



INSURANCE

The State of the Insurance Industry

No. 04-2005

KPMG LLP

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Changes & Trends

Industry Overview

General Highlights

- According to preliminary estimates by Swiss Reinsurance Co., more than 112,000 people died worldwide in natural and man-made catastrophes in 2005. Swiss Re reports that these catastrophes triggered total financial losses of around \$225 billion, with insured losses estimated at \$80 billion, making 2005 the costliest year ever for insurers. Losses of \$70 billion, or about 88 percent of all insured catastrophe losses in 2005, were recorded in the United States. The worst catastrophes in terms of victims in 2005 listed in the Swiss Re report include the following by date:

- February 9 – Pakistan – Rain, mudslides, avalanches; three dams burst
- March 28 – Indonesia – Earthquake, several aftershocks
- July 7 – India – Floods and landslides
- August 24 – U.S., Gulf of Mexico, Bahamas – Hurricane Katrina: dams burst, flood, damage to oil rigs
- October 2 – Mexico, Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica – Hurricane Stan: heavy rain, floods, and landslides
- October 8 – Pakistan, India, Afghanistan – Earthquake, aftershocks, landslides

Swiss Re reports that although the full scale of the catastrophes in 2005 has not been fully assessed, the trend toward very high losses appears to be continuing. (*Swiss Reinsurance Co. Press Release, December 20, 2005*)

- A flu pandemic could cost the global insurance industry between \$15 billion

and \$20 billion and could impact nearly all insurance sectors with the possible exception of personal lines, according to a Standard & Poor's report. The industry's worst-case models, assuming the disease jumps from birds to humans, predict overall losses worldwide of \$71.3 billion to \$200 billion, according to the report, "Determining The Insurance Ramifications Of A Possible Pandemic." More optimistic models show \$15 billion to \$20 billion of insured losses, reflecting medical advances and containment efforts of the type that corralled Severe Acute Respiratory Syndrome (SARS) in 2003.

According to new analysis by the Insurance Information Institute, a moderate avian flu outbreak similar to the 1957 and 1968 flu pandemics could generate \$31 billion in additional death claims. A severe avian flu outbreak along the lines of the 1918 pandemic could have a far more serious effect, causing an estimated \$133 billion in additional death claims. The Insurance Information Institute pointed out that the impact of an influenza pandemic on specific life insurance companies might differ widely, depending on a number of factors. (*Press Releases: Standard & Poor's, November 16, 2005; Insurance Information Institute, January 17, 2006*)

- The Center for Health and the Global Environment at Harvard Medical School, along with co-sponsors Swiss Re and the United Nations Development Programme released a study showing that climate change will significantly affect the health of humans and ecosystems and these impacts will have economic consequences. The study, entitled "Climate Change Futures: Health, Ecological and

Economic Dimensions," surveys existing and future costs associated with climate change and the growing potential for abrupt, widespread impacts. Study findings indicate that the insurance industry will be at the center of this issue, absorbing risk and helping society and business to adapt and reduce new risks. (*The Center for Health and the Global Environment (PR Newswire) Press Release, November 1, 2005*)

- Risk Management Solutions (RMS) reports that terrorism activity increased for the third consecutive year in 2005, following a decrease in 2002 after the initial military phase of the global war on terror and the removal of the Taliban government in Afghanistan. In the twelve months ending September 2005, the number of "macro" terrorism attacks (car bombs or worse) worldwide has more than doubled from the previous year. This excludes Iraq, where the insurgency has increased to a rate averaging more than two damaging attacks a day during 2005. RMS indicates that terrorism activity continues to spread to more countries, with macro attacks occurring in more than 30 territories last year, compared to 20 the year before. In the past eight years, 76 countries have experienced some form of a macro terrorism attack. RMS has quantified the risk of terrorism to different types of property assets, business interruption, and human casualties in countries and cities throughout the world, and has published a map of global terrorism risk, depicting the risk in each country. (*Risk Management Solutions Press Release, October 12, 2005*)
- "Gartner's Top Predictions for 2006 and Beyond" forecasts that business process outsourcing (BPO) service

providers will capture \$11 billion of insurance revenue by 2008. Gartner says that insurers are turning to external BPO providers to expedite their legacy transformation process. BPO providers are responding by assuming the business process requirements from insurance providers. Gartner analysts expect that by 2008, BPO will have the intellectual property and technology platforms to align with the distribution channel (for example, bank and investment houses) and launch insurance ventures that capture up to one percent of the global annual premium total of life, annuity, and property and casualty products. Using the United States as an example, Gartner indicates, this translates into a shift of nearly \$11 billion to BPO, which will have a substantial impact on the market landscape. (Gartner, Inc. Press Release, November 29, 2005)

Property & Casualty

- The U.S. property and casualty insurance industry's net income after taxes rose 4.4 percent, or \$1.2 billion, to \$28.8 billion in the nine months ended September 30, 2005, compared with \$27.6 billion at the end of the third quarter of 2004, according to the Insurance Information Institute. Reflecting the industry's income, its consolidated surplus, or statutory net worth, increased 5.2 percent to \$414.3 billion at September 30 from \$393.8 billion at year-end 2004, according to ISO and the Property Casualty Insurers Association of America (PCI). The industry's net income and surplus increased despite record catastrophe losses. Including losses from Hurricanes Dennis, Katrina, Ophelia, and Rita, direct insured property losses due to catastrophes through the nine-months of 2005 totaled \$47.6 billion—nearly double the \$27 billion in direct insured property losses due to catastrophes

through the nine-month period of 2004, according to ISO's Property Claim Services (PCS) unit. Adjusting for losses covered by residual market mechanisms and foreign reinsurers, ISO estimates that private insurers' net catastrophe losses through nine-months 2005 totaled \$27 billion to \$32 billion—up from \$15.8 billion through nine-months 2004. (ISO Press Release, December 27, 2005)

- Despite extraordinary, back-to-back hurricane seasons, U.S. property and casualty impairments in 2005 are on track to hit the lowest level seen in a decade, according to a special report issued by A.M. Best Co. In terms of 2005 dollars, each of the seven major hurricanes in 2004 and 2005 ranks among the 20 costliest U.S. catastrophes ever faced by insurers. Hurricane Katrina displaced the San Francisco earthquake and fire as the costliest U.S. insurance event in history. Coinciding with improving operating results, property and casualty insurers' financial impairments have shown a sharp downtrend in 2003-2005, with the failure rate in 2004 falling to the lowest level since 1996, and known 2005 impairments annualizing to an impairment rate even lower than in 2004, one that would tie 1996 for the lowest impairment rate since 1980. The final number for 2005, however, may well be higher or lower, but it is not likely to be significantly worse than the 2004 results. The combined ratio—a core barometer of profitability, which historically has a high correlation with impairments—improved by 2.1 points to 98.1 in 2004, giving the industry its first underwriting profit since 1978. With the industry absorbing roughly \$60 billion of new catastrophe losses in 2005, the year still may show an underwriting profit. (A.M. Best Co. Press Release, December 13, 2005)
- The physician-led traffic safety advocacy group called End Needless

Death on Our Roadways (END), and the National Safety Council, released their annual list of the 15 deadliest states in the country for impaired driving and reported that 13 states have made the list for two years straight. The Fatal Fifteen are states in which 41 percent or more of all traffic fatalities are alcohol related. END said that nearly 17,000 motorists were killed nationwide in alcohol-related traffic crashes in 2004. Nearly 6,000 of those fatalities occurred in the Fatal Fifteen. The Fatal Fifteen states in rank order are Rhode Island, Puerto Rico, Montana, Texas, Louisiana, Hawaii, Wisconsin, Illinois, Maryland, South Carolina, Washington, South Dakota, Connecticut, Oregon, Massachusetts, Washington D.C., and Pennsylvania. In addition, six states that have seen an increase and are near the Fatal Fifteen threshold were placed on a watch list: Arkansas, North Dakota, California, Missouri, New York, and New Mexico. (End Needless Death on Our Roadways & National Safety Council Press Release, November 28, 2005)

- Recent research from Aon Consulting finds fewer medical malpractice claims are being made against hospitals and physicians. While the severity of malpractice claims continues to rise—growing at a rate of 7.5 percent annually—the frequency of malpractice claims has decreased by one percent over the past year, according to Aon's "2005 Hospital Professional Liability and Physician Liability Benchmark Analysis." This is the first time in the history of the study the frequency trend decreased in claims for both hospitals and physicians. The study examines more than 200,000 hospital bed equivalents and represents approximately 10 percent of the hospital professional liability market, and 15 percent of the alternative segment of the market, making it the largest analysis of its kind, according to Aon. (Aon Corporation Press Release, October 18, 2005)

