



INSURANCE

The State of the Insurance Industry

Winter 2005

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Contents

	Page
Changes & Trends	
Industry Overview	2
– General Highlights	2
– Property & Casualty	2
– Life & Health	3
– Reinsurance	4
Earnings	4
Regulatory Issues	4
Legislative Issues	5
Accounting Standards and Developments	6
Taxation	8
Market Forces	
Consolidation and Convergence	12
International Focus and Globalization	13
e-Business and Technology	13
Risk Management	14
KPMG Insurance Insider	
Analysis and Commentary	15

Changes & Trends

Industry Overview

General Highlights

■ On December 26, 2004, near the Indonesian island of Sumatra, an earthquake with a magnitude of 9.0 on the Richter scale, the strongest in 40 years, triggered tsunamis that caused widespread death and massive damage to coastal areas around the Indian Ocean. The countries suffering the most damage include Indonesia, India, Sri Lanka, and Thailand. Losses have also been reported from Malaysia, Bangladesh, Myanmar, the Maldives, and the Horn of Africa. While it is too early to provide an accurate estimate of the damage, it is thought that insurance property losses are likely to be limited, as the insurance penetration in the coastal areas of these countries and the concentration of value is comparatively low. According to Swiss Re, most of the insured losses likely will be for property damage and business interruption. (*Swiss Re Press Release, December 30, 2004*)

Munich Re has been documenting and analyzing all reports of natural hazard events with a large number of human losses throughout the world over the past 30 years. In 2004, there were approximately 650 natural catastrophes recorded, most of which were due to weather-related events. According to Dr. Gerhard Berz, the head of Geo Risks Research at Munich Re, these weather-related events confirm their assumptions that climate change, most likely triggered by human activity, will cause an increase in the frequency and intensity of such catastrophes. According to the Munich Re release, the findings of their continuing research underline a need for measures to be taken against global climate change. (*Press Release, Munich Re, December 18, 2004*)

■ KPMG Canada conducted a survey at its 13th Annual Insurance Industry Conference, held in October 2004, to investigate current issues in the Canadian insurance marketplace. The majority of the Canadian senior insurance executives who responded to the survey are generally more confident regarding the increase in premium growth for the life and health industry than that of the property and casualty industry. Where applicable, the survey results are compared to the results of the KPMG U.S. survey conducted during KPMG's 15th Annual Insurance Industry Conference held in New York in September. Canadian respondents are generally more optimistic about the insurance industry's ability to increase margins over the next one to three years than the U.S. respondents. Other key survey findings include:

- The risk posing the greatest threat to the Canadian insurance industry is regulatory/market conduct, followed by concentration of risk, and capital deployment.
- Major competition is seen from other insurance companies, followed by banks, over the next three to five years.
- Most important areas for future growth are customer focus and underwriting.
- Forty-nine percent of the respondents expect mergers and acquisitions to increase in the next 12 months.
- Legislation that will most affect the way companies do business – 31 percent cited Sarbanes-Oxley and 27 percent cited the potential provisional automotive insurance reforms.

(2004 KPMG Insurance Issues Conference Survey Results, Canada, October 2004)

Property & Casualty

■ Despite the major hurricane losses posted during the third quarter of 2004, the U.S. property/casualty industry reported very strong nine-month 2004 operating results, driven by underwriting income of an estimated \$3.4 billion, according to A.M. Best Co. During the third quarter of 2004, and just after companies reported very strong operating results for the first half of the year, four devastating hurricanes hit the Southeastern United States within a period of six weeks. A.M. Best Co. estimated that 55 to 70 percent of the loss was incurred by U.S. insurers, and contributed to the worst-ever third-quarter catastrophe loss reported by the industry. However, strong underwriting results and improved investment income contributed to the reported pretax operating income of nearly \$32.4 billion for the nine months of 2004 — a 38.5 percent increase over the same period of 2003. According to A.M. Best Co. data, the combined ratio improved to 97.8, from 100 in 2003. The industry's continued improvement in the combined ratio was driven by a 2.5 point decline in the loss and loss adjustment expense ratio. Contributing to keeping the combined ratio below 100 is the surge in earned premiums, which increased an estimated 7.4 percent over the prior year. According to A.M. Best Co., this will likely continue into 2005, as premiums will earn on the rate increases applied during prior pricing periods. However, it is not sustainable, according to A.M. Best Co., given the gap between the percentage increases in net written premiums vs. net premiums earned, which highlights the reduction in premium writings that will affect earned premium results in 2006. (*A.M. Best Co. Press Release, December 27, 2004*)

- U.S. property/casualty insurers suffered a record \$21.3 billion in insured property loss from eight catastrophic events during the third quarter of 2004, according to preliminary estimates by ISO's Property Claim Services unit. This compares with insured losses of \$3.7 billion in third quarter 2003. For the first nine months of the year, losses due to catastrophes stood at \$24.7 billion, more than twice the amount of \$10.2 billion for the same nine-month period in 2003. Over eighty percent of the loss (more than \$21 billion) stemmed from four hurricanes that made landfall during the quarter. The remainder of the loss was due to Tropical Storm Gaston and three wind and thunderstorm events. (*Insurance Service Office Press Releases, November 2, 2004 and January 7, 2005*)
- A preliminary assessment of the impact of the recently announced verdict indicated that the 9/11 attack on the World Trade Center was two insurable events. According to A.M. Best Co., the two-occurrence verdict would result in an additional \$1.1 billion of losses for the nine insurers named in the lawsuit and their reinsurers. Given the overall financial strength of each of the companies, and their favorable 2004 earnings to date, A.M. Best does not believe this decision itself will result in any rating changes for the insurers affected nor their reinsurers. (*A.M. Best Co. Press Release, December 9, 2004*)
- A.M. Best Co. announced in October 2004 that despite almost \$47 billion in reserve charges taken between 2001 and 2003, the property/casualty industry continued to carry substantial reserve shortfalls. According to the rating agency, reserves are deficient by as much as \$67.0 billion. About \$38.5 billion of the shortfall is related to unfunded asbestos and environmental losses and \$28.5 billion is related to core loss and loss-adjustment expense reserves. A.M. Best also noted that it expected adverse reserve adjustments to continue in the near- and mid-term future, particularly for commercial lines and reinsurance. (*A.M. Best Co. Press Release, October 5, 2004*)
- More than one in four auto accidents resulted in bodily injury liability (BI) claims in 2003, according to a recent study by the Insurance Research Council (IRC). The study, "Trends in Auto Injury Claims, 2004 Edition," reveals that BI claim rates have remained high even though IRC research suggests that auto accident rates and the seriousness of auto injuries have decreased in recent years. People who are injured in auto accidents not only receive compensation for medical treatment and other accident-related expenses under the BI coverage, but also they receive compensation for the pain and suffering and emotional distress associated with their auto injuries. (*Insurance Research Council Press Release, January 24, 2005*)
- The trend toward increasing insurance rates for physicians and hospital professionals may slow in 2005, according to a study released in October by Aon risk services experts. Aon's Hospital Professional Liability and Physician Liability 2004 Benchmark Analysis revealed that claims costs in 2004 are trending at 8 percent — the lowest level in the study's five-year history. Using ten years of loss data and measuring trends in loss costs, claims frequency, and claims severity, the study revealed that trends in both the frequency (0.5 percent) and severity (7.5 percent) of claims are contributing to the overall 8 percent annual trend rate. According to Aon, its analysis reinforced past findings that indicated that increasing claim sizes is the major factor driving increased hospital and physician professional liability costs, while the frequency of claims has remained steady. (*Aon Press Release, October 12, 2004*)
- A spokesperson for the Insurance Bureau of Canada (IBC) said on January 18 that Ontario auto insurance consumers will save an estimated \$900 million in 2005 as a direct result of a financially stronger, more competitive insurance industry, and essential reforms undertaken by the Ontario government. This announcement was made in response to the release by the Financial Services Commission of Ontario (FSCO) of approved auto insurance rate changes for fourth quarter 2004. Rates are now 10.6 percent lower than they were a year ago. Additionally, according to industry data collected by IBC, premiums for private passenger vehicles in Ontario have actually gone down by 12 percent since November 2003. (*Insurance Bureau of Canada Press Release, January 18, 2005*)
- ISO reported on December 14 that a new study by the IRC found that auto injury claims in four no-fault states have escalated at very different rates. The IRC report, "Analysis of Auto Injury Insurance Claims in Four No-Fault States," found that from 1997 to 2002 average claims increased by 122 per-cent in Colorado, 60 percent in New York, 37 percent in Florida, and just 2 percent in Michigan, which also had fewer claims per number of insured drivers. Currently, 12 states have no-fault insurance, and although Colorado repealed its no-fault insurance in July 2003 and reverted to a tort system, the ISO release indicates it still has a backlog of claims to settle. Following the release of the study, ISO has identified three key areas where it is indicated that software can help reduce the dramatic rise in no-fault auto insurance claims costs. According to ISO, companies should examine procedures to combat the massive increase in fraud, control spiraling personal injury protection costs, and determine thresholds to control payments. (*ISO Press Release, December 14, 2004*)

