



INSURANCE

The State of the Insurance Industry

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FINANCIAL SERVICES

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Changes & Trends

Industry Overview

General Highlights

- On May 5, the Treasury Department announced an interim final rule as part of its implementation of the Terrorism Risk Insurance Extension Act of 2005 (Extension Act). The Extension Act, signed into law by President Bush on December 22, 2005, extended the Terrorism Risk Insurance Act of 2002 (TRIA) to December 31, 2007 and made other changes implemented by this rule. The May 5 interim final rule generally incorporates interim guidance issued by Treasury in January 2006, to assist insurers, policyholders, and other interested parties in complying with immediately applicable requirements of TRIA as modified by the Extension Act. The rule addresses changes to the types of commercial property and casualty insurance covered by TRIA, clarifies requirements for insurers in satisfying the mandatory insurance availability provisions, and implements a new Program Trigger loss threshold that must be met before the federal government potentially shares in insured losses. Although Treasury is issuing these requirements as an interim final rule, the press release indicates that comments are being solicited through a Federal Register Notice. (*United States Department of the Treasury Press Release, May 5, 2006*)
- According to the 2005 Annual Benchmark Survey from the Risk and Insurance Management Society (RIMS), the commercial insurance industry remained a buyers' market in 2005, and

shows no signs of hardening any time soon. The 2005 survey, produced and published by Advisen Ltd., revealed that the total cost of risk (TCOR) was down for the first time since 2001. Following 9/11, insurance costs skyrocketed through 2003. While insurance costs fell in most lines in 2004, higher retained losses and rising worker compensation costs through the first half of the year pushed TCOR up marginally. However, in 2005, the median TCOR fell about 11 percent, driven almost completely by lower insurance costs, attributed by Advisen analysts to abundant underwriting capacity that led to heightened competition. Despite the devastation caused by Hurricanes Rita, Wilma, and Katrina, the property and casualty insurance industry posted approximately \$55 billion in earnings in 2005. (*Risk and Insurance Management Society Press Release, May 25, 2006*)

- Conning Research and Consulting, Inc.'s new study indicates that insurance industry mergers and acquisitions increased in 2005 to the highest level since 2001 and may foreshadow an acceleration of activity this year and the next. Stephan Christiansen, director of research at Conning Research & Consulting, says that this increase is expected to continue. (*Conning Press Release Press Release, May 15, 2006*)

Property and Casualty

- Although property and general liability insurance rates increased in the first quarter of 2006, all indications point to a continuing soft commercial insurance

market, according to the RIMS Benchmark Survey™, produced by Advisen, Ltd. In keeping with the soft market conditions evidenced in the last six quarters, directors and officers (D&O) premiums dropped 3½ percent in the first quarter of 2006 and workers' compensation rates declined just over 3 percent. The property and casualty insurance industry overall saw a profit in 2005, according to survey officials, despite ever-dropping prices and a projected \$58 billion in hurricane losses, suggesting that competition among carriers would provide for a continuing soft market. RIMS indicates that the enduring effect of last fall's hurricane season was still evident in property premium renewals as 70 percent of survey respondents reported higher premiums. Average rates rose by nearly 7 percent in the first quarter of this year, though Advisen analysts suggested the market buoyancy was due more to underwriter support than to underlying market conditions. Property premiums increased in the fourth quarter of 2005 after having steadily declined since the third quarter of 2003. General liability rates experienced an upward swing of 5.1 percent; previous quarter survey data showed steadily falling premiums since the fourth quarter of 2003. Advisen analysts believe that general liability premiums may have been temporarily pulled higher by the spike in property premium levels, but will return to the pervasive softening trend by next quarter. (*Risk and Insurance Management Society Press Release, April 24, 2006*)

"RIMS Benchmark Survey" is a trademark of Risk and Insurance Management Society, Inc.

- According to a new special report by A.M. Best Co., the U.S. property and casualty industry was able to absorb record-high catastrophe losses and report an overall operating profit in 2005 as net income after taxes improved to \$48.4 billion, a 20 percent increase from 2004 year-end results. A.M. Best reports that the industry's noteworthy operating results were driven by solid investment returns, along with prudent underwriting practices and sound risk management implemented throughout the industry. In the midst of softening market conditions and significant catastrophe losses, the industry continued to improve its capital base as a result of another solid year of operating performance. According to A.M. Best Co., although an underwriting loss was reported, investment income, driven by growth in the invested asset base and strong cash flows, offset the loss to generate solid operating returns for year-end 2005. (*A.M. Best Co. Press Release, May 10, 2006*)
- U.S. property and casualty insurers are expected to pay an estimated \$1.38 billion to homeowners and businesses in insured property losses from seven catastrophe events in first-quarter 2006, according to preliminary analysis by ISO's Property Claim Services (PCS) unit. PCS also estimates that the catastrophes produced nearly 390,000 claims in 19 states. Personal lines claims accounted for 53 percent of the total, 12 percent for commercial lines claims, and 35 percent for auto claims. The large number of vehicle claims stemmed from hail and tornado damage. The quarter's costliest event was an outbreak of severe weather across six states from Kansas to Indiana. The insured damage from the event is slightly more than \$800 million and the claims count is in excess of 222,000. Missouri suffered the largest insured loss (estimated at \$475 million), followed by Kansas (\$113 million), Arkansas (\$108 million), New York (\$103 million), and Illinois (\$100 million). Three winter storms and four wind and thunderstorm events constitute the quarter's seven catastrophes—slightly above the average of six events during the past decade. (*ISO Press Release, April 20, 2006*)
- The Insurance Information Institute reports that back-to-back devastating hurricanes in the last two years battered the U.S., claiming lives, destroying property, and uprooting thousands from their homes to seek temporary shelter. The Commerce Department's National Oceanic and Atmospheric Administration (NOAA) predicts an active hurricane season in 2006, with 13 to 16 tropical storms forming over the Atlantic Ocean. Ten of these could become hurricanes. The hurricane season, which officially began on June 1 and will continue through the end of November, exposes to property losses from hurricanes and tropical storms tens of millions of people living along the U.S. Eastern Seaboard and the Gulf Coast. According to NOAA, warmer ocean water combined with lower wind shear, weaker easterly trade winds, and a more favorable wind pattern in the mid-levels of the atmosphere are the factors that collectively will favor the development of storms in greater numbers and to greater intensity. (*Press Releases: Insurance Information Institute, June 1, and NOAA, May 22, 2006*)
- The number of vehicle losses due to hurricanes, floods, tornadoes, large hailstorms, firestorms, and other severe storms nearly doubled in the five years between 2001 and 2005, according to ISO's PCS unit. The number of reported claims for vehicle loss from natural disasters recorded by PCS increased steadily, from 485,150 claims in 2001 to 982,350 claims in 2005, for a total of 3.3 million losses over the past five years. PCS's numbers track auto insurance claims on vehicles with insurance policies that include comprehensive coverage, which covers damages or loss due to natural disasters, catastrophes, or events other than a collision with another car. (*Insurance Information Institute Press Release, May 16, 2006*)
- The cost of auto insurance is expected to rise by just 0.5 percent in 2006, the smallest increase in six years, reports the Insurance Information Institute. The average cost for auto insurance nationwide for 2006 is estimated at \$867—an increase of just \$4 per vehicle from last year despite record vehicle-related losses arising from the 2005 hurricane season. The projected increase represents a continued slowdown from 2005 when auto insurance costs rose by 2.5 percent. Robert Hartwig, senior vice president and chief economist of the Insurance Information Institute, cited the declining number of auto accidents, safer cars, new auto theft technology, fraud-

fighting efforts, and graduated licensing laws for teen drivers as additional key factors contributing to the cost slowdown. However, he observed that rising costs for medical care and vehicle repairs as well as defense costs and jury awards remain a problem, according to Insurance Information Institute's analysis. (*Insurance Information Institute Press Release, May 3, 2006*)

- Across the United States, if someone is injured in an auto accident, the chances are about one in seven that the at-fault driver is uninsured. Findings of a recent Insurance Research Council study indicated that the estimated percentage of uninsured motorists increased nationally from 12.7 percent in 1999 to 14.6 percent in 2004. However, the magnitude of the uninsured motorists problem varied widely from state to state. The recently released study, "Uninsured Motorists, 2006 Edition," examines trends from 1999 to 2004 in the percentage of uninsured drivers by state. In 2004, the five states with the highest uninsured driver estimates were Mississippi (26 percent), Alabama (25 percent), California (25 percent), New Mexico (24 percent), and Arizona (22 percent). The five states with the lowest uninsured driver estimates were Maine (4 percent), Vermont (6 percent), Massachusetts (6 percent), New York (7 percent), and Nebraska (8 percent). (*Insurance Research Council Press Release, June 28, 2006*)
- For many people, their home is their greatest asset. Yet studies show that 59 percent of today's homes are under-insured by an average of 22 percent, according to the Insurance Information

