



INSURANCE

The State of the Insurance Industry

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FINANCIAL SERVICES

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Changes & Trends

Industry Overview

General Highlights

- On January 22, 2007, the Florida Senate unanimously passed legislation that will provide insurance rate relief on homeowner policies in that state. The property and casualty insurance reform:
 - Eliminates “cherry-picking” by requiring that insurers who write private passenger auto insurance in Florida, and who write homeowners policies in other states, write homeowner’s coverage in Florida. This change will lead to increased coverage options for homeowners.
 - Raises the level of backup coverage insurers can purchase by creating the Temporary Increase in Coverage Limit options (TICL) for the 2007–2009 hurricane seasons. Through this program, insurers will be allowed to buy additional reinsurance of up to \$12 billion above the Florida Hurricane Catastrophe Fund industry limit of \$16 billion (estimated for 2007), allowing them to lower rates.
 - Eliminates the “Panhandle exemption,” enforcing a unified, statewide building code to ensure that all Florida homes are safeguarded against storm damage. Homes that are storm resistant are less at risk, leading to lower rates.
 - Requires property insurers to provide coverage for catastrophic sinkholes.

(State of Florida Senate Press Release, January 22, 2007)

- According to the RIMS Benchmark Survey™, commercial insurance premiums fell slightly in the third quarter of 2006, representing a continuation of the trends that occurred in the past two quarters. The Risk and Insurance Management Society’s study indicated that property insurance was the only line of business that increased in the third quarter, by 1.7 percent. Directors and officers and general liability premiums decreased by less than 1 percent. *(Risk and Insurance Management Society’s Press Release, November 10, 2006)*
“RIMS Benchmark Survey” is a trademark of Risk and Insurance Management Society, Inc.
- More than 7,900 baby boomers are turning 60 years old every day—more than 330 an hour—yet, according to AXA Equitable, with record numbers of Americans entering retirement, only one in five workers actually knows what his or her specific retirement income will be. And although Social Security is a significant income element for retirees, more than 90 percent of current workers view Social Security as “troubled” or “in crisis.” These are among the findings released from the AXA Equitable Retirement Scope, a global survey on retirement. Current U.S. retirees report on average \$4,243 in monthly income—the highest amount of any country in the study; nearly double that of Canada and well ahead of France, Japan, and Germany. However, most American workers are concerned about the source of income in retirement. Nearly 65 percent of America’s working respondents plan to rely on their own retirement savings or income sources rather than Social

Security or pensions, the survey finds. High expectations for retirement income may influence U.S. workers’ hopes to continue working in retirement. Other key findings indicate that Americans lead the world in preparing for their retirement; nearly half of retirees surveyed have invested in real estate (home ownership); 19 percent of U.S. workers expect retirement income to be higher than their last salary, an optimism that trumps all other surveyed nations; on average, people would like to retire before 60 years old but realize it’s not likely to happen; and Americans plan to spend retirement savings, not pass them on to heirs. *(AXA Equitable Press Release, January 24, 2007)*

- According to a survey by Prudential Retirement, a business of Prudential Financial, America’s youngest workers strongly support the auto-enrollment provision in the recently enacted Pension Protection Act and believe this would produce better financial results and lead to more secure retirements. The survey found that the young workers would feel “optimistic” if employers automatically enrolled them in workplace-provided defined-contribution (DC) plans. Also, they would be enthusiastic about an automatic approach to other key components of DC plan management, including mandated minimum-contribution rates, a program of gradually but automatically increasing contribution levels, and defaults into investment options that employ asset-allocation modeling based on age and risk-tolerance. Responding to a similar set of questions, the Prudential survey

found that baby boomers not only endorsed the “autopilot” idea, they enthusiastically recommended the approach to younger workers. They also agreed that they would be better prepared for retirement today if automatic plan features had been in place 30 years ago. (*Prudential Press Release, November 16, 2006*)

Property and Casualty

- With \$23.7 billion of underwriting income through the first nine months of the year, U.S. property and casualty insurers have recorded a combined ratio of 91.9, improved from 100.1 in 2005, according to a newly completed A.M. Best statistical study. The 2006 results have been driven by a relatively mild hurricane season, continued adherence to underwriting discipline, and favorable prior-year reserve development and loss frequency trends, according to Ed Keane, financial analyst with A.M. Best’s property and casualty division and author of the report. Given current market conditions, A.M. Best projects that the property and casualty industry could record a full-year combined ratio of approximately 93.3, which would mark only the second industry-wide underwriting profit since 1978, and the best since 1953’s 93.1 ratio. (*A.M. Best Co. Press Release, December 15, 2006*)
- In 2006, ISO’s Property Claim Services (PCS) unit identified 33 catastrophe events. Together these events cost insurers an estimated \$8.8 billion. PCS also estimates that insurers received more than 2 million claims for damage to personal and commercial properties and vehicles. Personal lines claims accounted for 58 percent of the total, while commercial lines claims were at 9 percent, and vehicle claims at 33 percent. Losses from catastrophic events declined sharply in 2006 but were nonetheless at their sixth highest level since 1997. The 2006 hurricane season produced only one storm of catastrophic proportions, Tropical Storm Ernesto, which caused close to \$250 million in insured property damage. (*ISO Press Release, January 16, 2007*)
- In a year remembered for no land-falling Atlantic hurricanes—following heavy land-falling hurricane activity in 2004 and 2005—global tropical activity was normal in 2006, according to a report issued by Impact Forecasting, LLC, a unit of Aon Corporation. While significant attention has been devoted to the fact that no hurricanes made landfall in the United States in 2006, hurricane activity in the Atlantic Basin lagged historical norms by only 1.2 events. Activity in the eastern Pacific Ocean was greater year-over-year, with 18 named storms, up from 15 in 2005. The activity in the western Pacific was down slightly with 15 typhoons versus the long-term average of 17.4. (*Aon Re Press Release, December 28, 2006*)
- Catastrophe risk modeling company AIR Worldwide Corporation estimates insured losses from Winter Storm Kyrill will be between EUR 4 billion and EUR 8 billion (USD 5.2 billion–USD 10.4 billion). The storm struck Europe on January 18 with hurricane-force winds over the course of two days, causing significant travel and power disruptions, flooding, and building damage over a large part of Europe including the United Kingdom, France, the Netherlands, and Germany. (*AIR Worldwide Corporation Press Release, January 19, 2007*)
- Tropical Storm Risk (TSR), the consortium of experts on insurance, risk management, and seasonal climate forecasting led by the Benfield UCL Hazard Research Centre at the University College London, warned that a return to high hurricane activity in 2007 was likely following the below-average 2006 hurricane season. TSR’s long-range forecast anticipates Atlantic basin and U.S. land-falling hurricane activity will be 60 percent above the 1950-2006 norm next season. (*Tropical Storm Risk Press Release, December 7, 2006*)
- According to preliminary Swiss Re *sigma* estimates, natural and man-made catastrophes triggered total economic losses of around \$40 billion, and cost property insurers worldwide \$15 billion in 2006. Earthquakes, cold spells, windstorms, and shipping disasters claimed numerous victims. In all, an estimated 30,000 people lost their lives in catastrophes. After years of record losses, the report indicates that property insurers appear to be getting off lightly in 2006. This will allow them to replenish their risk capital, depleted by record payments for hurricane damage in 2005 and 2004. Up until mid-December, only three loss events in the billion-dollar range have made themselves felt: two tornados in the U.S. and a typhoon in Japan. Unlike in previous years, the *sigma* report indicates that Europe has also been

spared expensive catastrophes up to now. And finally, no major industrialized regions have been hit by earthquakes, nor have there been very expensive man-made disasters—such as aircraft crashes or large-scale fires. (*Swiss Re Press Release, December 20, 2006*)

- The typical U.S. driver will pay less for auto insurance in 2007 than in 2006, with the average premium expenditure expected to drop by 0.5 percent, reported the Insurance Information Institute (I.I.I.). The average annual cost for auto insurance premiums nationwide for 2007 is estimated at \$847 per policy, the first decrease since 1999. This translates into a \$4 per policy savings as compared to the \$851 the typical U.S. driver paid in 2006. The I.I.I. attributed the auto insurance price reductions to declining claim frequency, very modest increases in claims severity, fewer accidents, safer vehicles and roads, and graduated licensing programs for teens. Many industry analysts believe that fraud-fighting successes have contributed to a decrease in bogus bodily injury claims. Also believed to be contributing to these cost reductions includes the changing demographics of the U.S. population, with millions of baby boomers now in what insurers calculate to be their safest driving years. (*Insurance Information Institute, December 5, 2006*)
- A recent poll, conducted by POLLARA, of Canadians suggests that while the majority is concerned about driver distractions and the dangerous behavior of others, many drivers are still reluctant to change their own driving habits. The poll found that 89 percent of

respondents were concerned about driver distractions such as talking on a cell phone or engaging in a growing list of tasks behind the wheel. But a high percentage (60 percent) of drivers indicated they would not stop using their cell phones when driving—even when told that their cell phone use makes them four times more likely to be involved in a collision. Canada’s home, car, and business insurers want to change that. The industry announced the launch of a \$4 million multimedia public education campaign that will remind drivers to keep their eyes on the road and avoid distractions while driving, such as cell phones, PDAs, text messaging, eating, and setting up the DVD player for the kids in the back seat. (*Insurance Bureau of Canada Press Release, January 11, 2007*)

Life and Health

- The rules for setting reserves and the capital requirements for life insurance products sold in the United States are poised to undergo a dramatic overhaul. In addition, the responsibilities of financial executives of life insurance companies could increase significantly.

