FROM THE WORLD OF GENERAL INSURANCE

Asbestos and pollution developments

No significant progress has been made towards passage of the Fairness in Asbestos Injury Resolution Act (FAIR), and there now appears to be a realistic concern that a consensus is unattainable, in spite of the efforts of the new judiciary committee chairman, Arlen Specter, and the support of President Bush.

Further reserve increases in relation to asbestos losses have been announced by St Paul Travelers Cos, ACE's Brandywine run-off subsidiary, Munich Re's American Re subsidiary, and Promina Group in Australia. The amounts involved are $1,006m, $339m, $180m, and A$60m respectively.

Equitas has announced six further asbestos settlements. These include contracts with Dana Corporation, Zurich's Centre Re subsidiary, and with American Standard, a manufacturer of plumbing and air-conditioning equipment. Also in relation to Equitas, the Association of Lloyd's members has disputed suggestions that the passage of FAIR could lead to the failure of the reinsurer, although there are clearly elements of the proposed legislation which are considered adverse to the company's interests.

Meanwhile, in the UK, the High Court has ruled that asbestos-related pleural plaques do not rank as a normal disease or illness, but that their existence should still be compensated by insurers (albeit to a significantly lower extent than has generally been seen in the past) in view of the anxiety caused to those having such scarring of the lungs. If the decision is not overturned on appeal, it is anticipated that this could lead to a continuation of the current trend for a considerable number of those workers potentially involved taking up offers by unions and lawyers to be scanned for these pleural plaques. On the other hand, the lower anticipated awards could be a disincentive to such 'ambulance chasers', as suggested by Julian Lowe, chairman of the GIRO asbestos working party, in an interview with *The Times*, one of several actuarial comments reported in the national press following the court decision. The ultimate impact on insurers, even without an appeal, is generally seen as beneficial compared with the worst-case scenario previously envisaged.

An insurance settlement has finally been achieved in relation to the Stringfellow Hazardous Waste Site in California. This amounts to $93m, and represents only a small proportion of the overall cost of cleaning up the site. The litigation has already taken over 20 years, and further actions are continuing with other insurers.

World Trade Center (WTC)

Some clarification has been achieved on the issue of the scope of business interruption losses emanating from the terrorist attacks on WTC in September 2001. An engineering and services company, ABM Industries Inc, has won a case that it can be compensated under its business interruption contract for losses arising from loss of WTC customers, although it had no ownership or leasehold on space in the affected buildings. ABM operated heating, ventilating, and air-conditioning systems for the principal leaseholder and many of the tenants of WTC. The decision reversed an earlier lower court ruling, and draws a distinction between a legal interest and an insurable interest in the property. It may be appealed by the insurers concerned.

Contingent commissions/placement service agreements

Marsh McLennan Companies (MMC) has agreed to pay $850m to finalise the investigations by Eliot Spitzer, the New York attorney-general into price-fixing, bid-rigging, and undisclosed incentive payments. The payment will be made in instalments over a four-year period and made into a fund which will be used to compensate affected US policyholders. In addition the company has made a public apology for its actions, although not admitting fault, which should protect it from criminal prosecution, and has made major changes to its operations to remove the chance of a repeat of these practices in future. In a similar case, Aon has announced that it has set aside $50m for settlement of their involvement in such practices. Mr Spitzer expects more settlements with other major insurance industry players in future.

The investigations have also resulted in three more executives (two from AIG and one from MMC) pleading guilty to criminal charges in the New York County Supreme Court – this brings the total to nine.

In addition, the scope of such cases is continuing to spread, with the Connecticut attorney-general filing a lawsuit against MMC in relation to alleged unfair trade practices between MMC and ACE Financial Solutions in the placing of a state workers compensation contract, and the North Carolina insurance commissioner has commenced investigations into price-fixing.

Enron/WorldCom

The WorldCom settlement has apparently collapsed on the basis that the remaining company directors would be left with significantly less D&O insurance coverage. The ten directors involved in the originally reported settlement will now face a jury trial, while in parallel fighting the reversal of the decision to deprive them of D&O coverage.

In a separate legal action, Merrill Lynch have been dismissed from a case holding them, as trustees of a WorldCom pension fund, liable for losses to pensioners. This is expected to limit the scope for similar charges to be brought against other pension scheme advisers.

