

Current Issues Committee

Newsletter March 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 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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GOVERNMENT AND REGULATORY ISSUES

EU Reinsurance Directive

The EU Reinsurance Directive (RID) came into force on 9 December 2005 and it is an interim measure that is intended to be in force until Solvency II is developed. The RID applies to all firms exclusively conducting reinsurance business.

The RID is based on the EU's life and non-life insurance Directives. As the UK already apply most of the EU's insurance requirements to reinsurance business, the main implementation issues are expected to be around:

- Introduction of "Prudent Person";
- Principles-based rules to determine asset admissibility;
- Changes to the life reinsurance solvency requirement; and
- Specific provisions relating to Special Purpose Vehicles.

The FSA will publish a formal consultation on the UK implementation during summer 2006 and has less than two years to 10 December 2007 to make the required changes from the RID to their Handbook.

Payment Protection Insurance (PPI)

The FSA published their report "Payment Protection Insurance - results of thematic work" at the start of November 2005 and this was followed by a "Dear CEO" letter to relevant firms. This was directed at non-regular premium product providers requiring them to review their sales processes, systems & controls and training & competence in relation to PPI.

Concerns were raised regarding whether customers have been treated in a fair manner. Specific areas of criticism from the FSA included: poor internal controls and governance of providers; inadequate cover and excessive price of products; inappropriate selling practices and disclosures; and poor servicing of claims and cancellations.

Additionally, the Office of Fair Trading ("OFT") is to launch an inquiry into PPI. The consumer watchdog said that the inquiry would begin in early 2006, in response to a complaint made by the Citizens Advice Bureau last year. The OFT highlighted concerns about the market similar to those raised by the FSA including a lack of transparency and barriers to entry for independent PPI companies.

The FSA, who is working closely with the OFT, has also told firms selling PPI that they must improve standards or face fines, saying that compliance standard in the sector are "generally weak". The FSA has given trade bodies representing the PPI industry until 17 March 2006 to prove to the FSA that they will clean up their act.

Financial Services Compensation Scheme (FSCS)

The FSCS have issued their budget and plan stating that in respect of general insurance business it is unlikely to need to raise a levy during 2006/07 (which would have been based on 2005 premium income). The FSCS also stated that a total refund of £42m will be made on a pro rata basis in respect of the 2005/06 levy.

This is a result of lower compensation payments for insurance insolvencies in 2004/2005 and recoveries made from estates of insolvent insurers. The budget and plan also details expected levies in respect of other sub-schemes.

In recent years the general insurance sector has had to pay significant amounts for compensation payments relating to the defaults of insurers such as Independent, Chester Street, Drake and KWELM.

Lloyd's ICA Market Feedback

In January 2006, Lloyd's provided some market feedback on the 2005 underwriting year ICA submission for Lloyd's as well as initial views on the ICA process for this year.

Key areas considered by Lloyd's were future profits recognition, reserve strength/consistency, definition of 99.5% stress test, new business classes, link to risk registers, group reinsurance programmes, correlation and diversification credits, audit trail and sensitivity analysis. Reference was also made to the lessons learnt from the document "FSA Insurance Sector Briefing: ICAS - one year on" published in November 2005.

The timetable outlined by Lloyd's for 2006 includes a June 2006 provisional ICA submission with dialogue to follow between Lloyd's and the managing agents before final submission in September 2006. More guidance will be issued in the first quarter of 2006.

Contract Certainty

This matter continues to receive coverage in industry publications, and continues to be the subject of considerable attention from the FSA. Most articles focus on the possibility of targets being missed, with the goal of having 85% contract certainty by December 2006 said to be particularly challenging.

One recent article suggested there are some promising signs that the market is rising to meet the challenge of contract certainty. Lloyd's latest figures reveal that 65 per cent of all contracts agreed during September were contract certain, compared with the industry-set target of 30 per cent. In addition, some anecdotal evidence from actuaries working in the London Market also suggests a change in the timing of work commitments, as employers, clients and brokers attempt to achieve contract certainty.

