

Launch of Solvency II draft directive

Perhaps unusually, there were almost universal plaudits for a revolutionary change in regulation of life assurance and non-life insurance announced by the European Commission on 10 July. On that day, Commissioner Charlie McCreevy spoke about the publication of draft new legislation in warm terms: 'This is an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers. We are setting a world-leading standard that requires insurers to focus on managing all the risks they face and enables them to operate much more efficiently. It's good news for consumers, for the insurance industry, and for the EU economy as a whole.'

As most readers will already be aware, Solvency II promises to shake up and improve the economic efficiency of European insurance markets even more than the parallel Basel 2 accord is doing for banking markets. Prudential supervision of European insurers was harmonised to a very limited extent alongside the original insurance directives which opened up the market to cross-border freedom of establishment and freedom of services back in the 1970s. At the time this involved achieving limited consensus among only nine prudential supervisory authorities. Solvency I was a limited general update taking effect in the early years of the present decade.

The cast of characters involved in the formulation of Solvency II is enormous, including the European Commission, representatives of finance ministries, and prudential supervisors from what are now 27 member states, together with stakeholders representing insurance firms, corporate buyers of insurance, and representatives of consumers. The actuarial profession in the form of the

Risk is our Business



Groupe Consultatif (www.gcactuaries.org) has played a strongly supportive role. It is a tribute to McCreevy's determination that a proposal for radical change commands widespread support. Those welcoming the proposals included most of the major professional services firms and leading multinational insurers including Aegon, Aviva, and Munich Re.

The commission also acknowledged a more realistic target implementation date of 2012 for the proposals, which should make for a better chance of parallel implementation with IFRS changes. The next step will be for the proposals to be reviewed in detail by the European Parliament where UK MEP Peter Skinner will act as rapporteur. The timetable depends on the parliament having finished its deliberations ahead of the next elections in 2009. Contentious issues may include the effects of the proposals on smaller (and particularly smaller mutual) insurers as well as adequate protection for policyholders in smaller jurisdictions served principally by non-locally owned firms.

The draft directive has as its driving force the ambition to reinforce best practice in risk management, including both use of sophisticated internal models to assess required economic capital and robust structured governance procedures to ensure all forms of risk are controlled as far as practicable. Readers will recognise a consistency with changes made in UK insurer supervision over the last five years or more, which have in varying degree been emulated in several more sophisticated insurer jurisdictions.

Apart from the many issues of technical detail

which have yet to be fully explored and apart from the need for insurers to raise their enterprise risk management game, key political issues are whether the pro-competitive emphasis can be retained in the face of likely resistance and how much impact Solvency II will have on supervisory practices globally. The signs are encouraging – the orchestrated welcome for the commission's proposals and positive comment in global publications suggest that actuaries with knowledge of risk management are likely to be in much demand not only in Europe but also beyond.

New ERM white paper

'This white paper has been written both for professional risk managers and for finance professionals with a responsibility for risk transfer. Both sets of readers stand to benefit from following the best practice the paper outlines. Risk managers can enhance the contribution and professionalism of their roles, by demonstrating that the decisions they make around buying insurance and managing risk are transparent and optimal. Finance professionals can ensure that their approach to risk transfer and insurance purchasing reflects the overall financial strength and strategy of their companies.'

So opens a new white paper on risk transfer optimisation that appeared this month from Marsh (www.marsh.co.uk). While not necessarily unique, the new paper provides an overview of the linkage between risk and value management, which may be of interest to readers of *The Actuary*.

Growth in insurance markets in 2006

World insurance premium growth in 2006 accelerated further, driven by the strong expansion of the life insurance sector. According to the most recent *sigma* study (at www.swissre.com), worldwide premiums written amounted to almost \$4 trillion, an increase of 5% over the previous year. The performance of the insurance industry has further improved in terms of capitalisation and profitability.

Worldwide insurance premiums amounted to \$3,723bn (US) in 2006. This translates into 7.7% of global economic value generation (GDP), unchanged to 2005. According to the Swiss *Re sigma* study, growth in total premium volume accelerated further to 5% (adjusted for inflation). Both life and non-life premiums increased over prior year by 7.7% and 1.5% respectively. Real

premium growth in the emerging markets of 16% continued to outpace the growth of 4% experienced in the industrialised countries.

Looking at insurance spending, the industrialised countries spent about 9% of the gross domestic product on insurance in 2006, while in the emerging markets this ratio varies from 1.4% in the Middle East and Central Asia to 4.7% in Africa.