Life & Health

- Premium rates for individual life insurance—both term life and “permanent” insurance—are expected to drop by 3 percent in 2006, driven largely by significant mortality improvements and increased competition, according to the Insurance Information Institute. For term insurance, this continues a generally downward trend begun several decades ago, although the 3 percent drop projected for 2006 is considerably less than the annual average 9 percent drop in the last decade, according to the Insurance Information Institute. Rate reductions for the best risks were even steeper, due largely to underwriting and pricing refinements. The effect of these forces drove the lowest rates available in 2005 to less than half of what they had been ten years earlier. Operational efficiencies and lower policy lapse rates also contributed to the forces resulting in the drop in life insurance premium rates. The Insurance Information Institute believes that demand for individual life insurance is expected to be strong, but it could be stronger. The number of individual life insurance policies bought each year averaged 17 million during 1970-1985 (the years when the baby boom generation had their children), trended downward to average 11.7 million per year during 1997-99, then rebounded to average 14 million per year during 2000-2005. (*Insurance Information Institute Press Release, October 12, 2005*)
- An ING Group study of American investing habits and goals shows that Baby Boomers earning at least \$50,000 a year like the benefits offered by annuities, but many are intimidated by the products. The report, conducted by ING and the research firm Roper Public Affairs, found that respondents believe annuities can provide a reliable savings

source for income in retirement, though almost half say they do not know enough about the products to decide whether or not they are a good investment. The ING study also finds that Baby Boomers may be relying too heavily on restricted investment vehicles to fund their retirements. More than 6 in 10 Boomers surveyed will rely on such restricted investment vehicles as 401(K) plans, Keogh plans, or pensions to fund their retirements; and fewer than 2 in 10 Boomers surveyed say they will rely heavily on stocks and bonds to fund their retirements. (*ING Group Press Release, October 3, 2005*)

- A survey conducted by the American Society of Health-System Pharmacists (ASHP) reveals that American families are coping with the rising price of medications by engaging in a number of potentially risky behaviors, including skipping medication doses, taking less than the prescribed dose of medication, or deciding to stop taking prescription medications altogether. The survey found that nearly three fourths of American households have at least one member currently taking a prescription medication. In almost half of all households, members were taking three or more prescription drugs. And, in homes containing senior citizens (65 years and older), the average number of medications being taken is 5.7, according to the release. The survey found that 10 million American households spend \$200 or more out of pocket for medications each month. Nearly one out of four surveyed (representing 68 million Americans) reported that their health insurance does not include prescription drug coverage. (*American Society of Health-System Pharmacists Press Release, December 15, 2005*)
- Most large employers (nearly 80 percent) that now provide retiree health benefits will accept government

subsidies for continuing to provide retiree drug coverage at least as good as Medicare’s coverage when the drug benefit plan starts in 2006, according to a recent survey of 300 of the largest private-sector employers in the United States conducted by the Kaiser Family Foundation and Hewitt Associates. Another 10 percent say that they will provide some drug coverage to supplement the new Medicare benefit, and 9 percent say that they plan to stop offering drug coverage to Medicare-eligible retirees. Firms accepting the retiree drug subsidy in 2006 are less certain about whether they will continue to take this approach in future years. The survey also finds that many firms that will accept the subsidy have policies in place that will affect retirees who enroll in a Medicare drug plan instead. Among these employers, 29 percent say that retirees who sign up for a Medicare plan would lose both employer-sponsored medical and drug coverage if they enroll in a Medicare prescription drug plan, and 31 percent say retirees would lose prescription drug coverage only and retain other benefits. (*Hewitt Associates Press Release, December 7, 2005*)

- General pharmacy cost increases are projected to be below healthcare cost increases for the first time in more than four years, according to Aon Consulting. In its survey of more than 70 leading healthcare insurers, Aon Consulting found that prescription drug costs are projected to increase by 11.8 percent during the next 12 months, more than a full percentage point lower than last year, when drug costs increased by 13.1 percent. Specialty drug costs, however, are expected to increase at a significant rate—19 percent during the next 12 months. (Specialty drugs are biotechnology-derived injectable medications used primarily to treat high-cost disease states for which

previous treatments were more invasive or unavailable.) As for retiree medical, experts say that many employer plans will save money in 2006, due to the impact of Medicare Part D legislation. However, the Aon Consulting study shows that future cost increases for retiree medical are projected at double-digit rates (12.9 percent for Medicare Supplement and 11.8 percent for Medicare Advantage), similar to active employees. (*Aon Consulting Press Release, November 16, 2005*)

Reinsurance

- Despite record 2005 hurricane losses, the Bermuda reinsurance market remains attractive to capital according to the latest Bermuda Reinsurance Quarterly Report, "Capital Carousel," from Benfield. The aggregate capital of the 16 Bermuda reinsurers tracked by Benfield was reduced by 8 percent to \$41.4 billion between December 31, 2004 and September 30, 2005. Catastrophe mono-line companies were hardest hit, but several of the multi-line 2001 companies sustained double-digit hits to their capital earlier in the year. Recapitalization has been swift with \$9.3 billion of new capital raised by mid-December 2005; equivalent to 20 percent of aggregate capital at June 30, 2005 and 18 percent of third quarter catastrophe losses. Bermuda reinsurers reported a net loss of \$1.4 billion for the first nine months of 2005 compared to a profit of \$3.4 billion for the same period in 2004. Only four companies reported a profit. For Bermuda reinsurers, Benfield anticipates the outlook for the January 2006 renewal season to be positive with substantial price increases expected on loss-affected treaties and likely stabilization of terms elsewhere. (*Benfield Press Release, December 19, 2005*)
- Over the past several years, the life reinsurance market has experienced a

number of industry-transforming events, the most significant being consolidation, whereby the number of players has been reduced to the point where the top five have a 75 percent market share, according to an A.M. Best Co. report, "Life Reinsurance Market – A Tempered Perspective." Additionally, the amount of life insurance business being reinsured has increased at double-digit rates for more than a decade, far outpacing the growth rate of the primary life insurance market. Against this backdrop of increasing demand for life reinsurance is a general reduction in capacity, according to A.M. Best. While these factors would appear to be positive for the future prospects of the life reinsurance market, A.M. Best's outlook is tempered by some recent emerging trends: further major consolidation is unlikely; and capacity continues to be an issue for the industry. One area where reinsurance is very limited is coverage for secondary guarantees on variable annuities, and here A.M. Best believes there is an opportunity for new entrants. There is, however, more investor interest in supporting new life reinsurance start-ups, and A.M. Best expects some new entrants over the next couple of years. (*A.M. Best Co. Press Release (Business Wire), November 28, 2005*)

- Fitch Ratings reports that a number of start-up reinsurers are being formed in the wake of the reinsurance sector's record 2005 hurricane losses. These reinsurers, commonly referred to as the Class of 2005, are being formed in large part to capitalize on anticipated favorable market conditions, and in this respect, resembles reinsurers formed in the wake of large sector-wide losses caused by 1992's Hurricane Andrew and the events of September 11. Fitch believes that the Class of 2005 may total as many as 10 to 12 reinsurers. (*Fitch Ratings (Business Wire) Press Release, December 14, 2005*)

- The Chubb Corporation announced that it has entered into an agreement regarding a new global reinsurance company, Harbor Point Limited, to be formed by Stone Point Capital LLC. Harbor Point, which is to be based in Bermuda, is expected to have an initial capitalization of about \$1.5 billion, according to Chubb. Chubb, along with Trident III LP—a private equity fund managed by Stone Point Capital—will be the lead investors in Harbor Point. As part of the transaction, Chubb will transfer to Harbor Point its continuing reinsurance business and certain related assets, including renewal rights effective January 1, 2006. Harbor Point will not assume the reinsurance liabilities of Chubb relating to reinsurance contracts started before December 31, 2005. Chubb will retain those liabilities and the related assets and reserves. (*Chubb Corporation Press Release, October 25, 2005*)

Accounting Standards and Developments

Public Company Accounting Oversight Board (PCAOB) and Securities and Exchange Commission (SEC)⁽¹⁾

- **SEC to Propose Amended Disclosures about Executive Compensation and Related Matters**
On January 17, the SEC voted to publish for comment proposed rules that would amend disclosure requirements for executive and director compensation, related party transactions, director independence and other corporate governance matters, and security ownership by officers and directors. The proposed rules would affect disclosures in proxy statements, annual reports, and registration statements, and would require most of those disclosures to be provided in plain English. The proposals also would modify the reporting on

¹ KPMG's *Defining Issues*, 06-2

Form 8-K of compensation arrangements.

