



INSURANCE

The State of the Insurance Industry

No. 03-2005

KPMG LLP

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Changes & Trends

Industry Overview

General Highlights

- Risk Management Solutions (RMS) says Hurricane Katrina can be viewed as two loss events: the direct impact from the wind and storm surge, and the subsequent flooding that occurred in New Orleans as a result of the levee breaks. RMS expects total economic losses from both events to exceed \$125 billion, including both insured and uninsured components of loss. In major catastrophes, RMS said that the uninsured component of loss often equals or surpasses the insured component. RMS estimates that the costs of interrupted economic activity attributed to losses from business interruption and displacement of residents will exceed \$100 million per day. RMS estimates private insured losses from Hurricane Katrina to be \$40–\$60 billion, \$15–\$25 billion of which are related to the Great New Orleans Flood. According to Fitch Ratings, Hurricane Katrina will represent the largest insured loss in U.S. history, surpassing the September 11, 2001 terrorist attack and Hurricane Andrew, which cost \$20.1 billion and \$20.5 billion, respectively (in 2004 dollars). (*Press Releases: Risk Management Solutions September 2 and 9, 2005; Fitch Ratings, September 2, 2005*)
- The National Association of Insurance Commissioners (NAIC) stated that while the damages from Hurricane Katrina may set record losses, the property and casualty industry maintains the adequate capital and liquidity required to withstand claims arising from one of the most devastating natural disasters in U.S. history. Currently, the U.S. property and casualty industry maintains policyholders' surplus of roughly \$390 billion and holds assets in excess of \$1.3 trillion. State insurance regulators

require insurers to maintain minimum levels of surplus to absorb the volatility inherent in property and liability policy coverages. Over 75 percent of the industry's assets are held in marketable securities. (*The National Association of Insurance Commissioners Press Release September 2, 2005*)

- Due to the evolving effects of Hurricane Katrina, A.M. Best Co. has been aggregating public and private information in order to assess the financial impact it will have on insurers. A.M. Best expects all rated companies will be able to meet their current loss obligations despite the projected magnitude of the potential insurance losses. However, according to A.M. Best, the insured losses from Hurricane Katrina have had a significant impact on some insurers, leaving potential capital shortfalls relative to their current rating level and also calling into question the risk management capabilities of some insurers. A.M. Best indicated that the determination of the potential impact of the hurricane and the rating agent's subsequent analysis of catastrophe risk management will take some time, and additional rating actions are likely in the future. (*A.M. Best Press Release, September 15, 2005*)
- Four years after the September 11 terrorist attack, conditions on terrorism insurance markets have improved, yet according to a new Organization for Economic Cooperation and Development (OECD) report, there are continuing shortfalls in coverage, which could be revealed by another large-scale attack. The OECD report, "Terrorism Risk Insurance in OECD Countries" examines market evolutions since 2001, as well as industry and government initiatives to address the challenge of modern terrorism compensation. One of its main conclusions is that private markets are not yet able to fully cover the

extremely large losses that could result from terrorist acts in the future. (*OECD Press Release, July 5, 2005*)

Property & Casualty

- An A.M. Best report indicates that trends in premium volume, loss reserves, and admitted assets show that the captive insurance industry has reached a level of stability as it absorbs the benefits of the recent hard market while coping with legacy issues still affecting some within the industry. Over the five years through 2004, net premiums written grew by 56 percent, but only by 3.6 percent in the past year. Loss reserves and admitted assets grew by 39.6 percent and 28.7 percent, respectively, over the past five years. The industry maintained the pattern in 2004 with growth rates of 6.0 percent and 5.9 percent, respectively. According to A.M. Best, these may be signs of more business remaining in the commercial market or more relaxed pricing by the captives even while loss reserves are growing. A.M. Best indicates, however, that while the aggregate growth in surplus kept pace in the past year with an 8.3 percent increase, the five-year cumulative growth was a mere 0.7 percent. As a result, while the underwriting risk covered by captives has grown, it has come at the cost of increasing leverage over the five-year period, according to A.M. Best. (*A.M. Best Co. Press Release, August 8, 2005*)
- Premiums in the commercial insurance industry continued along the path of an 18-month long down market, according to the latest Risk and Insurance Management Society, Inc. (RIMS) Benchmark Survey. However, mixed signals from the market suggest that it may be poised for a change. The survey, compiled by Advisen, Ltd., found renewal prices stabilized or even slightly increased for some lines of business, but indicators of market

direction signaled further declines. According to RIMS, seemingly contradictory indicators deliver proof of the first soft market since 1998; for instance, directors and officers liability insurance has recently suffered some of the steepest premium declines of any major line. Larger, macro-economic conditions also demonstrate the contradictory nature of the market. Overall, the property and casualty industry continues to enjoy strong financial returns, which typically portends heightened competition and falling rates, according to RIMS. (*The Risk and Insurance Management Society, Inc. Press Release, August 3, 2005*)

- U.S. property/casualty insurers are expected to pay homeowners and businesses an estimated \$920 million for second-quarter insured property losses from four catastrophes in 25 states—the lowest tally among second quarters in the past 10 years, according to preliminary estimates by ISO's Property Claim Services (PCS) unit. This compares with insured losses of \$2.3 billion in second-quarter 2004 and \$5.1 billion in second-quarter 2003. Severe weather, including high winds, hail, tornadoes and flooding, was responsible for all the insured damage in the quarter.

PCS also estimates that property/casualty insurers are expected to pay policyholders in four states \$900 million on claims for insured property losses from Hurricane Dennis. Dennis caused much less damage than each of the four hurricanes that hit the Gulf Coast in 2004, according to ISO, but nearly matched this year's second-quarter catastrophe loss of \$920 million. Florida suffered \$640 million in losses to residential and commercial property and auto, followed by Alabama (\$115 million), Georgia (\$85 million) and Mississippi (\$60 million). (*ISO Press Releases, July 6 and July 26, 2005*)

- The National Insurance Crime Bureau's latest report for 2004 on auto theft

rates found that fewer cars were stolen last year in the United States. California is listed as the nation's auto-theft "Hot Spot" for the second year in a row. Seven of the nation's top ten areas with the highest vehicle theft rates are in California. The communities of Las Vegas, Nevada; Phoenix-Mesa, Arizona; and Seattle-Everett-Bellevue, Washington round out the top ten. Nationally, there was a slight drop in auto theft in 2004 after four years of steadily rising auto theft figures. Preliminary FBI data shows a 2.6 percent decline in motor vehicle thefts from 2003's activity. (*National Insurance Crime Bureau Press Release, August 23, 2005*)

- The four airplane crashes that occurred in rapid succession in Canada, Italy, Venezuela, and Greece, have made August the worst month for airline losses since January 2002, according to Aon Corporation. But, Aon indicates that despite the loss of aircraft hulls valued at over \$170 million, the monthly trend in the cost of losses has continued to fall steadily. The overall loss profile for 2005 is still within the average for the last three years, both in terms of incidents with a value of loss of over \$50 million and incidents with more than 50 fatalities. Aon says recent years have represented the safest in airline industry history. (*Aon Corporation Press Release, August 19, 2005*)

Life & Health

- According to a survey conducted by the Tillinghast business of Towers Perrin, a majority of North American life insurance company chief financial officers consider capital management to be a key concern for them today and expect that to continue over the next three to five years. The survey showed that concerns about current and future availability of capital are driving nearly one third of the respondents to actively explore one or more alternatives for raising capital. Many of the CFOs are considering nontraditional sources of managing capital, such as reinsurance

and securitization. Beyond securitization, respondents are considering surplus notes, trust preferreds, and funding agreements as other sources for obtaining capital in the next two to three years. (*Tillinghast Towers Perrin Press Release, August 2, 2005*)