Life insurance: wealth accumulation products drive growth

With real growth of 7.7%, the life insurance market expanded faster than overall economic activity in most countries, with the clear exception of Japan. Booming stockmarkets favouring unit-linked products, in combination with regulatory changes and tax incentives, were the main contributors to 2006's strong growth rate. More-

over, higher demand for retirement provision in countries with ageing populations, together with the efforts of governments to shift from public to private pension schemes, boosted demand for the life industry's products.

Progress on 'financial advice'

Speaking in July at a savings conference in London, actuary Otto Thoresen has outlined some of the concepts currently being considered in his 'Review of Generic Financial Advice' (for HM Treasury).

Mr Thoresen emphasised that the remit of the review was to look at how, not whether, a generic financial advice service might work in practice. Although he said nothing had yet been set in stone, he highlighted some of the key ➤

- ▶ themes emerging from the responses and from the work of the review team.

First, looking at how the service might be labelled and how this would reflect the type of service it is destined to provide, Mr Thoresen said that the new service was unlikely to use the words 'generic financial advice' in its strapline, and commented: 'People may not necessarily understand what we mean by "generic" and for the financial services industry the word "advice" is too closely associated with FSA-regulated advice. The terms "guidance", "information", "education", and "coaching" have all been suggested... I feel that "guidance" resonates well but I am keen to hear peoples' thoughts on this.'

Turning to the design of the service, he said the emerging options lay between a 'monolith' approach – a single organisation providing all aspects of the service – and a 'decentralised' approach, which would consist of a small central body with an advisory, strategic, and accreditation function, but with actual services delivered by external providers. In between was a hybrid approach that could sit at any number of points between those alternatives.

Uncertain prospects for financial services

The financial services sector enjoyed a third quarter of strong growth, as business volumes increased at their fastest rate in over seven years, but demand and profitability are set to weaken next quarter, the CBI and PricewaterhouseCoopers LLP said in July.

Their latest *Financial Services Survey* shows that over the last three months business volumes grew at their fastest rate in seven years, business

incomes continued to rise, and employment in the sector increased. However, in what could be an early indication that conditions are turning, the sector expects a tougher quarter ahead, with hardly any growth in business volumes, a modest decline in incomes, and a squeeze on profitability.

One-off survey questions about M&A activity revealed that the majority of financial services firms expect levels of activity to continue to pick up. A large proportion of building societies and general insurers think the current increase in financial services M&A activity primarily reflects consolidation within sectors. Looking at future behaviour, all building societies and securities traders, and nearly all banks, consider that M&A activity is likely to be initiated from within their own sectors.

Cross-border pensions?

The members of the European Financial Services Round Table (EFR – www.efr.be), chairmen or chief executives of leading European banks and insurers, have issued a paper, *Pan-European Pension Plans – From Concept to Action*. The paper identifies the differences between national legislations affecting the creation of a single market for (private) retirement savings and shows how the obstacles could be overcome to create a framework for truly European products.

Henri de Castries, chief executive officer of AXA Group and chairman of the management board of EFR, said: 'People need to be able to benefit from an integrated European pension market for private savings, which does not exist today. People are expected to be flexible and to work in other member states. However, the differing

national rules create quite complicated scenarios, in particular in the area of taxation. European citizens will not be able to believe in the concept of Europe if one of their fundamentals needs – simple and secure retirement provisions across the EU – do not exist.'

Buyout market to boom

Based on a new survey of investment managers, the Bank of New York Mellon predicted that the bulk annuity market in the UK will triple to £190bn by 2011 from a base of £60bn now. The survey, prepared by BoNY Mellon, found that investment managers believe that traditional and new entrants to the bulk annuity market could capture 20% of the for-profit market and 10% of the defined benefit or final salary scheme market. The survey also showed that asset managers see the emergence of specialist consolidators in the bulk annuity market as an opportunity, since they are expected to outsource the management of assets.

The research, which examined the effect the for-profit and defined benefit consolidators may have on the investment management industry, compared qualitative and quantitative data from 22 global investment management companies that together manage £6 trillion. Additionally, the survey canvassed Paternoster, a defined benefit consolidator, and consulting actuary Watson Wyatt.

Asked about the effect of the evolution on hedge funds, around three-quarters of the asset managers said they expected it would enhance their prospects. Also expected to benefit are active fixed-income and active equity managers along with asset- and liability-matching solutions providers.

Survey respondents also said they were envious of the Dutch pension market where fiduciary managers are well established and consultants much less so. 'The sophistication of the funds themselves and the differing legal structure in the Netherlands allows the funds to move much more quickly than their trustee equivalents in the UK', according to the report.