SOLVENCY II

The work on Solvency II by CEIOPS has moved at a rapid pace, there have been three key documents in 2006: a consultation paper from CEIOPS, a joint paper from the FSA and Treasury and a paper on Risk Margins from Group Consultif.

CEIOPS

In a recent publication Consultation Paper 9: "Draft Answers to the European Commission on the third wave of Calls for Advice", CEIOPS have collated ideas and consultation from various stakeholders including Group Consultatif and the Solvency Working Group.

The paper mainly deals with the less technical issues surrounding eligibility of assets and disclosure arrangements, but also looks at the issue of "procyclicality". Procyclicality is a term used in the discussions on the possible economic impacts of the new solvency standards. The question CEIOPS asks is whether the new solvency regime could contribute to, or trigger, cyclical effects by strengthening the correlations and interactions between economic and insurance factors. For example, Solvency II capital requirements might encourage an insurer to sell shares at a time when share prices are falling and thereby cause shares to fall further. The paper discusses the level of existence of procyclicality and what can be done to mitigate such effects.

For more information on how CEIOPS see these issues as feeding procyclicality see www.ceiops.org/media/files/consultations/consultationpapers/CP9/cp_0506_CP9DA3_wave.pdf.

In terms of the next steps, CEIOPS will continue to work on Solvency II by finalising the answers posed in the recent document and assisting the European Commission in dealing with the different phases of the project. The European Commission expects to propose the overall Directive in mid 2007. During 2006 this Framework Directive will be developed with the assistance of CEIOPS. After the Framework Directive is set out by the European Commission it will need to be approved by the Council of Ministers and the European Parliament. The current expectation is for the Directive to come into force in 2010.

FSA and Treasury Document

A joint paper has been produced by the Treasury and FSA: "Solvency II – a new framework for prudential regulation of insurance in the EU – a discussion paper". This useful paper sets out the role of the HM Treasury (UK Government representatives into the Council of Ministers) and FSA (UK representatives into CEIOPS) in the Solvency II process.

The document discusses the estimation of liabilities and, in particular, confidence levels and risk margins. The discussion paper invites responses on various issues including: confidence levels – what levels should they be set at and whether they

should vary by class; cost of capital approaches to risk margins; and appropriate risks to be modelled for Pillar 2 requirements.

Risk Margins

A paper on risk margins from Group Consultif was submitted to CEIOPS in February 2006. The paper compares and contrasts three approaches to calculating risk margins: Percentiles, Cost-of-Capital and Assumption based. The short paper gives background and definition to each approach and sets out the challenges. The risk margin debate appears to have gone relatively quiet in recent years but this paper may be set to refuel the debate in the context of Solvency II.

FSA

The FSA has been looking at the results of the first Quantitative Impact Study. The conclusions were:

- The UK results covered 35% of the life market, and 47% of the non life market by size of provisions, this was significantly below the participation rates of some other Member States, with smaller firms being particularly under-represented.
- Differing views emerged on the valuation of options and guarantees for life business, while on the non-life side the techniques were broadly consistent.
- Only a few firms used the cost of capital approach proposed by the CRO Forum. For this to be taken forward CEIOPS will need to see plausible figures from across a wide range of firms.

The FSA are also working on feeding into the development of the specifications for the Solvency Capital Requirements formula. This will obviously feed into the second Quantitative Impact Study (“QIS2”) which is due to be completed by 31 July 2006.

All issues regarding Solvency II are discussed with industry representatives via the Insurance Standing Group, which meets monthly. Feeding into that group the FSA have set up two expert groups to look at ICAS technical issues in Life and Non-life. These are also formed of representatives from the market and meet on a monthly basis.

INTERNATIONAL NEWS

US storms forecast above normal for 2006

US landfalling hurricane activity is expected to be 60% above normal in 2006, according to Tropical Storm Risk ("TSR"). Sixteen topical storms are predicted for the Atlantic basin as a whole, with eight of these being hurricanes and four intense hurricanes. TSR has also predicted five tropical storm strikes on the US, of which two will be hurricanes.

