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Financial Services

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# Reshaping the Business Model

*How the insurance placement process  
will be redefined by compliance pressures  
and new business economics*

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Dear Colleague:

It is hard to believe that less than a year ago, contingent commissions were a common but less controversial component of insurance broker compensation. These fees, which on average represented little more than 5% of total 2003 revenues at the 100 largest U.S. brokers, have since become the central focus of investigation into the property & casualty insurance industry. The reason is simple: in their current form, contingent fees can exemplify fundamental inconsistencies in insurance placement economics. More importantly, we believe that their evolution will help pave the way to reform.

*While regulation provides an important foundation, companies must themselves set the tone of compliance if they are to restore the public's trust in their integrity.*

To address this transformation, Deloitte & Touche LLP examined the new post-settlement landscape for the U.S. insurance industry. While it is difficult to predict the final shape insurance financial and business economics will take, our analysis provided insight into the drivers for improvement. Most important among these was compliance reform. To be enduring, any change must be accompanied by public support. While regulation provides an important foundation, companies must themselves set the tone of compliance if they are to restore the public's trust in their integrity.

Finally, this report reflects the collaborative efforts of many Deloitte professionals who advise clients on audit, regulatory, risk, actuarial, distribution and business performance issues – all of whom are acknowledged in the back of this book. I would like to extend a special thanks to Rebecca Amoroso, Managing Principal, Actuarial Insurance Services, for her extraordinary leadership on this endeavor.

Through reading this research report, we hope you will not only develop a deeper understanding of the causes of scrutiny, but some insight into how compliance reform and industry choice may reshape the insurance business model.



Owen Ryan  
US and Global Managing Partner – Insurance  
Financial Services Industry

*The insurance trade needs to focus proactively on improving the public's perception of its integrity, or risk further scrutiny and regulation.*



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# Executive Summary

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The recent settlements reached between several large U.S. property and casualty (P&C) insurance brokers and the N.Y. Attorney General provide some resolution to the allegations of fee manipulation. Specifically, they mandate that the affected companies introduce new business models for insurance placement which exclude the criticized compensation.

While such legal settlements eliminating particular broker fees may be viewed as money returned to the pockets of insurers who supplied them, we believe they simply marked the beginning of what will likely be a difficult, but necessary, restructuring of the U.S. insurance industry's business economics and compliance operations.

Insurers and broker intermediaries need to redefine their roles, and formulate new financial models that eliminate industry cross-subsidies. To that end, they must identify the core services that differentiate their offerings and devise fee structures that reward value from these activities in an explicit way. To enable profitability in a more regulated post-settlement paradigm, they may also need to rationalize non-core commodity services across the insurance placement process.

Underlying these evolving financial models are changes in the business economics of insurance distribution. We expect that rationalization across the insurance placement process will transform the interfaces between insurers, broker intermediaries and buyers. While the recent investigations provide an impetus for this transformation, its nature and course of change will likely be determined by industry choice.

In sum, the investigations and settlements highlight a need for change in insurance financial and business economics. However, in order to evolve the existing transaction models in a rational way, the industry must first expose the inconsistencies that led to this call. It is, therefore, critical that any transformation be guided by greater transparency and a tone of compliance reform. The insurance trade needs to focus proactively on improving the public's perception of its integrity, or risk further scrutiny and regulation. While the initial investigations focused on the property and casualty market, attention appears to be broadening to other areas of the industry.

In this paper, we explore the new post-settlement landscape for the U.S. insurance industry. Specifically, we discuss (1) contingent commissions and future models for industry costing; (2) drivers and frameworks for industry economics; (3) compliance reform through self-policing and regulation; and (4) future implications for the industry.

*Insurers and broker intermediaries need to redefine their roles, and formulate new financial models that eliminate industry cross-subsidies.*

# The Contingent Commission Conundrum

## Current scrutiny of the insurance placement process has centered on an evaluation of contingent commissions and the conflicts of interest they can encourage.