Life & Health

- Interest rate risk, market consolidation, and the implementation of enterprise risk manage (ERM) are key concerns for North American life insurance

company CFOs going into 2005, according to the latest CFO survey from the Tillinghast business of Towers Perrin. The majority of the CFOs surveyed identified the competitive and economic environments as the top two challenges for achieving their companies' growth, profit, and risk management objectives in 2005. Nearly two-thirds of the respondents said that regulatory issues are causing them to enhance ERM practices; however, almost all of the companies feel at least somewhat unprepared to address these challenges. Nearly all respondents indicated interest rate risk as their top concern about the economic environment, although the nature of the specific interest rate concerns varied. Other findings of the survey indicated that CFO confidence was down significantly from the CFO survey conducted in 2003 with respect to preparedness to address distribution and expense issues. Looking to 2005, the majority of respondents indicate they expect significant growth in year-over-year annuity sales, while life sales are expected to remain flat. (*Towers Perrin Press Release, November 30, 2004*)

- The combined net assets of U.S. variable annuities stood at \$1.0 trillion at the end of the third quarter 2004, unchanged from second-quarter levels, according to statistics released by the National Association for Variable Annuities (NAVA) in December 2004. Net assets for the industry increased by 12.9 percent relative to the third quarter 2003. Total variable annuity premium flow, or total sales, for the third quarter 2004 was \$30.0 billion, a 5.8 percent decrease from the same quarter in 2003. The mix of net assets by investment objective showed that \$564.0 billion, or 53.8 percent of assets, were held in equity accounts at quarter end, an increase of 21.1 percent compared with the same period in 2003. (*National Association for Variable Annuities Press Release, December 1, 2004*)

- According to the 2004 MetLife Market Survey of Nursing Home and Home Care Costs released in September 2004, the average cost of a private room in a nursing home in the U.S. has increased to \$70,080 per year, or \$192 per day, from \$66,065, or \$181 per day, in 2003. The average length of stay in a nursing home for current residents is 2.4 years. The study also found that the cost of a home health care aide averaged \$18 per hour nationally, unchanged from 2003.

In another study, 2004 MetLife Market Survey of Assisted Living Costs, released in October 2004, it was reported that assisted living in the U.S. costs an average of \$2,524 per month, or \$30,288 per year, compared with \$2,379 per month, or \$28,548 per year, in 2003. According to MetLife, assisted living is becoming a popular option with older Americans who are seeking support but want to remain independent. Assisted living facilities are typically not funded through Medicaid, although a number of states are starting to provide payment. MetLife indicates that the majority of residents in assisted living facilities pay privately or through long-term care insurance policies. (*MetLife Press Releases, September 27, and October 25, 2004*)

Reinsurance

- On October 18, ING Group (ING) announced that the company planned to exit the individual life reinsurance market in the United States. As a result, ING has signed a co-insurance agreement with Scottish Re under which Scottish Re would reinsure the individual life reinsurance business of ING Re. ING will transfer all assets and reinsure the liabilities of the business through Scottish Re. ING will pay Scottish Re a ceding commission of EUR 450 million (approximately USD 560 million). Scottish Re would assume the obligations of the business, including client service, administration, and claims payments.

All future business after the closing of the transaction, expected during the fourth quarter of 2004, will be written by Scottish Re. (*ING Group Press Release, October 18, 2004*)

Earnings

Fourth quarter 2004 insurance company earnings will be published by KPMG *Insurance Insider* once all financial statements become available, which is generally four to six weeks after the close of the quarter. For a complimentary subscription, please go to www.kpmginsiders.com to register. For additional information on KPMG *Insurance Insider*, please see the section at the end of this publication.

Regulatory Issues

■ Insurance Broker Disclosures — Proposed Model Legislation

The National Association of Insurance Commissioners (NAIC), at the Winter National Meeting, held public hearings on a proposed model legislation focusing on producer commission disclosures. A general theme, at the hearings, was for state insurance regulators to adopt some form of commission disclosure rules for insurance producers by the end of the year. This goal was triggered by the current litigation and probes against several prominent insurance brokers, alleging actions of bid rigging and client steering in order for the broker to obtain substantial contingent commissions.

The hearing focused on the draft model legislation, which would amend the NAIC's current Producer Licensing Model Act. The hearing participants consisted of state regulators, consumer advocates, producer trade organizations, and various insurance carriers. The key components within the draft model legislation would require:

- Producers to first obtain the insured's written consent before

- receiving compensation from the insurer for the same transaction.
- Producers to disclose the amount of compensation from the insurer and the method for calculating the compensation, including any contingent compensation.
- Producers to provide, in cases where the contingent commission is not known, a reasonable estimate of the amount and method for calculating such compensation.
- Producers to disclose to customers: (i) that the producer will receive compensation from the insurer, (ii) that the compensation received by the producer may differ depending upon the product and insurer and (iii) that the producer may receive additional compensation from the insurer based upon other factors, such as premium volume placed with a particular insurer and loss or claims experience.

The public hearing was conducted by a recently formed NAIC Executive Task Force on Brokers Activities, comprised of the following 13 states: California, Connecticut, Georgia, Illinois, Maine, Missouri, Montana, New Jersey, New York, Oregon, Pennsylvania, South Carolina, and Texas.

The task force is pursuing a three-pronged action plan designed to coordinate multi-state interest and inquiries, leverage state expertise and resources, and engage consumers. The three-pronged approach involves creating:

- Greater Transparency on Broker Compensation: The Task Force was charged with developing a model for brokers' disclosure of compensation, which was the subject of the hearings described above.
- Full Inquiry and Coordination: The Task Force was charged with developing and coordinating implementation of a uniform inquiry "template" for states to query domestic insurers and brokers doing business in their respective states.

- A Mechanism for Fraud Reporting: The Task Force was charged with launching an on-line fraud reporting mechanism to allow for anonymous reporting of unscrupulous business practices for investigation by the states.

■ **Insolvency – Catastrophic Losses**

The Catastrophe Insurance Working Group (CIWG) met at the Winter National Meeting to discuss issues related to natural disasters. Regulators indicated that hurricanes have resulted in 1.5 million claims, with insured losses estimated to be over \$20 billion in Florida. CIWG indicated that as many as 12 insurers became insolvent following the aftermath of the 1992 hurricane, while only one insolvency is expected from the four 2004 hurricanes. The Working Group attributed this change to the following regulatory actions:

- A moratorium was issued to prohibit insurers from non-renewing no more than ten percent of its business in any one county and five percent statewide;
- Creation of the Florida Residential Property and Casualty Joint Underwriting Association as an insurer of last resort (known as Citizens Property Insurance);
- Creation of the Hurricane Catastrophe Fund to ensure that reinsurance coverage is available to insurers;
- Closely monitoring and encouraging rate adequacy for insurers so they are able to pay claims from the four storms; and
- Implementing tougher building codes so that housing stock is better able to withstand hurricane winds and storm surge.

During the meeting, CIWG heard from the Federal Emergency Management Agency (FEMA) on the implementation of Section 207 of Senate Bill 2238. This section of the Bill requires the Director of FEMA to work with states

and the insurance industry to establish minimum training and continuing education requirements for insurance producers that sell flood insurance.

The FEMA representative encouraged states that do not currently include flood insurance provisions in producer licensing tests and continuing education to consider enacting a section of a National Conference of Insurance Legislators model law that deals with the topic.

(NAIC Press Releases: October 20, November 1, November 16, 2004; NAIC Winter National Meeting, December 4-7, 2004)

Legislative Issues

■ **House Financial Services Committee Moves on Legislation**

On September 29, the House Financial Services Committee successfully passed legislation to extend the terrorism reinsurance program for two years. H.R. 4634, the "Terrorism Insurance Backstop Extension Act of 2004," would extend the terrorism risk insurance program for two years to ensure continued availability of commercial property and casualty insurance and reinsurance. An amendment was added to this bill that would increase the industry's retention of risk and insurer deductibles to encourage private insurers to develop long-term solutions for the risk of terrorism. *(KPMG's The Washington Report, October 4, 2004)*

KPMG hosts *Regulatory Perspectives*, a quarterly teleconference briefing for clients on important legislative and regulatory activities specific to the financial services industry. For more information about *Regulatory Perspectives*, or to register for future teleconferences, please send an e-mail message to mcedre@kpmg.com and include your name, title, company name, and e-mail address. You will be notified via e-mail regarding future teleconferences.

To receive KPMG's regulatory and legislative reports electronically, please send an e-mail message to fsregpubs@kpmg.com for any of the following:

- *Washington Report*
- *Regulatory Practice Letters*
- *Legislative Practice Letters*
- *Compliance and Regulatory Focus*

These reports also can be accessed through KPMG's Web site at www.us.kpmg.com (Financial Services industry).

Accounting Standards and Developments

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

■ **Some Accelerated Filers Get Extra 45 Days to File Reports on Internal Control over Financial Reporting**
 "Accelerated filers" with less than \$700 million in "public float" have an extra 45 days to file both the management and auditor reports on internal control over financial reporting required by SEC rules implementing Section 404 of the Sarbanes-Oxley Act, according to an exemptive order released on November 30, 2004. The exemptive order allows qualifying accelerated filers with fiscal years ending between and including November 15, 2004 and February 28, 2005 to initially omit the reports on internal control over financial reporting from their upcoming filings on Form 10-K and submit them later as an amendment, as long as they comply with the exemptive order's disclosure requirements.