Taking its cue from the proposal (now adopted) for a principles-based approach to risk-based capital (RBC) for variable annuities with supplemental guarantees, the Life and Health Actuarial Task Force of the National Association of Insurance Commissioners asked the American Academy of Actuaries to develop a similar approach for universal life insurance and term life insurance. While many details remain to be

resolved, and many observers are skeptical about the timetable, a principles-based approach for life insurance RBC, and possibly reserves as well, with all the attendant drain on resources, could be required for the 2008 annual statement.

In addition to changing the actuarial calculations, the proposals would also affect the governance of statutory financial reporting. For example, if the proposals are adopted:

- The work of the company’s qualified actuary will be reviewed by an independent reviewing actuary with results communicated directly to the board of directors and the insurance commissioner; and
- The company must adopt internal controls over the principles-based valuation process, and the controls must be evaluated annually by the qualified actuary, with “participation” by the company’s chief financial officer.

(*KPMG’s Financial Executive’s Guide to the Principles-based Approach to Statutory Reserves and Risk-based Capital for Life Insurance, February 2007*)

- The life insurance industry should experience flat to modest growth in 2007, according to the annual forecast by the LOMA Board of Directors. The LOMA Board of Directors is composed of chairmen, presidents, CEOs, and other top executives of leading insurance and financial services companies in the United States, Canada, and internationally. The

directors said that the industry will see overall premiums and sales grow in the low single digits. In addition, the directors said:

- Sales of universal, variable universal, and term life products are expected to be strong in 2007, and annuities are also expected to do well.
- The imminent retirement of many members of the baby boomer generation presents great opportunities for the industry.
- Key issues pertaining to regulation and legislation include the optional federal charter, reform or repeal of the estate tax, principle-based reserve requirements, and annuity disclosures.

(LOMA Press Release, January 5, 2007)

- Individual annuity sales continued to grow in the third quarter at \$58.7 billion, a 9 percent increase over the same period in 2005, according to LIMRA International. Sales for the first three quarters of 2006 were up 9 percent over the same period in 2005, reaching \$177.9 billion. Variable annuities continue their strong growth, up 9 percent in the third quarter to \$37.9 billion and up 18 percent for the first three quarters, reaching \$119.6 billion. Fixed annuity sales reversed their declining trend, growing 9 percent for the quarter. At \$58.3 billion, fixed annuities are down 5 percent for the first three quarters compared with 2005. Equity indexed annuities (EIA) were down 7 percent from third quarter 2005, marking a fifth

straight quarter of decline from the comparable period prior year. EIA sales did increase in third quarter after four consecutive quarters of decline. (LIMRA International Press Release, November 28, 2006)

- Suitability standards for annuity products and long-term care insurance that will apply nationally are the centerpiece of new standards recently issued by the Insurance Marketplace Standards Association (IMSA), the standards-setting organization for the life insurance marketplace. According to IMSA, the new suitability standards incorporate the essential elements of the National Association of Insurance Commissioners (NAIC) model regulations for annuities and long-term care insurance. Inclusion of these provisions means widespread, national application of these consumer protection standards by IMSA companies. They will cover the 60 percent of the life insurance marketplace represented by IMSA-qualified companies. In addition to suitability provisions, the new IMSA standards adopt a streamlined methodology to more closely track the compliance approach of companies and (more) regulators. The new IMSA standards are effective immediately with a compliance date of January 1, 2008. (IMSA Press Release, October 19, 2006)
- Healthcare cost increases are projected to be about 11 percent in the next 12 months, representing the lowest increase in five years, according to Aon Consulting. Surveying more than 90 leading healthcare insurers

(representing more than 100 million insured individuals), Aon Consulting found that healthcare costs are projected to increase by 11.4 percent for HMOs, 11.2 percent for POS plans, and 11.6 percent for PPOs. This is compared to one year ago, when HMO cost increases were 12.9 percent, and POS and PPO increases each were 13.0 percent. Five years ago, the medical trend rate was estimated to increase about 16 percent. Meanwhile, consumer-driven health plans (CDH) are estimated to increase by 10.5 percent, a 2.8 percent decrease from one year ago. This is lower than traditional medical plan rates and the lowest increase since 2004 when Aon began tracking CDH trend rates. As for prescription drugs, general pharmacy costs are expected to increase by 10.6 percent, compared to 11.8 percent one year ago. Specialty drug costs will increase by 14.9 percent, down from 19 percent at this time last year. (Aon Press Release, November 15, 2006)

- A year after its first report *Pandemic Influenza: Managing the risks of an invisible threat*, which called on businesses to wake up to the potential risks of a pandemic, Aon released its second white paper, *Pandemic Influenza: Exploding the myths*. Aon says the new report analyzes the steps that have been taken in the past year to protect businesses against the inevitability of a pandemic, calling on them to increase their contingency planning. While advances over the last year have been made, including additional research into the cause and effects of the 1918 pandemic, rather than spurring businesses into action,

Aon reports that a sense of complacency seems to be creeping in. Although less news has been devoted to the issue, statistics from the World Health Organization demonstrate that the H5N1 virus, which is causing the most concern, is becoming increasingly fatal, having now spread into 10 countries compared to just 4 a year ago. Aon says that its white paper shows that preparations are inconsistent across the world and will not provide adequate protection against the spread of the pandemic. Aon indicates that businesses cannot rely on government response development of vaccines or the supply of antiviral drugs. According to the white paper, few businesses have experience establishing procedures sufficient to protect staff, and should be looking at how they can reduce the chance of virus transmission in their processes and operations. (*Aon Press Release, December 7, 2006*)

Reinsurance

- Benfield reports that net income for 13 major U.S. reinsurers rose to \$6 billion for the first nine months of 2006 from a breakeven position in the comparable period last year. This positive result was prompted by a 30-percentage point fall in the loss ratio according to the latest *Benfield U.S. Quarterly* report. Premium levels stabilized at \$26.4 billion, halting the falling trend in place since 2003. Underwriting results for the *Benfield US Quarterly* group in the first nine months were positive owing to the lack of major catastrophe losses and minimal adverse development on prior year losses. The weighted average combined ratio declined 27.8 percentage points from 123.8 percent to 96.1 percent. (*Benfield Press Release, December 7, 2006*)
- With the end of the North Atlantic hurricane season the beginning of December, Bermuda reinsurers were anticipating record profits, according to the latest *Benfield Bermuda Quarterly* report published on December 4. Total net income for the first nine months of 2006 was \$7.1 billion compared with a loss of \$1.2 billion for the same period in 2005. The aggregate combined ratio decreased from 115.7 percent last year to 88.2 percent this year with the biggest reductions coming from the catastrophe specialists. An estimated aggregate annualized RoE of 20 percent for 2006 is the highest on record for the group at the nine-month point. (*Benfield Press Release, December 4, 2006*)
- European reinsurers' confidence for full-year results was reinforced by the continued absence of major catastrophes up to the nine-month 2006 reporting dates according to the latest *Benfield European Quarterly* report. Contrary to earlier expectations, the 2006 North Atlantic hurricane season turned out to be relatively benign, with only four named hurricanes to date. The resulting strong operating performance of the reinsurers tracked by the *Benfield European Quarterly* report in the first nine months was a relief after the huge storm losses of 2005. Premium income growth was subdued as appetite for U.S. peak property cat exposures was contained. (*Benfield Press Release, December 6, 2006*)
- Collateral requirements for alien reinsurers should stay the same and not be changed by the NAIC, according to results of a recent Best's Review survey. Approximately 42 percent of more than 200 survey respondents said the NAIC should keep things the way they are—with alien reinsurers required to post 100 percent of their U.S. obligations in U.S. accounts as collateral—and forgo its proposal to base collateral requirements on financial strength and other factors and possibly reduce or eliminate collateral for some companies. In a close vote at its national winter meeting in San Antonio on December 11, the NAIC Reinsurance Task Force voted the proposal out to the Financial Conditions Committee with a target date for final adoption of September 2007. (*A.M. Best Co. Press Release, December 12, 2006*)
- Despite a severe mid-year U.S. capacity crunch, the property reinsurance market has recovered rapidly from the record losses of 2005, and by the end of 2006 it was a case of 'no wind, no problem,' according to a report published today by Benfield. The report finds that although post-Katrina market discipline has not evaporated, competition in both property and casualty is being fuelled by the drive for greater diversification, the appetite of newcomers to enter the market, and the determination of established reinsurers to protect market share. At year-end renewals, catastrophe rate increases in loss-affected areas of the U.S. were steep but less than buyers had feared, while elsewhere reinsurance prices generally gave up the gains seen at last year's renewals. (*Benfield Press Release, January 17, 2007*)