Briefly defined, contingent commissions are special payments, made by insurers to brokers, which supplement regular commissions and are based on some agreed measure of insurance placement activity. Such fees have existed in the industry for some time, and were calculated, frequently, on the profitability of the policies placed with the insurers. These profitability-based contingent fees rewarded brokers for the quality of their risk assessment. Other contingent fee agreements have been based on the volume of business placed with insurers. These have raised questions of broker loyalty. The controversy was refueled in late 2004-early 2005, when NY Attorney General Eliot Spitzer accused several large insurance brokers of steering business to insurers who paid these volume-based contingent commissions. To give a sense of their prevalence, we note that contingent fees, on average, represented little more than 5% of total 2003 revenues at the 100 largest U.S. brokers, as estimated by an October 2004 *Business Insurance* survey. However, for many brokers these contingent fees can be a key driver of profits.

In our view, the legitimacy of contingent commissions is a complex issue with varied implications. While some of the largest U.S. insurance brokers have opted to remove these fees, most of the remaining firms, with lower economies of scale, will likely continue to accept them. These smaller players contend that the majority of their contingent commissions remain profitability-based, which benefits both insurers and buyers and, therefore, presents fewer conflicts of interest. Further, the NAIC (National Association of Insurance

Commissioners), an organization that helps coordinate the activities of state insurance commissioners, maintains that contingent commissions are acceptable when revealed and not abused. To that end, the NAIC has recently proposed explicit documentation for compensation disclosure - a measure that will likely increase insurance placement expenses. The reality is that despite the ongoing controversy over contingent fees, the industry still needs to subsidize and supplement its cost structure.

And so we are faced with this contingent commission conundrum: an issue, as we see it, of cross-subsidization of broker activities in the insurance placement process. Specifically, we believe that these controversial volume-based fees have been used, in part, to cover the costs of important "core" activities. In this way, cross-subsidies make it difficult for customers to undo the value of contingent compensation and what they fund. Simply eliminating these commissions may, therefore, reduce brokers' ability to provide critical services to the insurance distribution system. What is needed to solve this problem is a clear understanding of the various insurance players' roles and the value they provide. Only then can the industry devise rational compensation structures.

While we do not believe it is wise, at this stage, for us to make an explicit call about future industry revenue models and costing, we attempt to frame this riddle by examining the existing fee structures and services provided by insurance intermediaries. To that end, we identify the sources and nature of all broker compensation (including contingent commissions) as follows:

From insurers:

- (1) Regular commissions, calculated either as a percentage of premium placed or as a flat fee
- (2) Contingent commissions, based on some measure of aggregate insurance placement
- (3) Fees for services such as risk management, marketing, and distribution

From buyers:

- (1) Some combination of flat and volume-based fees for representation and services, such as risk analysis, record-keeping, and claims management
- (2) Fees for loss prevention and engineering services, frequently based on time & materials
- (3) Consulting services in risk management, claims, actuarial and risk information systems

Next, we define and classify broker value. Exhibit 1 presents the broker "value chain", as described by Swiss Re.

It is clear from this abstraction that brokers do contribute significantly to the insurance placement process. Specifically, they help drive new product development, enable improved marketing and distribution, as well as bolster insurer risk assessment and financial management. Such value-added activities by brokers are particularly critical to regional insurers that lack the scale necessary to compete with their larger counterparts. Further, brokers supply many consulting services of benefit (actuarial analysis, loss prevention and safety engineering services, claim advocacy, and transparency through quote-shopping). We classify all these critical offerings as "core", and note them as sources of potential differentiation and pricing power.

