

Current Issues Committee

Newsletter July 2006

The content of this newsletter is a summary of some of the current issues that might be of interest to UK General Insurance actuaries and that have come to the attention of the Current Issues Committee. As such it is not a complete list. Anyone who feels that relevant issues have been omitted or that the above summaries are in anyway misleading is invited to contact the Chairman of the Committee, Laurence Townley.

The information provided has been derived from a variety of sources. The Committee has not been able to check independently the veracity of all of the facts stated. Any opinions expressed are those of the Committee members, and do not necessarily reflect the position of the Institute or Faculty of Actuaries.

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CLAIMS AND LEGAL ISSUES

UK Asbestos

The House of Lords, has decided that in cases where several employers have negligently exposed an individual to asbestos, more than one may be considered liable, and thus be expected to help pay compensation.

The judgment will be of interest to providers of employers' liability insurance, and the Association of British Insurers reacted positively to the news, commenting that the new judgment is "fairer than the current approach, which sometimes puts the full burden of compensation on one employer when many may have been liable".

The Law Lords judged that in instances where workers had been exposed to asbestos a number of times, all cases of exposure should be considered before any one employer was ordered to pay compensation. If these instances had occurred under the supervision of more than one employer, it was judged that compensation bills would be split between the employers according to the length of time they had wrongfully exposed the employee to harmful amounts of asbestos.

In the resolution of one case, *Barker v Corus*, it was decided that Corus was liable jointly with another of Mr Barker's former employers, Graessers, but that the compensation should be subject to a 20% reduction for Mr Barker's contributory negligence because he was also exposed to asbestos while self-employed.

The *Barker* case is one of a series of developments surrounding claims where a mesothelioma sufferer has been exposed to asbestos by more than one employer. Previously, the House of Lords ruling in the *Fairchild* case was widely interpreted as allowing a mesothelioma victim to recover in full from any one employer. *Barker* has been viewed as a partial reversal of *Fairchild*, as *Barker* indicates that each potentially negligent employer should only be required to make a partial contribution to damages.

Some have expressed concern that *Barker* places the onus to trace all culpable employers on employees. In particular, the employee's compensation is likely to be reduced in the case that a previous employer is insolvent and insurers cannot be traced. In the latest twist to the saga the government has proposed to amend the Compensation

Bill currently going through parliament to attempt to reverse the Barker ruling. At present the ABI appears to be the lone dissenting voice to this proposal.

US Asbestos

The New Jersey Supreme Court ruled that an employer can be sued for injuries allegedly caused by exposure to asbestos to the wife of a worker who had been in contact with asbestos.

The decision opens the way for a claimant to seek damages from a previous employer for the death of his wife, who died of mesothelioma in 2001. The claimant alleged that his wife had contracted the disease while washing his work clothes that had been contaminated with asbestos.

In judgement, the judge noted that the employer, Exxon Mobil owed a duty to spouses handling the workers' unprotected work clothing based on the foreseeable risk of exposure from asbestos borne home on contaminated clothing.

Equitas Increases Asbestos Reserves

Equitas raised its asbestos reserves by £128m to £2.2bn by the end of March. This is the sixth time in seven years that it has increased its asbestos reserves.

Gross claims paid were £744m last year, compared to £1bn in the previous year. Equitas' reported surplus has fallen by £18m to £458m, implying a solvency margin of 12 per cent. This compares to the 5.6 per cent level solvency margin when the group was formed in 1996.

Scott Moser, chief executive, said that Equitas had completed 18 significant asbestos settlements, finalising the claims of each of the policyholders. However, he noted that given the size of potential claims, the ultimate success of Equitas was not guaranteed.

Digital Risks

Insurers are taking digital risks more seriously, according to research by the International Underwriting Association. Its findings showed that over half of the insurance companies surveyed had suffered an unexpected computer system failure in the last year.

The surveyors reported that the proportion of firms that operate a centralised global information security policy continues to increase.

The findings also showed that 73 per cent of organisations have formal business continuity plans in place, and almost half of companies have been prompted to invoke them. Almost a third of respondents reported that anything more than four consecutive hours of downtime could be disastrous for their organisations.

Climate Changes at Lloyd's

Lloyd's has published a report urging insurers to act now to understand and manage potential risks from climate change, including greenhouse gases and rising sea levels. Lloyd's said that investment in research and a change in behaviour by insurers were required immediately.

Lloyd's suggested that the industry should adopt a new approach to underwriting that would factor in climate change scenarios rather than rely purely on historical records. The report marked the launch of the 360 Risk Project from Lloyd's which aims to generate debate about current risks and how best to manage them.

