled believe that a significant regulatory change will occur in 2017 that will require them to substantially change their operating model, while 42% rate this possibility as highly unlikely.

A Republication administration supported by a Republican congress seems less likely to enact or enforce new restrictions on the industry, such as the pending DOL fiduciary rule that has threatened to up-end the distribution of retirement products. On the other hand, the uncertainty of what exactly a “Repeal and Replace” of the Affordable Care Act would involve is keeping health insurers up nights.

At the same time, the waning of federal regulatory initiatives may open the way to more activist states like New York and California. New York’s proposed Cyber-Security rules, for example, have the potential to be extremely onerous for financial institutions including insurers.

But when it comes to anticipating significant change in 2017, few insurers expect the government to be the catalyst.

CONCLUDING THOUGHTS

As Yogi Berra is alleged to have said, it's tough to make predictions, especially about the future. Despite the potential for real changes in 2017, most insurers are expecting continuity rather than disruption.

Nonetheless, more than half of insurance IT leaders admit the possibility of real change in all of the areas discussed in this brief. Insurers need to take steps to be prepared to react if this change does occur. Going into 2017, insurers should carefully consider their own abilities to:

- ✓ Rapidly launch substantially different products
- ✓ Fully leverage the potential of predictive analytics and third-party data
- ✓ Adapt to new cyber-threats
- ✓ Compete with digital distributors in terms of convenience and ease of use
- ✓ Monitor and engage with regulators to avoid unpleasant surprises

NEXT STEPS AND RELATED RESEARCH

Contact Novarica at *inquiry@novarica.com* to learn more about our research and advisory services.

Read related reports:

- *Insurer IT Budgets and Projects for 2017*
- *Hot Topics for Insurers: Social, Mobile, Analytics, Big Data, Cloud, and Digital*
- *Novarica New Normal: 100 Data Digital, and Core Capabilities for Insurers*

Author

Matthew Josefowicz is the President and CEO of Novarica. He is a widely published expert on insurance technology, operations, and business issues who has presented his research and thought leadership at numerous industry conferences. Over the past 15 years, he has worked directly with dozens of CIOs to advise them on IT strategy selection, and has written more than 100 reports. He is also the lead moderator of the Novarica Insurance Technology Research Council. Prior to launching Novarica in 2007, he founded the global insurance group at analyst firm Celent and led it for more than six years. His other experience includes hedge fund D. E. Shaw & Co., LP. He holds a BA magna cum laude from Brown University. He can be reached at *mj@novarica.com*

ABOUT NOVARICA

Novarica helps more than 90 insurers make better decisions about technology projects and strategy through research, advisory services, and consulting.

We serve clients in life/annuity/retirement, property/casualty, workers compensation, and reinsurance. Our clients range from Fortune 100 insurers to small regionals and specialty companies. Although most of our clients prefer to us to keep their names confidential, a partial client roster includes Amica, GenRe, Penn Mutual, ProSight, SECURA, SunLife, and XL Catlin.

Our senior team has direct experience as senior IT executives at firms including AIG, Arbella, AXA, Guardian, Liberty Mutual, Marsh, Progressive, Prudential, and others.

We publish frequent, independent, in-depth research on trends, best practices, and vendors. Our research projects are directed by our senior team, and leverage the knowledge of more than 300 insurer CIO members of our Research Council. All reports are available to our clients without seat license restrictions.

Our Strategy-as-a-Service advisory services provide on-demand phone and email consultations on any topic in insurance or technology (as well as full access to our library). Our clients have told us it's like having a team of experts down the hall, for a flat annual fee that is a small fraction of the cost of a single employee.

Our consulting services include vendor selection, benchmarking, project assurance, and IT strategy development. They are based on our deep knowledgebase, extensive relationships, personal experience, and proven methodologies. Our clients get rapid, actionable insights and guidance, delivered directly by our senior team.

More information at *www.novarica.com*

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