- Swiss Re's *sigma* study on securitization in insurance indicates that insurance-linked securities (ILS) provide insurers with a financing vehicle and a means of transferring risks to the capital market. They increase industry capacity, improve insurers' return on equity, and reduce the volatility of earnings. For fixed-income investors, ILS provide an attractive rate of return that is not correlated with the rest of their portfolio. Structuring costs for such securities are coming down as the market grows rapidly. According to the report, the total volume of ILS outstanding has grown three-fold over the last five years, and is now close to \$23 billion. Of this, two-thirds or \$15 billion are life bonds, and the remaining \$8 billion non-life. According to Swiss Re's new *sigma* study, insurers and investors increasingly benefit from these new opportunities. Since total bonds outstanding are still just a small fraction of the potential market, issuance is likely to see strong growth going forward. (*Swiss Re Press Release, December 12, 2006*)

Consolidation and Convergence

- Deal volume increased in all financial institution industries in 2006 according to SNL Financial. There were a total of 1,261 financial institution deals in 2006, up from 1,169 in 2005, and aggregate deal value rose to \$211.6 billion from \$202.4 billion a year ago. Although the number of insurance deals announced climbed to 112 in 2006 from 107 a year ago, aggregate deal value dropped to \$12.3 billion from \$46.8 billion. Aviva's acquisition of AmerUs Group Co. topped the deal list for the insurance industry with a deal value of \$2.7 billion. Following in second was Protective Life Corp.'s buyout of Chase Insurance Group from JPMorgan Chase & Co., which had a deal value of \$893.0 million. Swiss Reinsurance Co.'s bid for UK GE Life business from General Electric Co. followed close behind with a value of \$862.8 million. Insurance broker deals announced in 2006 totaled 216, up from 207 in 2005. Aggregate deal value rose to \$1.7 billion from \$1.6 billion in 2005. The top insurance broker deal was AEGON NV's acquisition of Clark Inc. for \$262.2 million. (*SNL Financial (Business Wire) Press Release, January 17, 2006*)
- On January 24, 2007, American International Group, Inc. (AIG) announced that it had submitted a letter to the board of directors of 21st Century Insurance Group (21st Century) proposing to acquire the outstanding 38.1 percent publicly held shares of 21st Century. AIG and its subsidiaries own approximately 61.9 percent of the outstanding shares of 21st Century. (*American International Group Press Release, January 24, 2007*)
- Scottish Re Group Limited, a global life reinsurance specialist, announced that it has entered into an agreement whereby MassMutual Capital Partners LLC (MassMutual Capital), a member of the MassMutual Financial Group, and affiliates of Cerberus Capital Management, L.P. (Cerberus), a private investment firm, will each invest \$300 million into the company, resulting in a total new equity investment of \$600 million. Under the terms of the agreement, MassMutual Capital and Cerberus will purchase a total of 1,000,000 newly issued convertible preferred shares of Scottish Re. (*Scottish Re Group and MassMutual Financial Group Press Releases, November 27, 2006*)
- Credit Suisse Group announced on December 22, 2006 that it had completed the sale of 100 percent of Winterthur Swiss Insurance Company to AXA, finalizing the agreement first announced in June 2006. (*Credit Suisse Press Release, December 22, 2006*)
- AXA announced it has completed the sale of AXA RE's business to Paris Re Holdings. The transaction closed on December 21, 2006. As announced on June 6, 2006, AXA has taken a 3.4 percent stake in Paris Re Holdings, a newly created company sponsored by a consortium of international investors led by Stone Point Capital. (*AXA Group Press Release, December 22, 2006*)
- AXA further announced it has reached an agreement with QBE Insurance Group for the sale of Winterthur's U.S. operations for \$1.156 billion. The transaction is expected to close in the second quarter of 2007. (*AXA Group Press Release, January 4, 2007*)
- AmerUs Group Co. announced its merger with Aviva plc was completed effective November 15, 2006, and that shareholders of AmerUs Group would receive \$69 in cash for each share of AmerUs Group common stock. Aviva's principal business activities are long-term savings, fund management, and general insurance. (*Aviva plc Press Release, November 15, 2006*)

- CNA Financial Corporation announced the completion of 13 subsidiary mergers effective December 31, 2006 in its initiative to streamline and consolidate its U.S. property and casualty insurance company structure. The majority of the 13 merged underwriting companies were primarily used to write personal lines business, which CNA sold in 1999. Twelve of the underwriting companies have merged, either directly or indirectly, with and into The Continental Insurance Company, and one underwriting company has merged directly with and into Continental Casualty Company. (*CNA Press Release, January 12, 2007*)
- Skandia Insurance Company Ltd., a subsidiary of Old Mutual plc, announced that it has reached an agreement to sell its 94 percent stake in Skandia Vida S.A. de Seguros y Reaseguros to CNP Assurances. Following this transaction, Skandia will continue to operate in the Spanish market through Skandia Link S.A. de Seguros y Reaseguros and Skandia Multigestión Agencia de Valores S.A., mainly in the segments of mutual fund and unit-linked products. (*Old Mutual Press Release, December 20, 2006*)
- Great-West Lifeco Inc. announced that its U.S. subsidiary, Great-West Life & Annuity Insurance Company, reached an agreement to acquire the bundled, full-service, defined contribution (primarily 401(k)) business from U.S. Bank. The agreement included the transfer of nearly 1,900 daily valuation and balance-forward plans, representing approximately 195,000 participants and more than USD \$9 billion in retirement plan assets. (*Great-West Lifeco Inc. Press Release, November 30, 2006*)
- Sun Life Financial Inc. announced it has reached an agreement to purchase the U.S. group benefits business of Genworth Financial, Inc. for \$650 million. Genworth's group operations primarily offer group life, disability, stop-loss, and dental insurance. (*Sun Life Financial Press Release, January 11, 2007*)
- Further to the announcement of December 4, 2006, Equity Insurance Group confirmed its acquisition by Insurance Australia Group (IAG) was completed on January 9, 2007. The acquisition, for a total consideration of GBP 570m, was subject to regulatory approval by Lloyd's and FSA. (*Equity Insurance Group Press Release, January 9, 2007*)
- On November 28, 2006, the heads of LIMRA International and LOMA announced that they have agreed to begin discussions that could lead to a merger of the two insurance and financial industry research and service organizations. LIMRA offers research, consulting, and other services to help member companies gain maximum marketing and distribution effectiveness. LOMA offers research and educational programs to help members improve operational performance. According to the announcement, both organizations have strong well-established brands in the industry and a broad international presence. It is estimated that a merger could be many months—possibly a year or longer—away as representatives of LIMRA and LOMA conduct due diligence and examine all the issues of bringing the two together. (*LIMRA International and LOMA Press Release, November 28, 2006*)
- According to a LIMRA International announcement on January 16, 2007, the typical bank in the latest "Kehrer-LIMRA Bank Life Insurance Sales Study" increased its new life sales revenue by an estimated 15 percent last year, on the heels of a similar increase the previous year. At the same time, the profit margin for banks' life insurance sales programs was 42 percent on average, which compares favorably with other uses of bank sales staff. (*LIMRA International Press Release, January 16, 2007*)