- **SEC Revises Accelerated Filer Definition and Filing Deadlines⁽²⁾**

On December 21, the SEC posted to its Web site its rule to amend the definition of accelerated filer in Rule 12b-2 of the Securities Exchange Act of 1934 to:

- Create a new category of accelerated filer, large accelerated filer, that would include reporting companies with a public float of \$700 million or more; and
- Ease current restrictions on the exit of companies from accelerated filer status.

Only a large accelerated filer will be subject to a 60-day deadline to file its annual report on Form 10-K under the final phase-in of the accelerated filing deadlines. However, the final phase-in has been extended one year and will first apply to a large accelerated filer for fiscal years ending on or after December 15, 2006. All other accelerated filers will continue to be subject to a 75-day deadline for filing their annual reports on Form 10-K. The deadline for filing quarterly reports on Form 10-Q will remain at 40 days for all accelerated filers. The filing deadlines for a non-accelerated filer and a foreign private issuer that files on Form 20-F or 40-F are not changed.

- **PCAOB Issues Report on Implementation of Auditing Standard No. 2⁽³⁾**

On November 30, the PCAOB issued its “Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial

Statements.” The report, which is based on inspections and other information, identifies some of the challenges that both accounting firms and issuers faced in the first year of implementation; it does not identify individual firms or registrants.

Financial Accounting Standards Board (FASB)

- **FASB Issues Exposure Draft on Fair Value Option**

On January 25, the FASB issued an Exposure Draft, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, which would allow companies the option to report selected financial assets and liabilities at fair value. Under the option, changes in fair value would be included in earnings. The proposed Statement seeks to reduce both complexity in accounting and volatility in earnings caused by the existing accounting rules. Under this proposal, entities would be able to measure at fair value financial assets and liabilities selected on a contract-by-contract basis. Entities would be required to display those assets and liabilities on the balance sheet separately from assets and liabilities measured under different attributes. Further, the proposal would require companies to provide additional information that would help investors and other users of financial statements to more easily understand the effect on earnings. The proposal also helps achieve further convergence with IFRS, which has a fair value option for financial instruments.

The Exposure Draft would be effective as of the beginning of an entity’s first fiscal year that begins after December 15, 2006, with earlier adoption permitted as of the beginning of an entity’s earlier fiscal year that begins after issuance of the final Statement. The comment period ends April 10.

- **Potential Revision of Statement 123R’s Classification Requirements for Contingently Cash-Settleable Share Options⁽⁴⁾**

Share options and similar instruments that are granted as employee compensation and that could require cash settlement when a contingent event occurs will be classified as either liabilities or equity, depending in part on an assessment of the probability of the contingent event, if a planned FSP is developed and approved in line with the decisions made at the FASB meeting on January 11. The Board instructed the FASB staff to revise the approach in FASB Statement No. 123 (revised 2004), *Share-Based Payment*, by drafting a proposed FSP that incorporates the probability assessment. If adopted, the revision would affect whether a company upon adoption of Statement 123R would have to reclassify as liabilities share-option awards that were previously classified as equity under FASB Statement No. 123, *Accounting for Stock-Based Compensation*, or APB Opinion No. 25, *Accounting for Stock Issued to Employees*.

- **FASB Issues FSP on Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies and Employee Benefit Plans⁽⁵⁾**

On December 29, 2005, the FASB issued FSP AAG INV-1 and SOP 94-4-1, “Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans.” The FSP addresses the accounting and disclosure requirements for fully benefit-responsive investment contracts held by certain investment companies (commonly referred to as stable value funds), and revises the definition of fully benefit-responsive in AICPA Statement of Position (SOP)

² KPMG’s *Defining Issues*, 05-23

³ www.pcaob.org

⁴ KPMG’s *Defining Issues*, 06-1

⁵ www.fasb.org/fasb_staff_positions/fsp_aag_inv1&sop_94-4-1.pdf

No. 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*. The FSP allows certain of these entities to continue to use contract value for fully benefit-responsive investment contracts. The FSP also amends SOP 94-4 to substantially conform the accounting and disclosure requirements for fully benefit-responsive investment contracts held by defined contribution health and welfare and pension plans to the requirements for those contracts held by certain investment companies. The FSP is effective for annual periods ending after December 15, 2006. Early application to interim or annual periods is permitted.

- **FASB Issues FSP on Nontraditional Loan Products⁽⁶⁾**

On December 19, the FASB issued FSP SOP 94-6-1, "Terms of Loan Products That May Give Rise to a Concentration of Credit Risk." The FSP addresses in what circumstances the terms of loan products give rise to a concentration of credit risk, as defined in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. That guidance is effective for interim and annual periods ending after December 19, 2005 (the date the FSP was posted to the FASB Web site).

The FSP also addresses the disclosures or other accounting considerations that apply for originators, holders, investors, guarantors, and servicers of those products that are subject to greater risk than traditional loan products. There is no effective date or transition guidance for those provisions of the FSP because the FSP only references existing effective literature.

- **FASB Decision on Other-Than-Temporary Impairments⁽⁷⁾**

FASB issued and proposed Staff Positions related to accounting for

financial instruments. FSP FAS 115-1 and FAS 124-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," puts an end for now to standard setting on other-than-temporary impairments of securities by endorsing existing requirements with relatively few modifications. In a separate action that may also affect the carrying amount of securities, proposed FSP FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133," would prohibit recognizing unrealized gains or losses on derivative instruments when initially accounting for transactions that took place in markets considered most advantageous to the reporting entity.

- **NAIC / Regulatory**

At the December 3-6, 2005 Winter Meeting of the National Association of Insurance Commissioners (NAIC) by the NAIC's Statutory Accounting Principles Working Group, Emerging Accounting Issues Working Group, Property & Casualty Reinsurance Study Group and NAIC/AICPA Working Group, matters discussed included:

- Exposure for comment of proposed revisions to the Model Audit Rule to incorporate new rules on Internal Control Over Financial Reporting, Auditor Independence, and Corporate Governance. The proposed rules on Internal Control Over Financial Reporting are available on the NAIC's Web site at www.naic.org/committees_e_naic_aicpa_wg.htm. The NAIC/AICPA Working Group will conduct three open conference calls to discuss comments received on the proposed rules, on February 10, February 16, and February 22;
- Adoption of new disclosures for property and casualty reinsurance for audited statutory financial statements beginning in 2006, and adoption of

annual statement instructions for the new property and casualty reinsurance disclosures and certifications that are required for statutory annual statements beginning in 2005;

- Adoption of a clarification to paragraph 13e of SSAP No. 88, *Investments in Subsidiary, Controlled and Affiliated Entities, A Replacement of SSAP No. 46*, which addresses discontinuing recognition of losses when applying the equity method unless the reporting entity has provided a guarantee, to make clear that the paragraph also applies to investments in U.S. insurance subsidiaries;
- Tentative adoption of Interpretation (INT) 05-05, *Accounting for Revenues Under Medicare Part D Coverage*;
- Exposure of modifications to INT 03-01, *Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund (FHCF)*, to address changes in accounting for FHCF assessments as a result of 2004 legislative changes that result in insurers merely acting as agents for the FHCF to collect assessments from policyholders, rather than insurers being initially liable for the assessment;
- Exposure of a modification to SSAP No. 25, *Accounting for and Disclosure About Transactions With Affiliates and Other Related Parties*, to require that transactions between related parties be in the form of a written agreement that provides for timely settlement, with a specific due date, and that amounts owed to the reporting entity over ninety days from the written agreement due date be nonadmitted;
- Deferral for further study of a proposal that would modify SSAP No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, to require separate disclosure of amounts of claims/losses related to extra contractual obligation lawsuits or bad faith lawsuits; and

⁶ www.fasb.org/fasb_staff_positions/fsp_sop_94-6-1.pdf

⁷ KPMG's *Defining Issues*, 05-21

- Review of comment letters from the bail bond industry questioning whether revenues from bailbonds should be reported gross, as currently required, or net of commissions to bond agents, and formation of a subgroup to study the issue. (*KPMG's Defining Issues, 06-1; KPMG's Issues & Trends in Insurance, 05-7*)