■ **Tax Services and Auditor Independence**

Rules proposed by the PCAOB would limit the tax services independent auditors can offer their public-company audit clients and affect the way audit committees fulfill their responsibilities under the Sarbanes-Oxley Act and SEC auditor independence rules. The proposed rules would ban all contingent-fee arrangements and make some tax services incompatible with auditor independence, including all tax services provided to officers "in a financial reporting oversight role." The proposal would also expand preapproval procedures by requiring auditors to supply audit committees with specified information about permitted tax services that might be

performed and to discuss the information with the committee.

The PCAOB release acknowledges that a number of tax services have not raised what it calls "independence concerns" and would continue to be permitted — subject to audit committee preapproval. Among those cited in the release are tax return preparation and tax compliance services, general tax planning and advice (including related tax research), tax return preparation for employees on international assignments, and personal tax services for client employees who are not in a financial reporting oversight role.

Financial Accounting Standards Board (FASB)

■ **Accounting for Income Taxes**

The FASB decided, during a joint meeting with the International Accounting Standards Board (IASB), to retain the FASB Statement 109 *Accounting for Income Taxes* exception to recognizing deferred taxes on investments in foreign subsidiaries. The decision will alleviate widespread concern that the exception would be eliminated, which would have significantly increased deferred tax liabilities and the complexity of deferred tax calculations. The exception to recognizing deferred taxes on investments in foreign subsidiaries limits the amounts of deferred tax liabilities and deferred income-tax expense that must be recognized.

Corporate accounting for income taxes will be affected by the American Jobs Creation Act of 2004, signed into law recently by President Bush. The new law allows domestic entities to repatriate foreign earnings at a reduced rate, subject to certain limitations. The law's incentive to repatriate foreign earnings will affect evaluations of whether some or all of those earnings qualify for Statement 109's exception from recognizing deferred tax liabilities. Companies with foreign operations will need to evaluate how the change in the tax law affects whether some or all

of their foreign earnings will be indefinitely reinvested in the foreign tax jurisdiction.

The FASB issued a staff position that allows companies additional time to evaluate the effect of the law on whether unrepatriated foreign earnings continue to qualify for the Statement 109 *Accounting for Income Taxes* exception to recognizing deferred tax liabilities and requires explanatory disclosures from those who need the additional time.

■ **Expensing Stock Options Becomes Mandatory**

New FASB Statement 123R, *Accounting for Stock-Based Compensation*, requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model. The Statement is effective for most public companies' interim or annual periods beginning after June 15, 2005 (the third quarter for calendar-year-end companies) and is effective for nonpublic companies for annual periods beginning after December 15, 2005. Small business issuers are given an additional six months to adopt the new Statement. Companies adopting the new requirements are likely to reexamine their valuation methods and the support for the assumptions that underlie the valuation of the awards. Many are also likely to carefully examine their share-based payment programs.

■ **Accounting for Nonmonetary Transactions**

Companies will no longer be permitted to use the "similar productive assets" concept to account for nonmonetary exchanges at book value with no gain being recognized, according to a new FASB Statement that amends APB Opinion 29, *Accounting for Nonmonetary Transactions*. Nonmonetary exchanges have to be accounted for at fair value, recognizing any gain or loss, if the transactions

meet a commercial substance criterion and fair value is determinable. The amendment is an outgrowth of the project to reduce differences between U.S. and international standards and will be effective for nonmonetary transactions occurring in fiscal periods beginning after June 15, 2005.

Emerging Issues Task Force (EITF)

■ 2004 Guidance on "Other-Than-Temporary Impairment"

The FASB will reconsider in its entirety the EITF's and all other guidance on disclosing, measuring, and recognizing other-than-temporary impairments of debt and equity securities. Until new guidance is issued, companies must continue to comply with the disclosure requirements of EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* and all relevant measurement and recognition requirements in other accounting literature, such as SEC Staff Accounting Bulletin No. 59 and EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*.

The reconsideration of EITF 03-1 and related literature on impairments of debt and equity securities opens the door to revisions that could affect many companies. In September, the FASB delayed the guidance on impairment losses under EITF 03-1, but the delay did not include the disclosure provisions, which will remain in effect until the full reconsideration of the EITF 03-1 guidance is completed. New measurement and recognition guidance had been expected to be in place by the end of the year. However, a full reconsideration of EITF 03-1 and related literature will take more time.

American Institute of Certified Public Accountants (AICPA)

■ Deferred Acquisition Costs on Internal Replacements

The AICPA's Accounting Standards Executive Committee (AcSEC) issued an exposure draft Statement of Position (SOP), *Accounting by*

Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements. The exposure draft provides guidance on accounting by insurance enterprises for deferred acquisition costs (DAC) on internal replacements other than those specifically described in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

In March of 2003, AcSEC exposed a prior draft of the proposed SOP, *Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Specifically Described in FASB Statement No. 97*, and received ten comment letters. After further deliberations with the members of AcSEC and the FASB, certain significant conclusions proposed in the exposure draft were changed. AcSEC exposed the revised document to allow respondents to view all changes to the proposed SOP in their entirety and to make sure the proposed guidance is clear and understandable.

The proposed SOP applies to all entities to which FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, as amended, applies; this includes entities writing both short-duration and long-duration contracts. The discussion of how to apply the guidance in the proposed SOP to short-duration contracts has been expanded.

NAIC/Regulatory

Developments at the Winter 2004 meeting

■ Incorporating Sarbanes-Oxley Type Provisions

The NAIC will hold a meeting in February on incorporating Section 404-like requirements into the insurance regulatory framework. These requirements now seem unlikely to be adopted by insurance regulators by 2006, as some had speculated would be the date. Additionally, regulators

plan to present recommendations at the NAIC's March 2005 meeting that will address the appropriate legal entity within a corporate structure to evaluate compliance with audit committee rules, the definition of "financial expert," and independence requirements for audit committees.

■ Reporting Control Deficiencies

AICPA and industry representatives expressed concerns to regulators about differences in obligations for reporting significant deficiencies under the Model Audit Rule as compared to those under Section 404. For example, some remediated deficiencies that need not be communicated to the audit committee under Section 404 may need to be reported to state regulators. At the recent Winter NAIC Meeting, the NAIC/AICPA Working Group indicated that it does not plan to address this issue, and referred it to state insurance departments for their individual and separate consideration. Representatives of the AICPA and industry plan to further discuss this issue.

■ Permitted Accounting Practices

Permitted accounting practices are expected to decline because of new rules governing state insurance regulators. New rules require each domiciliary state considering approving or renewing an accounting practice for an insurer within its jurisdiction to notify all other states in which an insurer is licensed before granting the approval or renewal. The required notification must occur at least 30 days prior to the financial statement filing date. This new protocol allows for a shorter notification period, but never less than five days, if the domiciliary state regulator explains the urgency of the request.

■ Determining Impairment of Fixed-Income Securities

The NAIC is developing a rule for determining whether a fixed-income security is other-than-temporarily impaired that would likely differ from U.S. GAAP. Under the industry

proposal, interest-rate-related impairment would be recognized at the reporting date if the insurer then intends "to sell" an investment before it recovers. Comments on this proposal are due February 14, 2005.

■ **Finite Reinsurance**

Regulators affirmed that finite reinsurance has legitimate uses, but they are becoming increasingly concerned about the misuse of these products to distort the financial statements of ceding companies. Regulators believe that the current NAIC accounting rules need to change. As a first step, they plan to focus on improving disclosure.

(Sources: KPMG's *Defining Issues* and KPMG's *Issues and Trends in Insurance*)

KPMG's Audit Committee Institute (ACI)

Recognizing the challenge that audit committees face in meeting their demanding responsibilities, KPMG created the Audit Committee Institute (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.

Taxation

■ **The American Jobs Creation Act of 2004**

The American Jobs Creation Act of 2004 (Pub. L. No. 108-357, hereinafter, the Act) that was signed into law by the president on October 22, 2004 is the culmination of a multiyear effort to resolve a number of controversial tax and international trade issues. Its primary objective, which has been accomplished, was the repeal of the foreign sales corporation (FSC) regime and the repeal of its replacement, the exclusion for extraterritorial income (ETI), which the World Trade

Organization had found to be an "illegal trade subsidy." The key provisions of the legislation are highlighted below.

– **FSC/ETI Repeal**

The Act repeals the existing FSC/ETI regime for transactions after 2004. However, a grandfather provision preserves tax benefits for contracts between unrelated parties that were binding as of September 17, 2003. In addition, some benefits of the ETI regime remain in effect for two years. Taxpayers are entitled to claim 80 percent of otherwise available ETI benefits in 2005, and 60 percent in 2006.

– **Insurance Tax Revisions**

The Deficit Reduction Act of 1984 froze the policyholder's surplus account balances of life insurers at their then-current amounts. Most life insurers were vigilant in protecting these previously untaxed amounts from taxation and also did not provide any deferred taxes on such amounts for financial reporting purposes.