Risk Management

- The Risk and Insurance Management Society, Inc. (RIMS) says terrorism is one of the largest and least predictable catastrophic exposures for businesses, and it is very concerned about the fast-approaching expiration date of the Terrorism Risk Insurance Act (TRIA) on December 31, 2007 without any long-term successor program in place. Without the stability offered by a permanent long-term solution, RIMS says its members are faced with an uncertain and costly marketplace that is not equipped to assist in the protection and sustainability of our country's assets. Accordingly, something must be done to ensure that terrorism insurance continues to be available to buyers of commercial insurance in a comprehensive and

affordable manner once TRIA expires. There are a number of proposals that have been issued by the insurance industry and from representatives of the real estate and financial services markets. Through ongoing discussions and polling of its membership, RIMS has identified critical factors that should form the foundation of any solution. Therefore, rather than endorsing a particular plan or developing one of our own, RIMS embraces four principles that it feels should underlie any plan that is adopted. RIMS believes that:

1. A private/public partnership provides the best alternative to addressing the long-term needs of availability and affordability of insurance to cover acts of terrorism.
 2. Any solution needs to address the long-term availability and affordability of insurance coverage for nuclear, biological, chemical, and radiological (NBCR) events caused by terrorism.
 3. All commercial property, workers' compensation, and liability lines should be included in any new plan.
 4. Insurance companies writing commercial lines should be required to participate in the program and be required to make coverage available for acts of terrorism. (*Risk and Insurance Management Society Press Release, December 8, 2006*)
- Leaders of the property and casualty insurance industry expect Congress to extend the Terrorism Risk and Insurance Act in 2007, according to a survey conducted by the I.I.I. at its

11th annual Property/Casualty Insurance Joint Industry Forum. Eighty-nine percent of the executives are confident that the new Congress will move quickly to extend the law for a significant period or to provide a permanent backstop. When it comes to whether Congress will adopt a National Catastrophe Insurance Plan in 2007, however, 88 percent of respondents do not think it will occur. In addition, 63 percent of insurance leaders think the push for an Optional Federal Charter will not gain momentum in the new Congress. Regarding the industry's financial performance, the survey indicates that a majority of industry leaders believe the market will soften in most property and casualty lines. Broken down by lines of insurance, a majority of respondents do not think there will be an improvement in personal auto, homeowners, workers' compensation, and commercial lines. Further findings indicate that 65 percent of respondents believe property catastrophe reinsurance pricing will ease in 2007. Seventy-seven percent of respondents do not expect consolidation among insurers and reinsurers. (*Insurance Information Institute Press Release, January 9, 2007*)

- A.M. Best Co. indicates that the overall investment climate for U.S. life and health insurers remains challenging, with a flat to slightly inverted yield curve and tight credit spreads. These challenges have been tempered by relatively benign credit default trends, which are expected to increase to

more normalized historical levels, supported by generally higher capitalization levels, according to the recently issued A.M. Best Co. special report on U.S. life and health investment trends. A.M. Best believes that default rates are likely to rise because of the slowing economy, significant amounts of equity capital actively pursuing leveraged buyout transactions, and ongoing merger and acquisition activity. (*A.M. Best Co. Press Release, January 8, 2007*)

- Swiss Re announced that the *Global Risks 2007* report, released on January 10, 2007, highlights a growing disconnect between the power of global risks to cause major systemic disruption, and the ability to mitigate them. The annual Global Risks report, published by the World Economic Forum in cooperation with Citigroup, Marsh & McLennan Companies, Swiss Re, and the Wharton School Risk Center, suggests that many of the 23 core global risks explored in the report have worsened over the last 12 months, despite growing awareness of their potential impacts. In addition to specific risk mitigation measures, institutional innovations may be needed to create effective responses to a complex risk landscape. (*Swiss Re Press Release, January 10, 2007*)
- Risk Management Solutions (RMS) released an extensive report on the future flood risk faced by the city of New Orleans due to hurricane storm surges. The report, *Flood Risk in New Orleans: Implications for Future Management and Insurability*, outlines the ongoing threat of flood risk due to

future hurricane storm surges and considers the role of insurance, the planning process, and the government in providing physical and economic protection so those living and investing in the city can have confidence that the risk is being effectively managed. The report concludes that the threat of flooding in the city continues to increase due to a combination of various physical temporal factors, which all serve to increase the storm surge flood hazard faced by New Orleans, and will significantly raise the risk of flooding in the city through the 21st century. (*Risk Management Solutions Press Release, December 4, 2006*)

- RMS reaffirmed its medium-term five-year view of land-falling hurricane risk for the period of 2007–2011. The company is projecting higher modeled annualized insurance losses by 40 percent on average across the Gulf Coast, Florida, and the Southeast, and by 25–30 percent in the Mid-Atlantic and Northeast coastal regions relative to those derived using long-term 1900–2006 historical average hurricane frequencies. According to RMS, a key driver of the current elevated view of land-falling hurricane risk is an increase of more than 30 percent in the modeled frequency of major (Saffir-Simpson Category 3–5) hurricanes making landfall in the U.S., to account for current elevated levels of hurricane activity in the Atlantic basin that are expected to persist for at least the next five years. The increased frequency and intensity of hurricane activity in the Atlantic Ocean Basin, as observed

since 1995, are driven by higher sea surface temperatures in the tropical North Atlantic and by associated changes in atmospheric circulation. (*Risk Management Solutions Press Release, November 22, 2006*)

International Focus and Globalization

- The complexity of navigating Europe’s diverse national pension systems is driving up costs for multinationals in the region, according to the first-ever pensions survey of multinational companies published by AEGON. The *Bridging Pension Plans Worldwide* survey, conducted in conjunction with LIMRA International, suggests that the diversity of pension systems across the European Union is making the region less competitive than their global rivals and accelerating the trend toward relocating jobs outside of the European Union. The worldwide survey of pension experts provides new evidence that multinational corporations will be looking for more efficient ways to provide retirement benefits to employees. Seventy-four percent of those interviewed would prefer to design and implement their own integrated cross-border corporate pension systems rather than waiting for EU-wide pension legislation to be implemented. The survey also highlights an increasing worldwide trend toward transferring a greater degree of financial risks off their own balance sheets and onto individual employees by shifting from defined benefit plans to defined contribution arrangements. (*AEGON Press Release, December 4, 2006*)
- On November 9, 2006, Canada’s Finance Minister Greg Sorbara announced that the “McGuinty government had established an expert commission to seek input about ways to ensure that Ontarians can rely on their pensions, and keep the province’s pension system sustainable.” The review will focus on the importance of maintaining and encouraging the system of defined benefit pension plans in Ontario; ensuring affordability; the importance of pension plans in supporting a competitive economy, and the need to safeguard the security of pension benefits; the need to balance the rights and obligations of employers, plan members and pensioners; and the impact of demographics and the changing nature of the workforce on the provision of employment pensions. The panel is expected to report back in the summer of 2008. (*Canadian Department of Finance Press Release, November 9, 2006*)
- According to a new report from The Fraser Institute, Canada’s government spending on healthcare has grown faster than the ability to pay for it since 1975, just four years after Medicare was first introduced. The Fraser Institute’s annual report, *Paying More, Getting Less*, analyzes the most recent five-year trend in average annual growth rates for provincial government health expenditure and total revenue from all sources, and then projects this trend forward without any adjustments for the expected aging of the population. The 2006 report found that public health insurance costs are on pace to consume more than 50 percent

of total revenue in six of 10 provinces by 2020 and 100 percent by 2050. The Canadian Union of Public Employees criticized the report, claiming the five-year trend is not a realistic expectation for future trends. To set the record straight and in order to allow public replication of the results, Brett Skinner, the Fraser Institute's Director of Health, Pharmaceutical and Insurance Policy research and author of the study, used data from Statistics Canada to compare provincial healthcare expenditures to total revenues over both 5- and 10-year periods. The new report says solutions can be found in the type of policies used in other countries to deal with similar financial sustainability problems in their public health insurance programs. (*The Fraser Institute Press Release, January 11, 2007*)

e-Business and Technology

- Celent's fourth annual survey of senior IT executives finds increased focus on strategic spending to meet market demands and some concern over a softening property and casualty market. Overall, the respondents to the survey represented \$50 billion in premium, or roughly 5 percent of the total U.S. insurance market. Top areas of significant new project spending vary by size and sector, but include initiatives focused on underwriting, claims, product development, and data mastery. Document handling, policy administration system replacement, ACORD XML adoption, agent portals, and BPM all show up among the most

common areas of significant new project spending. (*Celent Press Release, November 27, 2006*)

- According to ISO, XactValue reached a significant landmark recently when it processed its five millionth valuation. XactValue is a tool used by the property industry to determine the replacement cost of a structure, which is critical for both insurers and policyholders, ISO says. XactValue builds an actual replacement-cost estimate for each building using the same replacement-cost data employed by most insurance adjusters and restoration contractors when they write damage-repair estimates. (*ISO Press Release, December 7, 2006*)
- The latest release of ISO HomeValue™, a residential replacement cost estimator, now allows personal lines insurers to assess catastrophe risk for individual properties using AIR Worldwide Corporation's (AIR) industry standard catastrophe models. By providing access to essential catastrophe risk data from a single Web-based application, ISO HomeValue enables improved underwriting decisions. By accessing AIR's catastrophe models from within ISO HomeValue, underwriters can generate real-time estimates of catastrophe risk, as characterized by the estimated average annual loss. Insurers can use this assessment of the catastrophe risk to automate, for example, simple issue/decline decisions, rating plan selection, and price adjustment under consent-to-rate procedures. (*ISO Press Release, November 13, 2006*)
ISO Home Value is a trademark of ISO Properties, Inc.