"Disappointing return to normal" for aviation industry

With 19 fatal accidents and more than 900 passenger deaths, 2005 represented a disappointing return to 'normal' for the world's aviation industry, according to Airclaims. An Airclaims report noted that the 2005 figures follow three years of exceptional safety. Airclaims is forecasting a long-term trend toward 20 to 25 fatal accidents a year, with last year's accident levels being in line with expectations. In the late 1940s and early 1950s they were 40 to 50 fatal accidents annually.

The Swiss Re Catastrophe Report, discussed later in this Newsletter, also noted a large number of fatalities compared to recent years but that for the aviation insurance industry it was a relatively low-loss year.

Lloyd's chairman attacks US reinsurance collateral rules

The Lloyd's chairman, Lord Levene, said that trade barriers against foreign reinsurers must be removed if those reinsurers are to be an effective cushion against another "mega-disaster" on the scale of Katrina. Speaking in New York he argued that, given the increasingly globalised nature of the insurance industry, US rules that force foreign reinsurers to post 100% of their gross liabilities in collateral no longer make sense. He added that the illogical demand for collateral based on ZIP code, not financial health, has helped to drive up the costs of reinsurance and restricted critical capacity.

Lloyd's has also invoked the European Union in the campaign to alter the US collateral rules for alien reinsurers. The chief sponsor of the European Union's reinsurance directive, Peter Skinner, recently implored US insurance regulators to move decisively to abolish collateral requirements for foreign reinsurers, which he argued have no place in a modern, globalised market.

Catastrophe bonds launched

Hannover Re has tapped the capital markets to finance a catastrophe bond covering US\$370 million of risk, the highest-volume risk securitisation the German reinsurer has yet created. The transaction was placed mainly with North American institutional investors and has an initial term of three years. The deal is designed to protect Hannover Re against expected contraction and price inflation in the retrocession

markets and to secure the underwriting capacity needed to take advantage of profitable markets expected to open in the near future.

Swiss Re has also launched a catastrophe bond - the first ever issued to cover Australian natural catastrophe perils. The bond is designed to cover some of the reinsurer's risks from earthquakes over the whole of Australia and tropical cyclones in Queensland. The cat bond is a US\$100 million retrocession agreement between Swiss Re and a special-purpose vehicle.

Other reinsurers to have recently floated catastrophe bonds include Montpelier Re, Munich Re (who secured some protection against western European windstorms) and PXRE (who issued a bond designed to shield it from a wide range of natural catastrophes over the next five years).

CLAIMS AND LEGAL ISSUES

Bullying

A woman who suffered bullying while at school 12 years ago was awarded £20,000 last month in a case that was widely reported in the media. Sophie Amor had started legal action against Torfaen Council in Wales, but their insurers offered an out-of-court settlement.

Also in February, Zurich Municipal revealed that the cost of claims in respect of school bullying had increased by 225% over the past 5 years. The increase in claim cost was despite a fall in claim numbers over the same period.

Asbestos Corner

UK - Pleural plaques

The Court of Appeal has ruled that pleural plaques are not a compensatable disease in a test case brought by a group of insurers. Individuals with pleural plaques, scarrings of the chest wall that are widely believed to be harmless, have been able to receive compensation from insurers for over 20 years. However, as claim numbers and the amounts awarded increased significantly insurers began to challenge the awards.

The latest judgement is one of a series involving pleural plaques. In February 2005, the High Court ruled that pleural plaques were compensatable because there was an increased risk of developing other asbestos related diseases, and so pleural plaques caused anxiety. At the same time, the High Court judgement roughly halved the amount to be paid to claimants.

Pleural plaque litigation is likely to continue as the Court of Appeal said the case should go to the House of Lords. A final ruling is not expected until 2007.

Although no insurers have announced that they intend to attempt to recover previous claim payments, most are believed to have put pleural plaque payments on hold.