The Act suspends for a stock life insurance company the application of the rules imposing income tax on distributions to stockholders from the policyholder's surplus account of a life insurance company. The provision applies to tax years beginning after 2004 and before 2007. The provision also changes the order in which any distribution to shareholders is treated as being made first out of the policyholders surplus account, next out of the shareholder surplus account, and finally out of other accounts. This provision effectively eliminates the potential tax on amounts in the PSA because life insurance companies are expected to distribute any PSA balances during the effective date period.

The Act replaces the term "source and character" with the term "amount, source, or character" in

Section 845 to reflect the Treasury Secretary's broad authority with respect to reinsurance arrangements. This provision is effective with respect to any risk reinsured after the date of enactment. The Joint Committee description of the Act indicates that Congress intends that the Treasury Secretary would exercise the Section 845 authority in a manner similar to that given to the Secretary under the transfer pricing provisions of Section 482, to cover situations in which the related persons are engaged in cross-border transactions that require allocation, recharacterization, or other adjustments in order to reflect the proper source, character, or amount of the item or items.

– **Manufacturing Benefits**

The centerpiece of the Act is a tax benefit for income from U.S. manufacturing. When fully phased in, this benefit will provide a deduction equal to a percentage of the lesser of qualified production activities income of the taxpayer for the tax year or the taxpayer's taxable income for the tax year. The eligible percentage increases from 3 percent in 2005 to 9 percent in 2010.

– **International Tax Reform**

The American Jobs Creation Act contains significant changes to the international tax law regime.

○ **Repatriation of Foreign Earnings**

For a limited time, the Act permits the repatriation of dividends above a historically determined baseline amount from a controlled foreign corporation to be eligible for an 85 percent dividends-received deduction (which in many cases is equivalent to being taxed at 5.25 percent instead of the standard rate of 35 percent).

The maximum amount that may be repatriated is equal to the greatest of: \$500 million; the amount shown as permanently reinvested outside the United States on the

most recent audited financial statement certified on or before June 30, 2003; or if such an amount is not shown but a tax liability attributable to such earnings is shown, an amount equal to the tax liability divided by 0.35. To satisfy statutory requirements, the repatriated funds must be reinvested in the United States pursuant to a domestic reinvestment plan that has been approved by the company's chief executive officer and its board (or a committee thereof).

The plan must specify that the repatriated funds will be used for specific purposes, including worker hiring and training, research and experimentation, infrastructure, capital investments, and the "financial stabilization of the corporation for the purposes of job retention or creation."

○ **Foreign Tax Credits**

The Act makes a number of changes to the foreign tax credit regime, including:

- Reducing from nine to two the number of categories ("baskets") by which income must be classified;
 - Extending the period of time over which foreign tax credits may be carried forward (from five years to ten years), but reducing the carryback period (from two years to one year); and
 - Modifying the calculation of the foreign tax credit by permitting deductible interest to be determined on a worldwide basis and providing a rule that redresses an inequity with regard to how domestic income following a domestic loss may be allocated to enhance the foreign tax credit.

○ **Deferral of Taxation of Foreign-Sourced Income**

The Act makes a number of specific, but relatively limited, changes to the regime governing

the extent to which the foreign earnings of a controlled foreign corporation are taxed currently in the United States.

○ **Inversions**

The Act imposes a new tax regime on companies that "invert" — i.e., become the subsidiary of a foreign-incorporated entity — after March 4, 2003. If the former shareholders of the U.S. corporation hold 80 percent or more of the stock of the foreign-incorporated entity, the foreign entity is deemed to be a domestic U.S. corporation for tax purposes. If the entity is 60 percent owned, the top-tier corporation is respected as a foreign corporation, but a number of corporate-level "toll charges" are imposed upon the establishment of the structure.

– **Deferred Compensation Rules Effective in 2005**

As a result of changes to the tax characterization of unfunded deferred compensation under the Act, virtually all such plans will need to be examined — and most will need to be changed — to conform to the new rules. When these rules become effective in 2005, any attempt to defer compensation will be deemed "ineffective" — and the deferred element of the compensation will be immediately taxable and subject to significant additional penalties — unless the following conditions are met:

- Distributions are payable only upon an employee's separation from service, death, or disability; a change in control of the company; an "unforeseeable emergency"; or a specific date in the future.
- The timing and schedule of payments cannot be accelerated (unless in accordance with certain regulatory exceptions). Thus, "haircut" provisions and "board-discretion" distributions are prohibited.

- Financial "triggers" based on the health of the company are not allowed. (Under the Act, plan triggers are treated as property transfers.)

Elections of "initial deferral" must be made in the preceding tax year (with a performance-based compensation deferral election possible later). "Subsequent deferral" elections cannot be made less than 12 months prior to the first scheduled payment, cannot take effect for 12 months, and must result in a deferral of at least five additional years.

These rules also may apply to stock appreciation rights or discounted stock options.

In addition, deferred compensation assets in foreign trusts (rabbi trusts) are taxed upon vesting, with the exception of assets in foreign jurisdictions where "substantially all" services were performed. Many U.S. taxpayers working overseas and covered under foreign deferred compensation arrangements (even if unfunded) may not be in compliance with these rules.

In a taxpayer-friendly provision, the Act specifies that the "spread" upon the exercise of rights under an incentive stock option or employee stock ownership plan will not constitute wages for employment tax purposes.

– **New Disclosure and Penalty Regimes for Reportable Transactions (Tax Shelters)**

Taxpayers should take particular note of new disclosure and penalty regimes that the Act establishes with respect to reportable transactions. These provisions — which are generally applicable to all companies — include the following.

– **Disclosure of Reportable Transactions**

The Act imposes a strict liability penalty for the failure to disclose

"listed transactions." It also imposes a penalty on nonlisted reportable transactions. Nonlisted reportable transactions include those that:

- Result in certain large losses or book/tax differences in excess of \$10 million per year;
- Are offered under conditions of confidentiality;
- Are subject to contingent fee arrangements or refunds if the intended tax results are not achieved; and
- Result in tax credits (including foreign tax credits) in excess of \$250,000 when the taxpayer has held the underlying asset for less than 45 days.

The penalty is \$50,000 (\$10,000 for a natural person) with respect to nonlisted reportable transactions, and \$200,000 (\$100,000 for a natural person) with respect to listed transactions. This penalty regime, which affects tax returns and statements due after October 22, 2004, applies solely to the issue of nondisclosure; *it is not in lieu of other penalties and is applicable even if the taxpayer prevails on the underlying merits of the position.* However, the Commissioner can rescind the penalty for failing to disclose a nonlisted reportable transaction but must submit an annual report to Congress describing each penalty and explaining why it was rescinded.

SEC reporting companies must inform shareholders, via their SEC filing, in the event that this penalty is imposed on the company for failure to disclose a listed transaction.

– Understatements

The Act created a new accuracy-related penalty for listed transactions, and other reportable transactions if a significant purpose of the other reportable transaction is the avoidance or evasion of federal income tax (reportable avoidance transaction). This penalty affects

returns for tax years ending after October 22, 2004.

The understatement penalty is 20 percent in the case of disclosed listed or reportable avoidance transactions and 30 percent if the transaction was not disclosed. The 20 percent penalty may be mitigated in the case of disclosed transactions by "reasonable cause" (although an opinion from a disqualified tax adviser cannot be used to establish reasonable cause). Companies that are penalized at the 30 percent rate under this provision must disclose the action in their SEC filing. An additional \$200,000 penalty may be imposed for failure to do so.

– Conclusion

The American Jobs Creation Act of 2004 provides significant opportunities for U.S. businesses to improve their tax positions. At the same time, however, it presents a host of new hurdles and risks, including stricter reporting requirements, increased penalties, and, potentially, new tax costs. In addition to the provisions highlighted in this executive brief, the Act affects a broad spectrum of business activities, transactions, and entities. Businesses, tax professionals, regulators, lawmakers, and third parties will have to devote significant time and resources to analyzing this new law to gain a better understanding of the implications of the Act and provisions that are pertinent to their interests.

■ Rev. Proc. 2004-69

This revenue procedure prescribes the loss payment patterns and discount factors for the 2004 accident year. These factors will be used for computing discounted unpaid losses under Section 846 of the Internal Revenue Code (the IRC).

■ Rev. Proc. 2004-70

This revenue procedure prescribes the salvage discount factors for the 2004 accident year. These factors must be

used to compute discounted estimated salvage recoverable under Section 832 of the IRC.

■ Waiver of failure to qualify as a life insurance contract under Section 7702

In PLR 200438005, pursuant to IRC Section 7702(f)(8), the IRS waived a failure of a life insurance company to satisfy the requirements of IRC Section 7702, which defines a life insurance contract. These waivers are granted if a taxpayer establishes that the statutory requirements were not satisfied due to reasonable error and that reasonable steps are being taken to remedy the error. The IRS concluded that the failure of the contracts to meet the cash value accumulation test as a result of rounding down was due to reasonable error. The IRS viewed the fact that upon discovery of the errors, the insurance company immediately corrected the problem by issuing cash value accumulation test contracts issued on the same policy forms as the original contracts with a cash value accumulation test endorsement in which cash value accumulation factors are rounded to six decimal places. The insurance company also instituted new procedures that will avoid the prior rounding errors.