Class action reform

The US Senate and Congress have both approved initial steps to reform the scope of class actions. The principal changes would move actions involving claims for over $5m to federal, rather than state courts, and reduce the scope for class actions involving claimants from different states, thus reducing the possibilities of 'forum shopping'. It will also reduce the scope for various types of settlement particularly those involving 'payment in kind'.

Large losses

Recent notable general insurance incidents/losses include:

- **Indian Ocean Tsunami** (26 December 2004) – In spite of further significant increases in the estimates of fatalities, now estimated to be just over 300,000 – the insured losses are estimated at no more than $4bn.
- **Windstorm Erwin** (8–13 January) – insured losses from this storm, have now been estimated at around $1.5bn with the largest elements arising in Denmark and Sweden.
- **Snowstorms in north America** (22–23 January) – these are believed to be among the five worst recorded in New England in the past century, with between one and three feet of snow being experienced quite widely. The storms, which were accompanied by high winds in places, and significantly affected the mid-west and parts of Canada as well as the north-east of the US, resulted in states of emergency being declared in Massachusetts, New Jersey, and Rhode Island, and around 20 deaths. No estimate of insurance losses is to hand, but amounts are not thought likely to be significantly higher than in other years, partly as a result of the timing of the storm being over a weekend.
- **Rail crash, California** (26 January) – a Metrolink commuter train crashed into a car abandoned on the tracks, hit another commuter train, and was derailed, resulting in at least 11 fatalities and over 100 injuries. It is understood that much of the company's liability coverage is placed in Europe, including London, although no estimate of the likely cost is currently to hand.

Large losses *continued from p16*

- **Australian storms** (first week of February). The rain, hail, and strong winds produced by these storms in New South Wales, Victoria, and Tasmania resulted in losses initially estimated at A$120m.
- **Sudan 1 dye and food recall in UK** (late February) – a batch of chilli powder was contaminated with the potentially carcinogenic dye Sudan 1, resulting in the recall of something like 350 food products. It is not yet clear whether the manufacturers involved will be successful in their attempt to claim compensation from their insurers.
- **Iranian earthquake** (21 February) – this measured 6.4 on the Richter scale, and was centred on Zarand, a town nearly 500 miles from Tehran. Hundreds are reported dead, and thousands injured, but insured losses are likely to be relatively immaterial.

The costs emanating from the hurricane season in the southern US and the Caribbean and typhoons in Japan have apparently increased somewhat from earlier estimates, with a considerable number of major insurers and reinsurers having to make additional provisions for these events in their fourth quarter figures. The total insured losses for these events are now estimated to be in excess of $30bn. In the US, a major driver of these increases is the continuing impact of business interruption losses on commercial policies.

Current issues newsletter

Other recent developments are covered in the General Insurance Current Issues newsletter, which can be accessed via the profession's website on *http://www.actuaries.org.uk/files/pdf/general_insurance/gicinews20050301.pdf.*

The latest edition is dated 1 March, and covers catastrophes, regulatory issues, solvency issues, international issues, government initiatives, and claims and legal issues.

DAVID HART

Changing pension fund investment scene

The weighted average return for UK pension funds in 2004 was 10.4%, according to Russel/Mellon's annual analysis. This puts pension funds just back into positive territory over five years, with a weighted average return of 0.1%pa. Pension funds have effectively wiped out the investment losses suffered in the first three years of the decade.

The fund median for 2004 was 10.5%, indicating that larger pension funds produced broadly similar performance to smaller pension funds over the year. However, the analysis shows that small and large schemes had different investment strategies. While the performance of smaller schemes benefited from higher equity weightings and lower fixed-interest and index-linked weightings, larger funds benefited from higher weightings in property.

Funds adopt new mandates

Over the past 16 years pension funds have been increasingly adopting new portfolio mandates within their fund structures. At the end of 1989, just less than one in ten portfolios had been newly appointed during the year. In 2004 however, this had risen to around one in five. This increase in activity has been influenced by a number of factors. Daniel Hall, Russell/Mellon's publications and statistics manager said, 'Since the end of the 1980s, pension funds have increasingly adopted scheme-specific benchmarks in place of universe comparisons. This has led to a move away from balanced and multi-asset-based portfolio structures and towards specialist structures with a greater number of mandates'.