KPMG's Audit Committee Institute (ACI)

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

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

Regulation and Legislation

- On December 22, 2005, President Bush signed into law the Terrorism Risk Insurance Extension Act of 2005, which will extend the Terrorism Risk Insurance Act of 2002 through 2007. This new legislation will increase the amount of property and casualty losses that trigger Federal payments over the next two years from \$5 million to \$50 million in 2006 and to \$100 million in 2007. In addition, the legislation will raise industry deductibles and co-payments and increase the financial stake of insurers. The final legislation also calls for the President's Working Group on Financial Markets to conduct a study on the long-term availability and affordability of terrorism risk insurance, including coverage for nuclear, biological, chemical, and

radiological events. A report of its finding is due to Congress by September 30, 2006. (*KPMG's The Washington Report, January 9, 2006*)

- On October 1, 2005, the Financial Crimes Enforcement Network (FinCEN) issued two final rules, requiring certain United States insurance companies to establish an Anti-Money Laundering (AML) program and file Suspicious Activity Reports (SARs) in compliance with the Bank Secrecy Act as revised by the USA PATRIOT Act. Along with other financial institutions, such as banking and securities firms, insurance companies have a significant role to play in preventing money laundering. Money launderers use insurance products with cash surrender value, stored value, and transferability to mask the movement of criminal proceeds and finance crime and terrorism. Insurance companies subject to these rules must establish an AML program to detect and deter money-laundering activity and start filing SARs 180 days after the date of the publication of the final rules in the Federal Register. The effective date of the regulation is December 5, 2005 and it applies to activity occurring after May 2, 2006.

These rules apply to any person (or company) engaged within the United States as a business in the issuing or underwriting of permanent life insurance policies other than group life insurance policies, annuity contracts other than group annuity contracts, and any other insurance products with features of cash value or investment features. Under these rules, insurance agents and brokers are not required to have separate AML programs. However, because brokers and agents often represent the insurance company's only direct contact with the customer, they should be integrated into an insurance company's AML program. (*KPMG's Issues & Trends in Insurance, November 2005, No. 05-6*)

- The NAIC adopted Life Risk-Based Capital C3 Phase II, which sets capital requirements for variable annuities except modified guaranteed variable annuities, group annuities containing guaranteed living benefits or guaranteed minimum death benefits, and other products that provide similar guaranteed benefits. The new rule involved modeling many scenarios to calculate the risk-based capital requirement and leaves certain assumption up to the actuary's discretion based on the company's product history, but it also includes a prescribed scenario that must be calculated as a comparison and floor to the risk-based capital requirements calculated by modeling. (*KPMG's Issues & Trends in Insurance, November 2005, No. 05-6*)

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

Taxation

- **IRS Issues Schedules M-3 for Insurance and S Corporations**
The IRS announced (IR-2005-141) the release of draft Schedules M-3, Net Income (Loss) Reconciliation for Corporations with Total Assets of \$10 Million or More, and instructions for corporations that file Forms 1120PC, 1120L, and 1120S. According to the release, the Schedules M-3—when finalized—will be used by property and casualty insurance companies, life insurance companies, and S corporations that have total assets of \$10 million or more, for tax years ending on or after December 31, 2006. The IRS has requested comments concerning the new draft

Schedules M-3 for Forms 1120PC, 1120L, and 1120S. Comments must be submitted by February 10, 2006.

- **IRS provides loss payment patterns and discount factors**

The IRS released Rev. Proc. 2005-72, providing the loss payment patterns and discount factors for the 2005 accident year. These factors are to be used by insurance companies to compute discounted unpaid losses under section 846. The IRS also released Rev. Proc. 2005-73, providing the salvage discount factors for the 2005 accident year, to be used by insurance companies to compute discounted estimated salvage recoverable under section 832.

- **Gulf Opportunity Zone Act of 2005 Is Enacted**

President Bush signed H.R. 4440, the Gulf Opportunity Zone Act of 2005, thereby making December 21, 2005, the date of enactment. The new Act includes technical corrections to the American Jobs Creation Act of 2004 (Pub. L. No. 108-357) and other legislation. There are no insurance-specific provisions in the Act.

Source: IRS; Court rulings; Legislative materials

- **A Defeat for Insurance Outsourcing Within the EU**

A recent European Court of Justice (ECJ) decision in *Arthur Andersen (Accenture) (C-472/03)* relates to the Value Added Tax (VAT) liability of outsourced back office services and whether these were subject to VAT. The outsourced back office services included acceptance of requests for insurance; processing of amendments to insurance contracts; claims handling; issue, administration and termination of insurance policies; settling and payment of commission to intermediaries; organization and administration of IT; provision of information to the insurer and intermediaries; compilation of reports for policyholders and third parties. The

ECJ concluded that the back office services are taxable because they do not fall within the scope of the insurance exemption in EU law.

As a result of this judgment, outsourced back office services would be viewed as subject to VAT thereby raising the costs of these services for insurers. Generally, insurers will only have limited or no recovery of the VAT they pay on their expenses. This could have wide-ranging effect on the bodies that provide outsourced services to insurers, the insurance companies themselves, and their policy holders who are likely to be the bearers of the additional VAT costs on outsourced services as part of an increase in premiums. However, as the rules regarding insurance and VAT are under review at present, many EU countries may take a wait and see attitude before changing their local rules. (*KPMG UK Indirect Tax Update, 6 December 2005*)

- **Supplies Between Single Legal Entities**

Transactions between two parts of the same business (e.g., a head office and a branch) do not have any VAT consequences as an entity cannot transact with itself (subject to specific anti-avoidance rules in some Member States). This interpretation, however, has been applied inconsistently throughout the EU.

FCE Bank plc challenged the treatment of consultancy, management, training, and data center services received by their Italian branch from their U.K. head office. The Italian authorities proposed to treat these as supplies for VAT purposes and accordingly subject to VAT.

In *FCE Bank plc (C-210/04)* the view of the Advocate General of the ECJ indicates that transactions between two establishments of a single legal entity (e.g., a head office to a branch)

are not subject to VAT. Provided the final decision from the ECJ is consistent with this, a uniform VAT treatment of such charges throughout the EU will result. (*KPMG UK VAT Alert, September 29, 2005*)

- **Modernizing VAT Rules for Financial Services**

The European Commission recently disclosed to providers of financial services at a KPMG sponsored industry roundtable that formal discussions will take place throughout the EU in 2006 on modernizing the VAT rules for financial services (banking, insurance, etc.). This is likely to commence in February 2006 and will include an examination of the current legislative problems and possible solutions. The additional VAT burden associated with outsourcing by this sector was identified as a key issue for consideration. Ultimately there will be a public consultation in the spring of 2006. The stated goal is to have a legislative proposal to amend the governing EU law ready for publication by autumn of 2006. (*KPMG UK Indirect Tax Update, November 29, 2005*)

Market Forces

Consolidation and Convergence

- Swiss Re has agreed to acquire GE Insurance Solutions from General Electric Company (GE) for \$6.8 billion. GE Insurance Solutions' U.S. life and health business will not be part of the transaction. The deal is expected to close by mid-2006. (*Swiss Re Press Release, November 18, 2005*)
- Winterthur Group announced that it is selling Winterthur Canada Financial Corporation and its wholly owned subsidiary, The Citadel General Assurance Company, to AXA Canada, Inc., a subsidiary of AXA S.A., for a consideration of approximately CAD 310 million. The Citadel is a provider of commercial lines and accident and sickness insurance across Canada as well as personal insurance throughout Canada, excluding Quebec. The sale of its Toronto-based operations completes Winterthur's withdrawal from the Canadian market, following the previous sale of its Quebec subsidiary, L'Unique. Subject to regulatory approval, the transaction is expected to be completed in the first quarter of 2006. (*Press Releases: Winterthur Group, November 30, 2005 and AXA Canada, Inc., November 29, 2005*)
- SCOR Group announced in early December 2005 that it has agreed to acquire the 2006 renewal rights relating to Alea Europe property and casualty treaty portfolio. The two groups estimate the value of the renewal rights to be in the range of EUR 8.3 million to EUR 16.6 million, depending on the treaties actually renewed by SCOR. In another transaction, Alea Group Holdings (Bermuda) Ltd. announced that a subsidiary, Alea London Limited,

has entered into an agreement to sell the renewal rights of part of its London-based facilities insurance and reinsurance business to Canopus Holdings UK Ltd., the specialist Lloyd's underwriter. Additionally, Alea Group Holdings (Bermuda) Ltd. announced an agreement to sell the renewal rights to certain portions of its U.S. primary program business written by Alea Alternative Risk to subsidiaries of AmTrust Group, a privately held New York based insurance and financial services company. The Group retains ownership of Alea North America Insurance Company and Alea North America Specialty Insurance Company. (*Press Releases: SCOR Group, December 8, 2005 and Alea Group Holdings (Bermuda) Ltd. December 5, and November 22, 2005*)