- The National Association of Mutual Insurance Companies (NAMIC) unveiled a new Web site it says is to help address the increasing concerns about climate change and its impact on the property and casualty insurance industry. According to Chuck Chamness, NAMIC president and CEO, the "site will not advocate a position on the scientific controversy of the causes of the increase in natural disasters around the world. Instead, it contains information and leading thought about how climate change impacts the insurance industry, and what insurers and reinsurers in the U.S. and Europe are doing with this issue." The Web site is at www.climateandinsurance.org. (*NAMIC Press Release, January 17, 2007*)

Accounting Standards and Developments

Securities and Exchange Commission (SEC)

- **Proposed SEC and PCAOB Guidance on Internal Control over Financial Reporting**

The SEC proposed interpretive guidance for management on evaluating internal control over financial reporting and postponed the compliance deadline on internal control over financial reporting for non-accelerated filers and newly public companies. In a related step, the Public Company Accounting Oversight Board proposed a revised standard for audits of internal control over financial reporting. All these actions are intended to make compliance with Section 404 of the Sarbanes-Oxley Act more cost-effective. The SEC requests and

encourages interested parties to submit comments to the SEC on specific issues related to this proposed guidance. Comments on the proposed rule are due by February 26, 2007. The PCAOB seeks comment for a 70-day period ending on February 26, 2007. Its final standards and rule will be submitted to the SEC for approval. The Board intends to set an effective date at the time the proposals are adopted that reflects the Board's commitment to minimizing disruption to ongoing audits.

A new SEC rule postpones the effective date for compliance with Sections 404(a) and 404(b) of the Sarbanes-Oxley Act for all non-accelerated filers, including non-accelerated foreign private issuers, and changes the rules for compliance with Section 404 for newly public companies. Under the new rule, non-accelerated filers must comply with the management-assessment requirement for the first fiscal year ending on or after December 15, 2007. The requirement to provide an auditors' report on internal control over financial reporting now applies to the first fiscal year ending on or after December 15, 2008. These changes are consistent with the SEC's proposal issued in August 2006. The SEC rule release encourages "frequent and frank dialogue among management, auditors and audit committees" in the initial year of compliance with Section 404(a). This recognizes that some auditor involvement will be necessary during management's initial year of compliance in order to plan effectively for the first-year audit of internal control over financial reporting and to discuss the implementation of the PCAOB's coming

new auditing standard on internal control over financial reporting.

The rule permits newly public companies to delay compliance with the requirements to file management assessments and the related auditors' report until they file their second annual report with the SEC following going public. A newly public company also need not comply with the periodic requirements to conduct an evaluation and disclose changes to internal control over financial reporting, or the requirements related to the maintenance of internal control over financial reporting, until after filing the first annual report that management must include its report on internal control over financial reporting. However, a newly formed public company that chooses to rely on its public parent's reporting history in order to qualify for Form S-3 eligibility (for example, a spun-off entity or a newly formed holding company) would be considered an accelerated filer and therefore would be required to comply with items 308(a) and 308(b) of Regulation S-K in the first annual report that it files. The new rule is effective 60 days following publication in the Federal Register. (*KPMG's Defining Issues, 06-34, December 2006*)

- **SEC Adopts Revised Executive Compensation Disclosures**

Newly adopted SEC rules, SEC Release No. 33-8765, *Executive Compensation Disclosure*, December 22, 2006, requires disclosures about executive officers' and directors' stock and option awards be more closely aligned to the amounts reported in the financial statements, reflecting earned

compensation for the service period as reported in the financial statements, rather than the aggregate grant-date fair value of the awards. The amendments, which are effective upon publication in the Federal Register, affect the amounts included in the calculation of "total compensation" under Item 402, which determines what individuals in addition to the principal executive officer and principal financial officer meet the definition of a "named executive officer." (*KPMG's Defining Issues, 06-35, December 2006*)

Financial Accounting Standards Board (FASB)

- **Modifications of Convertible Debt (EITF 06-6)**

This Consensus would exclude changes in the fair value of an embedded conversion option from the cash-flow analysis performed under EITF 96-19 to determine whether modifications or exchanges of debt are substantial. A modification would be substantial if the present value of the modified cash flows is at least 10 percent different from the present value of the cash flows immediately before the modification. If the modification is not found substantial under that test, a separate, additional analysis of the change in the fair value of the conversion option would be performed. Under this test, if the change in an embedded conversion option's fair value is found to be at least 10 percent of the debt instrument's carrying amount, the modification would be considered substantial. Modifications that either add or eliminate a substantive conversion option would always have to be treated as substantial. If a modification or

exchange is considered substantial, extinguishment accounting with recognition of a gain or loss would be applied to the existing debt and the modified debt would be recorded as a new debt instrument at fair value. Under the Consensus, an increase in the fair value of a debt instrument's embedded conversion option in a modification that is not substantial would reduce the carrying amount of the debt instrument, thereby increasing the debt discount or reducing the debt premium, with a corresponding increase in additional paid-in capital. However, a decrease in the fair value of an embedded conversion option in a modification that is not substantial would not be recognized. If ratified by the FASB, the new Consensus would replace the Consensus in EITF 05-7 and amend EITF 96-19.5. The new Consensus would apply to future modifications or exchanges of debt instruments that occur in interim or annual reporting periods beginning after ratification. Early application would be permitted for modifications or exchanges of debt instruments in periods for which financial statements have not yet been issued. (*KPMG's Defining Issues, 06-32, November 2006*)

- **Previously Separated Conversion in Convertible Debt (EITF 06-7)**

The EITF reached a Consensus on how to account for an embedded conversion option that was previously accounted for separately from a convertible-debt instrument under the requirements of FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998, and EITF Issue

No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, but no longer meets Statement 133's requirements for separate accounting. The Consensus would require companies to reclassify to shareholders' equity the fair value of a previously separated conversion option when it is no longer required to be separately accounted for. Prior to the transfer to equity, the previously separated conversion option is accounted for at fair value, and its carrying amount, which would equal fair value, would therefore be reclassified to shareholders' equity. If a convertible debt instrument with a conversion option that has previously been reclassified to shareholders' equity under this Consensus is extinguished before maturity, a portion of the reacquisition price would be allocated to equity based on the fair value of the conversion option at the extinguishment date with the remaining amount being used to determine the gain or loss on the extinguishment of the debt. If ratified by the FASB, the Consensus would be applied prospectively in interim and annual periods beginning after December 15, 2006 to all conversion options previously separated from convertible debt instruments that no longer meet Statement 133's requirements for separate accounting. The requirements would apply regardless of whether the debt instrument was entered into before the Consensus's effective date. Early application would be permitted in periods for which financial statements have not yet been issued. Companies

would be permitted to apply the Consensus by retrospective application to all prior periods. (*KPMG's Defining Issues, 06-32, November 2006*)

- **Change in Subsidiary's Fiscal Year-End (EITF 06-9)**

The Consensus addresses how a company should report the effect of a change in the period between a parent company's period-end and the period-end of a subsidiary or equity-method investee used in the parent company's consolidated financial statements (referred to as a lag period). The Consensus would require the parent company to recognize the effect of a change in the lag period as a change in accounting principle under Statement 154 through retrospective application to all prior periods, unless that approach would be impracticable. If the approach is impracticable, the effect of the change would be recognized as a cumulative-effect adjustment to beginning retained earnings in the earliest period to which the new accounting principle can be applied. If ratified without change, this Consensus would be effective for changes in a lag period occurring in interim or annual periods beginning after November 29, 2006. Earlier application would be permitted in periods for which financial statements have not yet been issued. (*KPMG's Defining Issues, 06-32, November 2006*)