UK – Allocation of Claims to Insurers

A recent court case established the principal that it is the insurer whose policy is current when the onset of an illness occurs that is liable, rather than the insurer whose policy was current at the time of exposure. The decision raises issues of considerable importance for public liability insurers with regard to asbestos-related claims. It is unlikely to affect employers liability insurers since EL policies are usually written on a 'causation' basis rather than an 'occurrence' basis, as is the case for PL policies.

The case in question related to an individual who was believed to have been negligently exposed to asbestos between 1960 and 1963. The individual experienced breathing difficulties around 1990 and died of mesothelioma a few months later. The

court ruled that the public liability insurer who was liable was the one who provided cover in 1980, on the basis that mesothelioma was probably contracted about 10 years before symptoms manifested themselves. This method of allocation differs significantly from that used in the US, or used in practice by many UK insurers.

UK – Barker v St Gobain

A legal challenge starts in March in the House of Lords to limit payments for mesothelioma claims.

The latest legal challenge concerns three test cases. In the lead case the widow, Sylvia Barker, was awarded £152,000 after her husband died of the cancer eight years earlier. The courts were told that between 1960 and 1968 he had been 'heavily, regularly and frequently' exposed to asbestos dust while working at the Shotton Steelworks on Deeside for John Summers and Sons (the French-owned St Gobain is the legal successor). Using a different argument from the insurers' previous stance, it will be argued that if there is more than one employer, compensation should be split between them all.

Another case concerns a former shipyard worker John Murray who died from the disease in November 1999. The company responsible for the majority of his asbestos exposure Sir James Laing & Sons Ltd no longer exists and had no insurance. Court proceedings were brought against the other insured shipyard employers who were responsible in total for 42.5% of the asbestos exposure. British Shipbuilding Corporation, a Government-funded statutory body, is arguing in the House of Lords that it should only be liable for less than half the total compensation awarded to Mr Murray's widow. This means her expected compensation payment could be reduced by 57.5% and could have implications for future claims made by those who worked for firms which have since disappeared without insurance.

Employers hope to overturn existing law by arguing that the cost of compensating mesothelioma sufferers should be apportioned between companies if a worker was exposed at more than one workplace. At present, full damages can be claimed against any company where there has been exposure and there is more than one defendant company.

Head of technical claims at Norwich Union, Dominic Clayden said that the Barker case was about "seeking clarity after Fairchild". The landmark Fairchild case did not deal with the issue of apportioning damages between multiple defendants, rather it dealt with apportioning liability between multiple insurers.

US – Asbestos Legislative Reform

The proposed \$140 billion fund for victims of asbestos, which has fallen out of favour with almost every interested party, struggled to win support in a series of votes in the US Congress. The bills co-sponsor, Senator Spectre, has been quoted as saying that further votes may be made, and that the bill is very much alive. Others are focussing

their attention on possible alternative methods for asbestos tort reforms, such as those that have recently been introduced in a number of states.

Broker Documentation

The Court of Appeal has ruled that insurers are entitled to access from brokers documents that were initially shown to underwriters as part of an insurance placing, even if the insured subsequently objects. This overturns an earlier High Court decision. The insurer involved in the court case was Goshawk and the broker was Tyser.

Bird Flu

Insurers continue to consider the possible impacts on their business from a global flu pandemic, with regard to both claims and operations. This action is being encouraged by the FSA, for example in its annual "Risk Outlook" document which was published recently. Also in the news, a survey from Aon reported that 85% of UK's business leaders saw a potential flu pandemic as a threat, but only 57% had measures in place to protect their businesses.

Catastrophe Report

Swiss Re has produced its annual report on natural catastrophes and man-made disasters. The headline was that 2005 turned out to be the costliest year ever for property insurers, with 400 catastrophes causing US\$230 billion of damage, of which US\$83 billion was insured. This compares to insured catastrophe losses of US\$48 billion in 2004.

The Kashmir earthquake was the most deadly disaster, claiming over 70,000 lives. The US and Caribbean hurricanes Katrina, Rita, Wilma and Dennis accounted for the majority of the financial cost of catastrophes. Other expensive natural catastrophes included European storm Erwin and summer floods in the Alps. The most costly man-made catastrophes were explosions at oil-producing plants in the US and Canada, and fires at electronic equipment manufacturers in Taiwan and Malaysia.