UK equity weightings at an all time low

UK pension fund weightings in UK equities fell for the fifth consecutive year in 2004. The weighting of 39.0% at the end of December 2004 represented another all time, year-end low. At the same time, weightings in overseas equities continued to rise from 26.7% to 27.5%, an all time, year-end high.

Weightings in UK bonds rose from 19.4% to 21.2% in 2004. By contrast, funds further reduced their weightings in overseas bonds from 1.1% to 0.7%. Within the UK, corporate bonds continued to increase in popularity with pension funds such that, by the end of 2004, they had overtaken gilts as an asset class. At the end of 2004, pension funds held on average 10.4% of their assets in gilts and 10.8% in corporate bonds.

At the end of 2004, Russell/Mellon measured the performance of 672 UK pension funds, representative of 1,885 separate manager portfolios, with a total market value of £178bn.

Insuring deficits

Hewitt has been urging companies and trustees to consider a wider range of solutions to manage their current pension plan deficits. With limited relief coming from stockmarket returns, and cash contributions able to plug only part of the hole, innovative techniques such as contingent payments or external contracts also need to be considered.

One idea which Hewitt has been discussing with some companies and trustees is the use of credit default swaps. These allow a corporate bondholder to buy protection against the risk of the company defaulting on its bond and not repaying the debt. In return for an agreed level of premiums, the financial institution involved undertakes to pay the difference between what the defaulted bond is worth and its nominal value. This instrument is common in the financial markets, but its relevance for pension funds does not seem to have been fully tapped.

Pension plan trustees will be keen to explore ways of improving the security of members' benefits in a period for pension fund deficits which Hewitt has described as 'stagnant'. Hewitt has estimated that the combined deficit for FTSE100 plans measured on the company accounting standard FRS17 remains around £60bn. Solely paying extra contributions to meet FRS17 deficits would for over a quarter of companies represent more than a full year's profits, and for more than one in ten companies it would require over five years' profits. Even then, an additional £100bn would be required over and above the FRS17 deficit before plans had enough money to meet the buyout cost of their pension commitments.

Raj Mody, pensions strategy consultant at Hewitt said: 'It makes a lot of sense for large funds in particular to at least look into the opportunities provided by instruments such as credit default swaps. This isn't about "betting against the company" behind closed doors – companies and trustees can work together openly and constructively on this. It may seem unsavoury to plan in such a calculated way for dealing with the possibility of a sponsoring company going bust – but nothing is certain nowadays. I suspect most pension fund members would prefer a proper airing for all ideas which could help improve their benefit security.'

Disastrous 2004

Swiss Re's *sigma* statistics (at *www.swissre.com*) for 2004 identify around 330 natural and man-made catastrophes worldwide, in which more than 300,000 people lost their lives. By far the largest number of victims was claimed by the tsunami in the Indian Ocean: the authorities in the 12 coastal states affected reported 280,000 people dead or missing.

The *sigma* study just published puts the total losses directly attributable to these natural and man-made catastrophes at $123bn – of this figure, $49bn was covered by property insurance. For property insurers, 2004 was a record year in terms of claims, mainly due to windstorms: hurricanes in the US and neighbouring countries cost insurers around $32bn, typhoons in Japan and neighbouring countries a further $6bn.

These record figures were the result of both the unusually high number of storms – 13 hurricanes in the US and 10 typhoons in Japan – and the increasing concentration of insured assets in highly exposed coastal regions. Climatologists attribute the high windstorm frequency to above-average sea-surface temperatures and the high year-round average temperatures measured in the last decade. 2004 was the fourth-warmest year since regular temperature measurements started in 1861.

Real options in IT management

Heavily dependent on information technology, financial services firms globally spend over €235bn on IT, representing – for large banks – 15% to 22% of their overall non-interest expense. Unfortunately, their investments too often fail to generate anticipated returns – and worse, many firms do not even know which are paying dividends and which are losing money. In fact, benefits realisation data was available for only 31% of those interviewed in a recent study initialised by ING and executed by IBM. Compounding the problem, few firms actually reserve funds as a contingency for projects that exceed their budgets, though there is a compelling need to do so. The repercussions can be considerable, as evidenced by one study participant whose projects, on average, ran more than 60% over budget. With so much at stake, financial services CIOs need a more effective way to manage IT investments – and the clues may come from the firms' asset managers down the hall.