■ Disregarded entities treated as divisions/branches for insurance purposes

In a legal memorandum (ILM 200442031), the IRS has concluded that indemnity arrangements between a captive insurance company (captive) that is wholly owned by a multi-member LLC (MLLC) and disregarded single member LLCs (SLLC) also wholly owned by the MLLC would lack the risk distribution needed to qualify the captive as an insurance company and the arrangements as insurance contracts.

A closely held MLLC that provides professional services and has several branches in separate locations plans to restructure its operations. It will form separate SLLCs. The taxpayer will be

the single member of each operating LLC. The taxpayer will transfer the assets, liabilities, and operations relating to the services provided by each of its branches to one of the SLLCs in return for the ownership interest in the LLC. The taxpayer will not be personally liable for the debts of any of the SLLCs. For federal tax purposes, the SLLCs will keep their default classification; they will be disregarded as entities separate from their owner.

MLLC will establish a subsidiary captive insurance company (captive). All the captive's indemnity arrangements will be with the SLLCs. The maximum percentage of liability coverage the captive provides to any one of the SLLCs compared to the total indemnity risks the captive assumes won't exceed 15 percent. The captive will be capitalized with contributions from some members of the MLLC, who will receive captive stock in exchange for their contributions.

The IRS concluded that the arrangements wouldn't qualify as insurance contracts for federal income tax law purposes because indemnity arrangements must involve both risk shifting and risk distribution. Risk distribution requires a pooling of premiums in which the potential insured is not essentially covering its own risks, the IRS said. However, the IRS observed, as a result of the SLLCs' default classification, the SLLCs are disregarded as entities separate from the MLLC, and their activities are treated as being the branch or division activities of the MLLC. Because there is only one purported insured, the IRS reasoned that the necessary risk distribution is absent from these arrangements, leading to the conclusion that they are not insurance contracts for federal income tax purposes.

(Source: KPMG's *The American Jobs Creation Act of 2004: Assessing New Tax Benefits, Costs, and Risks for U.S. Businesses: IRS; Court rulings; U.S. legislative materials*)

Market Forces

Consolidation and Convergence

- MetLife, Inc. and Citigroup Inc. announced on January 31, 2005 an agreement for the sale of Citigroup's Travelers Life & Annuity, and substantially all of Citigroup's international insurance businesses, to MetLife for \$11.5 billion, subject to closing adjustments. As a result of this combination, MetLife will become the largest individual life insurer in North America based on sales, and MetLife's Retirement and Savings general account assets will increase by almost 60 percent, according to MetLife. *(MetLife, Inc. Press Release, January 31, 2005)*
- While the M&A deal volume fell in the insurance industry during the second quarter of 2004, industry consolidation is expected to increase its pace going forward, according to a CFO survey from the Tillinghast business to Towers Perrin. Data released by SNL Financial in October 2004 indicates the number of insurance deals announced during the second quarter 2004 fell 21 percent to 58 deals versus 73 deals during the first quarter 2004. The value of the deals declined 81 percent to \$1.3 billion versus \$6.5 billion in the first quarter and down 92 percent from \$14.9 billion in the second quarter 2003. Respondents to the CFO survey anticipate that the market share of the top ten life insurance fleets will increase 5 percent from 40 percent to 45 percent of total industry assets by 2007. According to the Towers Perrin release, in the U.S. life insurance market it is expected that the top 20 fleets will control more than 60 percent of the market. *(Press Releases: SNL Financial, October 8, and Towers Perrin, November 30, 2004)*
- According to an American Bankers Insurance Association (ABIA) study, insurance premiums sold by banks reached an estimated \$78.1 billion in 2003, up from \$69.5 billion in 2002. The growth rate for bank-produced insurance and annuity premiums, however, fell to 12.4 percent, its lowest level in five years. The ABIA study attributes this reduction in growth primarily to an increase of only 8.2 percent in annuity premiums sold by banks. Despite the slower growth, annuity sales still produced an estimated \$51.6 billion, or 66.1 percent of total bank-produced premiums in 2003. Commercial lines premiums grew 23.5 percent to \$14.2 billion, personal property and casualty premiums grew 26.7 percent to \$6.3 billion, and individual life/health premiums grew 29.1 percent to \$3.6 billion. *(American Bankers Insurance Association Press Release, October 21, 2004)*
- On December 9, Allianz Group and ING Group (ING) announced that ING had completed its acquisition of Allianz's Canadian property and casualty insurance operations. The transaction included Allianz of Canada and its subsidiaries, Allianz Insurance Company of Canada, Trafalgar Insurance Company of Canada, and Canada Brokerlink. Allianz retained its Canadian industrial lines of business. The purchase price amounts to CAD 370 million and would be financed in part through the proceeds of an initial public offering of ING Canada shares. In an October 12 press release, Allianz Global Risks Canada announced it had received federal approval to become a branch of Allianz Global Risks US Insurance Company. *(Press Releases: Allianz, October 12, and ING, December 9, 2004)*
- American International Group, Inc. (AIG) announced on November 11 that its subsidiaries American Home Assurance Company and AIU Insurance Company will purchase the insurance portfolio of the Royal & SunAlliance branch operations in Japan. The purchase price of the book of business is GBP 92 million, and AIG expects ongoing annual gross premiums to approximate JPY 11 billion. *(AIG press release, November 22, 2004)*
- Prudential Life Insurance Company, Ltd. announced on September 22 that it had signed a definitive agreement with Tawa, S.A. to acquire Aoba Life Insurance Company, Ltd. (Aoba) for JPY 20 billion (approximately USD 180 million). Following the close of the transaction, Aoba will operate as a subsidiary of Prudential Life. The transaction and integration of Aoba is expected to be final during the first quarter 2005. *(Prudential Life Insurance Company, Ltd. Press Release, September 22, 2004)*
- On November 29, UnitedHealth announced that it planned to acquire Definity Health Corporation (Definity), based in Minneapolis. Under the terms of the proposed agreement, Definity shareholders will receive approximately \$300 million for their shares. Following the close of the transaction, expected in fourth quarter 2004, the company estimates it will serve nearly 500,000 consumers nationwide. *(UnitedHealth Press Release, November 29, 2004)*
- On November 23, IBM and RBC Insurance announced that IBM had agreed to acquire Liberty Insurance Services Corp. (LIS), the U.S. business process services and solutions operations of RBC Insurance. In addition, IBM and RBC Insurance agreed to enter into a long-term agreement for IBM to perform key business processes for RBC Insurance's U.S. operations, including contact center management, policy administration, claims management, and payment receipt and reconciliation. Following the acquisition, LIS will become part of a new subsidiary of IBM that will focus on delivering life

insurance and annuity processing and administration services. The deal was expected to close by year end 2004. *(RBC Insurance Press Release, November 23, 2004)*

- The Swiss Life Group announced on December 9, 2004 that it was selling its UK life business to Resolution Life Group for GBP 205 million. Swiss Life UK ceased writing new individual and group business in 2003. The deal, pending regulatory approval, is expected to close in the first quarter 2005. *(Swiss Life Press Release, December 12, 2004)*

International Focus and Globalization

- Analysis released by Swiss Re in October and December 2004 indicates that the outlook for emerging insurance markets look bright in the coming years. Swiss Re anticipates that non-life premiums will grow 5.9 percent and life premiums by 8.4 percent in 2005 for Asian markets outside Japan. In China, Swiss Re forecasts growth of 9.3 percent for non-life and 13 percent for life insurance during the year. According to a Swiss Re spokesperson, Asian non-life premium growth will be driven by strong economic fundamentals, increased trade and investment flows, and implementation and enforcement of enhanced compulsory insurance. Life insurance growth will be driven by increases in average household wealth, improved distribution channels providing for increased availability of more products, and increased awareness of consumer risk. In its sigma study released in October 2004, Swiss Re projected that the total non-life premiums collected in emerging markets would double to around \$250 billion by 2014 while life premiums would almost triple to \$450 billion during the same period. The sigma study identified China and India as the most promising insurance markets. *(Swiss Re Press Releases, October 7, and December 2, 2004)*

- On October 20, 2004, AEGON N.V. announced that its joint venture in China had reached a cooperation agreement with the Agricultural Bank of China. Under the agreement, AEGON-CNOOC Life Insurance Company, Ltd. would provide life and accident and health insurance to the Agricultural Bank's customers. The Agricultural Bank would in turn provide AEGON-CNOOC cash management and payment services. AEGON-CNOOC Life Insurance Company, Ltd. is a 50/50 joint venture between AEGON N.V. and the Chinese National Offshore Oil Corporation. *(AEGON N.V. Press Release, October 20, 2004)*

- Manulife-Sinochem Life Insurance Co. Ltd., a subsidiary of Canadian-based Manulife Financial, announced that it has received approval from the China Insurance Regulatory Commission (CIRC) to convert its Guangzhou branch license into a province-wide license for Guangdong, excluding Shenzhen. The license provides the company with access to a market of almost 80 million in the province, according to Manulife Financial. *(Manulife Financial Press Release, January 18, 2005)*

e-Business and Technology

- In analysis released in November 2004, Celent estimated that insurers are devoting an average of 20 percent, or \$1.4 billion industry-wide, of their IT budgets to compliance efforts related to Sarbanes-Oxley, HIPAA, GLBA, the USA PATRIOT Act, and various state regulations. According to Celent, insurers tend to approach compliance on a statute-by-statute basis in an attempt to meet the specific requirements of each new mandate. In its release, Celent indicates insurers could reduce compliance-related IT spending by 25 percent, or more than \$350 million industry-wide, by shifting to a strategic, issue-based approach. According to a spokesperson for Celent, there are a few key issues involved for compliance requirements

that map to four key IT areas, including data and network security, data quality, operational and financial transparency, and record retention and accessibility. *(Celent Press Release, November 4, 2004)*