- The U.S. life insurance industry is projected to post operating gains in 2005 and 2006 that build on positive 2003 and 2004 results, according to Conning Research and Consulting, Inc. The industry's operating gain for 2004 was \$6.5 billion greater than the 2003 gain, which Conning Research indicates was itself a record. The report, "Life-Health Forecast & Analysis by Line of Business," notes projected operating gains for 2005 and 2006, while slightly less than 2004, are likely to keep the industry on solid financial ground. (*Conning Research and Consulting, Inc. Press Release, July 13, 2005*)
- The Hartford's recently completed 2005 Life Insurance Literacy Study shows that Americans believe life insurers are offering important products to help them reach their financial goals. However, they also admit to having little understanding of life insurance, and buying it is not on the top of their financial "to-do" list. September 2005 was designated as "Life Insurance Awareness Month" (LIAM) by The Life and Health Insurance Foundation for Education (LIFE). Launched in September 2004, LIFE, industry associations, and the more than 100 life insurance companies that participated in the inaugural event hope to see the campaign conducted each September to help raise awareness about the importance of life insurance. (*Press Releases, The Hartford, September 30, 2005; The Life and Health Insurance Foundation for Education, November 29, 2004*)

Reinsurance

- Although global European reinsurers such as Munich Re, Swiss Re, and Hannover Re have already provided

estimates for their potential exposure to Hurricane Katrina, A.M. Best Co. believes that it may take longer to fully assess the extent of damage and that it could be significantly higher than initially anticipated. A.M. Best believes that earnings for reinsurers with large natural catastrophe exposure could come under pressure in 2005, not only from higher than anticipated claims relating to Katrina, but also from new claims arising from the continuing hurricane season. Also, reinsurers have already been hit by a number of other natural catastrophes this year. A.M. Best believes that the financial impact of Hurricane Katrina could positively influence the forthcoming renewal season as reinsurers remain more inclined to stick to pricing targets. According to A.M. Best, there was a clear downward trend in the underwriting cycle. However, the accumulation of floods, hurricanes, and typhoons may alleviate the anticipated pressure on rates, especially in property where ample capacity has been available, A.M. Best indicates. (A.M. Best Press Release, September 9, 2005)

- Though now overshadowed by Hurricane Katrina, the second quarter of 2005 provided Bermuda reinsurers a welcome respite from the series of above-average catastrophe losses that persisted into January. According to the most recent Benfield Bermuda Quarterly report, second quarter catastrophe losses were at their second lowest level in a decade. According to the report, aggregate H105 net income was down by 5 percent to \$3.9 billion. Lower catastrophe losses were partially offset by increased provisions for the 2004 Florida storms. Earnings were supported by a 40 percent increase in investment income driven by an up-tick in short-term U.S. interest rates and an enlarged base of invested assets. Benfield indicates that Hurricane Katrina on top of Hurricanes Dennis and Emily, the European alpine floods, and a spate of air crashes has raised expectations

that rates will stabilize. In the meantime, companies asserted their commitment to disciplined underwriting and willingness to decline business they believe is inadequately rated. (Benfield Press Release, September 9, 2005)

- While reinsurance recoverables are now the largest asset class in the U.S. property and casualty industry, representing almost 45 percent of policyholder surplus, less than half of primary insurers use an automated or semi-automated system to process and track reinsurance. According to a survey of primary insurers commissioned by Paragon Strategic Solutions Inc., a member of Benfield, the majority of companies surveyed continue to rely on manual ceded reinsurance processes, which are largely inefficient and vulnerable to errors. Some of the companies surveyed recognize the need for improved reinsurance automation and indicated they were in the process of moving to a more comprehensive reinsurance system. Many others, however, are not planning to automate their reinsurance process soon. Some of the reasons cited for not moving to a comprehensive reinsurance system included lack of internal IT resources, low transaction volume, and system cost. (Paragon Strategic Solutions, Inc. Press Release, July 28, 2005)

Accounting Standards and Developments

Public Company Accounting Oversight Board (PCAOB) and Securities and Exchange Commission (SEC)

- **FASB and SEC Guidance on Applying Statement 123R**

The FASB proposed new Staff Positions on determining the grant date of a share-based payment and on a simplified transition method for computing the available excess tax benefits in additional paid-in capital at the time Statement 123R is adopted,

and the SEC's economists reported their analysis of using market instruments to value employee stock options.

As previously reported, under the SEC's deferred effective date for applying Statement 123R, public-company registrants that are not small business filers must apply the Statement as of the beginning of their first annual period beginning after June 15, 2005. Public companies that are not small business filers and have fiscal years ending in June, July, or August will apply the Statement at its original effective date, the beginning of the first annual period that begins after June 15, 2005. Non-public companies and public companies that are small business filers must apply the Statement as of the beginning of the first annual reporting period that begins after December 15, 2005. (KPMG's *Defining Issues, September 2005, 05-19*)

- **SEC Delays Section 404 for Non-Accelerated Filers and Proposes Revised Accelerated Filing Deadlines**

The SEC's new deadline for complying with the reporting and disclosure requirements on internal control over financial reporting applies to public companies that are not accelerated filers, including foreign private issuers that are not accelerated filers. We understand from staff comments at the meeting that a foreign private issuer is considered an accelerated filer if it has a public float of at least \$75 million, has been subject to the SEC's periodic reporting requirements for at least 12 months, and has filed at least one annual report. The revised compliance deadline for non-accelerated filers is the first fiscal year ending on or after July 15, 2007. For foreign private issuers that are accelerated filers, the compliance deadline remains fiscal years ending on or after July 15, 2006.

The SEC's proposed amendments to Rule 12b-2 of the Exchange Act would create a new category of accelerated filer. The new "large accelerated filer"

category would include registrants with a public float of \$700 million or more. The proposals would also make a related change in the final phase-in of the Form 10-K and Form 10-Q accelerated filing deadlines that are scheduled to take effect next year. The filing deadline for annual reports on Form 10-K for the new category of large accelerated filers would be 60 days following year-end for fiscal years ending on or after December 15, 2005, but would remain at 75 days following year-end for all other accelerated filers for fiscal years ending on or after December 15, 2005. The filing deadline for quarterly reports on Form 10-Q would remain at 40 days following the fiscal quarter-end for both categories of accelerated filers. The filing deadlines for non-accelerated filers and foreign private issuers that file on Form 20-F or 40-F would not be changed. (KPMG's *Defining Issues, September 2005, 05-18*)

- **SEC Regulatory Relief in Response to Hurricane Katrina**

Recognizing the disruption caused by Hurricane Katrina, on September 15, 2005 the SEC issued an Order providing emergency regulatory relief to affected investors, companies, and securities firms. The Order applies to registrants whose principal executive office as listed on the cover page of the most recent period report filed on Form 10-Q, 10-QSB, 10-K, or 10-KSB is located within one of the counties or parishes designated as of September 15, 2005 to be within the Presidentially Declared Disaster Areas. The Order also applies to persons other than registrants whose address as listed on the most recently filed schedule or form, or the address that the person would be required to list on any covered schedule or form required to be filed during the time period covered by the Order, is within one of the Presidential Disaster Areas. (KPMG's *Defining Issues, September 2005, 05-18*)

Financial Accounting Standards Board (FASB)

- **Proposal on Accounting for Tax Uncertainties**

Companies will not be permitted to recognize the tax benefits from tax-return positions unless the positions are at least "probable" of being sustained by tax authorities, if a proposed FASB Interpretation of Statement 109 is adopted. The proposal contains guidance on recognizing, derecognizing, measuring, and classifying the tax effects of uncertain tax positions.

The proposed Interpretation says that it would be effective as of the end of the first fiscal year ending after December 15, 2005, but the FASB may decide to delay that date depending on when it will issue the final Interpretation. (KPMG's *Defining Issues July 2005, 05-13*)

- **Proposed Requirements on Business Combinations and Noncontrolling Interests**

Companies will record business combinations at full fair value and treat noncontrolling or minority interests as components of equity in the consolidated financial statements, if two new proposed FASB Statements, *Business Combinations: a replacement of FASB Statement No. 141, June 30, 2005*; and *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries: a replacement of ARB No. 51, June 30, 2005*, are adopted. The proposed Statements would also expand the definition of a business, change the accounting for "step acquisitions," and require companies to account for acquisitions of mutual entities using the purchase method, which would be renamed the "acquisition method."