SOLVENCY

Quantitative Impact Studies

CEIOPS, the European Commission advisors, are in the lengthy process of investigating the impact of the new solvency system. These investigations are known as Quantitative Impact Studies. The first study, QIS1 was carried out in Autumn 2005 with results available in March 2006. QIS2 started in May 2006.

The aim of QIS1 was to gain insight into the current level of prudence of technical provisions within insurance companies. CEIOPS also wanted to understand the difficulty and practical issues of estimating liabilities at various percentiles. Non-life insurance companies were required to submit discounted and undiscounted technical provisions on various bases: booked amounts, best estimate and 75th and 90th percentiles.

The level of UK participation for non-life insurers was broadly in line with other countries and covered 45% of the non-life market by reserves. CEIOPS indicated that their key conclusions were that best estimates plus risk margins are less than the existing provisions and that risk margins are small. Additionally, CEIOPS observed that the effect of discounting is relatively large. Conclusions on the ability for insurers to carry out these calculations are cautious – it is feared that insurers who did not contribute to QIS1 may also be the insurers that would struggle to resource the requirements of a new solvency system.

A QIS1 summary report with interesting data tables is available on the CEIOPS website. The report indicates that in the UK the ratios of gross discounted best estimate and 75th percentile of the total provisions to current booked amounts are 102% and 117% respectively. Taking the claims reserves in isolation, the UK ratios of the best estimate, 75th and 90th percentiles to the current basis was 81%, 85% and 91% respectively. The corresponding amounts for other members are given.

Member states are required to submit data for QIS2 by 31 July 2006 and CEIOPS intends to issue the results by October 2006. The aim of QIS2 is to assess the effect of the new solvency system on insurers' balance sheets and in particular new capital requirements under each of the proposed approaches (including cost of capital approach). In a similar way to QIS1, QIS2 also looks at practical issues.

Role of the Actuary

Group Consultatif, the collective of European Actuaries, have been looking at the role of the actuary in a new solvency system. An informal paper from a sub-committee was circulated and discussed in April. This paper looks at the governance, reports and competencies of a solvency actuary. These three areas form the basis of Group Consultatif's overall strategy to enable actuaries to adapt to the new world of Solvency 2. It is noted by Group Consultatif that there has been divergence in the position of the actuary within the various EU countries and that this should be avoided or changed in the future. Group Consultatif have asked for feedback by August 2006.

Solvency 2 Glossary

Group Consultatif have also produced a Solvency 2 glossary containing definitions of the key terms associated with Solvency 2. Group Consultatif hope that this document will reduce the potential for misunderstandings to arise. Where there is currently multiple terms meaning the same thing, the document proposes a preferred term.

In addition to an A to Z list of approximately 150 terms, the glossary presents risk maps, insurance product maps and lists of synonyms.

Insurance Standing Group

In the UK, issues relating to Solvency 2 have been discussed by the FSA's Insurance Standing Group. This group is formed of representatives from across the market.

In April, the FSA issued a list of questions for the ISG to consider and discuss relating to the Solvency 2 Pillar 2 requirements. Pillar 2 requirements concern the internal risk management processes of an insurer and the internal capital adequacy assessments. Under the current proposals, Pillar 2 would involve a supervisory regime, which could make amendments from an insurer's Pillar 1 solvency requirements. The combination of Pillar 1 and 2 is intended to create a regime that is more responsive to an insurer's individual risks. The details of Pillar 2 requires a good deal of thought and discussion – the current debate concerns when and how to impose additional Pillar 2 requirements. The FSA propose a scope for how such a regime might work and have asked the ISG to consider its proposed details. This scope includes the requirement of insurers to carry out, as standard, pieces of quantitative analysis in addition to the SCR calculation. For example, one such analysis could be the current ICA calculation. The ISG must also consider capital add-ons for risks emerging beyond a one-year time horizon.

MARKET NEWS

Part VII Transfer from Lloyd's to Company Market

In a move that could smooth the use of run-off within the Lloyd's market, a Lloyd's managing agent has shifted £400,000 of liabilities into the company market through a Part VII transfer. The transaction, carried out by Spectrum Syndicate Management Limited with its Syndicate 982, was the first of its kind to successfully transfer liabilities to outside the Lloyd's market. The syndicate's liabilities were transferred to UK based Sterling Life Limited, part of the Sterling Insurance Group. Transfers of this kind, under Part VII of the Financial Services and Markets Act, are well established within the company market. With the principle extended to include transfers from Lloyd's to the company market, this technique has broad potential with the number of open years of account within Lloyd's estimated to be greater than 100. However, it remains to be seen how successful this technique will be where there are US liabilities involved.