Munich Re changes modelling tool

The GoldSim Technology Group, a provider of advanced probabilistic simulation software, has announced that Munich Re has entered into a site licence agreement to use the company's GoldSim software in support of underwriting of non-traditional reinsurance solutions. This agreement followed a year-long evaluation phase, where Munich Re actuaries tested and developed models using GoldSim.

Pensions: forward or reverse?

July saw both good and bad news on the occupational pensions front.

New bill

There was a general welcome for the renewed commitment on the part of the government to introduce a new pensions bill to give effect to the introduction of low cost personal accounts. Announced in the 'mini-queen's speech' following the handover to a prime minister whose interest in pensions has not always been viewed positively, the proposal was particularly welcomed by the Consumers Association. Industry bodies generally were positive about the government's willingness to take their particular concerns on board.

Schemes closed to new members

Meanwhile, however, the Association of

Consulting Actuaries (ACA) published its regular *Pensions Trends* survey suggesting that four out of five defined benefit pension schemes run by companies responding to the survey are now closed to new entrants (up from seven out of ten two years ago), with an increasing number (14% from 10% two years ago) closed to future accruals.

The ACA suggested that defined benefit pensions are to an increasing degree a luxury enjoyed only by public sector employees and those working for the very largest private companies. While included among those welcoming personal accounts, the ACA was critical of government for not acting on initiatives such as employer/employee risk-sharing so as to preserve the availability of employer-sponsored schemes.

From the world of general insurance

Asbestos and pollution developments

A New York appeals court has limited the discovery rights of reinsurers in a case involving cessions of Western MacArthur asbestos claims by United States Fidelity & Guaranty Co (USF&G). The finding was that the USF&G attorney/client and work product privileges limited discovery to testimony and documents relating to the insurer's preparation of its reinsurance claim. USF&G had originally denied coverage to Western MacArthur, but had reached a \$975m settlement after Western MacArthur had sued for bad faith. USF&G apparently allocated all this settlement to the last treaty year (and claimed for reinsurance recoveries on this basis), rather than spreading it over the entire period of coverage. Reinsurers wished to see details of the settlement in order to decide on whether they considered this to be a legitimate approach.

The Texas Supreme Court has ruled that claimants for asbestos-related injury must demonstrate that exposure to products containing asbestos was a substantial factor in contracting asbestosis. As a consequence of failing to do this, the court overturned an award to a retired brake mechanic against Borg Warner, who manufactured some of the brake pads on which he worked.

The US Supreme Court has ruled that companies which are potentially responsible for contamination of a polluted site, and which begin remediation voluntarily, can recoup some of the cost from other liable parties under the Comprehensive Environmental Response Compensation and Liability Act (CERCLA). This may result in more voluntary clean-ups, but could also make it less likely that the companies involved will settle with the government. The ruling clarifies the uncertainty that resulted from a 2004 decision that the recoup of costs could only arise following a lawsuit under CERCLA.

Terrorism and World Trade Center (WTC)

In mid-June, the US Congress unveiled a new draft Terrorism Risk Insurance Revision and Extension Act, which would extend government back-up cover for a further ten years, and expand the scope to include domestic terrorism. It would also require insurers to provide coverage for terrorist attacks from nuclear, biological, chemical, and radiological agents, a proposal for which the insurance industry does not consider itself prepared. Subsequently, the US Treasury rejected the draft on the grounds that the ten-year extension could stifle growth in the private sector.

A New York federal judge has ruled that Zurich American Insurance Co and two firms of attorneys must pay a total of \$1.25m for failing to produce a key document in reasonable time as part of the WTC coverage litigation. The document in question was an earlier version of the policy wording, which included coverage for leaseholders Port Authority of New York and New Jersey and Westfield Corp under an endorsement. This endorsement was deleted subsequently, but not until after the 11 September 2001 terrorist attacks.

Contingent commissions

The Risk & Insurance Management Society Inc has called for all placement fees and contingent commissions to be prohibited, and for full disclosure of all broker remuneration.

Solvency II

Jane Portas, director of general insurance regulation at KPMG, has propounded the view that non-European (including Bermudian) reinsurers will potentially need to increase their capital base to comply with European Solvency II rules, in order that they can accept reinsurance from European insurers and reinsurers. This arises from the prin-

ciple of equivalence, under which they need to demonstrate to regulators that they have complied with the Solvency II risk-based capital regime.