Institute. The cost of building or repairing a home has increased dramatically in recent years. The U.S. Census Bureau indicates that homeowners spent over \$218 billion on additions, alterations, maintenance, and repairs in 2005, up from \$201 billion in 2004. Materials like lumber, cement, gypsum, and structural steel products have become scarcer, not only because of the devastation from last year's storms, but also because of increased global demand. (*Insurance Information Institute Press Release, May 8, 2006*)

- Despite the past two devastating hurricane seasons, as many as a third of residents in Atlantic and Gulf coast states may not be adequately insured, according to a recent Mason-Dixon poll commissioned by the National Hurricane Survival Initiative. When asked about their homeowners insurance coverage, one in three of those surveyed said it has been three years or longer since they reviewed their policy and an equal number said they didn't have or weren't sure if they had replacement coverage. In addition, more than half of those surveyed thought their homeowners insurance covered flood damage or weren't sure. In fact, homeowners only have protection from flooding, including wind-driven water and storm surge, if they've purchased a flood insurance policy from the National Flood Insurance Program or a private insurer. Seeking to educate residents of hurricane-prone states on how to be prepared for a natural disaster, St. Paul Travelers is sponsoring the 2006 National Hurricane Survival Initiative, a collaborative effort led by the National Hurricane Center, The Salvation Army,

the National Emergency Management Association, and the State of Florida. The Hurricane Survival Initiative includes a Web site and television specials on local stations from Texas to New York that will reach the Gulf and Atlantic coasts to help educate the public about hurricane preparedness. (*St. Paul Travelers Press Release (Business Wire), May 30, 2006*)

Life and Health

- First quarter 2006 individual life insurance sales rose 15 percent in new annualized premium, compared with the first quarter of 2005, according to LIMRA International's quarterly survey of U.S. individual life insurance sales. The strongest increases were in universal life (UL) and variable universal life (VUL) products. The number of policies sold remained even with the same period last year, while face amount showed a 4 percent increase. Fixed premium products—term and whole life—also showed premium increases of 5 percent and 3 percent, respectively. The survey represents more than three quarters of industry sales. LIMRA said this year's sales were strengthened by a strong stock market, which probably made producers and consumers more comfortable with variable products, particularly since several newer products offer guarantees. This is only the second time in five years that VUL has posted a double-digit quarterly increase. (*LIMRA International Press Release, June 7, 2006*)
- The overall growth rate in admitted assets for the top 200 life insurance groups slowed in 2005 to a more

moderate 6 percent range from more than 9 percent in 2004, according to an A.M. Best Co. statistical study in the June 19 issue of *BestWeek*. Total industry growth also was lower, down to 5 percent in 2005. Following two years of higher growth, U.S. life insurers settled for slower but still continuing growth in admitted assets, as fixed annuity sales continued to experience a slowdown. Despite the slowdown in 2005, A.M. Best notes that asset-accumulation products remained at the forefront in enabling life insurers to manage higher admitted assets. Protection-based life insurance products also had a positive impact on growth in admitted assets in 2005. (A.M. Best Co. Press Release, June 16, 2006)

- Variable annuity sales were up in 2005, though total net flows dropped, caused by a lack of new investors in the product, according to a story in the April 10 issue of *BestWeek*. The industry is optimistic for 2006 and beyond, however, looking to attract the baby boomers by offering product features such as lifetime income options and death-benefit protection, according to A.M. Best Co. (A.M. Best Co. Press Release, April 7, 2006)
- While still reaching double-digit figures, healthcare costs are beginning to increase at a lower rate, according to Aon Consulting, which surveyed more than 70 leading healthcare insurers (representing more than 100 million insured individuals) and found healthcare costs are projected to increase in the next 12 months by 12.2 percent for HMOs, 12.4 percent for PPOs, and 11.9 percent for POS

plans. This is compared to one year ago, when HMO cost increases were 13.2 percent, PPO increases were 13.0 percent, and POS cost increases were also 13.0 percent. Meanwhile, consumer-driven health plans (CDH) are estimated to increase by 12.5 percent, similar to a year ago when these plans were forecasted to increase 12.7 percent. (Aon Corporation Press Release, June 1, 2006)

- A disproportionately large share of companies' healthcare costs stem from the treatment of a small group of employees and dependents who have chronic or catastrophic illnesses, according to an analysis by Watson Wyatt Worldwide. As a result, companies that focus solely on providing financial incentives to encourage plan participants to be more discerning healthcare consumers are apt to realize only limited cost savings. According to the analysis of health benefit plan expenditures, the 4 percent of participants with serious health conditions account for nearly half of health benefit spending in any given year. This group is unlikely to be won over by financial incentives or plan design features, such as high-deductible health plans paired with health savings accounts, which allow employees to save for healthcare expenses on a tax-advantaged basis. Watson Wyatt indicated that such plans are likely to be attractive only to healthier employees. Those who are not as sick—the roughly 25 percent of participants in the early stages of chronic conditions or with acute health episodes—account for 40 percent of spending. In contrast,

those who are healthiest—72 percent of participants—account for just 11 percent of healthcare spending. (Watson Wyatt Press Release, April 24, 2006)

- Sufficient scientific evidence indicates that asbestos exposure can cause cancer of the larynx, says a new report from the Institute of Medicine of the National Academies. There is suggestive but ultimately insufficient evidence that asbestos exposure can cause cancers of the pharynx, stomach, colon, and rectum, added the committee that wrote the report. The evidence is inadequate to draw any conclusions about esophageal cancer and exposure to this class of minerals. The Institute of Medicine undertook the study to answer questions raised in congressional discussions about compensation for people with ailments associated with asbestos exposure. The study committee assessed the quality, limitations, and applicability of 120 epidemiological studies of asbestos exposure and cancers of the throat and digestive tract. It also considered information from approximately 200 experimental studies. Cancer of the larynx is relatively rare. The American Cancer Society estimates that about 9,500 new cases of laryngeal cancer will occur this year and predicts about 3,740 people will die from it. Smoking and heavy consumption of alcohol are the principal risk factors for this type of cancer. The cumulative results of more than 50 epidemiological studies provided compelling evidence that asbestos exposure is associated with an increased incidence of laryngeal

cancer and that the risk increases with the intensity and duration of exposure, the committee found. Smoking alone or in combination with drinking may contribute to the accumulation of asbestos fibers in the lining of the larynx. The study was sponsored by the National Institutes of Health at the request of Senator Arlen Specter, R-Pa. (*The National Academies Press Release, June 6, 2006*)

- U.S. adults fear getting Alzheimer's disease more than heart disease, stroke, or diabetes. However, nearly 9 out of 10 survey respondents have taken no steps to prepare for an illness that attacks nearly 50 percent of those who live past age 85. For example, more than half report that they have not designated anyone to take care of their affairs if they were to get Alzheimer's disease. These are the findings from a report, "MetLife Foundation Alzheimer's Survey: What America Thinks," conducted by Harris Interactive for MetLife Foundation. The survey also found that more than a third of U.S. adults have a family member or friend who has Alzheimer's, and 3 out of 5 are concerned that they may someday have to provide for or care for someone with the mind-robbing disease. Other major findings in the MetLife Foundation survey are that almost three-quarters of Americans say they know very little or nothing about Alzheimer's, although 93 percent are at least aware of the disease. Currently 4.5 million Americans have Alzheimer's, a number that is expected to nearly quadruple to 16 million by 2050, according to the Alzheimer's Association. One in 10 people over 65 have the disease; the

rate is closer to 50 percent for those over 85. The Alzheimer's Association and the National Institute on Aging estimate that the cost of current care exceeds \$100 billion annually. According to the MetLife press release, with the aging of America's population, these numbers are sure to become even more dramatic in the future, making it imperative that individuals and institutions plan for the future. The growing number of older people, many with Alzheimer's, will have an impact on every part of society. (*MetLife Press Release, May 11, 2006*)