MIB Victory for Vehicles to be Insured

The Motors Insurers' Bureau ("MIB") has successfully lobbied the government to introduce a law which will require all motor vehicles to have insurance. Off the road vehicles are currently exempt from insurance, but this will change when the Road Safety Bill is passed creating a new offence of "keeping a vehicle without insurance". It is hoped that this change will boost the MIB mission to wipe out insurance evasion.

New Capital Vehicle

The insurance industry could see an influx of capital under plans by the FSA to create a more flexible investment vehicle. As discussed earlier in this newsletter, the regulator announced recently that it intends to implement a regime whereby investors can establish insurance special purpose vehicles ("ISPVs"). Under the EU's Reinsurance Directive each member state is allowed to implement a regime of ISPVs, which will be authorised as reinsurance companies so that they can take full advantage of reinsurance treaties and provide reinsurance to primary insurers or other reinsurance companies. Announcing the plans, Thomas Huertas, director of the FSA's wholesale firms division, said "we believe that the introduction of ISPVs will allow primary insurers to diversify their sources of capital".

GOVERNMENT AND REGULATORY ISSUES

CP06/12 Implementing the Reinsurance Directive

The FSA published a consultation paper at the end of June setting out proposals for how it intends to implement the EU reinsurance directive ("RID"). The EU RID came into force in December 2005 and the FSA have two years from this date to carry out the implementation. However, the FSA have applied most of the existing direct insurance directives to UK reinsurers and, as a consequence, the effects of any changes should be relatively small. The EU RID for non-life reinsurers has largely been based on the non-life directives for direct insurers.

Three potential changes could relate to the treatment of discounting, credit equalisation reserves, and additional services. Currently, UK reinsurers are allowed to reduce their technical provisions to allow for the effects of discounting. The new RID requires reinsurers to remove the benefit of discounting. The FSA note that very few UK reinsurers currently discount and so the effects of this change should not be significant.

Direct insurers are required to hold credit equalisation reserves but this is not a requirement of reinsurers. The RID extends this requirement to ongoing reinsurers. The FSA do not expect this change to have a significant impact.

The current rules do not allow reinsurers to carry out additional services; an example provided in CP06/12 is actuarial advice. This RID gives reinsurers the leeway to carry out such operations in the future. However, since UK reinsurers generally set up service subsidiaries, the effect of this change may not be material.

Elsewhere in CP06/12 the FSA make proposals to introduce principle-based rules for defining risk transfer. Rather than having strict definitions for items such as financial reinsurance, the FSA argue for a framework of principles. The proposals place the emphasis on reinsurers to consider the effectiveness of the reinsurance transaction and whether this effectiveness is determined by the accompanying document of the reinsurance transaction. These proposals together with the discounting rules may have the potential to make it harder for reinsurers to put in place financial reinsurance that in reality only has the effect of understating the company's risk or overstating the capital.

Strengthening Capital Standards

The FSA also published CP10/06: Strengthening Capital Standards – Restructuring the Handbook (http://www.fsa.gov.uk/pubs/cp/cp06_10.pdf) in May 2006. The primary purpose is to describe FSA's plans to revise the structure of the prudential sourcebooks within the Handbook. This is a consequence of FSA's implementation of the Capital Requirements Directive (CRD).

This is a follow-on from the concept of an Integrated Prudential Sourcebook and the revised approach affect insurance firms by:

- creating a prudential sourcebook for insurers (INSPRU) out of the existing PRU sourcebook
- and incorporating the provisions in the Lloyd's sourcebook (LLD) into INSPRU and other modules of the Handbook.

As this sourcebook is created from existing material and the integration of the material on Lloyd's will not have substantive changes from the current rules, the effect on these firms will be minimal. The only change is the location of the rules. The new structure will help in future consultations such as the implementation of the Reinsurance Directive (as discussed above) and Solvency 2.

Client Money

The FSA has published a guide to help firms interpret the client money rules in the Handbook (http://www.fsa.gov.uk/pubs/other/Client_Money_Guide.pdf) and announce the development of an e-learning package for firms that will be launched in the autumn.