- **Collateral-Assignment Split-Dollar Life Insurance (EITF 06-10)**

This tentative conclusion addresses only collateral-assignment split-dollar life insurance arrangements that provide a benefit to an employee that

extends to postretirement periods. In a collateral-assignment split-dollar arrangement, the employee owns and controls the policy and irrevocably assigns a portion of the death benefits to the employer as collateral for the employer's interest. The EITF tentatively concluded it would extend to collateral-assignment split-dollar arrangements that include a post-retirement benefit the same treatment EITF 06-4 requires for endorsement split-dollar life insurance arrangements, namely, that the company should record a liability for the postretirement benefits. This approach would significantly change current practice. The EITF also tentatively concluded that an employer should measure the asset associated with collateral-assignment split-dollar life insurance based on the terms of the arrangement. In some cases, this may be the present value of the amounts due from the employee's estate upon death. In other cases, the asset would be measured based on the cash surrender value of the insurance policy. If adopted as a final Consensus, this tentative conclusion would be effective for fiscal years beginning after December 15, 2007. Early adoption would be permitted as of the beginning of a company's fiscal year. Companies adopting the Consensus would choose between retrospective application to all prior periods or treating the application of the Consensus as a cumulative-effect adjustment to beginning retained earnings or to other components of equity or net assets in the statement of financial position. (*KPMG's Defining Issues, 06-32, November 2006*)

- **Tax Benefits from Dividends on Restricted Stock and Option Awards (EITF 06-11)**

EITF 06-11 applies to share-based payment arrangements in which the employee receives dividends on the award during the vesting period, the dividend generates a tax deduction, and the employer thereby obtains a tax benefit. The EITF tentatively concluded that the tax benefit received on dividends paid to employees associated with their share-based awards should be recorded in additional paid-in capital until the award is settled through exercise (if the award is an option) or vesting (if the award is nonvested stock). Once the award is settled, the company would determine whether the cumulative tax deduction exceeded the cumulative compensation cost recognized in the income statement. The cumulative tax deduction would include both the deductions from the dividends and the deduction from the exercise or vesting of the award. If the tax benefit received from the cumulative deductions exceeds the tax effect of the recognized cumulative compensation cost, the excess would be recognized as an increase to additional paid-in capital. If adopted as a final Consensus, this tentative conclusion would be effective for income-tax benefits on dividends declared in annual periods beginning after September 15, 2007. Early application would be permitted for dividends declared in periods for which financial statements have not yet been issued. (*KPMG's Defining Issues, 06-32, November 2006*)

- **FASB Staff Position No. EITF 00-19-2, Accounting for Registration Payment Arrangements**

Companies that agree to register securities will be required to recognize a liability separate from the related securities if a payment to investors for failing to fulfill the agreement is probable and its amount can be reasonably estimated, according to a newly issued FASB Staff Position. The Staff Position is intended to eliminate diversity in practice in accounting for registration payment arrangements. The amount to be paid to the investor is often calculated as a percentage of the proceeds from the issuance of the security and may be settled in cash, equity shares, or as an adjustment to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument). The Staff Position is effective immediately for new and modified registration payment arrangements. Arrangements that were entered into before the Staff Position was issued would become subject to its guidance for fiscal years beginning after December 15, 2006 by recognizing a cumulative-effect adjustment in retained earnings as of the beginning of the year of adoption. Adopting the Staff Position may cause some securities to be reclassified from liabilities to equity. The transition guidance described in the Staff Position is a modified version of the cumulative-effect-of-adoption approach. Early adoption of the Staff Position is permitted as of the beginning of an interim period if the financial statements for that period

have not yet been issued.

Retrospective application to periods for which financial statements have been issued is prohibited. (*KPMG's Defining Issues, 06-33, December 2006*)

Regulatory and Legislative Matters

NAIC 2006 Winter Meeting

- **NAIC/Regulatory**

The NAIC's Reinsurance Task Force voted to recommend to its parent committee a proposal that would revise the provisions under which U.S. ceding insurance companies are permitted to take credit on their balance sheets for risks transferred to U.S. and foreign reinsurers. Other groups adopted changes to enhance the NAIC's securities rating process, made progress toward revising the model law that prescribes the process used to set reserves for life and annuity products, and proposed revisions to the model regulation on viatical settlements. In addition, certain statutory accounting changes were adopted to address industry concerns and implementation issues.

- **Reinsurance Regulatory Framework**

The NAIC Reinsurance Task Force transmitted a proposal to its parent committee recommending that it be refined by the committee no later than September 2007. The proposal would establish a U.S. regulatory system that distinguishes financially strong reinsurers from weaker ones, would reduce or eliminate collateral requirements for many non-U.S. reinsurers, and would create such requirements for some U.S. reinsurers.

Six ratings would determine whether and how much collateral a reinsurer should post in order for U.S. ceding companies to take credit on their balance sheets for the risks the reinsurers assumed. Under the current system, full credit is virtually automatic if the reinsurer is subject to U.S. regulation and the balances have not been deemed uncollectible and are not in dispute or overdue. If the reinsurer is not subject to U.S. regulation, credit is available only if the reinsurer posts collateral to secure the balances. The Task Force proposed that a new organization, the Reinsurance Evaluation Office (REO), assign ratings to reinsurers that assume business from U.S. companies. Each rating, from REO-1 through REO-6, would be based on the REO's evaluation of the financial strength ratings nationally recognized statistical rating organizations assign to the reinsurer, and the REO's review of the reinsurer's business operations, claims paying history, management expertise, and overall performance.

Statutory Accounting Changes

The Blanks Working Group adopted guidance on hybrid securities that will be posted to the NAIC Web site for use by companies preparing their 2006 statutory annual statements and the Statutory Accounting Principles Working Group exposed "transition guidance" on SSAP No. 88.

- **Hybrid Securities**

In response to industry concerns about what was considered overly high-risk-based capital charges for investments in hybrid securities, the NAIC adopted a short-term solution on how to report hybrid securities. For the short term,

securities meeting the NAIC's definition of a hybrid security will be classified as preferred stock for financial-reporting purposes. Securities that meet a definition of hybrids and are issued after August 18, 2005, and all hybrids classified by the NAIC as common stock in 2006, will be given an NAIC designation one level lower ("notched down"). Any securities classified by the Securities Valuation Office as debt in 2006 will be reported as debt and not "notched down." The changes were not adopted until after the 2006 Annual Statement Instructions had been distributed in hard copy. The Blanks Working Group therefore adopted the guidance on the short-term solution in an Annual Statement Instructions format and will post it on the NAIC Web site for use by insurers in 2006 year-end financial reporting.

- **Guidance on SSAP No. 88**

The Statutory Accounting Principles Working Group developed and exposed for public comment "transition guidance" on some of the interpretive questions intended to be resolved by the proposed appendix to SSAP No. 88, *Investments in Subsidiary, Controlled, and Affiliated Entities* (SCA Entities). The new guidance will apply for purposes of 2006 reporting. The proposed appendix focuses primarily on what audited financial statements are required to support the carrying value of investments in an SCA entity. The "transition guidance" pertains to three elements that have not been interpreted consistently by insurers, auditors, and regulators. The guidance would allow insurers, for 2006 reporting only, to obtain balance-sheet-only audits

to support the carrying value of these investments and to obtain audits of all subsidiaries below a downstream holding company and non-admit the remaining assets of the downstream holding company. It would also clarify that an audit of an upstream holding company that includes the reporting entity and all downstream subsidiaries is not sufficient to meet the requirements of SSAP No. 88 for 2006. Some of the conclusions in the "transition guidance" are expected to be allowed only for 2006 reporting and will not be allowed when the proposed appendix is adopted and finally issued in 2007. The exposed "transition guidance" has a comment deadline of December 20, 2006 in order to allow regulators to consider comments and issue final guidance in time for 2006 reporting. Revisions to the proposed appendix and to paragraphs 8-9 and 17-18 of SSAP No. 88 will be addressed during interim calls in the first quarter of 2007.

- **The Securities Rating Process**

The Valuation of Securities Task Force adopted procedural changes intended to make the activities of the NAIC's Securities Valuation Office more transparent to constituents and to make the Office's rating process more predictable. The changes require the Valuation Office (1) to post its determinations for publicly traded securities on the NAIC Web site; (2) to permit broker dealers to make direct requests for analyses of new securities through the Advanced Rating Service submission process, rather than route such requests through insurers; (3) to publish research reports that explain in greater detail its methodology for

classifying securities; (4) to amend the NAIC Accounting Practices and Procedures Manual to clarify matters related to the filing exemption rules and the classification process; and (5) to reestablish the Invested Assets Working Group as a central forum to study technical questions related to new investment vehicles. These changes responded to industry concerns about the Valuation Office's actions earlier in 2006, when its classifications of certain hybrid securities led to higher risk-based capital charges and temporarily disrupted the markets for those securities.