For decades since Markowitz, Miller, and Sharpe first began publishing their complementary Nobel Prize-winning theories in the 1950s, financial services firms have applied portfolio management concepts to reduce risk and improve returns on invested assets. More recently, progressive firms have turned to those same basic concepts to significantly enhance the performance of their IT portfolios, particularly important with the spotlight Basel II has put on returns and efficiency. IT 'portfolio management' takes a holistic view of IT projects across the enterprise, evaluating proposals against the firm's strategic objectives. More conservative investments compensate for riskier ones, thereby lowering the overall reserve requirement – for study participants, reserves could be reduced by up to 55% of total project budgets.

For more on this rather actuarial approach to managing IT investment, see *http://www-1.ibm.com/industries/financialservices/doc/content/bin/fss_bae_IT_management.pdf*

Challenges in European wealth management

Adjusting to an ageing investor population and slow stockmarket growth will be the two most important factors driving the success or failure of European wealth managers over the next five years, according to a report out recently from Mercer Oliver Wyman (may be requested from *www.merceroliverwyman.com*).

The report, *Wealth Management: Strategies for Success*, was based on research conducted among over 50 wealth managers serving all the main European countries and with clients that have investable assets of €300,000 or more. The findings reveal that wealth managers are significantly overestimating potential for growth in the market. Mercer Oliver Wyman predicts that the market will grow by an average of 7% pa over the next five years, yet wealth managers continue to believe that 10% to 15% growth will be achievable.

Market growth will be hampered by population demographics and low economic growth. The ageing population is likely to increase its allocation to safer, lower-margin investments, such as fixed income, which will lower traditional wealth management revenues for all but a few players with strong structured derivatives capabilities.

Another key issue facing wealth managers is the need for greater focus on customer relationship management (CRM). According to the report, wealth managers expect 30% of new assets over the next five years to come from existing clients, a number which jumps to 55% if clients of a parent bank are included. Despite this, only one-third of those polled has made any significant investment in

Safe as houses?

Prudential has sponsored a report on equity release by Professor Merlin Stone which cautions against over-reliance on home equity release as a financial planning tool.

The lack of financial preparation for retirement by consumers in the UK is well documented. The government has taken a number of steps to encourage individuals to save responsibly for their future. Yet there is still a gap between the financial assets that consumers gather in time for retirement and the amount of money that they need to live on comfortably.

The situation has not been helped by the decline of equity values and associated investments, such as pensions. A great many consumers now question the value of investing in financial assets, and believe that their 'homes are their pensions'.

The rapid rise in property prices, widespread ownership of homes, and a prevailing view that property is a 'one-way bet' have made bricks and mortar look much more attractive as a long-term investment than pension funds.

Yet it's becoming increasingly clear that consumers are courting financial disaster by putting all of their eggs into a single investment basket. They're forgetting an important lesson from history: while both equity and property markets tend to rise over the long term, both suffer periods of significant price decline in real terms.

Additionally, it can be difficult to exit the housing market at a time that is convenient to sellers. While an investment plan can be turned into cash relatively quickly (depending on terms and conditions), it's less easy to predict how easily a building can be sold, or the timeframe in which income can be realised.

The full report can be found at *http://www.aedifico.co.uk/PDF/Safe%20as%20Houses.pdf*

CRM to understand their clients' needs and maximise the value of existing clients. What's more, most wealth managers conservatively estimate up to 20% of their client base to be unprofitable, yet have few systems in place to tackle this.

Rapid growth in annuities

At a seminar held on 11 February 2005, the Association of British Insurers (ABI) published its three latest research reports looking at the future of the annuities market. These reports comprise the ABI's own paper 'The pension annuity market: developing a middle market', a report by leading actuary Mike Wadsworth of Watson Wyatt LLP, and qualitative consumer research by ORC International. All point towards a need for government and the pensions industry to work together in order to improve public knowledge about pensions and annuities and to simplify the process of securing income in retirement.

The ABI's research findings show that:

- demand for annuities will continue to rise because of demographic change and the switch from DB to DC pensions;
- sales of annuities have almost trebled in the past ten years, from around 120,000 new contracts in 1994 to around 340,000 in 2003;
- the market for individual annuities is predicted to rise from £7.2bn in 2002 to £18.1bn in 2012, based on a medium-demand scale.