The proposed Statement on business combinations would replace Statement 141, and the proposed Statement on noncontrolling interests would replace ARB 51.2. However, much of the guidance in the replaced pronouncements would be retained.

(KPMG's *Defining Issues July 2005, 05-12*)

- **NAIC / Regulatory**

Due to Hurricane Katrina, the NAIC's 2005 Fall Conference, which had been scheduled for September 10-13 in New Orleans, was cancelled. Since that time, the work of various NAIC committees that would otherwise have been conducted at the Fall conference is continuing primarily via conference calls.

The NAIC Joint Executive (EX) Committee/Plenary held a conference call on October 14, 2005 at which, among other agenda items, it took the following actions:

- The new property and casualty reinsurance disclosure and officer attestation requirements were adopted effective beginning with 2005 statutory annual statement reporting. The proposed changes were adopted without further changes.
- The Life Risk-Based Capital C3 Phase II proposal was adopted effective for year-end 2005 life risk-based capital reporting. These rules set capital requirements for: (a) all variable annuities except modified guaranteed annuities; (b) group annuities containing guaranteed living benefits (GLBs) or guaranteed minimum death benefits (GMDBs), and (c) all other products that contain guarantees similar in nature to GMDBs and GLBs.
- The revisions to Actuarial Guideline XXXVIII proposed by the Life Insurance and Annuities (A) Committee were adopted.

At the September 28, 2005 meetings of the NAIC's Emerging Accounting Issues Working Group (EAIWG) and the Statutory Accounting Principles Working Group (SAPWG) the more significant actions taken are as follows:

- The EAIWG tentatively adopted a one-time modification to the

provision in Statement of Statutory Accounting Principles (SSAP) No. 6, Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers (SSAP No. 6), that requires non-admission of premiums that have been past due for 90 days or more. The tentative consensus relates to uncollected premium balances, bills receivable for premiums, and amounts due from agents and policyholders directly impacted by Hurricanes Katrina and Rita. For policies in effect as of the date that the state or federal government declared a state of emergency, past due amounts must be non-admitted after 150 days, rather than after 90 days.

- The SAPWG adopted changes to eliminate the requirements for specific first quarter income tax notes in SSAP No. 10, Income Taxes (SSAP No. 10), such that now, for first, second, and third quarter statutory quarterly statements, the full tax disclosure footnotes that are required in the statutory annual statements, specifically those required by paragraphs 18, 20b, 21, and 23 of SSAP No. 10, are only required in the statutory quarterly statements if the underlying data has changed significantly from the most recently completed year-end.
- The SAPWG exposed for comment proposed changes to SSAP No. 62, Property and Casualty Reinsurance (SSAP No. 62), which would require the same new disclosures regarding property and casualty reinsurance that the NAIC adopted on October 14th for statutory annual statement blanks, except that the SAPWG has proposed that these new disclosures not be required to be included in the audited statutory financial statements until the year ending 2006.
- The SAPWG exposed a proposed clarification to paragraph 13e of SSAP No. 88, Investments in Subsidiary,

Controlled, and Affiliated Entities, A Replacement of SSAP No. 46, which addresses discontinuing recognition of losses when applying the equity method unless the reporting entity has provided a guarantee, to indicate that this guidance was intended to also apply to entities accounted for under 8 b.i of SSAP No. 88, which addresses investments in U.S. insurance subsidiary, controlled, or affiliated entities. The comment deadline for this proposed clarification is October 28, 2005.

Source: National Association of Insurance Commissioners

KPMG's Audit Committee Institute (ACI)

Recognizing the challenge that audit committees face in meeting their demanding responsibilities, KPMG created the ACI in 1999 to serve as a resource for audit committee members and senior management. Our primary mission is to communicate with audit committee members and enhance their awareness, commitment, and ability to implement effective audit committee processes. ACI's initiatives include semiannual roundtables, publication of *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site. During the past five years, ACI has conducted active outreach among thousands of audit committee members and we have sponsored hundreds of workshops, presentations, and issue-oriented meetings.

ACI's Web site address is <http://www.kpmg.com/aci/>. ACI can be reached toll-free at 877-576-4224 or via e-mail at auditcommittee@kpmg.com.

Regulation and Legislation

- On July 29, the House Committee on Financial Services' Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises held a hearing on the future of the Terrorism Risk Insurance Act (TRIA), which will expire on December 31. Witnesses at the hearing included representatives from various states' Departments of Insurance and representatives from various insurance associations and coalitions.

The witnesses overwhelmingly supported extension of the TRIA. They indicated that allowing the law to

expire would create an immediate gap in terrorism risk insurance coverage. To substantiate their claim, they added that, in anticipation of the sunset date, and in light of the uncertainty regarding Congress' actions, insurance policies were currently being renewed with conditional terrorism exclusions.

Witnesses also stated that even though the TRIA had met its goal, and in spite of the availability of the Federal backstop, certain types of coverage were still not being offered. This coverage included losses from nuclear, biological, chemical, or radiological attack. One witness suggested that, because of the broad and catastrophic nature of these events, these losses should be treated separately from other terrorism risks.

Some suggestions made by the witnesses to guide Congress in any future legislation included:

- Offering coverage to businesses;
- Removing the distinction between domestic and foreign terrorism;
- Reviewing the justifications for excluding general liability; and
- Developing a pooling mechanism with a limited Federal backstop that would phase-out over time.

(KPMG's Washington Report, August 1, 2005)

- The Senate Committee on Commerce, Science, and Transportation unanimously approved comprehensive legislation to protect consumers from identity theft on July 28. As announced by the committee, the legislation, entitled the "Identity Theft Protection Act of 2005" (S. 1408), is intended to address two core problems:
 - Recent data breaches of sensitive personal identification, and
 - The current lack of tools for consumers to protect themselves from identity theft.

The bill covers any business, school, or other entity that collects sensitive personal information, including social security numbers, financial account information, driver's license information, and other information that the Federal Trade Commission (FTC) determines can be used for identity theft. The bill also covers any third party that purchases or otherwise acquires this information. Further, it would set national standards to:

- Safeguard individual personal information,
- Notify consumers of data breaches,
- Require businesses to improve their safeguards for sensitive consumer information,
- Give consumers the right to freeze their credit reports to thwart identity theft, and
- Limit the solicitation of social security numbers by commercial entities.

The bill will now move to the full Senate for consideration.

(KPMG's Washington Report, August 1, 2005)

- On September 19, Bates White, a national economic consulting firm, announced that it has completed a study of The Fairness in Asbestos Injury Resolution (FAIR) Act of 2005, and found that there is a substantial financial shortfall with the proposed legislation. The Bates White's study found that the FAIR Act, which will remove claims from the court system and establish a \$140 billion asbestos trust fund, financed by defendants and insurers, creates entitlements to pending and future claimants that exceed the \$140 billion in receipts specified in the FAIR Act. According to the study, the fund would be bankrupt and forced to sunset a few years after its enactment. Dr. Charles E. Bates, president and senior partner, who released the report at Mealey's National Asbestos Litigation Conference on September 19-20, indicates that the

financial shortfall results primarily from entitlements created for a number of individuals with lung and other cancers who were not compensated in the historical tort environment. According to Dr. Bates, the other major contributing factor to the fund's financial shortfall involving dormant claimants who have settled with most, but not all defendants, would be able to recoup additional recoveries. *(Bates White Press Release, September 19, 2005)*

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Taxation

• **Notice 2005-58: 2004 Differential Earnings Rate**

Notice 2005-58 contains a determination under section 809¹ of the differential earnings rate for 2004, which is zero. This rate is used by mutual life insurance companies to calculate their federal income tax liability for taxable years beginning in 2004. Notice 2005-18, 2005-9 I.R.B. 634, contained a tentative determination of this rate.

The Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147, section 611, amended section 809 by adding new paragraph (j). Section 809(j) provides that the differential earnings rate shall be treated as zero for purposes of computing both the differential earnings amount and the recomputed differential earnings amount for a mutual life insurance company's taxable years beginning in 2001, 2002, or 2003. Under section 809(j), the final recomputed differential earnings rate for 2003 is zero. Subsequently, the Pension Funding Equity Act of 2004, Pub. L. 108-218, section 205, repealed section 809 for taxable years beginning after December 31, 2004. Therefore the Internal Revenue

Service is required to determine a differential earnings rate for 2004.

• **Private Letter Ruling 200538012**

In this ruling the IRS has determined that a corporation providing workers' compensation coverage established by a state is an insurance company. The facts of the ruling are as follows. Industry operates within State in the following manner: a customer contracts with Unit to procure services. Unit then refers the contract to an Operator. Operator performs the specified services for the customer. Operator collects from customer the fee for the specified services and Operator remits (less its allocable portion) the payment to Unit. The Operators are classified as "independent contractors," not as employees of Unit. The Operators face the possibility of injury while performing the specified services. However, because the Operators are not employees they are not covered by workers' compensation laws.

In order to provide workers' compensation benefits for Operators, State revised its workers' compensation laws and created Taxpayer as a not-for-profit corporation to administer and pay workers' compensation benefits to Operators. Each Unit doing business as such within State is required to be a member of Taxpayer; though as such each Unit can participate in governing Taxpayer, no "profit" earned by Taxpayer can be distributed to, or inure to the benefit of, any Unit. Taxpayer determines the amount needed to fund its activities. This amount is converted to a surcharge added to the fee for specified services. Unit collects the surcharge and remits it to Taxpayer. For purposes of workers' compensation only, Operators are deemed employees of Taxpayer while performing the specified services. As allowed by law, Taxpayer satisfies its obligation to administer and pay workers' compensation benefits to Operators through a policy issued by Fund. Several hundred Units are a member of Taxpayer and more than that number of individual Operators are covered by Taxpayer.

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

Besides the surcharges remitted by Units, Taxpayer receives *de minimis* revenue from its investments.

The IRS observed that the underlying predicate for workers' compensation is the employer's potential liability—an economic risk of loss—to the employee. This potential liability is viewed as the risk of the employer for purposes of insurance qualification. However, here the underlying predicate is not present. Operators are classified as independent contractors of Units. But for the revision to State's workers' compensation laws, Operators would have no recourse against Units or Taxpayer to remedy injuries suffered while performing the specified duties. Accordingly, the risk of loss involved here is the Operators', not Units' or Taxpayer's. The IRS noted that this risk of loss is an insurance risk. For the consideration of the surcharge, this risk is shifted from Operators to Taxpayer and distributed across the many similarly situated Operators. This arrangement constitutes insurance for federal income tax purposes, as both risk shifting and risk distribution are present. Taxpayer will be an insurance company within the meaning of section 831(c) for each taxable year that this arrangement is more than half of its business.

- **Deferral of M-3 Filing Requirement**

The IRS announced on September 16, 2005 that it is deferring the planned effective date of Schedule M-3 reporting for life, property and casualty insurance companies that file Forms 1120L and 1120PC. Schedule M-3, filed in conjunction with income tax returns by certain large and mid-size corporations to reconcile net income, will be required for 1120L and 1120PC filings for tax years ending on or after December 31, 2006. Previously, the IRS planned to require Schedule M-3 for these filings for tax years ending on or after December 31, 2005. The IRS and the Treasury expect to release drafts of the Schedule M-3 for Form 1120L and 1120PC soon.

- **Exception from Asset-Use Test**

The IRS has issued final regulations (T.D. 9226) on the determination of the

effectively connected U.S. income of foreign insurance companies. The final regulations adopt without change proposed regulations (REG-117307-04) issued in June 2004 and are effective as of October 3, 2005.

A foreign company with U.S. operations is subject to U.S. tax on the portion of its income attributable to such operations. With respect to such foreign corporations doing business in the United States, section 864(c)(2) determines whether certain income from sources within the United States or gain or loss from the sale or exchange of capital assets is income effectively connected with the conduct of a trade or business within the United States. In making this determination, the factors taken into account include whether (a) the income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business (the asset-use test), or (b) the activities of such trade or business were a material factor in the realization of such income, gain or loss. Section 864(c)(2). The general rule is that stock of a corporation (whether foreign or domestic) is not an asset used in or held for use in the conduct of a trade or business in the United States (See Treas. Reg. section. 1.864-4(c)(2)(ii)(a)).

The regulation recognizes that, since insurance companies hold investment assets, such as stocks and bonds, to fund obligations to policyholders and to satisfy surplus requirements, stock held in an investment portfolio might be an asset held for use in the business of a foreign insurance company. By contrast, stock of a subsidiary generally is not held for the purpose of meeting an insurance company's business needs.

Thus, the regulation would provide that the rule excluding stock from the asset-use test does not apply to portfolio stock held by a foreign insurance company. The 10-percent threshold on the ownership of stock in a company is intended to distinguish portfolio stock from investments in a subsidiary.

- **Revenue Procedure 2005-64**

The IRS has released the domestic asset/liability percentages and domestic investment yields needed by foreign life insurance companies and foreign property and liability insurance companies to compute their minimum effectively connected net investment income under section 842(b) for tax years beginning after December 31, 2003.

For the first taxable year beginning after December 31, 2003, the relevant domestic asset/liability percentages are:

- 121.7 percent for foreign life insurance companies, and
- 173.6 percent for foreign property and liability insurance companies.

For the first taxable year beginning after December 31, 2003, the relevant domestic investment yields are:

- 5.5 percent for foreign life insurance companies, and
- 3.7 percent for foreign property and liability insurance companies.

- **Comments Sought on Notice 2002-69**

The IRS has requested public comment on Notice 2002-69 by November 28, 2005. Notice 2002-69 allows U.S. shareholders of a foreign insurance company to use the foreign insurance company's historical loss payment patterns in computing the company's insurance reserves provided the company has a certain number of years of data and makes an election to use that data. A domestic insurance company can elect to use its own historical data in computing its reserves provided certain requirements are satisfied and an election is made. This notice allows a foreign insurance company to elect to calculate its insurance reserves in a manner similar to a domestic insurance company. Also, this notice provides guidance on how to determine a foreign insurance company's foreign loss payment patterns

Source: IRS; Court rulings; Legislative materials, July-September 2005

Market Forces

Consolidation and Convergence

- Lincoln National Corporation, the parent company of the Lincoln Financial Group of companies, and Jefferson-Pilot Corporation, the parent of the Jefferson Pilot Financial group of companies, announced that they have entered into a definitive merger agreement, unanimously approved by both companies' boards of directors. The merged company, which will operate under the brand name of Lincoln Financial Group, will provide life insurance, annuity, retirement income and investment products and services, supported by retail and wholesale distribution platforms that provide industry-leading financial products and solutions. The terms of the merger were negotiated to provide Jefferson Pilot shareholders with an 11 percent premium based on the average closing prices of each company's common stock from September 7, 2005 to October 7, 2005. Jefferson Pilot shareholders will receive 1.0906 Lincoln shares or \$55.96 in cash for each Jefferson Pilot share, subject to proration. The aggregate amount of the cash payment to Jefferson Pilot shareholders will equal \$1.8 billion. This represents a total blended cash and stock consideration of \$55.48 per share based on the October 7, 2005 closing price of Lincoln Financial Group common stock and total consideration of approximately \$7.5 billion. (*Lincoln Financial Group Press Release, October 10, 2005*)
- MetLife, Inc. completed its purchase of CitiStreet Associates, a division of CitiStreet LLC that is primarily a distributor of annuities and retirement plans to the education, health care, and not-for-profit markets. The transaction was related to MetLife's acquisition of Travelers Life and Annuity from Citigroup, Inc., which closed July 1,