Reinsurance

- Net premiums written in 2005 by leading U.S. reinsurers fell by 13 percent, according to the most recent U.S. Quarterly Report from Benfield's Industry Analysis and Research Team. Reserving deficiencies and hurricane losses were the primary reasons for a 66 percent reduction in earnings for the 13 major U.S. reinsurers. Return on equity was reduced by nearly half and remained positive due only to total investment income of \$8.5 billion, \$2.4 billion higher than in 2004. According to the report, average combined ratio rose 26 percent to 130 percent. Only three companies had a combined ratio of less than 100 percent—none less than 95 percent. Unlike their Bermudian counterparts, the report says that most U.S. reinsurers retained strong ratings thanks largely to the financial backing of some of the world's largest parent companies. Larger players continued to dominate the U.S. reinsurance market with the top five companies accounting for 56 percent of gross premiums. (*Benfield Press Release, April 7, 2006*)
- According to the most recent Bermuda Quarterly Report from Benfield's Industry Analysis and Research team, Bermuda reinsurers have forecast that rates will continue to harden through the year and could even spread into other territories in 2007. Increased demand, revised catastrophe models, and more stringent capital constraints continue to squeeze capacity. The report observed that total net income for Bermuda's 16 leading reinsurers was up 21 percent over the first quarter of 2005 to \$2.3 billion. Premium income decreased 5 percent to \$16.5 billion, the first decrease in first quarter premium volume since 2001. The weighted average combined ratio decreased from 91.6 percent to 89.2 percent. (*Benfield Press Release, June 16, 2006*)
- European reinsurers made a profitable start to the year reflecting a quiet first quarter of 2006, according to the latest Benfield European Quarterly report. For the first time since the first quarter of 2004, the report indicates that Europe's reinsurers reported underwriting profits, and none of the companies studied saw any adverse development on 2005 hurricane losses. While investment income declined modestly, diluting some of the better underwriting results, the report indicates that profits for the European reinsurers nevertheless rose strongly, driving up the group's capital base. (*Benfield Press Release, June 20, 2006*)

Accounting Standards and Developments

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

• Guidance on Section 404 Compliance

The SEC took a first step toward new guidance for management on complying with the assessment requirements on internal control over financial reporting, and the Committee of Sponsoring Organizations of the Treadway Commission (COSO), known for its widely used evaluation framework on internal control, introduced its guidance to help smaller public companies with compliance. COSO believes its new guidance can be helpful to companies of all sizes.

A new SEC Concept Release requests comments on issues that might be the subject of guidance for management on assessing internal control over financial reporting. The Release cites views and comments the SEC has received since it adopted rules implementing Section 404, including the views expressed at the Roundtable in May on second-year compliance experiences.

COSO released its new guidance for smaller public companies on internal control over financial reporting which includes an executive summary, and published answers to 27 related frequently asked questions. (*KPMG's Defining Issues, No. 06-20, July 2006*)

Financial Accounting Standards Board (FASB)

• Comments Requested on Accounting for Insurance Contracts

Most companies that sell or buy insurance are likely to be affected by the FASB's project on insurance risk transfer, and those that might be most affected may want to respond to the FASB's just-published Invitation to Comment. The fundamental question is whether to separately account for the financing and insurance-risk-transfer elements of insurance contracts. The Invitation to Comment also addresses potential definitions and methods for deciding when and how to separate the contracts. The FASB uses the term "bifurcation" to refer to dividing a contract into two components for accounting purposes and the term "deposit" to refer to the financing component.

Requirements to separately account for the insurance and deposit elements of insurance contracts would be a significant change, because most contracts are now accounted for in their entirety as either insurance or a deposit. The Invitation to Comment cites the consequences of the insurance-or-deposit decision and the opportunities to limit the amount of risk transferred and still achieve insurance accounting for the entire contract. It then asks whether required bifurcation would more consistently depict the economics of the arrangements. The project is partly a response to perceived abuses in accounting for certain "finite risk" insurance and reinsurance contracts, allegedly used in some cases to enhance reported financial condition or

financial results, rather than to protect against loss. Comments on the Invitation to Comment are due by August 24, 2006. (*KPMG's Defining Issues, No. 06-16, June 2006*)

• New Accounting and Disclosures About Tax Uncertainties

New FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes*, which defines the threshold for recognizing the benefits of tax-return positions in the financial statements as "more-likely-than-not" to be sustained by the taxing authority, will affect many companies' reported results and their disclosures of uncertain tax positions. The FASB also released a Staff Position that requires lessors to apply the Interpretation 48 model in determining the timing and amount of expected tax cash flows in leveraged-lease calculations.

"Uncertainty in income taxes," as used in the title of the new Interpretation, refers to uncertainty about how some transactions will be treated under the tax law. This uncertainty leads to questions about whether tax positions taken or to be taken on tax returns should be reflected in the financial statements before they are finally resolved with the taxing authorities. Earlier authoritative literature provided no specific guidance. Some companies historically recognized tax positions only if they were "probable" of being ultimately realized, guided by views expressed by the SEC staff and consistent with the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*. However, research by the FASB staff

and comments on the FASB's Exposure Draft suggested there was diversity in practice with respect to the recognition and measurement principles used and the scope of transactions to which such principles were applied. The new Interpretation should result in more consistent application.

Interpretation 48 requires significant new annual disclosures in the notes to the financial statements. A significant additional requirement is a table disclosing the beginning and ending balances of unrecognized tax benefits and separate presentation in the table of certain items resulting in increases and decreases in the unrecognized tax benefits.

Interpretation 48 is effective as of the beginning of the first fiscal year beginning after December 15, 2006, with early application permitted if no interim financial statements have been issued. (*KPMG's Defining Issues, No. 06-21, July 2006, and 06-14, May 2006*)

NAIC/Regulatory

- **NAIC's 2006 Summer Meeting, June 10-13, 2006**

NAIC committees and groups adopted changes to the Model Audit Rule on corporate governance and internal control over financial reporting and a new Statement on and statutory accounting for transferable state tax credits; exposed for comment two tentative consensuses and implementation guidance on accounting for investments in subsidiary, controlled, and affiliated entities; and made

progress on revising the regulatory framework for reinsurance. The model audit rule is discussed in the Regulatory and Legislative Matters section of this publication.

- **Statutory Accounting**

The Statutory Accounting Principles Working Group adopted a new Statement. Insurers will defer gains on transferable state tax credits until the amount of the credits applied on tax returns or sold to other entities exceeds their recorded cost, according to new SSAP 94, *Accounting for Transferable State Tax Credits*. The Statement also prescribes new disclosures for transferable state tax credit investments. The new Statement is effective for reporting periods ending on or after December 31, 2006, with early adoption permitted. A change in accounting from adopting the Statement is to be treated as a change in accounting principle in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*.

- **Emerging Accounting Issues**

The Emerging Accounting Issues Working Group adopted a final consensus that revenues for sales of claims data to a pharmacy benefits manager should be treated as "other income." In these situations, the pharmacy benefits manager may acquire the claims data for use in pharmaceutical research or to enhance its cost-containment services. Certain SSAPs treat revenues from analogous situations as a reduction of claims expense.

- **Property & Casualty Reinsurance Study Group**

The Property & Casualty Reinsurance Study Group reviewed input from "interested persons" on questions that arose as companies completed their year-end disclosures in response to the NAIC reinsurance interrogatories and the requirement for CEO/CFO attestations. Industry personnel submitted many suggested clarifications and improvements, which are available on the NAIC's Web site. The Study Group approved the proposal to increase the materiality threshold of the finite interrogatory 9.1 from 3 to 5 percent, and it agreed with the submitted suggestion to remove the word "unconditional" when discussing commutation clauses in interrogatory 9.1(d).

- **Reinsurance Regulatory Framework**

Progress was made on revising the regulatory framework for reinsurance. In March, the Reinsurance Task Force had been charged with developing alternatives to the current U.S. reinsurance regulatory framework, including the use of collateral within the U.S. and abroad. The charge originates in the issues discussed in the 2005 U.S. Reinsurance Collateral White Paper.