While acknowledging some improvement in medium to large size firms, the FSA is concerned that there is still a worrying number of serious rule breaches, including failure by firms to:

- do a client money calculation – at all or correctly;
- keep track of money held at third parties;
- observe trust law – to avoid potentially jeopardising trust account status; and
- inform customers how their money is being handled.

In particular, the FSA has found that while many smaller retail firms are willing to comply with the client money rules, they are struggling to understand the complexities of some of the rules and, in particular, how to do the client money calculation.

FSCS Funding Review

In March, the FSA published a discussion paper on how the cost of funding of the Financial Services Compensation Scheme (“FSCS”) should be shared out in the future (http://www.fsa.gov.uk/pubs/discussion/dp06_01.pdf). The FSA cites intensifying concerns about the fairness, proportionality and sustainability of the present funding arrangements including:

- whether the levies by which the scheme is funded are too volatile;
- whether the levy has a disproportionate impact on one or two contribution groups;
and
- whether some of the contribution groups firms are lumped together without having enough business interests in common.

In addition, FSA are concerned that the funding arrangements may not be robust enough to cope with the demands that might be placed on the scheme in some scenarios (for example, the failure of a significant institution, or the coincidence of a large number of claims centred around a particular product or service).

The FSA has published an independent analysis of the impact of the current arrangements and the options for funding the compensation scheme in alternative ways.

The FSA envisage that any new funding arrangements will not come into effect before 1 October 2007.

Cost of Insurance Regulation

The ABI has published a report *The Regulation Of General Insurance Sales: One Year On* (<http://www.abi.org.uk/BookShop/ResearchReports/1%20year%20on%20v131.pdf>) that assesses the impact of FSA regulation of the sale of general insurance and health protection products a year into the new regime.

Citing independent research commissioned by the ABI, conclusions are drawn that the regime is not justified on cost-benefit grounds with the estimated cost to customers of nearly £400m each year. Other conclusions are that customers are not interested in most of the information that they are required to be informed about by regulation and that the regime does not always distinguish properly between risks in different parts of the market.

The ABI suggests improvements incorporating a more principles-based approach to regulation and more risk-based supervision going forward.

INTERNATIONAL NEWS

Lawsuits Allege PXRE Misled Investors Over Hurricane Losses

Two lawsuits filed in New York allege that PXRE Group Limited misled investors by concealing the full impact of last year's hurricanes (namely Katrina, Rita and Wilma) on its financial position. According to complaints, PXRE's loss exposures to the hurricanes doubled from the company's initial loss estimates and, once their magnitude became known, those losses caused PXRE to be downgraded by rating agencies. The lawsuits claim that the Bermuda based catastrophe reinsurer "issued a series of false and misleading statements to the market, artificially inflating the company's stock". The complaints, which seek class-action status, include anyone who bought PXRE securities between 28 July 2005 and 16 Feb 2006.

PXRE has previously stated that it lost one-third of its clients in the wake of the big hurricane losses and subsequent rating downgrades "to a level that is generally unacceptable to many of our reinsurance clients". More than 75% of PXRE's premium volume was subject to provisions allowing clients additional rights if the company's ratings or capital fell.

Cat Losses May Double in 10 Years

While scientists may debate whether cyclical or long-term trends are to blame for warming sea-surface temperatures that influence hurricane activity, the main driver of catastrophe losses is growth in exposure according to a leading catastrophe modeller. Karen Clark, president and chief executive officer of AIR Worldwide Corporation, predicted catastrophe losses to double about every 10 years because of greater numbers and values of properties at risk.

European Commission Clears Swiss Re Acquisition of GE Insurance Solutions

The European Commission said it has cleared Swiss Re Group's proposed acquisition of GE Insurance Solutions, after concluding that the move wouldn't significantly impede competition in the European Union market. The commission said that the two insurance groups' activities do "overlap horizontally" in the worldwide life and non-life reinsurance markets, "however, in these markets the combined market shares of the parties are moderate and the parties face competition from a number of strong competitors". Addressing non-life reinsurance markets in particular, the commission said competition

would remain essentially unchanged in many "sub-categories" of reinsurance, such as accident, health, motor and property. The activities of both Swiss Re and GE Insurance are "very limited" in any national market or at the level of the European Economic Area, the commission said.

AXA to Acquire Winterthur

French insurer AXA is to acquire Winterthur Group, from Credit Suisse, in a move that will give AXA an instant leading position in Switzerland while boosting its presence in other key European markets. AXA has stated that it will pay €7.9 billion for Winterthur. The sale price is 11.6 times Winterthur's reported 2005 net income and 1.3 times its reported shareholders equity.