2005. CitiStreet LLC is a joint venture of Citigroup and State Street Corp. CitiStreet Associates is to be integrated by January 1, 2006 with MetLife Resources, a division of MetLife that provides retirement plans and financial services in the same markets. (*Metlife, Inc. Press Release, September 1, 2005*)

- Allmerica Financial Corporation has entered into an agreement to sell its run-off variable life insurance and variable annuity business to The Goldman Sachs Group, Inc. The transaction includes the sale of Allmerica's life primary insurance company, Allmerica Financial Life Insurance & Annuity Co., which holds 94 percent of Allmerica's variable insurance and annuity business. Additionally, Goldman Sachs will purchase from Allmerica the Allmerica Investment Trust funds' current investment advisory company. After the sale, Allmerica will no longer have exposure to variable annuity business with guaranteed minimum death benefit risk. (*Allmerica Financial Corporation Press Release, August 22, 2005*)
- The Chubb Corporation announced on August 1 that it had entered into an agreement to sell Personal Lines Insurance Brokerage, Inc. to Hub International Limited. Terms of the transaction were not announced. Hub indicated that the acquisition would increase Hub's personal lines business to approximately 20 percent of consolidated revenue and make Hub one of the largest personal lines brokers in the United States. (*The Chubb Corporation Press Release and Hub International Limited Press Release (Business Wire), August 1, 2005*)
- Royal & SunAlliance Insurance Company of Canada recently acquired the renewal rights of ING Insurance

Company of Canada's \$13-million marine commercial insurance business. Under the terms of the agreement, Royal & SunAlliance acquired the renewal rights to ING Insurance's commercial ocean marine business, including hull, cargo and liability and yacht programs underwritten through several managing general agencies. Terms of the transaction were not disclosed. (*Royal & SunAlliance Insurance Company of Canada Press Release, July 14, 2005*)

- The Nasdaq Stock Market, Inc. announced that it has entered into an agreement to acquire Carpenter Moore Insurance Services, Inc., a privately held, San Francisco-based insurance brokerage firm specializing in management liability. As a result of this transaction, NASDAQ indicates that its insurance business will be ranked as a top 10 provider of management liability insurance with a total of seven offices throughout the country. (*The Nasdaq Stock Market, Inc. Press Release, September 7, 2005*)

Risk Management

- In July, RMS announced the release of its Global Geocoding Platform and upgraded Global Terrorism Risk and Terrorism Scenario models, to provide insurers and reinsurers with the first worldwide view of their catastrophe risk accumulations. Geocoding has been expanded to over 150 countries. RMS' exposure accumulation functionality allows users to identify and quantify concentrations of property and human life exposures within a user-defined radius, along with assessing the implications for associated natural disaster and terrorism risk. The Terrorism Scenario model allows the user to estimate losses and casualties for multiple lines of business for 30 different attack scenarios, ranging from conventional bombs to chemical,

biological, radiological, and nuclear attacks. (*Risk Management Solutions Press Release, July 13, 2005*)

- An analysis AIR Worldwide Corporation conducted for the Association of British Insurers determined that if U.S. hurricane wind speeds increased by as little as 6 percent on average, insured losses could increase by as much as 75 percent per year. AIR also analyzed the potential impact of increased typhoon intensity in Japan and windstorm frequency in Europe on estimated insured losses. According to the ABI report, possible impacts of climate change include an increase in tropical cyclone storm intensity and European windstorm frequency. The AIR analysis determined that a 20 percent increase in the frequency of major European windstorms could result in as much as a 35 percent increase in average annual insured losses. (*ISO Press Release, June 29, 2005*)
- U.S. insurers, government, and consumers are at risk of escalating losses from hurricanes and other weather-related events, according to a report issued by the Ceres investor coalition. The Ceres report cites a 15-fold increase in insured losses from catastrophic weather events (those with over \$1 billion of damages) in the past three decades—losses that have far out-stripped premium increases, inflation, and population growth over the same time. Even before Hurricane Katrina, consumers and businesses in many parts of the U.S. were seeing higher premiums, lowered limits, and increased restrictions in coverage due to rising weather-related losses in Florida, Texas, California, and elsewhere, the report notes. Yet, despite rising insurance risks, climate change has received little attention to date from U.S. insurers, regulators, and governments. If climate change trends and insurance trends continue, the report warns, the availability and affordability of insurance will be at even greater risk for homeowners and businesses. State and federal governments may also become “insurers of last resort” in

response to private insurers further restricting coverage and withdrawing from more markets, according to the report. (*Ceres Press Release, September 8, 2005*)

- Automobile drivers who use their mobile phones while driving are four times more likely to have a car crash than those who don't, even if they aren't holding the phone, according to a recent study. The research was undertaken by The George Institute at the University of Sydney in collaboration with The University of Western Australia, and published in the *British Medical Journal*. The study has found an elevated risk of an injury related crash irrespective of whether or not a hands-free device was used. More than 400 drivers were involved in the study that was carried out at three major hospital emergency departments in Perth, Western Australia. The researchers also accessed participants' phone records to assess mobile phone use before a collision and compared this with journeys undertaken by the same drivers in the week prior to their crash. (*The George Institute for International Health Press Release, July 13, 2005*)
- Urban Canadians are 70 percent more likely to be involved in an injury-related motor vehicle collision when driving during bad weather than normal seasonal weather according to a report released by the Institute for Catastrophic Loss Reduction. The report, “Toward a National Assessment of the Travel Risks Associated with Inclement Weather,” provides detailed risk data from a motor vehicle collision analysis involving 27 major urban areas in Canada over a 17-year period, and it contains information on driver adjustments during inclement weather derived from a case study done on Gardiner Expressway in Toronto. (*Institute for Catastrophic Loss Reduction Press Release, June 29, 2005*)

International Focus and Globalization

- On September 17, Allianz AG announced that it would set up a holding company for its German-based insurance activities this year. The new Allianz Deutschland AG will unite Allianz Versicherungs-AG, Allianz Lebensversicherungs-AG and Allianz Private Krankenversicherungs-AG. All three companies will take the form of independent subsidiaries. In addition, the sales organizations of the individual Allianz companies will be integrated into an independent sales company, which will also be a subsidiary of the new holding company. Allianz AG, in the future Allianz SE, will be the sole shareholder of the Munich-based holding company. (*Allianz Group Press Release, September 17, 2005*)
- A recent publication by Financial Insights, a global independent research and advisory firm, profiles the growth potential for the insurance sector in the emerging markets of China and India. The report, “Asia/Pacific Insurance – Attractive Dynamics in China and India,” comments that the acceleration in economic momentum and nascent insurance industries, coupled with increased consumer risk awareness, pave the way for spectacular expansion going forth. According to the report, China's promising economic growth coupled with commendable structural changes will enhance sector performance, and expectations are that the country will uphold its position as one of the fastest growing insurance markets globally. The Financial Insights report indicates that life premium growth rates are projected to expand in excess of 20 percent per year, with volumes more than doubling the next 5 years to \$100 billion. Additionally, non-life operations appear poised to expand beyond \$20 billion by 2010. (*Financial Insights Press Release, October 7, 2005*)