At the 2006 Summer Meeting, industry groups presented views on revising the regulatory framework, including two different sets of proposed "core principles" for the project. The Interested Persons Group recommended, as a core principle, the need for balance between solvency protection and access to capital. The

Ceding Insurers Interested Parties Group expressed concerns about this core principle, citing the need to focus on solvency protection. After hearing presentations, the Reinsurance Task Force adopted a motion directing the interested parties to focus primarily on the "Rating Proposal," which would create an organization to rate the financial strength of reinsurers doing business in the U.S., regardless of their country of domicile, and would require reinsurers to post collateral in an amount that depends on the rating it receives from the rating organization. (*KPMG's Issues & Trends in Insurance, July 2006*)

Regulatory and Legislative Matters

Insurance Regulatory Reform

- On April 5, Senators John Sununu (R-NH) and Tim Johnson (D-SD) announced the introduction of the National Insurance Act of 2006, which would allow life and property and casualty insurers to choose federal rather than state charters under an "optional federal charter" regulatory system. The legislation would establish a parallel, federal system of regulation and supervision for insurers and insurance producers (agents and brokers), similar to the dual banking system. Supporters of the optional federal charter legislation contend that it will modernize insurance regulation by reducing inefficiencies and inconsistencies created by the existing state regulatory structure, thereby encouraging greater competition and innovation. Particulars of the Act may

be found on the U.S. Senate Web site at www.senate.gov.

On July 11, NAIC President, Alessandro Iuppa, in testimony before the U.S. Committee on Banking, Housing, and Urban Affairs, outlined the need to retain a coordinated, national system of state-based insurance supervision that would continue to meet the needs of the modern financial marketplace while effectively protecting individual and commercial policyholders. President Iuppa's testimony may be found on the NAIC Web site at www.naic.org. On July 12, the National Governors Association and the National Conference of State Legislatures announced in a statement their strong opposition to the National Insurance Act of 2006 (S.2509), indicating that the establishment of a federal insurance regulatory authority would radically restructure the current system of state insurance regulation. (*United States Senator John E. Sununu Press Release, April 5, 2006; National Association of Insurance Commissioners Press Releases, July 11 and 12, 2006*)

Annuity Suitability Model

- The original Senior Protection in Annuity Transaction Model Regulation, also known as the Suitability Model Regulation, focused on sales of annuities to consumers age 65 and over. The amendments to this model relating to suitability of life insurance and annuity sales practices expand the target audience from senior citizens to include all citizens. According to the NAIC, state insurance regulators, working through the NAIC, are making

progress in developing new examination standards addressing marketing and sales practices for life and annuity products. The revisions to the life insurance, annuity, and indexed products standards address recent NAIC activities and updates to model regulations. In addition, two new examination standards have been created to address indexed annuity products. (*National Association of Insurance Commissioners Press Release, June 11, 2006*)

Model Audit Rule

- Acting in Plenary Session, the NAIC adopted amendments to the Model Audit Rule on corporate governance, internal control over financial reporting, and auditor independence, after three changes were made to the proposal. The changes originated at a public hearing held by the Financial Condition (E) Committee on May 11, 2006 and were adopted by the Committee at that time.

The amendments relate to auditor independence, corporate governance, and internal control over financial reporting. The adopted revisions require that insurance companies have an audit committee and indicate that some audit committee members may need to be independent from management. The adopted revisions also require that insurance companies with \$500 million or more in direct and assumed premium file a report with the state insurance department regarding its assessment of internal control over financial reporting. The scheduled effective date is January 1, 2010.

The three changes to the proposed amendments that were adopted by the Financial Condition (E) Committee on May 11, 2006 include increase of the premium amount above which at least 75 percent of an insurer's audit committee members must be independent. The new threshold is total written direct and assumed premiums "over \$500 million," up from the former threshold of "over \$300 million." The change also requires at least a majority of independent audit committee members if the insurer's total written direct and assumed premiums exceeds \$300 million but not \$500 million.

Another change extends the effective date for the revised requirements by one year. The audit committee requirements would become effective January 1, 2010, and the requirements for Management's Report of Internal Control Over Financial Reporting would become effective beginning with the reporting period ending December 31, 2010 or thereafter. The revisions to the lead audit partner rotation requirements would become effective for audits of years beginning January 1, 2010 and thereafter. (*KPMG's Issues & Trends in Insurance, July 2006; National Association of Insurance Commissioners Press Release, June 12, 2006*)

AML Guidance for Life & Annuity Products

- The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) released additional questions and answers to supplement its "Frequently Asked Questions" (FAQs) that are designed to assist insurance

companies in establishing their anti-money laundering and suspicious activity reporting programs. The FAQs were released in October 2005. The new guidance, which is contained in FinCEN's FIN-2006-G010, addresses:

- The definitions of "covered products" and "any other insurance product with features of cash value or investment;"
- The requirement for insurance companies to have a Customer Identification Program;
- The forms to be used to report suspicious activity; and
- The implications for insurance companies that did not train all of their agents prior to May 2.

(*KPMG's The Washington Report, June 5, 2006*)

Taxation

• Notice 2006-42

The IRS has issued guidance with respect to the "gross receipts" test for determining whether insurance companies, other than life insurers, qualify for tax-exempt status under IRC Section 501(c)(15) (All section references are to the Internal Revenue Code of 1986, as amended). Under this provision, a non-life insurer is treated as exempt from income tax if its gross receipts for the taxable year do not exceed \$600,000, and more than 50 percent of those gross receipts consist of premiums.

The Notice provides that gross receipts will generally include premiums,

including deposits and assessments, without reduction for return premiums or premiums paid for reinsurance and gross investment income of a nonlife insurance company. Gross receipts would also include tax-exempt interest. However, it would only include the gain, and not the entire amount realized from the sale or exchange of capital assets. Gross receipts do not include contributions to capital excluded from gross income under section 118 or salvage or reinsurance recovered and accounted for as offsets to losses incurred under section 832(b)(5)(A)(i).

• Rev. Rul. 2006-25

The IRS has supplemented the schedules of prevailing state-assumed interest rates of Rev. Rul. 92-19 (Announcement 2006-35 announced subsequent corrections to some of those rates). This is the fourteenth supplement to the interest rates provided in Rev. Rul. 92-19. The information is used by insurance companies in computing their reserves for life insurance and supplementary total and permanent disability benefits; individual annuities and pure endowments; and group annuities and pure endowments.

• Treasury Decision 9258

The IRS issued temporary regulations concerning the requirements for including insurance companies in a life-nonlife consolidated return.

The recent adoption of Regulation XXX has resulted in a higher level of statutory and tax reserves for certain life insurance contracts (XXX business), which causes surplus strain to life

insurers. To obtain relief from surplus strain, some life insurance companies have formed a new affiliated life insurer which has assumed their XXX business. The new company then issues debt secured by the cash flows from the XXX business, which provides relief from the surplus strain. However, the higher reserves for XXX business may cause losses for a period of time in the newly created company. Treas. Reg. section 1.1502-47(d)(12)(v) contains five requirements for applying certain tacking rules. In this case, the tacking rules would be necessary so that the new life insurance company could join in the life-nonlife consolidated group in the taxable year of its formation. Companies filing life-life consolidated returns were concerned that the new company could not be included in the return as one of the tacking requirements would not be met as there would be separation of profitable activities from loss activities.

The temporary regulations provide an exception to the five-year affiliation rules of sections 1503(c)(2) and 1504(c)(2) and replace the tacking rules under Reg. section 1.1502-47(d)(12)(v) with rules that do not contain a condition relating to the separation of profitable activities from loss activities.

- **Treasury Decision 9257**

The IRS has published final and temporary regulations in T.D. 9257 that would generally treat a deemed asset sale by an insurance company or an acquisition of an insurance business as an assumption-reinsurance transaction.

Final regulations were issued with respect to a deemed sale or acquisition

of an insurance company's assets pursuant to an election under section 338, to a sale or acquisition of an insurance trade or business subject to section 1060, and to the acquisition of insurance contracts through assumption reinsurance. The regulations generally treat the transfer of insurance or annuity contracts and the assumption of related reserve liabilities in a deemed asset sale under section 338 similar to ordinary assumption-reinsurance transactions under Treas. Reg. section 1.817-4(d) and other subchapter L provisions. Similar rules also would apply to the acquisition of an insurance business governed by section 1060, including to indemnity reinsurance arrangements if the purchaser acquires significant business assets, in addition to insurance contracts, to which goodwill and going concern value could attach.

The final regulations are effective on April 10, 2006 and allow elective retroactive application. These regulations adopt, with some revisions, proposed regulations published in March 2002.