Insurers to fight periodical payments ruling

Insurers are to appeal against a court ruling concerning whether future loss of earnings and future costs of care should be indexed by reference to the Average Earnings Index ("AEI") rather than the Retail Price Index ("RPI"). The claimant in *Singh Flora v Wakom* argued that future loss of earnings and care costs should be based on the AEI, while defendant insurers said that the legislation governing periodical payments had intended that RPI should be used in all but exceptional cases. The judge dismissed the insurers' argument. The ruling threatens to create uncertainty and increase claims costs, given that historically the AEI has risen at a higher rate than the RPI.

MARKET NEWS

Outlook gloomy for home and motor

Deloitte has forecast that the UK household market will fail to make a profit in 2006 because of the knock-on effects of Hurricane Katrina. As a result of rising global catastrophe reinsurance rates caused by last year's most devastating Atlantic hurricane season on record, Deloitte has predicted that the market's combined operating ratio will be 100% for 2006.

Deloitte has also predicted that the private motor market will fail to make a profit in 2006, predicting a combined operating ratio of 108% unless rates increase significantly. If the market's expected losses for last year materialise, 2006 will be the twelfth year running that the market has failed to make a profit.

Separately, Datamonitor has predicted that the private motor market will not make a profit until 2010. The independent market analyst warned that motor insurers face a continued long period of unprofitability as rates fail to increase in line with claims inflation.

2005 Profit unlikely for Lloyd's

Lloyd's has doubled its estimate of claims from last year's devastating Atlantic hurricane season, resulting in the chances of the market making a profit in 2005 becoming small. Lloyd's forecast of losses from hurricanes Katrina, Rita and Wilma increased from £1.4 billion to £2.9 billion. This would be the first financial loss for Lloyd's since 2001.

No more DVT claims for airlines

A House of Lords decision to exonerate airline companies from paying compensation for deep vein thrombosis ("DVT") sufferers signalled the end for similar claims, lawyers have said. The House of Lords quashed the appeal on the basis that the onset of DVT caused by air travel did not meet the definition of an accident under the Warsaw Convention, which governs airline regulations.

Independent bosses charged with fraud

Three former directors of Independent Insurance have been charged with conspiracy to defraud following the collapse of the insurer in 2001. The Serious Fraud Office brought the charges against Michael Bright, the former company chairman and managing director; former deputy managing director and group director Philip Condon; and Dennis Lomas, former group finance director. They have been charged with conspiracy to defraud over the "true extent of the liabilities" of the Independent Insurance Company and Independent Insurance Group.

Reinsurance rate hikes overplayed

According to reinsurance brokers Willis Re and Guy Carpenter, the fall-out from last year's record hurricane season on the wider reinsurance market has been overplayed. Reports from the two companies suggested that while property, marine and energy have seen major rate increases, other lines have remained steady.

Lloyd's publishes three-year plan

Lloyd's three-year strategic plan was published in January, receiving a positive response from managing agents who have described it as sensible, but not revolutionary. The plan aims to maintain Lloyd's competitiveness in the face of other markets, such as Bermuda, and covers areas such as examining the annual venture, looking at Lloyd's capital regime and introducing cost-saving measures such as the handling of claims.

Lloyd's to sue Benfield and Aon

Lloyd's is planning to sue insurance brokers Benfield and Aon in a compensation claim over its long-running Central Fund dispute. The dispute began in April 2003 when six reinsurers (Swiss Re, St Paul, XL Re, Federal Insurance Company, Hannover Re and Employers Re) refused to pay claims in respect of the reinsurance policy for the Central Fund, claiming the policy had not been affirmed and they were not legally bound to pay up. Lloyd's reached a £152 million settlement with the insurers following arbitration in March 2005 and now plans to claim the shortfall of £325 million from Benfield and Aon, who placed the policy.