- In November 2005, Aon Corporation completed the sale of its wholesale insurance broker firm, Swett & Crawford, to an investor group including Hicks, Muse, Tate & Furst, Incorporated and Banc of America Capital Investors. Terms of the sale were not disclosed. Aon also said that it is considering selling its warranty, credit insurance, and property & casualty underwriting businesses. (*Press Releases: Hicks, Muse, Tate & Furst Inc. (Business Wire), September 22, 2005 and Aon Corporation, November 16, 2005*)
- Nationwide Financial Services, Inc. filed an application with the Office of Thrift Supervision in September 2005, to expand the powers of its wholly owned subsidiary, Nationwide Trust Company, FSB. If approved, the newly expanded federal savings thrift would be renamed "Nationwide Bank" and would have the authority to engage in a full range of activities. According to the

release, Nationwide's application would expand its ability to provide retail banking products and services, and trust operations would continue as a division of the new bank. The expanded thrift is expected to begin operating by Spring 2006. (*Nationwide Financial Services, Inc. Press Release, September 16, 2005*)

- Allianz AG announced in September 2005 its intent to acquire the remaining shares in Riunione Adriatica di Sicurtà (RAS) SpA. In December 2005, both boards approved the merger in which Allianz will offer three of its shares for 19 RAS ordinary or savings shares. The merger is expected to be completed in the summer of 2006. The value of the deal is approximately EUR 5.7 billion. Allianz said the full acquisition of RAS will enable the company to reorganize its Italian activities and to directly reallocate the holdings of operations to Allianz Holding in key European markets, such as Austria, Switzerland, and Spain. (*Press Releases: Allianz AG September 11 and December 16, 2005*)

Risk Management

- The United States and the Caribbean should brace themselves for yet another active Atlantic hurricane season in 2006, according to Tropical Storm Risk (TSR), a forecasting consortium co-sponsored by Benfield Group Ltd. TSR's long-range forecast anticipates landfalling hurricane activity in the United States and the Atlantic basin during the 2006 season being 60 percent above the 1950-2000 norm. TSR's prediction includes 16 tropical storms for the Atlantic basin as a whole, with 8 being hurricanes and 4 being intense hurricanes. TSR predicts five tropical storm strikes on the United

States in 2006, two of which will be hurricanes. (*Benfield Group & Tropical Storm Risk Press Release, December 6, 2005*)

- U.S. life insurers are using more robust approaches to measure investment risk, according to the latest CFO survey by the Tillinghast business of Towers Perrin. The study indicates that more than two thirds of life insurance company CFOs use stochastic modeling techniques to model investment and other risks for many lines of business. In particular, more than half of respondents use stochastic defaults or credit risk transition matrices to properly model credit risk. The survey—the 12th in a Tillinghast series of periodic surveys among more than 70 North American life insurance CFOs—focused on how insurers measure and model investment risk. Investment risk, such as market volatility and credit risk, represents a major financial risk exposure for life insurers. Yet, nearly half of the companies surveyed reported that Board members do not sit on any of the investment-related committees. However, most Boards do provide input into the process, such as assessing investment policy and constraints, establishing risk tolerances and determining derivatives policies. The survey showed that most respondents still use primarily traditional asset-liability management approaches, such as duration/convexity and cash flow matching of assets and liabilities, to incorporate liability-side risks into the investment policy process. However, more than half have begun to supplement these approaches with more robust and precise solutions such as hedging programs—most frequently, for annuity products. (*Tillinghast Business of Towers Perrin Press Release, November 3, 2005*)
- 28 percent of identity theft victims indicate they have not been able to

restore their identities, despite averaging more than a year trying. Results of a new survey of 1,097 identity theft victims released by Nationwide Mutual Insurance Co. show the average amount of total charges made using a victim's identity is \$3,968. Often, ID theft victims don't know who to turn to for help in restoring their identity. 40 percent of the victims named either the police, financial institutions, or credit issuers as the most difficult to work with while attempting to resolve their case. Poor customer service and failure to resolve the fraudulent charges were at the root of their dissatisfaction. According to Nationwide, ID theft victims need to be able to turn to someone who can provide professional guidance to help them restore a stolen identity. (*Nationwide Press Release, July 26, 2005*)

- Canada's home, car, and business insurers and SMARTRISK, along with other consultative partners, have called on the federal government to implement the recommendations contained in the comprehensive study, "Ending Canada's Invisible Epidemic: A Strategy for Injury Prevention." According to a recent press release from the Insurance Bureau of Canada (IBC), saving thousands of lives, reducing hospital care expenditures, and shrinking a CAD 15 billion burden to Canadian taxpayers are among the benefits of a proposed National Injury Prevention Strategy released on October 25 by injury prevention groups and the insurance industry. The IRC indicates that despite the toll exacted every year, very few resources are dedicated to either learning more about the causes of injury or putting in place coordinated plans to address injuries. The study, which was contributed to by IBC, would involve the creation of an Injury Prevention Centre of Canada, which would collect data and research, and help communities and

governments implement effective, evidence-based strategies to reduce injury. According to the IBC, the strategy could considerably reduce the human, economic, and health system costs of injury. SMARTRISK is a charitable organization that aims to help reduce injuries of all Canadians but places special emphasis on children, youth, and seniors. (*The Insurance Bureau of Canada Press Release, October 25, 2005*)

- To help assess the capital adequacy and financial strength of insurance companies in North America and Europe, Fitch Ratings now utilizes AIR Worldwide's catastrophe risk management systems to assist in evaluating insurers' natural catastrophe risk. According to AIR Worldwide, a member of the ISO family of companies, this is the first time a rating agency will integrate a third-party catastrophe modeling system into the proprietary models it uses to assess the financial strength of an insurer or reinsurer. (*Air Worldwide Press Release, October 17, 2005*)
- A recent Insurance Research Council (IRC) study of auto injury insurance claims puts a price tag on the cost of claim abuse in California. In 2002, between \$319 and \$432 million in bodily injury liability (BI) payments in the state were attributable to claim fraud and buildup, the IRC estimates. The appearance of fraud, or the misrepresentation of key facts of claims, was found in almost one in ten paid California BI claims. The appearance of buildup was more common and was found in more than one in five paid California BI claims. The term "buildup" refers to the inflation of otherwise legitimate auto injury claims. Buildup can occur through the exaggerations of injuries, the application of excessive medical treatment, or the intentional inflation of lost wages. This report follows the

release of a national IRC research publication on fraud and buildup in auto injury insurance claims. The IRC indicates that while this report shows that claim abuse in California is a significant financial problem, the percentage of claim fraud found among California BI claims was comparable to the percentage found country wide. The prevalence of BI claim buildup in the state was 4 percentage points higher than the corresponding national percentage. (*Insurance Research Council Press Release, January 5, 2006*)

International Focus and Globalization

- A Swiss Re sigma study indicates that liability insurance outperformed overall non-life business in emerging markets. While overall non-life insurance premiums grew by 5 percent per year between 1999 and 2003, liability premiums increased at an annual average of 13 percent. Swiss Re's new sigma report analyzes the recent trend and the opportunities and threats for insurers, particularly in Asia, Latin America, and Eastern Europe. Robust economic performance was observed in the emerging markets in 2004. Together with the implementation of compulsory insurance and changes in taxation and pension systems, this boosted insurance growth: life and non-life business grew by 7.5 percent and 8.9 percent in real terms, respectively, to a premium total of \$372.2 billion. This trend is seen to continue in the medium term. According to the study, the emerging insurance markets are expected to grow by 8 percent and 5 percent per year in life and non-life business, respectively, in the period 2005-2010. Liability insurance in the emerging markets is expected to grow twice as fast as GDP. (*Swiss Re Press Release, December 2, 2005*)