The regulations claim to be an amalgam of subchapter L and subchapter C rules, and prescribe:

1. Using the residual method of sections 338 and 1060 to determine the value of goodwill and going concern value (which assumes that the value of all assets other than goodwill and going concern value is readily determinable), rather than the residual method of section 1.817-4(d) to determine the value of insurance in force (which assumes that the value of all assets

other than insurance in force is readily determinable);

2. Treating the amount of old target's tax reserves as a fixed liability as of the close of the acquisition date that is taken into account in determining the seller's aggregate deemed sales price (ADSP) under section 1.338-4 and the buyer's AGUB under section 1.338-5;
3. Treating certain of new target's increases in reserves for any insurance contracts acquired in the deemed asset sale as a contingent liability as of the close of the acquisition date that becomes fixed when new target increases its reserves;
4. Assuming that the amount of reinsurance premium is equal to the amount of old target's tax reserves, even though the ceding company would have to pay the reinsuring company an amount greater than the tax reserves in an arm's length reinsurance transaction. This rule ensures that the acquirer of an insurance business will not have immediate net taxable income merely as a result of the acquisition; and
5. Not requiring capitalization for new target's increases in reserves due to the time value of money for any insurance contracts acquired in the deemed asset sale.

Final regulations were also issued under section 381 concerning the effect of certain corporate liquidations and reorganizations on certain tax attributes of insurance companies. The regulations provide that if one corporation

distributes or transfers a substantial portion (50 percent or more) of an insurance business to another corporation in a transaction to which section 381 applies, then the acquiring corporation succeeds to the distributor or transferor corporation's shareholders surplus account, policyholders surplus account, and other accounts. However, if an acquiring corporation in the section 381 transaction acquires less than 50 percent of the distributor or transferor corporation's insurance business, then the acquiring corporation succeeds only to a ratable portion (determined by reference to reserves) of the distributor or transferor corporation's shareholders surplus account, policyholders surplus account, and other accounts.

Temporary regulations were issued under section 197 relating to the determination of adjusted basis of amortizable section 197 intangibles with respect to insurance contracts; under section 338 relating to increases in reserves after a deemed asset sale; and under sections 338 and 846 relating to the effect of a section 338 election on a section 846(e) election.

(Source: IRS; Court rulings; Legislative materials)

Market Forces

Consolidation and Convergence

- Fidelity National Financial, Inc. announced that its Board of Directors has approved pursuing a plan that will eliminate its holding company structure and result in what will become a new FNF (New FNF), and the existing Fidelity National Information Services, Inc. (FIS) will become independent public companies. The plan involves a number of transactions that will result in the three public companies that currently comprise the FNF family of companies, FNF, Fidelity National Title, Inc. (FNT), and FIS, becoming two public companies, New FNF and the existing FIS. New FNF will have no ownership interest in FIS. FNT will be renamed Fidelity National Financial. New FNF will essentially consist of the title insurance, specialty insurance, and Sedgwick business lines. (*Fidelity National Financial Press Release, April 27, 2006*)
- Credit Suisse Group announced that it has entered into a definitive agreement for the sale of Winterthur Swiss Insurance Company (Winterthur), its insurance business, to AXA for a cash consideration of CHF 12.3 billion. AXA will acquire 100 percent of Winterthur. The transaction is expected to close around year-end 2006. (*Credit Suisse Group Press Release, June 14, 2006*)
- On June 9, 2006, Swiss Re announced the completion of the acquisition of GE Insurance Solutions. According to the announcement, the acquisition creates the world's largest and most diversified global reinsurer. GE Insurance Solutions will be integrated into Swiss Re over the next 18 months. Swiss Re acquired GE Insurance Solutions for \$6.8 billion plus closing adjustments of \$0.6 billion, for a total of \$7.4 billion. (*Swiss Re Press Release, June 9, 2006*)
- Prudential Financial, Inc. announced the closing of its acquisition of Allstate Financial's variable annuity business through a reinsurance transaction. Prudential's initial investment in the business is approximately \$591 million. As part of the transaction, Prudential is granted exclusive distribution rights to sell variable annuity products through Allstate's proprietary distribution force of approximately 13,700 independent contractors and financial professionals. With respect to Allstate's Bank channel, Allstate Financial will continue to market variable annuity products through its set of bank distribution relationships by transitioning to an Allstate-branded, Prudential-designed variable annuity. (*Prudential Financial Press Release, June 1, 2006*)
- Great-West Lifeco Inc. announced that its U.S. subsidiary, Great-West Life & Annuity Insurance Company, has reached an agreement to acquire from Metropolitan Life Insurance Company and its affiliates, several parts of their full service-bundled, small and midsize 401(k), as well as some defined benefit plan business. The transaction is expected to close in the fourth quarter of 2006. (*Great-West Lifeco Inc. Press Release, June 26, 2006*)
- On May 11, Great-West Lifeco Inc. announced that its wholly owned United Kingdom subsidiary, Canada Life Limited (Canada Life), has reached an agreement with The Equitable Life Assurance Society (Equitable Life) in the UK to acquire the assets and liabilities associated with most of Equitable's not-for-profit pension annuity business. (*Great-West Lifeco Inc. Press Release, May 11, 2006*)
- Unity Life of Canada announced it has entered into an agreement to acquire the remaining Canadian block of individual life and health insurance business of The Prudential Insurance Company of America. According to the announcement, Unity life would assume Prudential's liabilities related to its Canadian Intermediate and Weekly Premium Life and Canadian Individual Health Insurance business. (*Unity Life Press Release, June 5, 2006*)
- On April 3, Lincoln National Corporation announced the completion of its merger with Jefferson-Pilot Corporation. The merged company will operate under the brand name, Lincoln Financial Group. (*Lincoln Financial Group Press Release, April 3, 2006*)
- AXA announced the signing of a definitive agreement to cede the business of AXA RE to Paris Re Holdings Limited. Paris Re Holdings is a newly created company with a capitalization of approximately \$1.5 billion, sponsored by a consortium of international investors led by Trident III, L.P., a fund managed by Stone Point Capital LLC., with other lead investors including Hellman & Friedman, Vestar Capital Partners, Crestview Capital Partners, ABN Amro, and New

Mountain Capital. AXA will take a stake of approximately 4 percent in Paris Re Holdings. Under the terms of the agreement, the business of AXA RE is expected to be ceded in 2007 to Paris Re Holdings. AXA will continue to manage underwriting and claims for 2006 and prior years. (*AXA Group Press Release, June 6, 2006*)

- Assurant, Inc., a provider of specialty insurance and insurance-related products and services, announced it has acquired all of the outstanding capital stock of Safeco Financial Institution Solutions, Inc. (Safeco FIS), a California corporation and indirect subsidiary of Safeco Corporation. Financial terms of the transaction were not disclosed. Safeco FIS is a provider of creditor-placed homeowners insurance and direct tracking services for mortgage lenders and servicers nationwide. (*Safeco Insurance Press Release, May 1, 2006*)

Risk Management

- On May 2, Risk Management Solutions (RMS) announced the completion of a probabilistic model for assessing the risk of influenza pandemics across multiple countries. Many published studies have already illustrated the effects of various pandemic scenarios, most commonly a repeat of the 1918 influenza pandemic that had a mortality level of 0.67 percent in the U.S. and even more severe effects in other countries. Analysis of the virology and epidemiological science shows that more severe pandemics are possible, and probabilistic estimation of virus characteristics incorporating the recent

H5N1 suggests that there is a one in five chance of a pandemic that is more severe than that experienced in 1918. H5N1, the virus that recently caused avian flu in Asia, has viral characteristics that will increase the likelihood of a virulent pandemic if it provides genetic material for human-to-human influenza transmission. RMS believes that many companies may be underestimating their risk if they assume that the 1918 pandemic is the worst-case scenario. The RMS® Influenza Pandemic Risk Model is intended to help insurers assess the losses they will experience from pandemics with all of the different permutations of potential characteristics and outcomes. (Risk Management Solutions Press Release, May 2, 2006)
RMS® is a registered mark of Risk Management Solutions.