Also reflected in the value chain are various administrative offerings such as policy issuance/maintenance, recordkeeping, and claims management. These "non-core"

**Exhibit 1: Value Chain – Brokers’ Involvement in the Insurers’ Value Chain**

		POLICYHOLDERS					
		Traditional core function of brokers	Brokers assist in providing data for underwriting	Brokers keep records for policyholders		Brokers represent policyholders	
SERVICES	Product Development	Marketing/Sales	Underwriting	Policy Issuance/Maintenance	Asset & Liability Management	Claims Management	
	Brokers assist with modeling and actuarial services	Traditional core function of brokers	Sometimes delegated to agents/brokers	Frequently delegated to agents/brokers	Brokers provide DFA, financial modeling services and 3rd party asset management	Brokers provide run-off services for insurers	
		INSURERS					

Source: Swiss Re Economic Research & Consulting; Sigma No.2/2004

services represent basic frictional costs of intermediation and are largely commoditized. By identifying such activities as non-critical, we believe brokers can start to rationalize these offerings in the insurance distribution process. For example, automation, outsourcing and shared services initiatives around non-core activities can enable even small and mid-size brokers to achieve economies of scale, and realize significant cost savings without reducing value.

As insurance broker fees are very loosely tied to the services they subsidize, it can be difficult to assess the value added from core activities. Without explicit recognition, brokers' contributions to the insurance placement process may then be trivialized as purely non-core, which can lead to disintermediation. For example, the use of "soft-dollar" compensation in the

securities industry contributed to the rise of discount online retail brokerage firms, reducing the use of full-service providers. We believe that in order to encourage core activities the insurance industry needs to remove cross-subsidies and link broker fees to measures that provide suitable incentive, such as:

- Policy profitability, which rewards risk analysis/management
- Flow of qualified submissions, which rewards marketing and distribution activities
- Consulting fees for product development and industry analysis

Through such processes, the very income that spurred scrutiny of the insurance distribution system can be the tool used to streamline broker operations and encourage value from all players.

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*In summary, the recent investigations of broker contingent commissions have drawn attention to the challenges of designing efficient compensation schemes for the insurance placement process. Existing structures contain cross-subsidies that have served to reduce transparency and misalign incentives. Going forward, intermediaries and other insurance players need to find tangible ways to link their compensation to the incremental benefits they provide. They must also rethink the provision and fee-mechanisms for non-core services. Finally, these changes need to be aligned with the evolving economics of the industry.*

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# The Emerging Industry Economics

As insurance players reexamine their financial models for operation, so too must they evaluate the underlying business configurations that spawned them. In this section, we explore the current economics governing the distribution of P&C insurance and the drivers that may force change.

The various players in the insurance market can be abstracted into three broad categories: (1) insurers; (2) intermediaries; and (3) buyers. Intermediaries, such as brokers and agents, serve as the link between the buyers who need to transfer risk and the insurers who accept that liability. They absorb the frictional costs of such shifts, and provide incremental value through the “core” activities outlined in the previous section of this paper.

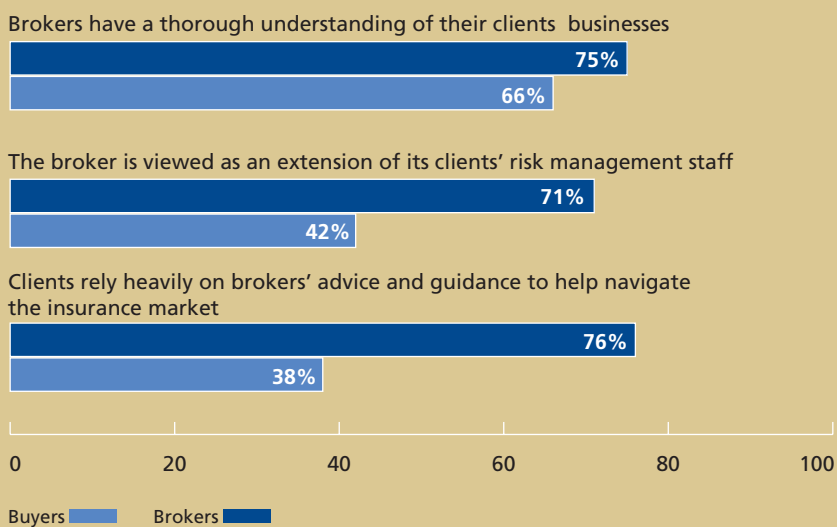
A November 2004 survey by Advisen indicated that a majority of risk managers or “buyers” believe the way insurance is transacted will likely be materially transformed as a result of the broker investigations and settlements. Still, it is difficult to define with any certainty the final shape of such transactions. We believe that there will be need for greater financial transparency across the placement process, which may call for standardized procedures for bidding, pricing and data dissemination. In the short-term, this change may increase costs, as businesses streamline by establishing new operating procedures and increasing their automation capabilities. In the long-term, such process changes can potentially improve profitability, if industry players extract incremental pricing on “core” offerings and rationalize “non-core” elements. While the recent controversy sparked this change, the key factors influencing industry transformation will include: (1) propensity for disintermediation; (2) consolidation; and (3) capital markets and investor sentiment. We examine each in turn.