- Global financial services institutions will spend \$362 billion on technology investments in 2005, according to estimates released by TowerGroup in December 2005. For the U.S. insurance sector, TowerGroup projects overall IT spending to remain relatively flat from 2004 to 2005, but with important differences in the way each business line will direct its resources. A slight increase in total IT spending in the property and casualty insurance segment is expected due to pent-up demand for new technology. IT spending for life and annuity companies would remain flat as insurers attempt to capitalize on existing investments. *(TowerGroup Press Release, December 15, 2004)*
- In a review of the insurance industry IT trends in Central and Eastern Europe released in November 2004, Celent projected IT investment in the region to reach \$543 million in 2004. The insurance markets in Poland, Hungary, the Czech Republic, Slovakia, and Slovenia are growing quickly. Celent reports that most of the current IT investment in these countries is focused primarily on distribution, given the market's focus on growth. However, Celent believes the insurers in these countries may be making a mistake by under-investing in the infrastructure necessary to support the growth over the long term. *(Celent Press Release, November 24, 2004)*
- TowerGroup's report, "Mobilizing the Financial Services Enterprise: Business Mobility Gets Unwired," released in September 2004, indicates that enterprise mobility in financial services is at the beginning of a significant long-term upswing as deployment costs fall and the available device, network, application, and other technology options improve. Adoption of mobile data devices by financial services

executives stood at approximately 10 percent of total industry employment. TowerGroup forecasted this to rise to 35 percent by 2009. Financial institutions are exploring mobile opportunities with enterprise applications tailored to a number of vertical sectors. Executive alerts, insurance claims and quotes, mortgage information, and institutional mutual fund sales are examples of applications being prepared for wireless deployment. (*TowerGroup Press Release, September 27, 2004*)

- According to TowerGroup, as assets in managed accounts continue to increase, financial institutions in banking, insurance, and brokerage are moving to offer managed account programs. In a report released in December 2004, TowerGroup estimated that assets in managed accounts will increase at a compound annual growth rate of 22.6 percent from \$399 billion in 2002 to \$1,105 billion in 2007, and that financial services industry spending on managed account platform services will increase at a rate of 11.2 percent from \$258.9 million in 2003 to \$439.2 million by 2008. According to TowerGroup, many financial services institutions are choosing to outsource through a managed account platform in order to reduce time to market. (*TowerGroup Press Release, December 6, 2004*)

Risk Management

- Liability systems throughout the world are growing increasingly costly, according to Swiss Re's latest *sigma* report. In the world's ten largest non-life insurance markets, commercial liability claims totaled USD 84 billion in 2002, with USD 67 billion originating from the U.S. alone. In all major economies examined in the study, general liability claims and premiums have grown faster than overall economic activity, with long-term estimates suggesting that claims are growing 1½-2 times as fast as nominal GDP. Among the several reasons for this, according to Swiss Re, the most

important are social and legal developments. The study, "The Economics of Liability Losses — Insuring a Moving Target," also addresses general issues regarding tort systems, and identifies a need for reform, particularly in the U.S., where less than half of the funds from litigation reaches victims. (*Swiss Re Press Release, October 28, 2004*)

- Research released by TowerGroup in November 2004 indicates that as concerns over identity theft in the U.S. intensify, so do debates within the financial services community over exactly what type of crime is involved. At issue is the distinction between identity theft and identity fraud. Identity fraud, which involves the theft or creation of financial information with the intent of gaining access to accounts or making purchases, is far more common than identity theft, according to TowerGroup. Confusion between what constitutes "identity theft" and "identity fraud" has hindered the development of full responses to the risk of identity theft, in which financial or other personal information is stolen with the intent of establishing someone else's identity as their own. TowerGroup reported that many regulatory actions aimed at preventing identity theft actually target forms of fraud that the financial services industry had already largely controlled. (*TowerGroup Press Release, November 9, 2004*)

- Risk Management Solutions (RMS) announced a comprehensive research initiative to analyze the unprecedented level of data generated by the 2004 Atlantic hurricane season. The 2004 hurricane season was unusual, with not only a high frequency of storms, but several major hurricanes affecting the same region. This was the first year since 1837 known to have four hurricanes causing loss in Florida. The program includes research into hurricane frequency and an extensive analysis of industry claims data. Findings from the research will be used to refine and enhance RMS modeling. (*Risk Management Solutions Press Release, November 30, 2004*)

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*.

Insurers Ponder a Post-TRIA World **By Jacqueline S. Gold, Managing Editor, *Insurance Insider*** **January 13, 2005**

Efforts to extend the federal terrorism insurance backstop, set to expire at the end of the year, face significant hurdles despite widespread belief among carriers that such a program is necessary to prevent massive market dislocation.

A recent report by the Congressional Budget Office maintained that an extension of the Terrorism Risk Insurance Act (TRIA) would shift the enormous cost of another terrorist attack from private insurers to taxpayers. In addition, many see TRIA as a government bailout, further damaging chances for renewal.

But insurers say that without the government backstop, passed in wake of the September 11, 2001 terrorist attacks, they will cut back the amount of coverage offered – or refuse to write policies altogether. They contend that if there is another attack, the federal government will be on the hook to pay claims; observers say that the government can either extend TRIA or pay after a terrorist strike.

"TRIA is standby capital," says Joel Freedman, director of government affairs for The Hartford Financial Services Group. "And it's a lot cheaper to have standby capital because it increases the chances that private insurers will come into the market."

Congress enacted TRIA in 2002 to entice carriers to provide terrorism insurance to buildings and businesses that were desperate for it after the World Trade Center attack the previous year. TRIA guarantees that in the case of a terrorist

attack causing more than \$5 million in damages, the government will cover 90 percent of terrorism-related losses after insurers pay a deductible equal to a percentage of their net premiums from the previous year. Insurers pick up the other 10 percent of claims.

Total losses for the industry are capped at \$15 billion, while government losses end at \$100 billion.

TRIA was not retroactive. Insurers largely covered the \$32 billion in claims that resulted from September 11. Before then, the idea of a massive terrorist event on American soil was so inconceivable that insurers covered terrorism as an incidental to a larger policy, charging little or nothing for it.

To date, TRIA has cost the American public little because there has been no terrorist event to force its use. An insurance industry study conducted by R. Glenn Hubbard, the former chairman of the Council of Economic Advisers, found that TRIA ran up \$4 million in administrative expenses in 2003.

Some conservatives in Congress believe that a federal presence in the insurance market chases private capital away. But Freedman and others say that the opposite is true. "TRIA gives people a sense of comfort," says Andrew J. Barile, an insurance industry consultant. "The industry wants TRIA because they need a backup."

As part of the legislation, Congress ordered the Treasury Department to study TRIA's effectiveness and issue its findings by June 30 of this year. Once that report becomes public, the insurance industry — and its allies in real estate, tourism, hospitality, and major league sports — will push for hearings and a bill to extend TRIA two years.

However, "we don't really know if TRIA is going to be renewed," says Lisa Stimson, a senior manager in KPMG's audit and risk advisory services. "The U.S. Treasury

Department is neutral on TRIA renewal at this point."

If TRIA is extended, the insurance industry hopes to create a permanent private-public partnership to handle terrorism insurance. A plan like the kind put together by insurers and the state of Florida to handle hurricane claims could serve as a model.

However, if TRIA can't get a place on the Congressional dance card this year or is rejected outright, then insurers have a backup plan. They have already gotten most states to agree to exclude terrorism from policies in place if TRIA doesn't go past Dec. 31.

"If the TRIA backstops go away, the insurers will go to the states and submit new policy forms that would exclude terrorism from the list of protections," says Steve Dreyer, regional practice leader for North American insurance ratings at Standard & Poor's. "They have already greased the skids for that to happen."

If a terrorist event were to occur after the end of this year, and TRIA was no longer operational, then "businesses and property owners will take it on the chin," Dreyer adds.

But some states with large populations, including New York, Florida, and Georgia, have not gone along with the exclusions. And in many states, mandated workers' comp coverage and "fire following" clauses (which cover fire damages following a terrorist attack) make these exclusions somewhat irrelevant. However, only TRIA keeps insurers from deciding to pull back from writing coverage at all, which happened following September 11.

"If TRIA isn't renewed," says Julie Rochman, senior vice president of public affairs for the American Insurance Association, "insurers will become defensive underwriters. Companies will be forced to make very difficult decisions about whether to write or not write policies."

This presents the government with an uncomfortable scenario: possibly refusing to cover damages in the event of a major terrorist attack.

"Under TRIA," says Dreyer, "the federal government is openly on the hook. Without TRIA, the government is on the hook implicitly. The question is: Will the government continue its commitment to protect against terrorism risk in advance or will it let TRIA expire and just handle it when it happens?"