- China Pacific Insurance (Group) Co., Ltd. (CPIC Group) and The Carlyle Group signed a definitive agreement to equally participate in the injection of RMB 6.6 billion new capital into China Pacific Life Insurance Co., Ltd. (CPIC Life). The Carlyle partnership will hold a 24.975 percent stake in CPIC Life after the injection. Currently, CPIC Life has an 11 percent share in China market, of which the top three players combined have over 80 percent. (*The Carlyle Group Press Release, December 19, 2005*)
- Lloyd's announced that it has been given permission to establish an onshore reinsurance operation in China. The onshore license will enable Lloyd's to reinsure local currency business, which currently comprises nearly 90 percent of the total Chinese market. It will also provide Chinese insurers with full access to the Lloyd's market. Lloyd's established a representative office in Beijing in 2000. (*Lloyd's Press Release, November 9, 2005*)
- CITIC Trust and Investment Company Ltd. (CITIC Trust) has become Allianz's new joint venture partner in China, and will take over Dazhong Insurance Co. Ltd. of China's shares in Allianz Dazhong Insurance Co Ltd. Allianz Dazhong opened in January 1999 in Shanghai. Its product range includes endowment, safeguard, investment, education, medical treatment, accident insurance, etc. In 2005, it extended its business to the Guangdong province. (*Allianz Group Press Release, October 18, 2005*)
- Watson Wyatt announced that it is setting up an insurance and financial services consulting presence in Shanghai in early 2006. The firm had been advising China's growing insurance company market from its long-standing base in Hong Kong. The firm initially established an office in Hong Kong in 1973, entered China in

1984, and opened a wholly foreign-owned representative office in Shanghai in 1995. Watson Wyatt's Greater China business unit comprises five offices—in Beijing, Hong Kong, Shanghai, Shenzhen, and Taipei. (*Watson Wyatt Press Release, November 28, 2005*)

- AIR Worldwide Corporation and ISO announced in December 2005 the opening of the AIR Worldwide Corporation Beijing Representative Office in China. Earlier in the year, AIR said that it released its detailed China earthquake model, which enables insurers and reinsurers to estimate potential property losses caused by earthquakes for multiple lines of business. To accommodate insurance coverage needs in the rapidly developing country, AIR indicated that its China earthquake model incorporates special damage functions for structures under construction—typically covered by construction all risks/erection all risks policies. (*AIR Worldwide Corporation Press Release, December 12, 2005*)

e-Business and Technology

- Celent's third annual survey of senior insurance industry IT executives reveals a positive IT outlook for 2006, modest budget increases, and renewed focus on enterprise data quality. In the fall of 2005, Celent surveyed senior IT executives to identify trends in the priorities, behaviors, initiatives, and infrastructures at U.S. insurers. The report summarizing the results, "Insurance CIO/ CTO Pressures, Priorities, Projects, and Plans for 2006: Survey Results," finds a notable development of increased awareness and focus on enterprise data initiatives, an area Celent has labeled "data mastery." Across the board, new project budgets continue to be focused

on core systems, distribution/e-business, compliance/security, and data mastery initiatives. Other areas like e-signature, VoIP, and wireless are under active consideration by many insurers for 2006. Celent also reports that use of IT outsourcing continues to be strong and growing, with the average large and midsize insurer spending 17 percent and 11 percent, respectively, of their IT budgets on outsourced services. (*Celent Press Release, December 14, 2005*)

- Another Celent report, released in November 2005, indicates that some insurers are already using emerging technologies, while others have not started to research their potential use. Celent says this ever-widening gap will allow some carriers to gain—and most likely sustain—a competitive advantage. In the report “Using Emerging Technology for Competitive Advantage: A Near-Term Guide for L/H Insurers,” Celent examines these technologies and how carriers should be using them. Emerging technologies that are already in use by consumers or other industries—and in some cases a handful of insurers—and are being increasingly considered by carriers include open source software, new wireless technologies, and VoIP. Other less mature technologies are starting to be piloted or at least investigated by carriers. These include grid, cluster, and/or utility computing, multifunction cell phones, as well as electronic forms, such as e-applications that leverage e-signatures or digital pens and paper. According to the report, other technologies are just now getting to market, such as WiMAX and 3G, new wireless technologies that will allow for always-on, broadband connections virtually anywhere. (*Celent Press Release, November 28, 2005*)
- Guy Carpenter & Company, Inc. announced that it has introduced i-aXs catastrophe mapping, an online tool

that enables clients to assess specific properties at a potential risk of loss in areas impacted by catastrophes, specifically Hurricanes Katrina and Rita. The Web application uses pre- and post-event satellite images to review damages down to an individual location level. The site also features data layer controls that allow the user to view live radar images and precipitation bands of an active event and maximum sustained winds, storm surge, and FEMA damage data on a post event basis. (*Guy Carpenter & Company Press Release, September 28, 2005*)

- BearingPoint, Inc. announced the results of a global study showing that the insurance companies that implement key automation technology can reduce costs by as much as 30 percent. BearingPoint indicates that insurance companies that have not already implemented business process automation technology, including straight-through processing, integrated client information systems, and service-oriented architecture (SOA) for customer service and administration functions, can improve efficiency by doing so. The study, “How To Create A Platform for the 21st Century Insurance Firm,” released in November 2005, notes other key trends for the next decade, including:
 - Insurance companies will act as an information network hub, with agents, banks, and policyholders as the spokes, able to initiate, or respond independently to requests.
 - Business process automation solutions are the next breakthrough technology for the insurance industry. These solutions will enable automated work assignment, eliminate manual tasks, and unlock productivity through better use of information.

- The customer experience will be a key differentiator regarding how insurance and financial products are sold, delivered, and fulfilled.
- The modernization of the large Asian economies will create a new, multibillion-member middle class. A key differentiator for insurers’ long-term growth will be how they adapt to China’s market, and Asia in general, where consumers’ technology sophistication is often beyond that of Western countries. (*BearingPoint, Inc. Press Release, November 2, 2005*)

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Analysis and Commentary

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One Step Forward, Two Steps Back for TRIA

**By Christopher Westfall, Managing Editor, *Insurance Insider*
December 29, 2005**

The insurance industry may not have long to enjoy its victory in the renewal of the Terrorism Risk Insurance Act (TRIA) by the U.S. Congress last week.

While the extension gives certainty to property/casualty contracts being finalized for 2006, it does little to ensure coverage beyond that. In fact, industry watchers say once carriers and reinsurers begin negotiating renewals in six months for 2007 policies, they will already need to assume the legislation's demise.

So while insurers breathe a sigh of relief over the next several weeks, there is a feeling that a federally-funded backstop for terror coverage will evaporate forever once the current legislation expires.

"In the long term there is a good deal of uncertainty," says Aaron Davis, vice president for Aon Property Syndication. "I would even say it's likely the industry will be in a worse position in two years."

TRIA was signed into law in November 2002 as a federal government guarantee for terrorism risk insurance. The law was passed to provide capacity for terror coverage that vanished from the commercial P/C industry after the September 11 attacks. The government acted essentially as a reinsurer, offering carriers a backstop for their P/C programs

if a terror event caused a large loss.

TRIA was designed from the beginning as a temporary program, and was set to expire by Dec. 31, 2005. But after a full-court-press by the insurance industry this year, both the House and Senate reached agreement to renew the TRIA program.

That's good news for insurance carriers and P/C policyholders in the short term, because they faced having to figure out how to finalize their 2006 contracts, set to take effect this week, if TRIA were not renewed.

"This will stabilize the industry and allow the carriers to continue to cover this potential loss," says Lisa Stimson, a senior manager with KPMG's Regulatory Risk Advisory Services practice in Hartford. "It appears to be a win/win situation for the government, the industry and those needing the insurance."

And having some sort of TRIA protection in place over the next two years—which is the length of renewal for the program approved by Congress—is certainly more desirable than having nothing at all, says Aon's Davis. "In the short term it's good news for the property market because 85 percent of policy holders were looking at exclusions [for terror cover] if [TRIA] was not renewed."

When negotiating the TRIA renewal, lawmakers made several changes to return more of the burden for terror cover to the insurance industry, such as increasing the industry's retention from \$25 billion to \$27.5 billion. The bill also raised the bar on the so-called per-event "trigger point" at which the program would be activated, from a \$5 million aggregate loss to \$50 million in 2006 and \$100 million in 2007. The final bill also excludes coverage for commercial auto, burglary and theft, surety, professional liability and farm owners' multiperil.