## Propensity for Disintermediation

The recent investigations have increased scrutiny of the insurance distribution process, causing all players to evaluate their existing and future roles. Moreover, technology has the potential to commoditize many of the “non-core” elements of the intermediary value chain. As insurers rethink their traditional distribution approaches, they may increasingly employ substitute channels, such as the Internet and direct sales, forcing brokers to clarify and quantify their value. As such, alternate delivery options can influence broker bargaining power and the dynamics of insurance placement.

In evaluating this factor we contrast perceptions of brokers by the insurance purchasers and themselves, through a subset of the surveys conducted by *National Underwriter* (N.U.) (Exhibit 2). Buyer opinion is critical, since insurers will likely take their clients' lead in formulating new blueprints for operation. According to *N.U.*, a majority of insurance buyers believe that their broker has a thorough understanding of their businesses, though less than indicated by the brokers themselves. More telling, however, are the results surrounding the conversion of such knowledge into risk assessment and insurance advice. As a percentage of total surveyed, roughly half as many buyers as brokers perceive such intermediary services to be valuable. These results reinforce the dangers of cross-subsidization. Without explicit links between services and compensation, buyers are likely to underestimate the value they receive, potentially increasing their propensity for disintermediation.

### Exhibit 2: How Valuable are Brokers? – Broker/Buyer Perceptions



Source: Adapted from the State of the Market Survey, National Underwriter, Fall 2004

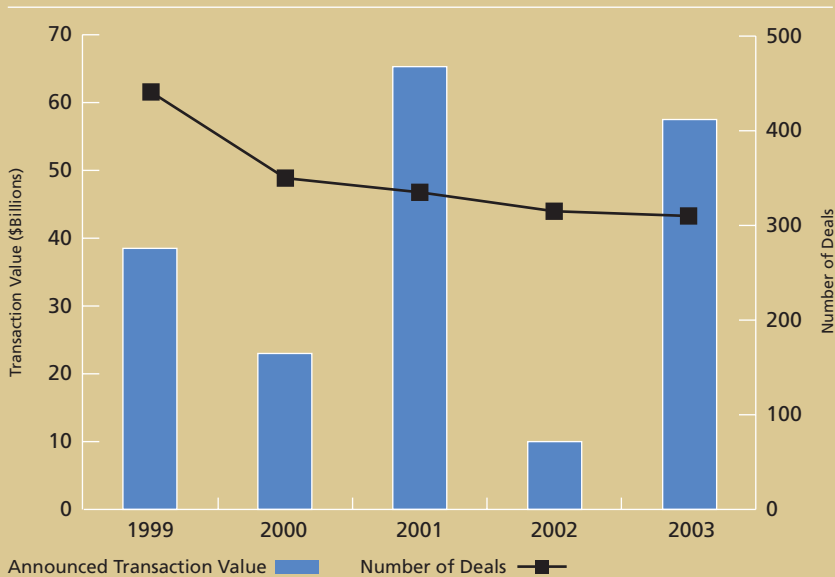
Despite differences in buyer and broker viewpoints, overall survey results, together with proprietary Deloitte field work, indicate that brokers are unlikely to be eliminated in the foreseeable future. Still, insurers and buyers may be more critical of the value they derive from these intermediaries. Such shifts in perception and power will naturally affect the development of business models for insurance distribution.