Also, TRIA will keep private insurers from leaving the terrorism insurance market completely. As Robert Hartwig, chief economist of the Insurance Information Institute, points out: "No insurer can afford to bet the corporate farm on terrorism risk."

However, even with TRIA's extension, there is no guarantee that insurers will offer terrorism coverage at an affordable rate. It is also unclear whether commercial customers will buy enough coverage to supply full property replacement value.

Terrorism is "a class of exposure that is difficult to price," says consultant Barile. And now that insurers know an attack can actually occur, they offer coverage at an incredible cost. "Terrorism coverage is so expensive, people don't buy it," he adds. He suggests businesses form their own captives to insure against terrorism; that way they can retain the profits if an event does not occur.

"What TRIA does is allow carriers to satisfy the requirement that they are offering the coverage," Barile says. "But nobody buys it or buys enough of it because it's so expensive. And TRIA does nothing about that."

Beleaguered Workers' Comp Lines Seek Captive Solution
By Christopher Westfall, Managing Editor, Insurance Insider
September 23, 2004

With workers' compensation insurance costs skyrocketing, many companies are considering a captive solution.

But industry observers say companies should first consider all alternatives, and if

they do decide to set up a worker's comp captive, ensure that it is well-designed and managed.

"Workers' comp is a controllable cost," said George Levine, a senior manager with the actuarial services practice of KPMG in Hartford, Conn. "And captives are one way to help a company manage those costs."

Levine and other industry professionals discussed workers' compensation insurance issues at the recent Vermont Captive Insurance Association meeting in Burlington.

Most observers agree that workers' comp costs are at a crisis point, although there has been some leveling off, said Lewis Pacala, vice president of General Reinsurance Corp.

"There is talk about how workers' comp reserve deficiencies decreased from a high of \$21 billion in 2001, and that's good news," he said. "But I don't think that a continued \$10 billion to \$15 billion in under-reserving is good news."

Both indemnity and medical claims for workers' comp have accelerated since 1995, Pacala said. For example, the annual cost growth for indemnity claims for the first half of the 1990s was 0.3 percent, but skyrocketed to 7.4 percent annually between 1996 and 2002.

The average annual change for medical claims between 1996 and 2002 has been 9 percent, while the first half of the 1990s tracked a 3.9 percent annual change. Increases in workers' comp costs are attributable to many factors, including the rise in medical claims, increased fraud, and insurers' reserve problems.

Currently, the majority of captives formed in the U.S. are created to cover workers' compensation. According to the 2003 Captive Insurance Companies survey, more than 34 percent of companies said that workers' comp was the major line fronted by their captive.

The most significant change in workers' comp has been the rising costs of medical liability. "For the first time, two years ago,

medical claims outpaced indemnity," Pacala said. Currently, workers' comp costs are now split 45 percent for indemnity and 55 percent for medical.

"We used to think medical was a small cost, and now it's a majority of the cost," he said. This is primarily due to the move away from managed care programs, Pacala said, which were able to keep health care costs down.

As with many other insurance lines in crisis, companies want to contain costs through a captive program. But before setting up a program, the CFO and management need to test and fully analyze whether a captive makes financial sense, KPMG's Levine said.

"It's important that a company get together its own loss history and analyze [it] to better understand the costs involved," he said. This includes an independent liability valuation, which determines the program's reserve adequacy, the effectiveness of claims handling, and payout pattern.

Management needs to be pragmatic about a captive solution and make sure other alternatives — like reducing liabilities with a claims management program or transferring the liabilities to an insurer or reinsurer — are explored.

"Many times captives are formed because it not only insures the liabilities, but also creates a new profit center," Levine said, noting that risk management professionals cannot often show in real terms how much money they are saving the company. With the creation of a captive, those savings are shown in a financial statement from a separate line of business.

Another important aspect of using a captive for workers' comp is taking over the claims management process, said Levine. While this gives the company more control over the claims process, it's a long-term commitment that does not guarantee success.

Claims management has become important in workers' comp because the severity of claims has increased, even as

claims frequency has dropped. The severity issue can be attributed to several factors, including rising medical costs and an aging workforce.

Even if a captive hires a third-party administrator (TPA) to handle claims, changes in the TPA market require companies to have strict oversight of the process, said James Kremer, vice president with consulting firm LewisCo Group in Deerfield, Ill.

He said that the TPA industry has become commoditized through mergers and decreased profit margins, and companies need to make sure their goals are aligned with the administrator by making sure they have the same goals as the captive, such as claims containment or resolution. "The relationship with the TPA needs to be managed closely," Kremer said. "It needs easy-to-measure goals for claims resolution."

Bermuda Insurers Contemplate Consolidation and a Soft Market
By Jacqueline S. Gold, Managing Editor, *Insurance Insider*
December 15, 2004

The Bermuda insurance market has grown up, but it remains to be seen if island-based insurers can weather a soft market better than in the past.

While it has long been home to many captives formed by multinational firms, Bermuda now calls itself "the risk capital of the world," boasting nearly 1,300 insurers and reinsurers with \$63 billion in gross premiums and capital, and surplus of more than \$75 billion.

But as it takes its place alongside London and the U.S. as a significant player in the global insurance market, Bermuda is subject to the same storms that affect the rest of the industry, such as softer pricing and possible industry consolidation.

Sustainability is a much bigger issue for Bermudan firms than for more established insurers in the U.S. and Europe. In fact, the softening of prices across business lines — particularly in property, directors and officers liability insurance, and excess casualty products — has Bermuda insurance professionals concerned about

whether their operations can prevail as the ice-hard insurance market that began in 2000 begins to thaw.

The island's insurance industry went through its first wave of spectacular growth after Hurricane Andrew hit in 1992, but in the soft market that followed in the mid- to late-1990s, "a lot of business left the island," says Henry Scully, president of Willis Bermuda Ltd. "The Bermuda insurers wouldn't drop to the crazy prices that were being offered in America and London."

As a result, four of the eight large P/C companies created in the wake of Hurricane Andrew were sold, according to Don Thorpe, an insurance analyst with Fitch Ratings.

"In the wake of Hurricane Andrew, companies, mostly limited to property and casualty lines, were raising \$300 million to \$400 million," says Steve Green, managing partner of KPMG Bermuda.

But in the growth spurt following September 11, companies were formed that were much more "broadly based and were capitalized with \$1.5 billion and more," Green says. "The post-Andrew companies had much smaller investors than the post-9/11 firms."

The more recent additions to the Bermuda market — sometimes called the Class of 2002 — are not only larger, and better capitalized, but also tend to have pristine balance sheets, having avoided some of the dicey mergers that entangled older counterparts.

What industry observers say is the real test for the Bermuda market (and the industry as a whole) is whether firms can maintain price discipline in the face of radical discounting from abroad. There is great hope that Lloyd's — which is a direct competitor to the Bermuda insurers in several highly specialized niche markets — will control its syndicates better than in the past.

"We're more confident that we'll survive this soft market," Scully says. "Bermuda carriers will say no to soft premiums. They'd rather just pass on it right now."

Rewarding company investors, rather than using premium dollars to chase market share, is a classic way for insurers to sit out the soft market. Already, some Bermuda insurers, like Endurance Specialty Holdings, are using excess capital to buy back stock. Earlier this month, AXIS Capital Holdings Ltd. said it would repurchase up to \$350 million of its common shares, and pay a quarterly dividend of 12.5 cents per share.

While some Bermuda insurers use their excess capital to reward shareholders, other firms are likely to see the soft market as an opportunity to consolidate. "The appetite for merger and acquisition activity was reduced a few months ago. Now, there may well be some deals," says Richard Lightowler, lead insurance partner for KPMG Bermuda.

While larger, older Bermuda firms such as ACE and XL are still digesting acquisitions, some of the smaller monoline island firms might be ready to broaden their business lines through acquisition, or sell and cash out.

Some of the Class of 2002 may grow through mergers in order to get large enough for an initial public offering.

Still other companies may be on the hunt for talent. "There are some very good underwriting teams here that might be very attractive," Lightowler says. "And an acquisition is a way to buy the team."

While the island is still a tax haven, Bermuda-based insurers are now under the close scrutiny of the rating agencies, which play a major role in certifying carrier balance sheets and financial strength.

Despite concerns about the edge coming off the hard market, Bermuda insurers are likely to be able to withstand whatever gets thrown their way.

"Bermuda has become a center of excellence for the placement of insurance and reinsurance and that differentiates it from the other islands trying to build offshore business," says Laline Carvalho, a director and insurance analyst with Standard & Poor's. "Bermuda will continue to be seen as an insurance market that companies want to go to."

Hedge Funds See an Opportunity in Reinsurance

By Jacqueline S. Gold, Managing Editor, *Insurance Insider* December 31, 2004

Seeking higher returns and investments not tethered to equity and bond markets, hedge funds are jumping into reinsurance, putting the industry on the defensive as traditional reinsurers seek to control the business as it hits a soft market.

At least six hedge funds have gotten directly involved in underwriting reinsurance, mostly through Bermuda-based companies but with at least one player located in Europe. They have hired experienced industry executives to do so.

Soros Fund Management and \$5 billion hedge fund HBK Investments helped start Swiss-based Glacier Re, which has \$300 million in capital and will specialize in aviation and marine reinsurance. UK reinsurance brokerage Benfield Group Holdings also has a small position in Glacier.