- HSBC announced on August 11th that it is selling insurance in mainland China through an agency service agreement with Ping An Insurance, China's second largest life insurer. The bank's Shanghai branch started providing the service in August 2005, with Beijing, Shenzhen, and Guangzhou branches following suit in September. The insurance products include accident, illness, and hospital insurance as well as life and mortgage protection insurance. In August 2005, HSBC also completed the acquisition of an additional 9.91 percent of Ping An, for HKD 8.104 billion (USD 1.039 billion). The company's aggregate holding is now 19.9 percent. (*HSBC Press Releases, August 11 and 31, 2005*)
- Sun Life Financial, Inc. said that it has agreed to buy CMG Asia and CommServe Financial, which together form the Hong Kong insurance and pension operation of the Commonwealth Bank of Australia, for CAD 560 million. The deal—subject to the approval of regulatory authorities in Hong Kong, Bermuda, and Canada—will turn Sun Life Financial into the seventh-largest life insurance company in Hong Kong by premiums from new sales, the Company said. (*Sun Life Financial, Inc. Press Release, July 5, 2005*)

e-Business and Technology

- Shanghai-based Manulife-Sinochem Life Insurance Co. Ltd., a subsidiary of Canada-based Manulife Financial, has launched its group insurance business. Manulife-Sinochem has been actively preparing for its group insurance business since the recent lift of product restrictions for foreign insurers, as part of China's commitment to the World Trade Organization. Manulife-Sinochem intends to first launch its group insurance to employers in Shanghai, Guangzhou, Beijing, and Ningbo and will roll out at a later time into the other cities in which it has operations: Foshan, Dongguan and soon in Hangzhou and Nanjing. (*Manulife Financial Press Release, August 2, 2005*)
- In July 2005, AEGON-CNOOC Life Insurance Company, AEGON's joint venture with China National Offshore Oil Corporation (CNOOC), signed national cooperation agreements with two of the leading banks in China: the Industrial and Commercial Bank of China (ICBC) and the Bank of Communications (BoCom). The agreements will permit AEGON-CNOOC to provide life insurance, accident, and supplemental health insurance products to the customer bases of both ICBC and BoCom. (*AEGON N.V. Press Release July 21, 2005*)
- Fiserv, Inc. announced in August 2005 that it has acquired VerticalPoint, Inc., a provider of underwriting software to the life and health insurance market. The acquisition will allow Fiserv's Insurance Solutions Group to offer a Web-based, new-business workflow portal solution to life insurance carriers. Details of the transaction were not disclosed. (*Fiserv, Inc. Press Release (Business Wire) August 31, 2005*)
- Claims processing is expected to be the focal point of IT spend among nonlife carriers in the U.S. through 2008, according to a report by Dublin, Ireland-based Research and Markets. The report examines how U.S. insurance technology strategies have evolved over the past 18 to 24 months. Both life and non-life carriers are currently experiencing a period of relative stability, and are reassessing their technology opportunities. Overall spending growth is expected to moderate around 2007 as the bulk of costly system rationalization and standardization efforts will be underway. Policy processing will remain the largest spend area for life insurers. Spending on distribution activities, including internet and intermediary integration will grow faster for life carriers than for non-life as competition and market concentration increase, and as U.S. bancassurance grows. External spending will grow more quickly over the period and outpace total internal spending by 2008. This will be driven by the adoption of Web-based architectures, which are beginning to generate significant interest in the U.S. insurance industry, according to the report. (*Research And Markets (Business Wire) Press Release, August 30, 2005*)
- U.S. insurers will be turning to professional services providers and consultants in developing, implementing, and managing complex technology projects. The report by U.K.-based independent market analyst Datamonitor, "U.S. Insurance Technology Strategies," predicts that by the end of 2005, spending on external solutions will, for the first time ever, outpace that of internal IT spending. Through 2009, Datamonitor forecasts that investment in external solutions will grow by 6.5 percent in U.S. life insurance, compared with 1.4 percent for internal IT. Non-life external spending is expected to grow at an even faster rate—7.2 percent, compared with only two percent on internal spending. (*Datamonitor Press Release, August 25, 2005*)
- According to Gartner, Inc., while property and casualty insurers need to implement the same standards to provide real-time transactions for brokers and agents, results of its recent survey show that many insurers have been slow in offering the technologies necessary to implement these transactions. The Gartner survey, conducted between January and April of 2005, showed that agents and brokers prefer to do business with insurers that provide real-time transaction capabilities to better service policyholders. However, adoption of single-entry multiple-carrier interfaces, which enable distributors to send and receive data seamlessly, continues to lag among insurers and distributors. Gartner analysts said that by providing a single workflow interface, agents and brokers can spend more time selling insurance and less time keying data into agency management systems, in addition to other benefits such as

improved productivity, increased efficiency, and reduced transaction costs. (*Gartner, Inc. Press Release, August 18, 2005*)

- China's rapid growth rates and huge potential make it a critical arena for expansion for both insurers and solution providers, according to Celent, which projects that IT spending by insurers in China will jump from \$2 billion in 2005 to over \$5 billion in 2009. Although China's financial services sector is still small compared to the U.S., Europe, or Japan, Celent indicates that its rapid growth rates and huge potential size make it a critical arena for expansion for both insurers and solution providers. Celent's latest report, "Insurance in China: Market and IT Overview," provides an overview of this market and a high-level look at some of the key organizational and IT-related issues for both local Chinese and foreign insurers. Since 2000, the Chinese insurance market has tripled in size to about \$60 billion in premium, and Celent estimates that it is on track to exceed \$100 billion by 2009. (*Celent Press Release, July 21, 2005*)

KPMG *Insurance Insider*

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Analysis and Commentary

In this section, we offer KPMG's analysis and commentary reprinted from KPMG *Insurance Insider* and KPMG's *Audit Committee Insights*.

Andrew's Lessons Mitigate Insurers' Katrina Pain
By Charles Keenan, Contributing Editor, *Insurance Insider*
October 13, 2005

Thanks to risk mitigation strategies implemented in the 1990s, insurers reduced their exposure to the recent Gulf Coast hurricanes. But the techniques used today could face even tougher tests in the future.

Insured losses from Hurricanes Katrina and Rita are estimated to range between \$44 billion and \$67 billion, according to Risk Management Solutions, a catastrophe risk-modeling firm based in Newark, Calif. While that dwarfs the \$21 billion (in 2005 dollars) in insured losses from Hurricane Andrew, which swept through Florida in 1992, insurance companies are now far better off.

"It's reaffirming that the plans worked for the market in general," says Tom Larsen, senior vice president at Eqecat Inc., a risk modeling firm in Oakland, Calif. "[Katrina] was a big disaster. But the industry looks like it's able to come through with all obligations."

However, the threat of other catastrophes looms large over underwriters, says Karen Horvath, an analyst at A.M. Best Co., a insurance rating firm in Oldwick, N.J. "There are very big non-correlated risks out there," Horvath says. "There is nothing to say a major earthquake or terrorist attack can't happen right now."

To be sure, with each disaster, the industry has adapted their risk management strategies. After Hurricane Andrew, 11

insurers went belly up due to high exposure in Florida, according to the Insurance Information Institute (III). Insurance companies have subsequently pursued several strategies to reduce their exposure. They have spread out risk geographically and have tapped the reinsurance market, and have raised rates.

They also have risk models that are more powerful and accurate than 13 years ago. And while limited in scope, selling catastrophe bonds have also offered reduced risk.

In other words, Hurricane Andrew served as a wake up call, says Don Manis, vice president of property and casualty actuary at Alfa Corp., an insurer based in Montgomery, Ala. "The industry has paid more attention to managing exposure and rate levels in hurricane prone areas," he says.

Not that the industry is out of the woods, as several issues in the Gulf Coast region remain unresolved, according to Patricia Teufel, a principal at KPMG Actuarial in Hartford, Conn. Estimates of insured losses keep rising, plus there's the wildcard of flood damage liability.

Meanwhile, insurers with big exposure in homeowners and commercial property stand to get broadsided by large losses, according to Manis. Energy and marine insurance lines were also hard hit.

And the failure of the levees in New Orleans brought unforeseen complications—particularly the destruction of homes left standing by the hurricane itself.

"There are lots of complicating factors with Katrina," Teufel says. "This will be a very difficult quarter and likely a difficult year-end in terms of understanding the full cost."