### Consolidation

Industry consolidation can reduce competition among insurance players and choice for insurance purchasers. This, in turn, can lower market efficiency, which may artificially raise the costs of risk transfer along the distribution chain. In fact, heightened consolidation has made it virtually impossible for large corporate insurance buyers to complete an insurance program without using every major player in the marketplace. On the other hand, the same industry consolidation can enable significant economies of scale for the companies that remain, thereby improving profitability. These offsetting consequences will necessarily affect the interactions between insurance providers, intermediaries, and buyers, and the evolution of business economics between them.

There have been notable consolidations across the various segments of the U.S. insurance industry to date. Exhibit 3 illustrates the trends in insurance industry mergers and acquisitions for deals involving at least one U.S.-domiciled company for 1999-2003. While the total number of insurance-related transactions dropped steadily from 441 deals in 1999 to 310 deals in 2003, the value of such arrangements fluctuated, reaching a peak of \$65.3 billion in 2001. M&A activity declined somewhat in 2004, given favorable organic growth opportunities, but could increase in 2005, driven in part by the perceived benefits of diversification and scale. As described above, these trends will likely influence industry dynamics and structure.

**Exhibit 3: Total Insurance-related Reported Mergers and Acquisitions, 1999 – 2003\***



\*At least one of the companies involved a U.S.-domiciled company. Does not include terminated deals.  
Source: SNL Financial L.C.

### Capital Markets

Access to capital markets provides insurance enterprises with needed liquidity and financial flexibility to absorb risk and fuel growth. As a result, insurance players are likely to be attentive to investor sentiment.

We note that, on average, 2004 stock performance for major public P&C insurers and brokers appears to be roughly in-line with general market movements (S&P 500). This could indicate that the market views the recent broker settlement expenses as largely one-time in nature. Looking ahead, we believe that the P&C insurance industry must first establish sustainable compliant and profitable business economics before it is likely to achieve notable equity outperformance. In this way, stock returns and valuation can signal capital market perception of evolving business dynamics. As publicly-traded insurance players strive to maximize their capitalization, they will naturally use this mechanism as critical feedback on the viability of their operating models.

*In sum, the changing operating environment, combined with heightened public scrutiny, will necessarily shift the economics of insurance placement. While we cannot be sure of its final form, we can gain insight by tracking its drivers, including evolving industry structure and capital market perception. The transformation process will likely be a difficult one, and require increased transparency across the distribution system. Such disclosure can further serve as a catalyst for needed compliance reform.*

# A Call for Compliance Reform

Before the insurance trade can effect new practices to improve financial and business economics, it must first restore public trust in its integrity. In Exhibit 4 we highlight this urgent need for reform through a November 2004 survey of insurance buyers, conducted by Advisen.

Although the majority of risk managers interviewed do not intend to replace their existing broker, they recognize the possibility of fraudulent and anti-competitive behavior by intermediaries and advocate new transaction models that incorporate greater transparency. This pressure for increased disclosure is not limited to insurance buyers. In fact, a large life carrier based in the northeast is withholding payments to brokers that do not first prove that clients understand and agree to the terms of underwriting agreements. It would therefore appear as though reform is not an option for the insurance industry, but a “must-have.” Compliance must set the tone of change, if it is to be rational and enduring.