The captive industry, which blossomed after TRIA's approval because it allowed companies direct access to the backstop, also sees the extension as a positive, says Molly Lambert, president of the Vermont Captive Insurance Association. "We felt it was of critical importance to our industry," she says. "There was some worry that the trigger point would have been raised to \$500 million, which would have not made sense for captives. But moving the trigger from \$50 to \$100 million is much more manageable."

But the insurance industry may have lost a chance this year to negotiate a permanent, workable solution and could just end up back at square one when the current legislation expires, Davis says. "I think the insurance industry will be in a worse position in two years because the political will for a government backstop will evaporate," he says. "You already see major increases in retention in this extension. In a lot of ways, this was the industry's last chance."

Davis explains that given the resistance to the TRIA extension this time around, legislators are unlikely to be willing to lengthen the protection in the "relatively short period" of two years, especially with Congressional elections coming up during that period.

"It's a two-year extension, so insurers are getting to underwrite (with TRIA in place) for one policy year," Davis adds.

The immediate changes, even though significant, should not lead to major adjustments to pricing on property coverage over the next 24 months, says Suzanne Douglass, managing director of property risk management for Willis Group in New York. "I don't think there will be much of a change in short-term underwriting position," she says. "But what really worries me is what happens in two years."

Douglass says the two-year TRIA extension simply postpones the inevitable, and doesn't even take steps to slowly include private capacity even though government subsidies are being removed. "In this extension there is no incentive for reinsurers to involve themselves [as deductibles and trigger points rise]," she says. "What you put out for reinsurance [above TRIA] you take for your own account, and this is not going to happen."

Davis adds that unless there is another terror attack on U.S. soil in the next two years, insurers should expect TRIA to sunset. "You are going to see the same exclusions in the 2007 renewals that were in the 2005 contracts," he says. "It's not going to be a pretty picture."

Avian Flu Casts a Frightening Shadow Over Insurers
By Christopher Westfall, Managing Editor, *Insurance Insider*
December 6, 2005

The possibility of a global avian flu outbreak is haunting insurers—including life, health and property/casualty—and it appears that there's little they can do to mitigate losses prior to a pandemic.

However, there are options. Carriers can take steps to prepare for a viral catastrophe, such as using computer models and underwriting to quantify what lines and regions that avian flu would hit hardest. In addition, arranging additional capacity with reinsurers in the event of a pandemic would also help prepare for the flu's financial shock.

But perhaps the most effective tactic is educating policyholders. Working with local, state and federal governments about flu diagnosis, treatment and containment may be insurers' best hope to avoid a major loss event.

"Most of the policies at risk are already in existence, so it all depends on how bad of a pandemic it is, and the age distribution of claims," says Steven Weisbart, and economist with the Insurance Information

Institute (III). "What can be done now is gathering information, as well as getting information out."

The nature of an outbreak presents a frightening scenario for life underwriters. The strain of avian flu that is causing the concern, the H5N1 strain originating from Asia, is expected to affect wide segments of the population, not just the groups that are considered particularly vulnerable to influenza, such as the elderly.

Although the disease has been limited to birds and those in direct contact with infected fowl, scientists fear it will mutate and spread to humans.

What concerns health officials most is a worldwide bird flu pandemic, in which a virus spreads across the globe. There were three influenza pandemics in the 20th Century, the most deadly the 1917-18 outbreak of Spanish flu that killed 40 million to 50 million people worldwide.

The U.S. Department of Health and Human Services estimates that 1.76 million Americans could die as the result of an avian flu pandemic; the World Health Organization estimates as many as 7.4 million deaths worldwide. Those numbers could go higher, depending on the virulence of the virus.

Weisbart, who is conducting a study on the impact of a flu pandemic on the life insurance industry, says that carriers should start a dialogue with the reinsurers on capacity issues.

"The first thing I would do is try and understand my reserves, and make sure my firm will have access to reinsurance to pay claims," Weisbart says.

Right now, life reinsurance is concentrated among a few global operators that include Swiss Re and Munich Re, Weisbart says. American life carriers could find themselves behind European carriers for additional capacity in order to pay claims.

Life carriers often approach reinsurers for additional capital, but only during the period when claims could outpace expected payouts.

"In a pandemic year, everyone would need capital," Weisbart says, in reference to demand for reinsurance. "There would be a huge scramble. It would look like Best Buy on a sale day."

A spokesman for Munich Re says that although carriers could approach them about capacity, the discussion would be a guessing game. The possible consequences of an outbreak are "a matter of pure speculation," because there's no way to estimate the severity of a pandemic.

Still, with the possibility of a high mortality rate, life insurers should start planning their response to avian flu and gauge the impact on their balance sheets, says Eric Rasmussen, vice president of risk management at ING Re.

"If you follow through on the possible outcome, individual life would be significantly [affected]," he says. "And among those companies, it really comes down to their geographic spread of business. For example, how much group life did you write in urban areas, [which] could see significant losses?"

While Rasmussen says that there is no way to determine if avian flu will disproportionately affect large cities, past experience has shown that to be true.

In addition, avian flu could hit policy holders normally considered low-risk for flu death: Americans in their youth or middle age who purchase term insurance during their prime working years.

"It all depends on the severity of the pandemic, and if it even gets to the urban centers and if quarantines are implemented and effective," Rasmussen says. "Either way, it's better to have a geographic spread of business."

The impact on insurers will also depend on the type of business written. Term and group life insurers could suffer significant losses compared to whole life insurers, whose policies have a savings component that offsets carrier risk.

The property/casualty industry may suffer the most in business interruption claims, according to Standard & Poor's report. Losses would come from business-interruption claims, particularly in tourism.

Insurers themselves could suffer from an operational standpoint, as they did in the aftermath of the Sept. 11 terrorist attacks, the report says. "Many insurance company employees could be barred from their workplaces at a time when their companies would have much more business to review."

According to Timothy Luedtke, a director in KPMG's actuarial practice, it's important for health insurers in particular to get accurate assessments of risk and costs ahead of any outbreak.

"Assess your potential financial risk [and] reinsurance programs, and include these assessments in your enterprise risk management and capital management planning," Luedtke says.

Some insurers have asked catastrophe modeling firms to develop financial scenarios, says Andrew Coburn, vice president of catastrophe research at risk modeling firm Risk Management Solutions.

In research done two years ago, Risk Management estimated that American insurers would suffer \$39 billion losses as the result of a flu pandemic. But the H5N1 virus produces greater mortality and sickness than the initial model; Risk Management is reworking its numbers and expanding its estimates to global insurers.

"We modeled 1918 type flu, where one-third of the population gets sick and it produces a 0.5 percent mortality rate,"

Coburn says. "[The bird flu] may be significantly higher than that." Some estimates are that the avian flu could sicken as many as one-third of adults domestically.

Coburn says that there's little life and health insurers can do on the "portfolio management side" to prepare for a pandemic, such as cut into surpluses, cancel dividends or tap reinsurance. And "pricing for a pandemic" is essentially unworkable.

Instead, insurer education may be the most effective measure against huge losses, says the Ill's Weisbart. "Get the word out to policyholders on how to prevent and avoid infections and to seek immediate medical treatment," he says. Such preparations also includes insurers working with all levels of government on infection prevention programs.

"I'm encouraged that the industry is pushing to create awareness and prevention programs with the government," says ING's Rasmussen. "It's the best thing that can be done on the front end to mitigate the back end."

Education should extend to the employees of life insurers.

"Insurers should review business continuity plans and assure the ability to continue servicing the insured population while significant portions of the workforce are homebound," KPMG's Luedtke says.

Insurers See an 'Explosion' in D&O Coverage **By Christopher Westfall, Managing Editor, *Insurance Insider*** **December 6, 2005**

In response to board members' anxiety that their personal assets are at risk, underwriters of directors and officers (D&O) insurance are rolling out new products designed to shelter personal fortunes from the long arm of class-action litigation.

Insurers are offering new twists on traditional D&O, such as "excess Side A"

coverage and "exploding insurance," to address the panic that has infiltrated boardrooms. With class-action lawsuits hitting board members' bank accounts, carriers are seeing high-profile interest in the new-and-improved D&O insurance.

"More and more, I'm hearing from committee and board members 'What about me? How do I make sure that I don't end up like those other guys?'" says W. Neil Eggleston, a partner with the law firm of Debevoise & Plimpton.