Citadel Investment Group, a \$10 billion Chicago-based hedge fund, has set up a dedicated reinsurance unit, hiring a former CEO of Ace's catastrophe reinsurance business to run it. Hedge fund Nephila Capital Ltd. is also in the game, as is Cooper Neff Advisors Inc., a unit of BNP Paribas.

They are entering the market because of returns of 20 to 30 percent on a gross basis. In addition, insurance market cycles have little correlation to swings in equity and bond markets.

Hedge funds have some sophistication and expertise through a decade of investing in catastrophe bonds, and they're now willing to place bigger bets directly.

Long-established firms say that the new capacity comes just as the market starts to soften, which could accelerate discounting. But they're also worried that hedge funds could control enough capital to become the market's new price-setters.

Carriers also question whether the hedge funds are pumping "hot" money into insurance, money that will disappear when returns fall. The new operations, observers say, may not make the long-term commitment necessary for a successful counterparty relationship.

At the Lehman Brothers' Global Reinsurance Briefing in December, several insurance and reinsurance CEOs — including American International Group chairman and chief executive Maurice "Hank" Greenberg — complained about competition from hedge funds.

"We've heard a lot about this new trend," said Chris Winans, a Lehman Brothers insurance analyst. "And while we can't know what kind of event will bring about the next wave of reckless competition, we think an unabated influx of capital from hedge funds and other capital markets participants could be one potential trigger."

The amount of capital hedge funds have invested in direct underwriting is so far probably no greater than \$2 billion. And with the entire insurance market estimated to be about \$1 trillion, hedge funds have a negligible effect on price setting, but that is expected to change in the long term.

Steve Evans, a tax partner in charge of alternative investments with KPMG, says the hedge fund activity dates back at least five years, when hedge funds were attracted to reinsurance by stellar returns in a hard market.

"Hedge funds like this kind of operation because they can hire the most savvy insurance guy they can find and if the vehicle makes money, they can 'IPO' the company or sell its stock at a gain, which is taxed at a lower long-term capital gains rate than corporate income," Evans says.

What started as a trickle in the late 1990s has turned into a tributary, if not a flood. Although established players might say they're worried about hedge funds' stability in the market, hedge funds say they will be disciplined market participants.

Robert Bredahl, Benfield Group executive vice president, says that market players are worried about competition. "More capital has to result in lower prices and prices are dropping right now," Bredahl says. "We're in a softening trend without question — hedge funds' entry into the market will accelerate that."

But Bredahl says that if there is a long-term soft market, hedge funds will wait until the market turns around, rather than cut and run. Given their growing appetite for new investment strategies and high yields, the hedge funds are likely to be in the reinsurance business for the long haul.

"What we see is that [hedge funds] are serious about it," says Christopher McGhee, managing director of Guy Carpenter & Co. Inc., a reinsurance broker owned by Marsh & McLennan Securities Corp. "They are committed to hiring experienced professionals and behaving like responsible reinsurance people."

One distinct advantage that hedge funds have is liquidity. After nearly a decade of seeing heavy investment flows, hedge funds can now bow out of the reinsurance market as returns deflate.

"In general, the capital structure of an insurance and reinsurance company should be partially permanent and partially temporary," says Tony Rettino, a managing director of Cochran Caronia & Co., a Chicago-based investment bank that specializes in insurance. "That is a great benefit to them."

The hedge funds are underwriting capacity that is fully cash-collateralized, making them a more attractive counterparty than some older reinsurers that have sometimes failed to pony up when it came time to pay claims.

"The hedge funds are collateralizing as fully as they can and reserving as fully as they can," McGhee says.

The hedge funds' reinsurance operations have incurred losses as a result of this year's hurricanes, and it looks as if all claims are going to get paid, according to Rettino. "Everyone was waiting to see what happened when they lost money,

and the answer turned out to be positive for the market," he says.

Like other sophisticated insurers and reinsurers, hedge funds have incorporated catastrophe modeling into their reinsurance business plans. The presence of catastrophe modeling has, in turn, contributed to a smoothing of the peaks and valleys in the insurance cycle because it allows underwriters to do a better job of reserving.

With reserves generally adequate to meet demand, the desperate shrinking of capacity in the aftermath of a hurricane or earthquake is no longer as severe as it once was.

The 1999-2003 hard market was the shortest in 30 years, says Robert Hartwig, chief economist of the Insurance Information Institute. The influx of hedge funds into reinsurance will only exacerbate the soft market, he says.

A Brief History of Contingent Commission Agreements
By Roger Wade, Senior Manager,
KPMG Casualty/Actuarial practice
January 5, 2005

The controversy over the payment of contingent commissions — which led New York Attorney General Eliot Spitzer to file suit against Marsh & McLennan Cos. Inc. last October — was in many ways the inevitable result of blurred boundaries between brokers and agents.

While agents are typically independent businesspeople working for major carriers, they essentially act as part of an insurance company's salesforce. Brokers work for the companies buying coverage.

Whether or not contingent commissions are a good thing won't be argued here. A contingent commission arrangement isn't inherently positive or negative. However, the existence of such agreements has allowed for unethical, if not illegal, transactions to flourish in certain instances.

Contingent commissions first appeared in the 1960s when claims were rising much faster than the rate of inflation and

insurance companies cut agent commissions on premiums. To make up for this loss of revenue, carriers offered agents contingent commissions of about 5 to 10 percent of premiums if the agents could meet certain volume and profitability goals. These first contingent commissions were paid on personal lines.

Over time, paying contingent commissions bled from personal lines into independent agents' business with small commercial customers. By the late 1970s and early 1980s, brokers — who were servicing some of the same clientele as the independent agents — asked large insurers to pay them contingent commissions as well.

Arguably, this is where problems first arose. It is one thing for an agent to get a sales incentive fee (in this case, a contingent commission) from a carrier. It's quite another for an insurance company to pay brokers such a fee because brokers were also paid by their clients.

In the late 1970s and early 1980s, insurance brokers were receiving money from both sides of the transaction. As the fees were paid for a book of business encompassing numerous clients, it was difficult to determine the impact of individual clients. Therefore, there was little regulatory investigation into the practice, although customers began questioning brokers about the arrangements.

Meanwhile, some brokers used the London market to buy excess coverage for their clients. The commissions they received on these products were usually not fully disclosed to regulators or customers. The practice increased regulatory and client scrutiny on broker compensation.

Today, contingent commissions among the 100 biggest insurance brokers operating in the U.S. comprise as much as 12 percent of their annual gross revenues, according to Business Insurance magazine, and average about 7 percent of their top line.

Contingent commissions were never seriously questioned because they

provided a mutually agreeable arrangement: the brokers brought carriers greater volumes of business and at the same time, brokers worked to keep down loss ratios for the policies they sold. In return, the brokers got bonus payments from the insurers.

The only problem — and it was by no means a small one — came from the fact that the insurance buyer was also paying the broker. Although this didn't exactly amount to double-dealing, it did confuse the question of just who brokers were ultimately serving.

As contingent commissions grew into an important revenue source, some national brokerages pushed their people to write more policies for insurers who paid them. By the late 1980s, the practice had become widespread. At this point, many brokers were more focused on earning those contingent commissions than getting customers the best deal. But the arrangements were generally unknown outside the insurance industry.

By the mid-1990s, the situation was complicated even further as insurance transactions began to be placed nationally, rather than locally. Contingent commissions represented a significant portion of a brokerage's profits, so it was incumbent on brokers to ensure that business went to the right insurer — the insurer who paid the highest fees, that is.

To make that happen, it was necessary to generate "friendly bids" that would never be as cheap or have terms as favorable as the preferred carriers'. While end buyers thought they were getting several honest bids, they were actually being presented with offers designed to steer them towards the carrier that paid the best contingent commission. But this was never disclosed to the customer. And it is unclear how much regulators knew about the details of the practice.

As recently as April 2004, the Risk and Insurance Management Society, the trade association representing the interests of commercial customers, looked into these arrangements and concluded that they "are endemic to the manufacturer/

distributor relationship, and there is nothing inherently wrong with them.”

Smaller, regional brokerages have steered clear of the issue simply because they can't generate the volume of business that national and international brokers can for the carriers. Therefore, the smaller brokerages have managed to stay clean by default. Some large national brokerages also avoided the controversy through a decentralized organization that did not make the shift from local to national transaction placement.

Despite the controversy surrounding the practice, it is still possible to use contingent commissions ethically. Three simple rules need to apply in each case: buyers must be informed if such an arrangement is in place; the agreement doesn't create bias in brokers as to which carrier customers should use; and, obviously, all false or friendly bids should be eliminated from any list of possibilities offered to a client.

The Council of Insurance Agents & Brokers, the Independent Insurance Agents and Brokers of America, The New York Department of Insurance, and The National Association of Insurance Commissioners have all already endorsed such disclosure requirements or are in the process of designing similar rules.

Every salesperson needs incentives. And it is appropriate for the insurance industry to use contingent commissions to motivate brokers and agents. But the practice needs to be transparent to all who participate in the market, including clients and regulators.

Caveat emptor works well in an unsophisticated world, but in today's complicated insurance market, everyone involved needs to understand and enforce best practices.

The information provided in the above 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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