While outside scrutiny spurred this call for compliance reform, there are several notable benefits to the industry. For brokers with ownership interests in risk-taking entities, greater voluntary disclosure can work to reduce conflicts of interest within the organization, and possibly eliminate the need for divestiture. Already, in the wake of the recent settlements, Marsh & McLennan has announced the sale of its Risk Capital unit, which specializes in investments of insurance-related businesses; Willis has made plans to divest its wholesale business, Stewart Smith; and AON is exploring a possible sale of its wholesale unit, Swett & Crawford. The sale of these entities could, in our view, hurt the insurance trade by reducing brokers' ability to “fill-in” gaps in risk transfer. In fact, it was the urgent need for such capacity that led Marsh & McLennan to be instrumental in creating insurers ACE, XL, and CODA in the mid-1980s. Further, after the 9/11 terrorist attacks, both Aon and Marsh played critical roles in forming Bermuda insurers Endurance and Axis

Specialty Holdings to counter the brewing insurance crisis.

Greater voluntary disclosure can also help reinsurers distinguish legitimate risk transfer in their finite risk operations and restore public trust in this offering. Recent investigations into this practice have scrutinized the validity of the actual risk shift, raising public concern that this tool may be used to artificially bolster insurer earnings. For the industry at large, improved compliance operations and disclosure can enable insurance players to expose inconsistencies and guard against them.

Existing norms for industry conduct have evolved from two primary sources: regulation and self-policing. We explore future models for operation in each context.

## Regulation: State or Federal?

At present, the insurance industry is regulated by the states, as was mandated by the McCarran-Ferguson Act of 1944. State authorities perform three main functions: (1) monitor the financial condition and claims-paying ability of insurers; (2) serve as consumer watchdogs; and (3) ensure availability/accessibility of insurance. Such activities are coordinated by the NAIC, a Missouri-based organization created in 1871 by state insurance regulators to organize insurance regulation. Still, the actual letter of the law is enacted and enforced separately by each of the 50 states, which can lead to a lack of uniformity.

### Exhibit 4: Risk Manager Reaction to Contingent Commission Controversy

I am considering replacing my current insurance broker firm(s)

14%

I believe that the transaction process to buy commercial insurance should be standardized and transparent to my company

74%

I am concerned that my company's insurance brokerage firm(s) does not fully disclose all sources of income related to my insurance

57%

I believe that contingent commissions are a conflict of interest

65%

I am concerned that my company's brokerage firm(s) may have participated in fraudulent practices related to contingent commissions

41%

I am concerned that my company's brokerage firm(s) may have participated in anti-competitive practices related to contingent commissions

53%

0 20 40 60 80

Strongly/Somewhat Agree

Source: Advisen Risk Manager Survey, 11/12/2004

Over the years, there have been periodic calls for modernization of state-based insurance placement regulation. In 1999, the Gramm-Leach-Bliley Financial Services Modernization Act was passed, endorsing uniform insurance agent licensing laws. In 2003, the NAIC issued a Reinforced Commitment Insurance Regulation Modernization Action Plan, emphasizing its commitment to regulatory improvement and including procedures to implement consistent product standards for life insurers. In 2004, certain Congressional representatives released a draft of the SMART (State Modernization And Regulatory Transparency) Act. This plan would require states to comply with uniform standards, resolve disputes, simplify new product introductions, enforce market-based rates and implement “single point-of-entry” licensing. State regulators and the NAIC oppose the SMART act, but have responded to the public scrutiny by adopting amendments to the existing NAIC Producers Model Act, a template for insurance placement. Specifically, these inclusions require increased transparency by brokers compensated by both insurers and buyers, and define the presentation of this information.

While proponents of state-based regulation claim that this structure facilitates speedier problem resolution and encourages innovation, there are still many who favor federal intervention. According to this faction, a centrally-regulated system could: (1) provide increased clarity into operation policies, particularly for multi-state and international insurers, brokers and buyers; (2) enable more rapid regulatory reform; (3) speed the introduction of new insurance products; and (4) allow for better competition with other financial services firms. One proposal would be to create a dual (federal/state) regulatory system, similar to the banking industry. Companies could then choose with which structure they wish to comply.