The ABI has also welcomed the government's recent consultation on 'ultra-long gilts' by the Debt Management Office (DMO), which could lead to improved supply of wholesale financial instruments to support annuities (all reports available free at *www.abi.org*).

Trading longevity risk

Longevity risk in conjunction with interest rate risk has created problems for the annuity market. The immediate annuity market in the US is approximately $2bn per year while the UK immediate annuity market is approximately $10bn per year. As more and more baby boomers retire, annuity markets will grow as will the risk and consequences of underestimating mortality improvements. The whole private sector pension system in developed economies like the US and UK are potentially at risk without hedging instruments such as longevity bonds. At the same time, the newly developing economies of Latin America, south-east Asia, eastern Europe, and the former Soviet Union states, which are attempting to establish private-sector pension systems, often under World Bank guidance, are likely to find that these attempts are frustrated by the absence of annuities markets which cannot get off the ground without the existence of hedging instruments to help annuity providers hedge the longevity risk they face.

A longevity bond conference organised by the Pensions Institute at Cass Business School in February attracted a huge amount of interest from government, regulators, investment banks, insurance companies, pension funds, and academics – those with a vested interest in dealing with the risk associated with people living longer.

For more about this important conference, see *http://www.pensions-institute.org/conferences/longevity/programme.html*.

NEWS ROUND-UP

Declining marriage

The number of people marrying in England and Wales is expected to fall significantly over the next 25 years. The proportion of men who are married will fall from 53% in 2003 to 42% by 2031, while the number of married women will drop from 50% to 40%. The number of people who have never married is expected to rise by 11%, and the proportion of divorced adults over 65 is also expected to keep rising, according to statistics published by the Government Actuary's Department (GAD). The figures predicted that the number of cohabiting couples, estimated to be 2m in 2003, would almost double to 3.8m over the next 25 years.

Global GAAP

Ernst & Young's Insurance and Actuarial Advisory Services (IAAS) division has announced highlights and survey results from a recent seminar co-hosted with the Society of Actuaries on international financial reporting standards (IFRS).

Addressing the audience, representatives from both the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) suggested US GAAP accounting standards and IFRS are likely to converge by 2010. US insurance executives attending also saw convergence in the near future, with three-quarters (75%) indicating that they believe IASB and FASB will unify standards within ten years.

The majority attending (66%) believed the IASB will ultimately adopt a fair value model for phase II insurance. Interestingly, a slightly higher percentage personally prefer fair value over current US GAAP (38% vs 34% respectively), and only 13% are leaning towards an embedded value methodology.

Explosive growth in India

The Actuarial Society of India (ASI) has projected the employment potential of the actuarial sector in India at 100,000 jobs soon. Its data shows that actuaries grew from 400 in 2000 to 4,000 in 2004. The projection is based on opening up of the pensions sector, implementation of Basel-II norms in the banking sector in 2006, and emergence of risk management as a key function of actuaries. The insurance sector, particularly general insurance, is now availing actuarial services. There are 80 firms in India offering such services. The Insurance Regulatory and Development Authority (IRDA) plans to set up a school of actuarial sciences. The UK profession will offer enhanced actuarial training facilities. IRDA is in negotiations with the Actuaries Society of India for the project.

Actuary banned

Actuary Geoffrey Trahair had his career in insurance terminated this month when APRA, the Australian regulator, disqualified him from involvement in the management or directorship of a general insurer. The Australian Prudential Regulation Authority found his behaviour deficient.

Trahair was an FAI actuary from February 1998 and its national workers' compensation manager from September 1998, moving to HIH after it bought FAI. APRA found that he knew FAI was significantly under-reserved and helped to withhold data from FAI's auditors, PricewaterhouseCoopers, so FAI's liabilities at June and December 1998 were significantly understated. APRA's findings have been referred to the Institute of Actuaries Australia.

Obesity threat

Life expectancy in the US is set to drop within the next 50 years owing to obesity, one of the world's top experts told an audience at Cass Business School last month.

Speaking at the first of two Watson Wyatt lectures for 2005, Professor Jay Olshansky from the University of Illinois said he believed that within the next 50 years life expectancy at birth will decline, and it will decline as a result of the 'obesity epidemic that will creep through all ages like a human tsunami'.

The second 2005 Watson Wyatt lecture is by Professor James Vaupel, the founding and executive director of the Max Planck Institute for Demographic Research, Rostock, Germany, on 23 March.