- A new Special Report from the A.M. Best Co. on the impact of a possible “mega-cat” hurricane—\$100 billion or more in insured losses—finds that the financial consequences would be serious and widespread for the insurance industry and the public. Possible scenarios include unusually intense hurricanes striking portions of the Eastern United States from the Northeast to Florida. Insured claims could surpass \$100 billion, wreaking havoc on insurer financials. Indeed, anywhere from 20 to 40 insurers could be vulnerable to failure from that magnitude of U.S. insured property losses, according to A.M. Best’s statistical analysis in “2006 Annual Hurricane Study: Shake, Rattle and Roar.” The new report assesses how the U.S. property and casualty industry might be affected by a potential, perhaps likely, \$100 billion-plus insured

property loss—almost twice the catastrophe losses from last year’s hurricane season. Beyond the obvious impact on insurers’ financial solvency, policyholders could see delayed payment of claims and difficulty finding affordable coverage. Some insurers, facing scarce and more costly reinsurance, would seek to mitigate their exposures in high-value coastal areas. With the property and casualty industry’s 2005 policyholder surplus at \$434 billion, a loss of 20 percent or more of that amount begins at \$87 billion. (*A.M. Best Co. Press Release, June 1, 2006*)

- People on the Gulf Coast, devastated last year by Hurricanes Katrina and Rita, are fighting to rebuild, but are now facing a new enemy—fake insurance. The NAIC has received numerous reports of unauthorized insurance sales, taking advantage of devastated consumers across the region. Already, there have been several arrests of individuals selling unlicensed or bogus automobile insurance cards. Also, consumers should be aware of fake homeowners coverage. Consumers exposed to these fake insurance schemes face hundreds of thousands of dollars in unpaid repair costs for home or automobile damage caused by future disasters. (*NAIC Press Release, June 11, 2006*)
- Given the recent enhancements made to many catastrophe management tools available to the insurance industry, A.M. Best Co. said it is making modifications to its catastrophe stress test, which in some cases will require less capital for a company to support its catastrophe

exposure. A.M. Best Co. indicates that those companies that would be afforded additional leeway in the catastrophe stress test demonstrate a strong understanding of their catastrophe exposure, sound catastrophe risk management, and the financial flexibility to replace a significant amount of lost capital after an event. In establishing the level of capital requirements within the catastrophe stress tests, A.M. Best Co. indicated that it took into consideration expectations relating to data quality, overall catastrophe management, the historical accuracy of the catastrophe model output, and the potential for enhancements to the catastrophe models. (*A.M. Best Co. Press Release, April 10, 2006*)

- With global climate change likely to have a fundamental impact on business operations and financial returns for many companies, Marsh Inc. has issued a 32-page report examining this emerging global issue from a risk management perspective. Marsh announced that its report, "Climate Change: Business Risks and Solutions," describes the potential impact of climate change, or global warming, on business risk, including the strong threat of increasingly volatile weather conditions; resulting impacts on commercial insurance markets, business resources, personnel, and corporate preparedness; and increasing legal and regulatory pressures and mounting public and shareholder activism. According to Marsh, although climate risk affects almost every industry worldwide, its report notes

that businesses in the U.S. ultimately may face a multitude of potentially conflicting regulations. In the absence of U.S. government participation in the Kyoto Protocol, some U.S. cities, states, and regions have taken their own actions on climate change issues. (*Marsh Inc. Press Release, April 10, 2006*)

- With the centennial of the 1906 San Francisco earthquake occurring this year, a new study by the Insurance Information Network of California (IINC) and Fireman's Fund Insurance Company finds that only 22 percent of Californians consider themselves to be prepared for a disaster in their area. This is in spite of the fact that Californians believe that their state is prone to disasters. In the wake of Hurricane Katrina, Californians also do not believe that they should count on government to bail them out financially after the next catastrophe. Many respondents indicated, however, that government should play a role in the preparation for and recovery after a catastrophe. According to the executive director of IINC, while most Californians recognize the risk to the area they live in, most are not motivated to take the necessary precautions. (*Allianz Press Release, April 12, 2006*)
- RMS announced the results of a study analyzing the impacts of the 1906 San Francisco earthquake and fire based on the 2006 population and property exposures of the San Francisco Bay Area. The study provides a comprehensive update to a detailed contemporary reconstruction of the earthquake first published by RMS in

1995. The new 2006 RMS analysis reveals that an Mw7.9 earthquake on the northern section of the San Andreas Fault today would result in at least \$260 billion of damages to residential and commercial exposures, of which \$50-\$80 billion would be covered by property and workers' compensation insurers. In contrast to the 1906 event, where 80 percent of the losses were caused by fire, less than 15 percent of the estimated total insured property losses are expected to be fire related in 2006. The property and workers' compensation losses estimated in the RMS report include residential and commercial property and contents losses, as well as direct business interruption and additional living expenses due to ground shaking. In the RMS scenario, strong ground shaking affects 19 Bay Area counties, with an estimated building inventory value of approximately \$2 trillion for residential, commercial, and industrial properties. (*Risk Management Solutions Press Release, April 18, 2006*)

- Aon Re announced that it has developed a comprehensive Earthquake Viewing Guide that provides a range of potential loss outcomes based on possible earthquake events throughout the United States. The guide provides exposure summaries and probable maximum-loss outcomes for given ranges of magnitudes in earthquake-prone regions. Aon Re says that with this tool insurance companies can now utilize a unique methodology to assess earthquake loss potential. The Earthquake Viewing Guide can also assist in making decisions regarding

exposure accumulation, reinsurance capacity decisions, and capital utilization. (*Aon Press Release, April 18, 2006*)

International Focus and Globalization

- Swiss Re's recent sigma study reported that in 2005, the worldwide insurance industry wrote premiums amounting to a total of \$3,426 billion, which is 7.7 percent of worldwide economic value creation (GDP). The study found that life insurance grew by 3.9 percent over 2004 to \$1,974 billion and non-life increased by 0.6 percent to \$1,452 billion. Industrialized countries generated over four-fifths of world premiums of \$2,999 billion, but grew by only 1.9 percent. The emerging markets generated \$427 billion in premiums, attaining a growth rate of 6.9 percent. Further, the study found that South and East Asia reported particularly strong growth of 9.5 percent. (*Swiss Re Press Release, July 12, 2006*)
- According to an A.M. Best Co. special report in the May 8 issue of *BestWeek*, three key European nations—France, Germany, and Italy—mirrored one another in 2005 with strong premium increases in their life and health insurance markets. The French, German, and Italian life and health markets are expected to continue to move in line with their respective 2005 growth rates of 14 percent, 6.9 percent, and 12 percent. As the life and health markets enjoyed robust growth, the non-life markets, especially the motor lines in France and Germany, showed some softening, driven in part by competition from outside entrants such as bancassurers and direct insurers, A.M. Best Co. reports. Unlike its European neighbors, the Italian non-life market has grown despite an overall weak economic environment. (*A.M. Best Co. Press Release, May 5, 2006*)
- The rampant costs of asbestos-related claims in the United States are worrying British insurers and lawyers, who are concerned the unique structure of the UK legal system, which has kept runaway litigation at bay, eventually may be breached, according to an article in the May 15 issue of *BestWeek*. Speaking at a seminar on the London market held in New York City, Richard Hopley, partner with the London law firm Kendall Freeman, said the United Kingdom "almost certainly" has the second largest asbestos liability problem in the world, after the United States. He also indicated that in some ways, the UK problem is more severe as there is greater exposure to so-called "blue" asbestos, the most dangerous form of the substance. (*A.M. Best Co. Press Release, May 12, 2006*)
- American International Assurance Company, Limited (AIA), a subsidiary of American International Group, Inc. (AIG), announced that it has received approvals from the China Insurance Regulatory Commission (CIRC) to conduct group insurance business throughout AIA's operations in China. With the approvals, AIA is authorized to issue a single group policy contract covering a range of insurance products, including group life insurance, personal accident and health insurance, medical insurance, and annuities. The single policy contract can cover a defined group of five or more people, enabling organizations to purchase policies for their workforces and their family members. Additionally, AIG announced that its life and general insurance subsidiaries in China, AIA and AIU Insurance Company Inc., respectively, have received approvals from the CIRC for expansion throughout Guangdong province. Approval has also been received for its life insurance subsidiary for expansion throughout Jiangsu province. The approvals enable branches of the two AIG subsidiaries to expand in Guangdong province and Jiangsu province. Guangdong province and Jiangsu province, with populations of 91 million people and 74 million people, respectively, are two of the top three Chinese provinces in terms of total economic activity. With their burgeoning middle classes, these provinces have a growing need for insurance products catering to both the individual and small business sectors. (*American International Group Press Release, May 15 and 26, 2006*)
- Zurich Financial Services Group (Zurich) has been granted a business license to establish a general insurance branch in Beijing by the State Administration for Industry and Commerce (SAIC), after receiving approval from the CIRC. According to Zurich, the company is the first foreign insurer to have been granted a license to establish a general insurance branch in Beijing. The new unit, Zurich Insurance Company Beijing Branch, will focus on serving corporate

customers, including foreign customers with activities in China and large and medium sized enterprises from China, particularly those with business overseas. (*Zurich Financial Services Group Press Release, May 22, 2006*)