Lloyd's

Lloyd's is preparing to raise a loan of up to £500m on the Stock Exchange to repay loans provided by syndicates to Lloyd's members. This is intended to 'give greater flexibility and liquidity' to the market.

Lloyd's has also settled a dispute with two firms of brokers, Benfield Group Ltd and Aon Ltd, regarding the reinsurance programme purchased to protect the Central Fund. Although the terms of the settlement have not been disclosed, it is understood that it will result in Benfield taking a net charge of about £8m – the cost to Aon is not known. This settlement follows the earlier resolution with the reinsurers, which paid £152m in March 2005.

The UK Treasury is to put forward proposals to reform the governance of Lloyd's 'to reduce costs and unnecessary bureaucracy' – the details are expected to be published early next year.

SCOR/Converium

SCOR's tender offer for Converium finally opened on 12 June, with a closing date of 9 July, after three delays were imposed by the Swiss Takeover Board in light of legal issues in the US. An additional acceptance period runs from 13 July until 26 July with a planned settlement date of 8 August. SCOR's confidence in the acceptance of the offer is reflected in the fact that details of the integration were being developed by two committees from early June. An extraordinary general meeting of Converium shareholders is planned for 16 August, to elect a new board of directors, as required under the terms of the transaction agreement with SCOR.

Meanwhile, SCOR has been delisted from the New York Stock Exchange 'to optimise operational

costs', a move for which the company filed on 4 June. It has stated that, once it has finalised its takeover of Converium, it proposes to apply for a secondary listing on the Swiss Stock Exchange (in addition to its main listing in Paris).

HIH Insurance Ltd

The company's former chief financial officer, Dominic Fodera, has been sentenced in Sydney to three years in jail for his part in HIH's collapse. In particular, he was found guilty of failing to disclose an agreement with the Australian subsidiary of Société Générale, which was acting as underwriter of an issue of HIH convertible notes in 1998. Under this agreement, HIH provided A\$35m to Société Générale to buy these notes and agreed to bear any risk or loss associated with them, thus misleading other investors. The notes issue, totalling A\$155m, helped to finance HIH's bid for FAI Insurance Ltd.

Independent Insurance

In early June, the trial commenced in London of three directors of the failed Independent, the ninth-largest UK general insurer at the time of its collapse. The three, Michael Bright (chief executive), Philip Condon (deputy managing director), and Dennis Lomas (finance director) are accused of conspiracy to defraud by withholding claims data from their actuaries and by dishonestly making incomplete disclosure of all agreements between the company and its reinsurers. In court, they were said to have 'told sustained and deliberate lies to their financial advisers and fellow directors'. It was also alleged that the financial accounts of the company as at 31 December 2000 had been 'dishonestly improved' by approximately £250m. As at the date of these notes (early July) the case is continuing.

Trinity Insurance Company

The administrators of the cut-off ➤

From the world of general insurance

► scheme of arrangement for Trinity have completed the wind-up of the company, 15 years after it went into run-off. The majority of creditors receive 76.75% of their debts, but those who are beneficiaries of the US trust fund will receive 93% of their established liabilities. In spite of initial concerns that the use of administrators from one of the 'big four' and actuaries from one of their rival firms would not work efficiently, this looks like a very satisfactory outcome.

American International Group (AIG)

In the middle of June, AIG sued two of its former executives, Maurice Greenberg (ex-chairman and CEO) and Howard Smith (ex-CFO), for over \$1bn for losses arising from their alleged wrongdoing in relation to bid-rigging, flawed accounting practices, and inappropriate use of financial reinsurances. AIG has taken over the case, which was originally brought by its shareholders. Most of the issues arose out of investigations by the former New York attorney general, Eliot Spitzer. In retaliation, Mr Greenberg sued 16 current and former AIG executives and directors, the company's auditors, and an outside consultant, alleging that AIG had overreacted to the Spitzer allegations in order 'to set an artificially low threshold for evaluating the future performance of AIG under the new management'.

Catastrophe bonds

In May, Mitsui Sumitomo announced the first risk securitisation of the year for Japanese windstorm risk, a five-year \$120m deal with Swiss Re, using Akibare Ltd, a Cayman Islands special purpose vehicle (SPV). This responds to a parametric trigger and provides cover for the first and subsequent events.

In June, Brit Insurance announced a \$200m bond covering Japan, Europe, and the US, and later in the month Kyoei Fire & Marine Insurance unveiled a partly sponsored

\$140m bond covering Japanese typhoon and Mexican earthquake risks. This latter deal uses another Cayman Islands SPV, Fusion 2007, and is said to be the first catastrophe bond to use another such bond as a trigger.