- **Principles-Based Life, Health, and Annuity Reserving**

A proposal to revise the model law prescribing the process used to set reserves for life and annuity products that could incorporate internal-control reporting requirements into the principles-based reserving process moved a step closer to a final version with a presentation to the commissioner-level Principles-Based Reserving Working Group that has been overseeing the project. The proposal will be discussed at future meetings. If adopted by the NAIC, the revisions would become the standard for reserves in statements filed in a state only if that state individually adopted the revisions. The proposal would expand the scope of the Standard Valuation Law to include funding agreements, guaranteed investment contracts, health insurance, health benefits, and healthcare services contracts. It would also establish both a valuation manual to govern reserving for life, annuity, and health policies, and a revised valuation process that would

require companies to incorporate assumptions and methods that are consistent with those incorporated in the company's overall risk assessment and management process. The proposed revisions to the Standard Valuation Law would require insurers to obtain an independent actuarial review of the valuation process. It would also require insurers to adopt internal controls to assure that all material risks inherent in the accounts subject to the valuation are included and that valuations are made in accordance with the manual. The company's qualified actuary would have to evaluate and report on the effectiveness of the controls annually, with the participation of the company's chief financial officer.

- **Viatical Settlements**

Proposed revisions to the model regulation on viatical settlements would extend the amount of time a viator has to rescind a viatical settlement contract, mandate certain disclosures that must be made to policy owners in viatical settlement arrangements, and prohibit parties from entering into a viatical settlement contract before or within five years after the issuance of the related insurance policy except in limited circumstances such as terminal illness of the viator, according to decisions by the NAIC Life Insurance and Annuities Committee. A viatical settlement contract is defined for purposes of the current model regulation as an agreement, between an owner of a life insurance policy (the viator) and a viatical settlement provider, that establishes terms under which

compensation of some amount less than the expected death benefits of the policy will be paid to the policy owner in return for the policy owner's death benefit or ownership of any portion of the policy. The proposed revisions would exclude from the definition of a viatical settlement provider entities, such as licensed lending institutions, that take an assignment of a policy solely as collateral for a loan. (*KPMG's Issues & Trends in Insurance, 06-4, December 2006*)

Taxation

- **ILM issued in accordance with Rev. Rul. 2004-75 (Withholding required on certain payments by an insurer's foreign branch)**

In Rev. Rul. 2004-75 the Internal Revenue Service (IRS) had ruled that income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source FDAP income that is subject to 30 percent tax and withholding (which may be reduced by treaty) under sections¹ 871(a) and 1441. In a legal memorandum, ILM 200646001, the IRS has advised that payments from the foreign branch of U.S. life insurance company to a nonresident taxpayer would result in U.S.-source income subject to applicable withholding taxes. The nonresident taxpayer had requested a private letter ruling but withdrew the request on being notified of a tentative adverse position, which was based on Rev. Rul. 2004-75. In this legal

memorandum, the Service has provided notice of the withdrawn request.

- **LTR 200646002 (Waiver of failure to qualify statutory requirements for an insurance contract)**

Pursuant to sections 101(f)(3)(H) and 7702(f)(8), the Secretary of Treasury may waive a failure to satisfy the requirements of section 101(f) or section 7702 (which provide the definition of a life insurance contract under the Internal Revenue Code), as applicable. These waivers are granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that reasonable steps are being taken to remedy the error. The IRS has granted the parent of two stock life insurance companies a waiver under sections 101(f)(3)(H) and 7702(f)(8) for life insurance contracts that failed to satisfy the requirements of sections 101(f) and 7702 due to reasonable errors. The IRS noted that companies' compliance systems (which were computer-based administrative systems) and procedures, if properly followed, would have prevented the errors described. Upon discovery of possible errors, the companies timely reviewed their procedures, discovered failures, and requested a waiver of their errors. The companies also proposed methods of correcting the errors.

- **LTR 200701014 – Revocation of a reciprocal's election**

Reciprocal underwriters and inter-insurers (reciprocals) conduct insurance business differently than ordinary

mutual insurance companies in that their insurance business is conducted by two separate entities. An ordinary mutual insurance company receives all of the premium income from insurance, pays losses, and manages the company's insurance activities. A reciprocal pays its insurance losses, but an "attorney-in-fact" performs all, or most of, the insurance functions, such as writing policies, collecting premiums, settling claims, keeping records, etc., and pays the related expenses for a portion of the premium income of the reciprocal.

In recognition of their unique form of operation with an attorney-in-fact, section 835 allows a reciprocal to elect to, in effect, combine certain income of its attorney-in-fact with its own underwriting income.

Under section 835(a), an electing reciprocal increases its taxable income by the income of the attorney-in-fact that is attributable to its business with the reciprocal. The electing reciprocal then receives a credit for the taxes paid by the attorney-in-fact with respect to the income attributed to the reciprocal to avoid double taxation of the income. Section 835(d). In addition, the electing reciprocal deducts amounts it paid to or that were incurred by the attorney-in-fact. The reciprocal's deductions are limited, though, to the deductions by the attorney-in-fact that are allocable to the income received by the attorney-in-fact from the reciprocal. Section 835(b). Electing reciprocals must comply with the annual tax information reporting requirements set forth in section 835(a).

¹ All section references are to the Internal Revenue Code of 1986, as amended.

A section 835(a) election is effective for the taxable year for which it is made and all succeeding taxable years, and may not be revoked without the consent of the Secretary.

In the ruling, Reciprocal represents that it is a reciprocal inter-insurance exchange that has an attorney-in-fact (AIF). Reciprocal is subject to tax under section 831 and has made an election under section 835(a) several years ago.

Reciprocal requested the IRS's consent to revoke its section 835(a) election because it no longer enjoys an economic benefit from the election. Reciprocal explained that it received a tax benefit under the election while it was operating at a loss because it could avail itself of the refundable credit. Reciprocal explained, however, that once it became profitable in a later year, this tax benefit was eliminated. At that point, Reciprocal was no longer able to claim the refundable credit for taxes paid by the AIF. Instead, Reciprocal had used the credit to offset the taxes AIF paid on the AIF's income attributable to Reciprocal, which Reciprocal has been including in its income pursuant to the election. Thus, since that year, the section 835(a) election has provided no tax benefit to Reciprocal. In fact, the tax Reciprocal reported on its tax return would have been the same regardless of whether the election was in place or not. Reciprocal also explained that despite the fact it does not receive an economic benefit from the election, it incurs compliance costs to produce the annual informational tax filings required by section 1.826-3(b). The Service

consented to the revocation of the election.

- **Loss payment patterns**

Rev. Proc. 2007-9 prescribes the loss payment patterns and discount factors for the 2006 accident year. These factors will be used for computing discounted unpaid losses under section 846. The IRS has also published the salvage discount factors for the 2006 accident year to be used for computing discounted estimated salvage recoverable under section 832. Rev. Proc. 2007-10

- **Notation for life-nolife returns no longer required**

Section 1.1502-47 provides rules for a life-nolife consolidated group to calculate its consolidated taxable income. Paragraph (s) of section 1.1502-47 requires a consolidated group to provide a notation on the face of its return identifying it as a life-nolife return. This requirement presents an impediment to e-filing. The Service has published temporary regulations (T.D. 9304) that remove the impediment by deleting the requirement to provide that notation.

- **Clarification of Controlled group rules**

The current regulations under section 1563 describe the treatment of life insurance companies under the controlled group rules. The IRS has published temporary regulations (T.D. 9304) clarifying that the life insurance company provisions do not apply to the controlled group rules where that type of company is a member (whether eligible or ineligible) of a life-

nonlife affiliated group for the consolidated return year for which a section 1504(c)(2) election is effective. These temporary regulations provide that if one or more life insurance companies are members (whether eligible or ineligible) of an affiliated group for the consolidated return year for which a section 1504(c)(2) election is effective, then those members are not treated as either excluded members of the controlled group or as members of a separate life insurance controlled group. See section 1.1502-47(f)(6). Rather, any eligible members are treated as members of the consolidated group, and any ineligible members are treated, along with the eligible and includible members of the consolidated group, as members of a life-nolife controlled group.

(Source: IRS; Court rulings; Legislative materials, October–December 2006)

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Analysis and Commentary

Insurers Give Physician e-Visits a Jolt December 19, 2006

**By Michael Galicia, Associate Editor,
KPMG's *Insiders***

In an effort to curb health care costs through technology, insurers are pushing doctors to try a new version of house calls: "e-visits."

E-visits consist of physicians and patients communicating through secure electronic communication systems. Such virtual visits help determine if a patient needs to visit a doctor's office or if other follow up is necessary. Physicians say e-visits work best when a patient is under long-term care for a chronic condition such as diabetes, high blood pressure or asthma.