But insurers have a few things going for them this year, including a capital base of \$400 billion, according to the III.

Since Hurricane Andrew, insurer-issued catastrophe bonds have spread risk. The bonds serve as a backstop for the most extreme disasters.

While the bonds pay higher-than-average rates, making them an expensive hedge, they are gaining in popularity. The market for cat bonds was \$4.7 billion in mid-2005, compared to \$4 billion at the end of 2004 and \$3.5 billion in 2003, according to Guy Carpenter & Co., a New York reinsurance broker. In the past year, The Hartford, FM Global and Oil Casualty Insurance Ltd. have all issued cat bonds for the first time.

Also helping are risk models. Before Andrew hit, insurers either were using crude models or nothing at all, relying upon an atypical stretch of history when major hurricanes were few. Meteorologists have noted that the North Atlantic Ocean began in the mid-1990s a phase of a higher frequency of hurricanes, expected to last about 25 years.

However, one shortcoming of models might have been that insurers did not take into account the increased frequency of storms.

"My sense is the insurers had not been putting [increased frequency] into their models and rates," says Robert Klein, director of the Center for Risk Management and Insurance Research at Georgia State University's Robinson College of Business. "That is causing some heartburn right now."

Still, there is a consensus that the sophisticated models used before Katrina hit were of some benefit. "The advances in technology have allowed the industry to data mine better," Horvath says. "The underwriting has become more sophisticated. It is more refined because you can have more control."

In addition to models, insurers have benefited from overcapacity in the reinsurance market. Despite four hurricanes in Florida and \$23 billion in

industry losses last year, losses for reinsurers were limited because retention limits were not reached. In fact, premiums overall declined 6 percent this year over 2004, following a drop of 11 percent over the period a year earlier, according to Guy Carpenter.

The overcapacity leaves insurers in a much more stable setting than the months following Hurricane Andrew.

"Many of these companies doing business in reinsurance didn't exist back in 1992," says Tom Upton, a managing director at Standard & Poor's in New York. "They provide a large reservoir of capital and absorb a big portion of the risk taken."

Katrina and Rita will hit reinsurers hard, but their capital base totals \$73 billion, and \$300 billion globally. That should shield them from another disaster, despite falling premiums and robust capacity, says Alfa's Manis. The storms "mostly will result in increased rates" for the insurer.

When it comes to rate hikes, Georgia State's Klein says the slowness to act may have been due to difficulties before the onslaught of storms in Florida last year. Before then, it was hard to justify rates to regulators based on catastrophic hurricanes hitting the United States infrequently. Now it might be easier to push through rate hikes where needed.

"The insurers will be attempting to make some adjustments," Klein says. "Because it looks like the weather is going to be bad for a while, and that is going to raise some interesting issues."

And legal battles for insurers may be just beginning. Richard Scruggs, the Mississippi attorney who has sued the tobacco and asbestos industries, has announced he will sue on behalf of residents in Mississippi, Alabama, and Louisiana, who may not receive compensation for flood damage despite the fact they had hurricane insurance.

Generally, homeowners' policies are clear about covering wind and rain damage, and not covering flood damage, KPMG's Teufel says.

Despite the reputational risk of not paying disputed claims, the cost of flood damage is far greater, Klein argues. "Any reputational risk is quickly outweighed by the financial cost of picking up damages they didn't price for," he says.

How Did Catastrophe Models Weather Katrina? By Christopher Westfall, Managing Editor, *Insurance Insider* September 16, 2005

While it's too early to tell if the highly touted computer catastrophe models met expectations for Hurricane Katrina, there are indications the models didn't work as well as some insurers had hoped.

Several factors—not the least of which was the unexpected flooding and storm surges—have presented challenges to cat models' accuracy. Some industry observers say that in a best-case scenario, actual insured losses from Katrina will be twice the amount that the models predicted.

But that does not mean the industry will abandon catastrophe modeling.

"If you look at the results, you may think that the models are not doing their job," says Andrew Castaldi, head of catastrophe and perils for Swiss Re's America's Division. "But these are probabilistic scenarios based on speculative events. These will never exactly match the actual event."

Instead of ditching the technique, providers of cat modeling are taking Katrina as an opportunity to refine or overhaul their programs to account for the powerful storm activity expected to batter the United States for years to come.

And while the hurricane showed that total reliance upon cat models is a recipe for disaster, a model integrated into the underwriting process will be a boon for insurers.

Catastrophe models generate different scenarios based on geographic and historical data, and calculate the probability of insured events and potential losses.

Carriers and reinsurers use them in two ways: on the front-end, cat models give an idea of what's at risk, and on the back end, models can help give insurers a quick and accurate picture of exposure following the catastrophe.

Currently, carriers and reinsurers are focused on the back-end aspect of cat modeling, which includes tracking the storm's impact on aggregated policies and inputting claims data.

Already, insurers are announcing major swings in post-storm estimates. Initial estimates when Hurricane Katrina made landfall were insured losses of \$15 billion to \$25 billion, according to the various catastrophe modeling firms such as Equecat, AIR Worldwide and Risk Management Services (RMS).

But on September 10, RMS revised its loss estimates to as high as \$60 billion, making Katrina three times as costly as Hurricane Andrew, which had been the most expensive storm ever in terms of insured losses. Neither Equecat nor AIR have updated their loss estimates.

One major hurdle for the various models was nature and aftereffects of Hurricane Katrina. Much of damage was the result of flooding and a "storm surge" from the Gulf of Mexico, which some models did not take into account.

(A storm surge is when coastal water rises above normal levels due to wind. These differ from tsunamis or tidal waves, which occur when water is displaced by geographic events such as earthquakes.)

"Most models are focused on wind damage which, from what I can tell, was not the most significant major issue in this storm," Castaldi says. Another aspect of the storm that wasn't necessarily modeled were losses from business interruption, Castaldi says are likely to be a major part of the overall loss.

And since much of the area that Katrina hit hardest was underwater, cat modeling firms were delayed in their efforts to obtain updated information for their systems, says Jeffrey Berg, senior analyst

in the insurance practice of Moody's Investor Services.

Many weather stations were either flooded in New Orleans or were destroyed by winds in the Gulf of Mexico. These stations help measure information on the exact path of the storm, as well as wind speed.

"Many firms had data issues early on since most of the [weather] equipment got flooded or was destroyed," Berg says.

Jayanta Guin, AIR's vice president for research and modeling, says initial estimates accounted for the extensive flood damage in New Orleans. While AIR's model does take into account storm surge, it does not include data on inland flooding, since most insurers do not cover the risk.

"There are a set of issues that are rather complicated once a major city becomes flooded," Guin says. Although hurricane coverage is usually limited to wind damage, flooding losses may end up being insured or may be contested in court.

Berg says that how efficiently insurers used models to determine the "risk aggregation" to the Gulf Coast, and subsequent purchase of reinsurance to offset that risk, will be the true test of the catastrophe models.

"The question they will ask is how closely the model losses predicted in the front end match up against actual losses," Berg says.

Swiss Re's Castaldi says that based on last year's hurricane season, actual losses to a company's portfolio were significantly higher or lower than those predicted by the catastrophe models typically because of poor data or non-modeled aspects.

"In many instances, local [insurers] using the models were off by a factor of two or three," he says. "In the proper hands, cat models can come up with good estimates, but if the data is not correct, it can cause significant problems. There is a lot of human error involved."

Modeling firms also depend on accurate information, says AIR's Guin. He explains that while AIR is constantly updating "event sets" to its clientele, it is also using insurers' claims information to make models more robust.

Pat Tuefel, a principal with KPMG's Actuarial Services practice, says that catastrophe models improve with each storm.

"The insurance industry has known, for quite some time, that there was potential for a significant hurricane through the Gulf to New Orleans and the Gulf Coast," she says. "The magnitude of the actual event has also been acknowledged as a possibility, through the modeling that has occurred. Any catastrophic event helps to refine the models going forward."