Earlier this year, litigants reached a \$6.1 billion settlement in regards to a class-action suit against WorldCom (now MCI), which had declared bankruptcy in 2002 following revelations of massive fraud. Although the corporation and its banks will pay most of the settlement, the lawsuit had a separate, \$60.5 million agreement with 10 independent directors; of that amount, 20 percent came from the director's personal assets.

Other lawsuits involving board members also involved directors reaching into their own wallets, including litigation against Walt Disney and Enron. Ten former Enron directors paid \$13 million as part of a \$168 million settlement.

Some class-action attorneys feel justified in raiding personal assets for the most egregious corporate frauds, said Sean Coffey, a partner with the law firm of Bernstein Litowitz Berger & Grossman and the lead trial attorney in the WorldCom suit.

"From our perspective, we are out there to empower other timid directors to raise the bar and not scare them off," Coffey said. He spoke at the recent Forbes Risk Conference in New York.

"I can think of less than six instances where a director had to pay out of pocket," Coffey said. "So a director should be cognizant of their fiduciary obligation, but not so afraid that they can't walk into a boardroom."

In response to the litigatory flood, D&O underwriters are offering coverage designed to protect directors' pocketbooks beyond traditional Side A, B and C policies.

Side A insurance generally covers individual directors and officers for non-indemnifiable losses, or losses that the company cannot pay for. Side B reimburses the company for payments made to individual directors and officers to cover claims, settlements and defense costs. Side C reimburses the company for securities claims made against the corporate entity itself.

Most new products are excess Side A policies, offering directors insurance where traditional policy would be tapped out or withdrawn.

Some excess Side A policies are "non-rescindable," which means a policy cannot be voided for a director if other directors or management are found to have committed fraud.

"This is a big concern because in many cases you have several board members left without insurance when they most need it because of one or two bad apples," says Todd Jones, North American leader for Willis' Executive Risks Practice.

Jones says that excess Side A can be sliced in numerous ways, with limits for individual directors. For instance, there are policies that include coverage that remains in place in case of a corporate bankruptcy.

Each different type of insurance commands different prices. "Some carriers are taking on a net basis, and some are getting reinsurance," Jones says. "I've seen some significant swings in pricing, depending on the carrier and the insured. It's not like everyone is charging \$10,000 per \$1 million in coverage."

Changes in how class-action lawsuits have been pursued—with the focus on directors' personal assets has made board members

skittish of relying on traditional D&O insurance. The increased regulatory burden of the Sarbanes-Oxley Act also has given directors extra motivation to get additional coverage.

"Fundamentally, when a director is making a personal contribution [to a settlement] the D&O is not responding anyway," Jones says. "So it's the insurance marketplace giving the insured more certainty."

Insurers are rolling out new products as quickly as possible, said Carol Zacharias, senior vice president for ACE USA, who spoke at the Forbes conference.

"The average cost of each case is going up, so I no longer have to walk into a boardroom and explain that D&O does not stand for 'Doctors and Osteopaths,'" Zacharias said.

Other products and services include A/B/C "towered" policies, insurance specifically tailored for independent directors and so-called "exploding" insurance. An "exploding" policy, Zacharias explained, would have the insurance "disappear" if the plaintiff goes after a director's personal assets, thus discouraging payouts coming out of directors' pockets by keeping the ultimate settlement within the D&O policy.

Insurers are even marketing estate planning tools, such as asset-backed trusts, to protect directors' assets.

But additional D&O policies aren't the only way for directors to protect themselves. Simply taking additional care when buying traditional A/B/C insurance will help board members, said Lou Ann Layton, managing director at Marsh & McLennan unit Marsh Inc.

In the past, the general counsel would be in charge of buying D&O insurance, Layton said, often "piling on" management or additional risks to the policy. For instance, a company would add lower-tier managers to a policy without expanding the total amount of the

coverage. When claims were made, directors were often the last in line.

"Directors today should be much more involved of who is covered [by the D&O policy] and what type are they buying," Layton said. "They need to understand all the different loss scenarios that can happen."

In the Wake of Hurricanes, Companies Shift Storage By Dave Pelland, Managing Editor, *Technology Insider* October 27, 2005

Damage from Hurricanes Katrina and Rita, as well as the July bombings in London, has prompted more large companies to back up data in distant locations and lessen their reliance on computer tapes.

"Everybody knows they should have a robust data protection and disaster recovery plan, and when [disasters] happen, anyone who hasn't updated [their plan] lately tends to take another look at it," says Glenn Groshans, director of product marketing for Symantec's data management group.

Until a few years ago, standard disaster plans generally entailed copying data to tape drives and storing the information in secure locations outside their data centers, says Stephen Higgins, director of business continuity and security for EMC Corp. Those plans usually relied on the companies' ability to retrieve their tape cartridges and restore data in 48 to 72 hours.

But with companies now generating huge amounts of data—and the price of storing information on disks decreasing an average of 40 percent annually—large firms are using networked storage hardware and replication software to transfer important records to servers located in remote data centers.

If a primary data center fails, companies expect to be able to access their records within an hour.

"More companies are moving data out of a region and having that data essentially live and ready to go," Higgins says.

In addition, companies are looking for ways to make sure data is automatically stored in multiple locations, while increasing the distances between facilities.

"We're getting questions about how to extend out-of-region recovery," Higgins says. "What's the likelihood of something happening in a region? What's the power grid like? Where do tornadoes or storms run? [Companies are] looking at those factors and deciding where best to replicate their data."

According to Jerry Shammas, director of business continuity and recovery services for AT&T Corp., companies tend to store backups about 200 miles from their primary data centers.

"Companies have learned that keeping a copy of the data in the same metro area as your production facility is OK, as long as there's another copy that's kept at a greater distance," Shammas says.

While vendors say it's too soon after Katrina and Rita to identify sales trends, interest in remote storage appears to be increasing. Michael McMillan, a sales vice president for AT&T, says several firms considering continuity services before Katrina struck have accelerated the purchase process.

One company in New Orleans considering remote storage before Katrina struck lost a great deal of information when its data center was destroyed, McMillan says.

But the reliable transfer of data to storage servers in distant locations can create challenges. The first is having necessary network capacity—companies must ensure that copying data for backups won't strain their information systems.

"Anytime you want to move things over the network, you have to make sure you have the bandwidth and determine what

else you're trying to do on the network at the same time," says Symantec's Groshans.

The cost of storing data can vary according to a number of factors, starting with the selected media, the amount of data being transferred and whether or not companies are purchasing storage as a hosted service. The falling price of disk-based storage media means the technology costs are roughly the same as using tapes for backups.

According to AT&T's Shammas, companies in financial services and health care, as well as the federal government, have been among the first adopters of remote-storage technology.

To avoid paying for idle remote data centers, some companies are dividing applications between two or more facilities that are able to take over for the other if necessary.

"If you're running five applications, you might have three at one data center and two at the other," says AT&T's McMillan. "The end user won't know which applications are running where, and they won't care. The key is that either center has enough capacity to run all five applications."

Groshans says companies are also turning to different technologies to improve the efficiency of data transfers. For instance, compressing data reduces the amount of information traveling over the network.

Perhaps more importantly, companies are evaluating their data needs and making sure they can restore the most critical data first. In the aftermath of a disaster, most companies would rather have immediate access to transaction records or customer data than personnel records.

"We recommend firms understand what data is important," says EMC's Higgins. "They can take the data that's not being accessed frequently and archive it to disk libraries or move it to tape."

Another replication technology, called "single instance storage" or "commonality factoring," tries to avoid backing up the same data too many times.

For example, if two copies of a single document are stored in separate locations, and both copies are scheduled to be backed up to a central facility, software can prevent the unnecessary duplication.

Similarly, software can examine the blocks of data within individual files to identify each block's unique signature. Instead of sending the entire block, the software will send only the signature to determine if the data blocks are already backed up on a storage server. That way, the system only needs to send new or changed blocks of data.

"You're trying to find common elements and not continue to make copy after copy of the same stuff," says Groshans. "Those techniques are reducing the amount of data that needs to be sent across the wire."

The de-emphasis on tape drives doesn't mean the technology is going away. Higgins and Groshans say tape is better-suited for long-term archiving of data than hard disks.

But the speed and distance advantages that disk drives offer, paired with strong replication software, means the role of tape in business continuity will likely continue to diminish.

"People tend to get a keen appreciation for the value of their data right after they lose it," Groshans says.

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

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