Large losses

Loss updates and related issues include:

■ **Hurricane Katrina (25–30 August 2005)** The Property Claims Services Unit of the US Insurance Services Office has revised its estimate of the insured losses from Katrina from \$40.6bn to \$41.1bn, the first change since June 2006. Insurers are also facing a further \$1bn increase if the industry loses a current legal action relating to coverage under homeowners policies for flood losses after levee failure.

■ **Hijack of *Danica White* off coast of Somalia (1 June)** This Danish cargo ship was hijacked 240 nautical miles offshore (outside Somalian territorial waters), while en route from Dubai to Mombasa, and taken to a place about two nautical miles off the coast. A US Navy ship tried to intervene later, and destroyed three small boats used by the hijackers, but had to abandon its chase of the *Danica White* when the hijacked vessel entered Somalian waters. It is the 12th piracy attack off Somalia this year, making the country the most dangerous in the world for shipping. Before the end of June the ship's generator was understood to have failed and food and fresh water supplies were exhausted. It is understood that a ransom demand has been made and that negotiations are taking place. Insurance details are not currently to hand, but amounts are unlikely to prove very significant.

■ **Cyclone Gonu, Arabian Peninsula (4–8 June)** This reached the equivalent of a category 5 hurricane, although it had moderated to tropical storm by the time it made landfall in Oman. There was significant damage to shipping, with some

vessels lost, although no details are to hand. It is believed to be the strongest cyclone in the area since records began and caused 70 deaths in Oman. There was some disruption to the country's oil and gas production, but relatively little damage was sustained to these facilities. There was significant impact on Fujirah in the United Arab Emirates, where one of a dozen boats to sink in and around the harbour caused the loss of 10 lives. The effects were also felt in south-eastern Iran where 40,000 people were evacuated from coastal areas and there were 23 deaths, mostly from drowning. The economic loss in Oman has been variously estimated to be 'more than \$1bn' and 'around \$4bn', whilst that in Iran was estimated at over \$200m. No insured loss estimates are currently to hand.

■ **Train crash in Melbourne, Australia (5 June)** This occurred when a V/Line passenger train collided with a lorry on a level crossing, causing the death of at least 11 train passengers and injuries to many more. It is thought likely that compensation will be paid by V/Line but subrogation against the lorry driver is probable if, as initially thought, the inquiry already set up indicates that the lorry driver ignored flashing lights on the level crossing. It is believed that there are likely to be reinsurance claims into the London market.

■ **Storms in New South Wales, Australia (8–11 June)** This hit north Sydney and Newcastle, causing severe flooding. More than 200,000 homes lost power and there were at least 9 deaths caused by the storm. A 40,000-tonne coal freighter ran aground in the stormy weather. Initial insured loss estimates are A\$270m, although this is predicted to increase, as many householders were away for a holiday weekend.

■ **Angora Fire, South Lake Tahoe, California (last week of June)** This wildfire destroyed 242 homes and 67 commercial buildings in the resort community, and involved more than 2,000 fire-fighters when

it was at its height. It started in an area that has been unusually dry over the past six months and was exacerbated by windy conditions. The early estimates of economic loss and insured loss are in the region of \$1bn and \$100m respectively.

■ **Floods in UK (second half of June/beginning of July)** These affected a number of areas, especially South Yorkshire, the East and West Midlands, and Northern Ireland. They were caused by a prolonged period of heavy rainstorms, resulting in overflow of surface drainage systems and a considerable number of rivers bursting their banks. In many parts of the UK, June rainfall was the highest on record, and Sheffield (one of the hardest-hit cities) is understood to have had a month's rainfall in only four hours. At least five deaths due to drowning have resulted from the floods, several thousand people have been evacuated from their homes, and many more forced to live upstairs, and schools, roads, and railways have been subject to widespread closure. Estimates given by the Association of British Insurers have steadily increased, with the latest being for claims from 27,000 homes and 5,000 businesses leading to insured losses of the order of £1bn. However, unseasonably wet weather is continuing across the UK at the time of writing (early July) and, given the already saturated state of the ground in many areas, further increases (possibly substantial) cannot be ruled out.

Current Issues Newsletter

Other recent developments are covered in the General Insurance Current Issues Newsletter, which can be accessed via the profession's website at:

www.actuaries.org.uk/Display_Page.cgi?url=/general_insurance/gen_ins-curr-issues.html

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