"If a diabetes patient is stable on insulin and you want to download the patient's sugar readings so you can determine if they should remain on the same dosage, this is brilliant," says Dr. Saul B. Helman, a director in KPMG's Audit & Risk Advisory Services in Indianapolis.

Although secure messaging has been available for years, doctors have been reluctant to use such systems because of privacy concerns, security issues and fear

of opening themselves up to malpractice claims. Physicians are also concerned they may not receive proper reimbursement for their time spent on e-visits.

"It's essential that [e-visits are] thought of as an ad-on service," Helman says. "This is about making follow-up care more convenient without compromising health care in the process."

Eliminating office visits from chronically ill patients frees up valuable time for physicians. When factoring in everything from the low cost of electronic claims processing to giving physicians more time to see patients, the long-term savings could be in the billions.

Secure messaging is by no means a typical e-mail. After registering for the service, a patient logs into a secure server on the Web. He or she is asked a series of questions regarding their health.

Insurers see huge savings in moving non-urgent medical situations from the doctor's office to the Web. In October, some of Minnesota's largest health care providers, including HealthPartners and Blue Cross and Blue Shield, began to cover e-visits. Under the plans, patients pay the same co-pay as an office visit, and doctors get reimbursed about \$35 for each patient response.

Other insurers that are using these type of systems include Aetna, Cigna, Blue Cross Blue Shield of Massachusetts, and Blue Cross Blue Shield of California, which was one of the first insurers to begin reimbursing e-visits.

"We have approximately 540,000 members who have access to doctors via secure messaging," says James Hereford, an executive vice president for

Seattle-based GroupHealth Cooperative, a nonprofit health care system that provides both medical coverage and care in Idaho and Washington state.

Hereford says GroupHealth processes about 5,000 secure messages per week.

"Our doctors' visits have more of an agenda to them; each patient is able to see their post-visit summaries via our secure messaging system, which eliminates a lot of follow-up questions that otherwise may have required another face-to-face meeting," Hereford says.

Consumers have indicated they want e-visit access, as information technology in health care is becoming a factor when deciding on a physician.

According to a recent Wall Street Journal Online/Harris Interactive poll, more than half of all adults surveyed said a doctor's use and investment in health information technology would influence their choice of a doctor a "great deal" or to "some extent." More than 75 percent said they wanted to use e-mail to make appointments and receive reminders for visits.

To directly address security and privacy concerns, health providers are mostly relying on outside vendors. The Health Insurance Portability and Accountability Act (HIPAA) requires all communications containing personal health information is sent via a secure delivery system. This means health providers must encrypt all outbound messages containing Social Security numbers and disease information.

McKesson's RelayHealth Corp. in Emeryville, Calif., supplies a secure Web site and messaging platform that supports electronic interactions between doctors

and patients, checks patient eligibility with insurers' systems, and enables electronic financial transactions for payments.

Participating doctors pay a monthly fee for the service (starting at \$50), the amount depending on the number of physicians who are registered to use e-visits within a group or practice.

The RelayHealth messaging system asks patients to answer a comprehensive set of questions that a physician would typically ask patients. All correspondence between patient and physician is recorded in the patient's medical record, creating an audit trail and addressing malpractice concerns.

"Our process is extremely thorough," says Ken Tarkoff, vice president and general manager for McKesson Consumer Solutions. "Malpractice insurers who understand the process of secure messaging [will] cover this without raising premiums. The market is evolving and secure messaging is inevitable; the question is how long will it take?"

Judging from physician's use of e-mail, it might be a while. Roughly one in four physicians reported e-mail was used in their practice to communicate clinical issues with patients in 2005, up from one in five in 2001, according the Center for Studying Health System Change in Washington, D.C.

"Look at how long it took banks to convince their customers that online banking was secure," says GroupHealth's Hereford. "Why should health care be any different? Patient's expectations are going to be very similar to the way we look at our financial data."

Fleeing the Coast, P/C Insurers Stampede Into the Midwest

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By Christopher Westfall, Managing Editor, *Insurance Insider*

The U.S. property/casualty business may be getting soft in the middle.

National insurers that have fled high-risk coastal exposures are pouring capital into the Midwestern United States. The result: prices for both commercial and personal lines in some Midwest states are dropping just as coastal areas are seeing double-digit premium increases.

So great has the shift been that some insurers are concerned that the P/C industry may make a classic mistake of a soft market cycle: acquiring new business at an underwriting loss to gain market share.

Industry watchers say that could be an especially risky gamble, as regional risks such as tornadoes, hailstorms and even earthquakes are just as potent and difficult to model as hurricanes and tropical storms. And a single catastrophic event (or series of smaller events) in an under-priced Midwest could wipe out all the progress the industry has made in managing coastal risks.

"The Midwest is not seeing the same price adequacy as the coastal regions," says Paul Hertelendy, senior vice president and chief underwriting officer for all North American business and specialty lines at Converium. "And there are some areas that are just stupidly priced."

P/C premiums in Midwest states have declined an average of 15 percent over the past year, according to insurance

consulting firm Advisen. Although insurers have different definitions of the Midwest region, it commonly includes state such as Indiana, Illinois, Ohio and Michigan, among others.

At the same time, property rates in coastal areas continue to rise substantially. Median premiums in the Southeastern United States have gone up over 30 percent year-over-year, Advisen says.

Additionally, several national P/C carriers have announced plans to stop underwriting new policies in coastal areas at risk.

There is a noticeable push among national carriers to underwrite more business in what they consider "non-catastrophe" exposed regions of the Midwest, says William McGlone, a Detroit-based executive vice president for broker Willis of Michigan. "There are some carriers that have reduced their coastal exposures and are moving more aggressively in the Midwest," he explains. "But it's an intangible issue. I don't think [competing in the Midwest] is their stated goal."

McGlone says the Midwest has turned into a "very aggressively priced" commercial property market, with national and regional carriers battling out for what they consider the most sought-after risks outside major metropolitan areas.

"We have seen some national carriers putting out loss estimates equal to every premium dollar that comes in, but they are picking and choosing their spots," McGlone says, referring to insurers being selective on price reductions.

The declines are not uniform, and observers report wild swings in price

declines. McGlone says while some commercial property owners have seen rates fall 10 percent, others have seen rates plummet as much as 40 percent.

"I will tell you, it's been good news to areas like Detroit that have been economically stagnant," McGlone says. "They have been struggling to reduce expenditures, and these declines have helped."

L. James Valverde Jr., vice president of economics and risk management at the Insurance Information Institute (III), says there's not enough data yet to suggest that the entire industry has hit a "tipping point" for under-pricing risk.

"On the commercial side, we have seen broad price declines of between 3 and 5 percent," he says. "But that is not necessary proof of [underwriting losses] on a broad basis, although we are hearing increasing anecdotal information of some under-pricing."

Price declines could also be a factor of a changing market, as insurers simply de-emphasize coastal regions. "Many P/C insurers have concluded they have significant aggregated risk in coastal areas, and they are actively looking for solutions to balance their risk," says Thomas Daugherty, KPMG National Industry Director – P/C Insurance in Hartford, Conn.

But even the possibility of having insurers rushing into the Midwest without adequate pricing is problematic. While some carriers consider the Midwest a "non-cat" region, there are significant risks, says Converium's Hertelendy. "I don't think that there is a deep understanding of Midwest risks," he says.

Hertelendy says insurers and catastrophe modeling firms have spent most of their resources measuring East Coast hurricane and California earthquake risk. But a recent Converium report points out that during a period of below-average hurricane activity from 1997 to 2003, wind, hail and tornado damage (considered the three greatest risks for the Midwest) accounted for 67 percent of all U.S. cat losses.

In addition, the insurance industry also does not have enough data to accurately model earthquake risk from the New Madrid Fault, which stretches from Northeast Arkansas and Northwest Tennessee through Southeast Missouri, Western Kentucky and Southern Illinois. The New Madrid Fault produces mostly mild tremors, but in 1812 caused what is thought to be the largest U.S. earthquake on record, registering approximately 8.0 on the Richter scale.

"Some people forget altogether that there is significant earthquake risk in the region," Hertelendy says. "Essentially, the catastrophe models used by many in the industry are way too low in terms of the risk of all types of Midwest cat."

There is no safety in insurance unless the industry adequately prices risk, adds the III's Valverde. "It was a very quiet hurricane season in 2006, but there was still \$9 billion in catastrophe losses affecting 34 states," he says. "There is really no place in the U.S. that is immune from catastrophe risk."

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