In our view, regardless of the governing body, the benefits of state and federal regulatory modernization will likely lag the industry's immediate need. Most of the responsibility for compliance reform, therefore, falls upon the insurance trade. Insurers and brokers must work at the company-level to enable standardization through increased transparency and disclosure. In this way, insurance organizations can themselves create more sustainable financial and operational models for insurance distribution.

### Self-Policing: Key Elements

We believe that the current scenario offers significant opportunity to those insurance players that adopt a “culture” of compliance and integrate best practices into their organizational fabric. Already the largest insurance brokers have taken proactive measures to strengthen their compliance infra-structure.

In suggesting models for improved transparency, we draw from “Taking Control”, a 2004 Deloitte publication outlining compliance with Section 404 of the Sarbanes-Oxley Act. While the trigger event in each case is different, we believe that the key elements to implementing compliance reform hold across both scenarios:

#### Integrity and ethical values

Management should demonstrate an unwavering commitment to character, and ethical values.

#### Commitment to competence

A knowledgeable, well-trained workforce will help execute a strong control environment, ensure that all employees are trained in ethical standards and have channels of communication to report non-compliant behavior.

#### Organizational structure

By configuring the company in a compliant way, information will flow naturally to the appropriate parties, reducing potential conflicts of interest. While discussion of information reform has centered on increased disclosure to buyers of the insurance placement process and sources of compensation, insurance intermediaries

can further bolster their organizational structure by:

- Enacting “Chinese wall” internal control structures that insulate broker practitioners from insurer incentive compensation. Similar constructs have been deployed in the securities industry and are effective in limiting non-compliant communication between investment banking and research divisions.
- Enforcing double signature procedures to verify conformity
- Conducting periodic reviews of compliance

Such reorganization is particularly critical to those brokers that have ownership interests in risk-taking entities.

#### Technology integration

Centralize and streamline operations through automation. This will enable the organization to systematically enforce compliance and reduce costs on “non-core” activities.

#### Assignment of responsibility

Create a central independent compliance group with governing responsibility assigned to a lead compliance officer.

#### Human resource policies

Provide employees incentives to adopt compliant behavior. Create measures to evaluate employees on business ethics and their success in representing insurance buyer interests.

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*The preceding discussion offered a skeletal structure for compliance reform. As is frequently the case, the devil is in the details. It is only through controlled implementation and execution that insurance players can create additional value from the compliance process and, in this way, distinguish themselves. Insurers and brokers need to change themselves now or risk having it done for them by potentially overzealous regulators. Such reform will likely become increasingly important as public scrutiny of the insurance industry expands.*

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# What Lies Ahead

**The recent allegations against the commercial P&C market have varied implications of note. These include state-level investigations into compensation practices, as well as possible criminal charges against employees and the threat of class-action litigation by shareholders.**

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Further, the issues raised are broadening into other areas of the insurance industry, including life and health insurance. In fact, in November 2004, New York Attorney General Spitzer filed a second civil suit against a life and disability insurance broker, alleging compensation fraud.

While many still believe that the criticized activities were limited to a few large P&C brokers and insurers, negative publicity affects overall industry perception. It is useful to note that Bob Hartwig, the chief economist for the Insurance Information Institute, believes that such conflicts of interest are less possible in consumer insurance, given that independent brokers compete more frequently with direct-sales companies and, therefore, have less pricing flexibility. He does, however, maintain that the recent investigations/settlements could have an impact on whether buyers want their accounts shopped around more aggressively, increasing the frictional costs of doing business. In our view, if these trends continue, they could reduce the confidence levels of insurance buyers and investors and spell reform for the industry as a whole.

In conclusion, the impetus for compliance reform outlined in this paper requires insurance players to work together to identify and rationalize value across the placement process. Seizing this opportunity now can generate pricing power on differentiated “core” services and significant cost-savings on “non-core” commoditized activities. As we stated at the outset, the recent allegations and settlements simply marked the beginning of the restructuring of the insurance industry. Now is the time for insurance companies to take ownership of their reputations and lead the reform and compliance initiatives needed to restore public trust.

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05/05 – Item #5051

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