- RMS announced a partnership with the China Earthquake Administration scientific and engineering arm, the Institute of Engineering Mechanics (IEM). The first product from the collaboration will be a fully probabilistic earthquake model covering the whole of China, for which RMS and IEM have already completed several months of development work. The model will utilize state-of-the-art modeling methodologies coupled with high-quality hazard, inventory, and vulnerability data. Recognizing the growing importance of this region for catastrophe risk management, RMS will be releasing the model in early 2007. (*Risk Management Solutions Press Release, May 16, 2006*)

e-Business and Technology

- The insurance software market is large and growing, according to Celent's new report "The Coming Wave of Consolidation in Insurance Software." Celent estimates that annual enterprise software spending by insurers in North America, Europe, Japan, and China stands at roughly \$10 billion in 2006 and will grow to nearly \$15 billion in 2011. In the U.S. alone, there are over 150 firms serving this market, and Celent believes that the industry is ripe for consolidation. The report provides an overview of the market, the reasons

for this upcoming consolidation, and projections for what the space will look like in 2011. Celent expects the hottest sectors to be property and casualty policy administration and claims. Other sectors will include billing, life policy administration, illustrations, business intelligence, and possibly document management. Celent also expects substantial acquisitions in Europe and China. (*Celent Press Release, May 17, 2006*)

- Companies that are best at controlling healthcare costs are more likely to offer multifaceted Internet tools that help employees model healthcare options, a study by Watson Wyatt and the National Business Group on Health has found. A majority (58 percent) of the 585 companies surveyed provide Internet resources that allow employees to compare healthcare insurance options side by side, but companies that are best at controlling costs offer additional Web tools. They are 38 percent more likely to provide quality comparison tools and 36 percent more likely to provide tools to model the tax impact of healthcare decisions, such as signing up for a flexible spending account. In addition, while only a small number of companies offer Internet resources for provider pricing, those best at controlling costs are 108 percent more likely to do so. (*Watson Wyatt Press Release, May 25, 2006*)

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Analysis and Commentary

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Health Insurers Try Cutting Fraud by Not Cutting Checks By Christopher Westfall, Managing Editor, *Insurance Insider* May 26, 2006

Health insurers are experimenting with stopping fraud at a critical juncture: before claims are paid.

An offshoot of fraud detection systems used in the credit card business, "predictive analysis" tracks patterns of fraudulent behavior in order to flag suspicious insurance claims. This gives insurers the ability to review or deny claims prior to disbursement, after which getting back ill-gotten gains becomes difficult.

Industry professionals say that predictive analysis is not an off-the-shelf software program that health insurers can simply upload and forget. Executives need to commit time, money and staff in order to tailor an effective program.

And the engine that drives predictive analysis—claims data—needs to be broad and rich enough to find meaningful fraud patterns.

But despite the costs, predictive analysis may be one of the better bets to stem in an industry that loses an estimated \$85 billion a year to scams.

"Many insurers are recognizing that current methods of fraud detection are not effective at preventing fraud losses," says James Littlely, a principal with KPMG Forensics in Philadelphia. "New methods need to be utilized to stop fraud at an earlier point in the claims payment process."

Predictive analysis searches past information for trends in future behavior. Computer systems compare information in a database and then look for matches against preprogrammed assumptions or conflicts with prior experience.

In the credit card business, predictive analysis looks for abnormal buying patterns or charges from unusual locations. A suspicious transaction can be stopped, or a retailer or customer is contacted to ensure the card has not been stolen.

Predictive analytics is just now being used in health insurance, Littlely says. To track down fraud, health insurers have depended on the "pay and chase" method: paying a claim and then monitoring behavior for suspicious transactions. The goal is to gain enough evidence in order to prosecute.

But even when an insurer can prove fraudulent activity, the firm needs to go through the legal system to reclaim the funds, which is expensive and often futile.

"Insurers understand that many times they are not able to reclaim any funds—at most, it would be a small portion of the loss," Littlely says. "More often than not, they find that the person or group responsible [has] no money left. Or some sophisticated scheme has moved the assets out of their reach."

And changes in Medicare and Medicaid are attracting more organized and elaborate fraud schemes, said Byron Hollis, national anti-fraud director for the Blue Cross Blue Shield Association, at a recent insurance fraud conference sponsored by the Association of Certified Fraud Examiners.

As private insurers become more involved through Medicare Part D, the new prescription drug benefit, large criminal rings are keen to siphon off from the hundreds of millions of dollars involved in the program.

"Health care fraud used to be limited to providers or subscribers," Hollis said. "Now we are seeing common street thugs. They figure why [should they] risk doing 20 years for [selling] illicit drugs when they can focus on health care fraud, where the harshest penalties are five years or a slap on the wrist?"

Hollis noted a California case in which a chain of surgery clinics has been accused of recruiting patients to conduct nearly \$100 million in unnecessary surgeries and procedures. The complexity of the scheme—which involved nine surgery centers, 5,000 patients, several surgeons and support staff—illustrates the sheer size of the health insurance fraud problem today.

The major benefit of predictive analytics is that health insurers can vet claims before payment, says John Powers, vice president of The Sentinel Group, an anti-fraud unit of Trustmark Insurance Company in Lake Forest, Ill.

"It saves time because it's getting harder to get the money back in," Powers says. "[Analytics] allows us to focus on a claim before a bill is paid and before a claim check is sent."

This has become especially important as insurers are increasing the quality of their anti-fraud programs, rather than simply having them seen as deterrents for the next fraud scheme. "We are starting to see recoveries," Powers says. "And that's very important given the cost [of predictive analysis]. We are getting [return on investment] and getting some money back."

Although models vary between technology providers such as SAS, IBM, and SPSS, they are all designed to make computers flag suspicious claims, says Marcel Holsheimer, vice president of vertical product marketing for SPSS, a predictive analytics provider based in Chicago.

The SPSS models take insurers' claims data and matches it against more than 200 health care fraud indicators such as improper procedure codes and large differences between actual and projected costs. Suspicious claims can be sent to a fraud examiner or to the insurers' special investigations unit.

"[Predictive analysis] has been a technology that has been around for 30 years, and now we are adopting it to a new set of circumstances," Holsheimer says.

Despite the technology's promise, the cost and support needed for predictive analysis may be hampering its widespread use. "When insurers buy these tools they understand that there is a big upfront cost," Powers says. "But the bigger cost that is not really understood is [the cost of] dedicating the staff and resources to develop the tool."

Carriers need to train and dedicate personnel to make sure the claims data is up to date and the model is working correctly. "That's the biggest difficulty I see in this becoming a common practice," Powers says.

KPMG's Littley says that carriers need to understand that predictive analysis requires a substantial investment in back-office support. "There is some resistance [among health insurers] because of the infrastructure cost," he says. "These systems need to be monitored and staff needs to be dedicated to keeping the information up-to-date. There can also be a significant cost involved with new hardware and software."

In addition, the large amounts of claims data needed for predictive analysis could put off smaller insurers. "They don't see it working for them because they don't have the vast amount of data that the larger carriers have in order for predictive analytics to be cost-effective," he says.

One answer could entail carriers pooling claims data through a third party, says Sentinel Group's Powers. "If you are a small or mid-sized carrier, you need to pool your resources," he says. "But that solution is really not available right now."

Even given the cost and data barriers, however, SPSS's Holsheimer says that predictive analytics will ultimately prove its value to health insurers. "Right now, health insurance companies are only detecting half a percent of the fraud in the system," he says. "If a carrier could just bring that up to three percent, that is a huge amount of money that is being saved."

Network Security Looks Inside the Perimeter

**By Dave Pelland, Managing Editor, *Technology Insider*
June 2, 2006**

The need to protect internal data and intellectual property is causing more companies to improve their network defenses against employees and other authorized users.

"Companies are concerned that their intellectual property is their core asset, and want to be sure it's protected on the network," says Shahed Latif, an advisory partner and Western leader for information protection services for KPMG based in Mountain View, Calif.

"They realize their networks are a lot more open because many processes are connected to the Internet and their business partners," Latif says.