Guin agrees that Katrina may lead to refinements in the AIR model.

"Katrina will not change our overall approach to modeling hurricane risk," he says. "However, every landfalling hurricane is an opportunity to further refine our models. Over the next year we will collect a lot of claims data and will analyze the data collected from our post-disaster surveys. The results could lead to minor changes in the model. It will be an interesting year."

KPMG Roundtable: Soft Market or Not, Captives Are Thriving August 9, 2005

During the week of August 9th, the captive insurance industry met in Burlington, VT, for the annual Vermont Captive Insurance Association Conference. KPMG's *Insurance Insider* asked several KPMG professionals what industry leaders would talk about in Burlington, as well as about other significant issues facing the industry.

Discussion participants included:

William Costello, a Stamford, Conn.-based manager with KPMG's Audit Risk & Advisory Services practice;

George Levine, a senior manager with KPMG's Audit Risk & Advisory Services practice in Hartford, Conn.;

James Mannello, a partner in the Stamford, Conn. office with KPMG's Tax Services practice; and

Roger Wade, an Austin, Texas-based senior manager with KPMG's Audit Risk & Advisory Services practice.

Insurance Insider: Why are companies so interested in captives right now?

James Mannello: There's been an awful lot of interest around captives over the last couple of years. [There are] several reasons why we're doing a lot of work with companies either interested in forming captives or expanding the use of captives.

One [reason] would be the insurance market. Executives [are looking at] retaining more risk within their organizations, especially post Sept. 11. Gaining access to the government backstop program for terrorism insurance has spurred many companies to look at captives because they're an excellent risk management tool, and they shift significant risk to the government.

TRIA [The Terrorism Risk and Insurance Act of 2002] expires at the end of this year, and it has yet to be seen whether it will be extended, and in what form.

II: What about tax considerations?

Manello: There are few areas where the Internal Revenue Service has issued positive pronouncements.

The IRS had been aggressive in questioning the validity of captive arrangements in the past. Then—beginning in 2001—they issued a number of rulings that relaxed their view. That is even between (and among) brother and sister entities, and in the absence of outside business.

That was a big sea change for the IRS, and they continue to hold by that.

Roger Wade: I agree with Jim, particularly with respect to the changes as far as the

IRS has been concerned. It seems like there are fewer hurdles in order to be comfortable with forming a captive.

But the Sarbanes-Oxley Act of 2002 has helped, too. Companies are now [considering] more financial controls being in place around the organization. If you have a self-insured program or retentions internally, formalizing the captive and the structure associated with a captive assures people that you have financial controls in place.

Mannello: In earlier years, there might be a reserve on the books of each division or subsidiary. Formalizing the program and centralizing it in a captive adds more rigor to the process. We hear that more and more from controllers and CFOs.

//: What would be an example of that extra level of control?

George Levine: Vermont as a domicile has contributed to the concept of "rigor" and given financial executives a great deal more confidence in the captive concept.

For example, six months after the end of the fiscal year [Vermont] requires that an actuary certify that the captive has examined and tested the level of the loss reserves, and certify that they are reasonable. In most other captive domiciles, there is no such requirement. That's an example of financial rigor that [the business community] sees as positive.

William Costello: The reasons that Jim and Roger mentioned from a financial perspective are certainly true, but there is also a general interest in effective outsourcing.

Over the last two hard markets, we've had sustained momentum in captives, and after the softening of the rates the momentum has lessened. That's the ebb and flow of the insurance market. But this year the opposite is happening.

More companies are exploring setting up a captive, even though some prices have softened. Many are conducting studies on how to tailor it to their needs.

And they're taking the lessons they learned from Sarbanes-Oxley compliance and outsourcing in other areas, and applying them to the captive industry. That means there's real focus on the vendors and the team [managing] the program.

There is a lot more interest in how to set up a captive, not a "let's just do it" attitude.

Wade: One of the issues associated with outsourcing and captives is making sure that there's independence among the vendors. That was not necessarily the case [in the past], but it's a priority now. You want to have many of the most important functions, whether it's brokerage, captive management or actuarial, done by separate independent organizations to preserve the integrity of the program.

//: How did that work in the past?

Mannello: You would rarely see anyone else but the broker being the captive manager. And that captive manager would often end up doing the feasibility study.

Now we're seeing clients actively seeking bids from several brokers and captive managers, and often choosing a group that is not one of their brokers.

//: What are the most active areas in forming captives?

Levine: There has been a good deal of activity in the formation of captives for high-excess layers for professional liability. There's been quite a bit of that, especially with the problems that the medical malpractice, fiduciary liability and the directors and officers liability areas have experienced in the last five or six years.

Costello: The association captives—the group businesses and the rent-a-captive businesses—have seen a good deal of activity. There's a strong interest from the smaller risks out there that are tired of the up-and-down insurance cycle.

//: Are fronting agreements still a problem?

Mannello: Using a fronting agreement can be a big plus in employee benefits [when] you might need a fronting arrangement to

get Department of Labor (DOL) clearance. But it also adds several basis points to the process and could make it uneconomical for many companies looking at forming captives for employee benefits.

Fronting—both in terms of fees and capitalization of the captive—is definitely an issue.

Wade: It seems to me that outside of the benefits area, fronting is not particularly a problem for single-parent captives.

Many captives used to be structured for workers' compensation, and they would have a fronting company. But most single-parent captives now have a large deductible program, and just make the coverages going into the captives a deductible reimbursement. That eliminates the need for a fronting company. That's been a big development.

//: How are captives choosing domestic or offshore domiciles?

Mannello: We see places like Vermont being a very attractive domicile for a variety of reasons, as more people are looking domestically.

To take advantage of TRIA, you have to have a domestically licensed insurance company. And if you want to place employee benefits in a captive, at the very least you [must] have a U.S. branch to get DOL approval. So many captives figure that if you're going to have a U.S. branch, you might as well have a U.S. domicile.

There are some tax issues regarding losses from offshore captives that you don't encounter in the United States, as well as some withholding issues.

Wade: Also, Vermont continues to [pay] good legislative attention to the captives and keep their legislation up to date. There are a number of things that they've clarified in legislation that make it easier for captives to operate. And they do that just about every year.

//: What do you guys think will be the most significant issues for captives in the coming year?

Mannello: One is what happens to TRIA. I think that's an important issue for many captives.

Also, the IRS is looking at various tax issues. There is also a great deal of interest in the structure and terms of status of limited liability corporations (LLCs) and other pass-through entities. The IRS is looking for comments and is probably going to issue pronouncements in those and other sort of hot button areas.

I think those are two very important considerations.

Costello: To add to that, I would also say the decision where to domicile your captive is going to be an important issue. Whether forming a captive offshore in Bermuda, the Caribbean, or having it on-shore in Vermont, South Carolina or one of the other captive friendly domestic jurisdictions is going to take further consideration and exploration of the regulatory and political environment. I think that is going to be an issue that a lot of captives and companies are going to be looking at in the years ahead.

Wade: I would say that continuing to make sure that the financial controls put in place by Sarbanes-Oxley are actually utilized as opposed to sitting on a piece of paper.

Also, a number of captives have been formed that had coverages associated with them that were designed to be very profitable. If you let those sit too long without getting reviewed, I think you open yourself up to criticism from the IRS. The issue is whether it's really an arm's-length transaction and are you operating it in a fashion similar to a commercial insurance company.

Costello: I would add that NAIC Model Audit Rule that includes Sarbanes-Oxley-type requirements [could] potentially have a huge impact on captives, if the model rule is adopted in its current form. Some of the requirements include establishing an audit committee made up of members of the Board of Directors who are independent of management and ownership.

The discussion right now still has a threshold of \$25 million in annual gross premiums for a company to fall under the proposed rules. The industry is trying to increase the threshold.

If it's approved in its current form with the \$25 million threshold it would [have an] impact on the captive industry.

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