A stronger focus on the network's interior defenses complements traditional security efforts, which are designed to control outside access. Most organizations assumed threats would come from hackers or other unauthorized users, and corporate network security was built around the principle that they could trust their employees.

But with companies routinely allowing temporary employees, outside contractors and business partners to use network resources such as customer databases or supply chain applications, it's become imperative to guard against internal data being accessed or copied inappropriately.

For instance, two workers at Connecticut's Dept. of Motor Vehicles pleaded guilty to selling driver's licenses

and identity cards to illegal immigrants and criminals. And in March, a former automaker security guard was charged with stealing information that allowed him to access an employee vehicle database. The guard allegedly sent annoying e-mails to some employees.

"The perimeter was originally built to keep the insiders in and the outsiders out," says David M. Lynch, vice president of product marketing for Brea, Calif.-based Apani Networks. "In today's world, sometimes you have more outsiders legitimately inside the network than you have insiders, and your insiders are so mobile that they're largely outside the perimeter."

In addition, compliance regulations mandating that companies document their controls against internal fraud are also leading to stronger internal security measures.

In response, companies are taking several steps, such as assigning users to specific network segments or applications based on their role. For example, a sales manager could be given access to regional revenue data, but not the finance department's servers.

Similarly, guest users like consultants or contract workers can be granted access to specific functions, such as Web browsing or e-mail, while still being walled off from more sensitive applications or data.

In some instances, companies are placing small software programs known as "agents" on servers, as well as computers and devices used to access network resources. When a server receives a request for data or to launch an application, the agent compares the request with the rights associated with

specific users or devices. If access is granted, the data is encrypted as it travels over the network to guard against unauthorized access or interception.

"Network access isn't a 'yes-no question' anymore," says Roy Chua, a vice president of software provider Identity Engines, based in Mountain View. "More companies are segmenting their networks and giving different users different rights based on their roles and the company's policies. Companies are taking policy enforcement and driving it down to specific devices."

KPMG's Latif says more companies are also exploring single-sign-on technology that allows a user to retain the same ID and password for different network resources.

"From an efficiency perspective, it's easier for the user to have one credential," Latif says. "From a risk perspective, it's stronger protection because if the user has to remember five passwords, you can guarantee they're going to write them down or use easily guessable passwords. There's a greater exposure than them having one strong credential to protect the network."

According to Latif, another problem arises when employees changing jobs keep their original job's permissions while receiving additional access rights associated with the new position. Over time, this can lead to employees having much broader rights than they need.

In another approach, companies are monitoring network traffic and associating it with specific users. By tracking where users go and what they do within the network, it becomes easier to identify unauthorized activity for reviews or audits.

"Companies are saying that they have to know not only who's on the network, but also what applications and data are being accessed," says Scott Ruple, vice president of marketing for San Jose-based software provider PacketMotion.

Similarly, software that links IP addresses to directories of authorized users can monitor network traffic and automatically associate IP address with specific users and devices, says Ermis Sfakiyanudis, president and CEO of security software firm eTelemetry, based in Annapolis, Md.

Server logs traditionally track network activity by the IP addresses assigned to the PCs or handheld devices that access the servers. But because different IP addresses are assigned when devices log onto the network, it can be difficult and time-consuming to track unauthorized activity to a specific user.

If a user attempts to access unauthorized data, an alert can be sent to a network engineer, who can then call the person to get them to shut down their machine, or they can remotely kick the machine off the network.

Similar steps are being taken to secure e-mail communications, according to Curtis Cresta, vice president and general manager of North American operations for security firm F-Secure in San Jose. Companies are examining the content of inbound and outbound e-mail to prevent inappropriate language or trade secrets from leaving the network.

In addition, if an employee downloads a virus to a laptop, e-mail monitoring software can detect it and prevent the device from further infecting the network.

"There may be certain e-mails that you don't want leaving a company," says Cresta. "For example, you don't want an engineer e-mailing source code or other secrets to an outsider. Even if that engineer was sending the information by mistake to the wrong person, you still need protection against errors as well as malicious behavior."

Insurers Balance Supply and Demand (Surge)

By Christopher Westfall, Managing Editor, *Insurance Insider* March 17, 2006

One issue that came to light with last year's hurricanes is how to accurately predict the spike in material and labor prices following a catastrophe. Known as "demand surge," such spikes could become one of the biggest drivers of insured losses in years to come.

With rebuilding costs spiking as much as 25 percent following Hurricane Katrina, insurers and state regulators have been forced to confront the problem.

"Since the 2004 hurricane season, demand surge has become an increasingly important issue in the property/casualty industry," says Pat Teufel, principal with KPMG's Actuarial Services practice. "And with [Hurricanes] Katrina and Wilma last year, insurers are starting to think about anticipating demand surge when they are writing their policies."

Demand surge occurs when construction materials and labor are in short supply following a disaster. The resulting "post-event inflation" raises construction and rebuilding costs.

For example, materials such as plywood and nails become scarce because of

massive demand following a disaster; at the same time, roads and bridges may have become impassable, cutting off supply. The labor pool also becomes thin as homeowners compete to have their property repaired.

Demand surge only dissipates as additional labor and materials come back to the affected area, which usually depends on the extent of the damage.

Demand surge is critical for insurers because payouts on homeowners' policies are based on replacement costs. So if the price of rebuilding spikes after a catastrophe, the insurers claims costs will rise greater than anticipated.

The larger the impact of the event on the local economy, the larger the effect of demand surge, says Thomas Larsen, senior vice president of the risk modeling firm Eqecat in Oakland, Calif. A hurricane causing \$5 billion in losses might cause demand surge to increase construction costs five percent, while a hurricane like Katrina with over \$40 billion in losses could increase construction costs 25 percent or higher.

"[Demand surge] has always been there, but the question everyone is asking now is 'How do we measure it?'" Larsen says. "After Hurricane Andrew [in 1994] it became something that was very noticeable, with demand surge increasing [labor and material] prices as much as five percent."

Larsen says that Eqecat and other risk modeling firms are reviewing how to improve their models' ability to forecast demand surge, but there are limits and challenges to getting the most accurate predictions.

"You really need quantitative data that you can depend on and is specific," he says. "A lot of people want to put in a single number, but it depends on the region and the makeup of the economy."

For example, since Florida is a peninsula, it is often harder to move supplies into affected areas than in other regions, Larsen says. Or if a catastrophe hits a state with a high unemployment rate, it would be easier to find available labor than a region undergoing a housing boom.

Katrina exemplified the limits of catastrophe models and demand surge, according to a Moody's report. Many of the models in place did not accurately predict demand surge in some pockets where labor and material prices rose as much as 60 percent.

Many reinsurers did not anticipate the huge demand surge, causing them to dip into reserves to pay claims and causing some significant downgrades.

"As difficult as all of these things make it for primary insurers to estimate losses, it is all the more difficult for reinsurers," according to the Moody's report. "For definitive estimates of their own losses, reinsurers depend on claims notices from their primary companies. This puts reinsurers in the position of having to make their initial estimates with very limited or poor-quality data."

There are other aspects of demand surge that may be even more difficult to quantify, but are as important, says Marcellus Andrews, an economist with the Insurance Information Institute in Washington, D.C. "There is a global excess demand that is having an effect on material prices in some of the states recovering from Katrina, Rita and Wilma," he says.

Andrews says that as materials demand from China and India keeps rising, it will add to the cost of rebuilding the Gulf Coast—or after any other catastrophe.

Insurers are not only having to deal with the demand surge surprise of last year, but how to include the results into models, in order to convince regulators for appropriate rate adjustments.

“If [demand surge is included in catastrophe models], it’s got to be done right,” says David Nye, a professor of business and the director of the Florida Insurance Research Center at the University of Florida.

Nye, who served on the Florida Commission of Hurricane Loss Projection Methodology, says that the Sunshine State was one of the first to approve demand surge in 1994 as a factor in catastrophe modeling and pricing.

“We realized that it was possible to balance the supply-demand equation quickly after most storms, but there are large events where the effect is fairly sustained,” Nye says.

Educating regulators nationwide on demand surge is one of the most challenging jobs for the insurance industry, KPMG’s Teufel says. “There is always a tug and pull for evidence for regulators to set appropriate rate actions,” she says.

The information provided in the preceding articles is of a general nature and is not intended to address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought. The views and opinions are those of the author and do not necessarily represent the views and opinions of KPMG LLP.

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