Leadership in Insurance series

Pressure, Power & Politics:

Leading Insurers Through the Crisis

An Insurancetimes publication

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LEADER

Finding method in the madness

Over the past six months, the turbulent economic climate has forced companies of all sizes in the financial services sector to revisit business plans, scale back, cut costs and scrutinise the economic landscape in a way not seen before. The magnitude of the financial crisis, in partnership with the onset of recession, has created an environment where business forecasting and budgeting has become increasingly complex and difficult. In turn, short- to medium-term planning, and the ability to reliably implement strategy, has become near-on impossible to execute with any confidence. But, still, life goes on.

This supplement attempts to make sense of the quagmire of issues facing the general insurance sector today, as well as providing a chance to pause, take a breath, and read the views, insight and vision of several leading business leaders operating across the spectrum.

The central themes of pressure, power and politics reflect the key influences in what has become an economic vacuum. Over the next 12 months, the only constant will be change. There will be regulatory change, structural change and personnel changes as businesses continue to operate in duress, and key players disappear and evolve in equal measure.

The market has been striving to understand what's on the horizon, in an effort to not only understand the opportunities but, crucially, to understand new threats, competition and to ensure survival and stability. What's more, there are a number of external influences impacting on the general insurance market like never before. Arguments must be won to stave off unfounded comparisons and parallels to the troubled banking sector; technology is changing at break-neck speed, and the state of the global investment markets means that executing the bread-and-butter functions of the day job have once again become paramount.

TOM BROUGHTON, EDITOR

PRESSURE

INDUSTRY VIEWS

Charting a course for bu

Jonathan Davey
Director
SSP

Business efficiency is always a factor in prolonged commercial success, but in difficult economic times it comes under increased scrutiny.

The decline of the stock market is no great secret, and while it seems likely we are now bumbling along the bottom, it will be some time before investment returns hit the heights that insurers would like.

Diminishing investment returns have significantly hampered the ability of the insurance industry to absorb underwriting losses, and so writing business for market share, or "cash-flow underwriting", is no longer the option it was previously. Indeed, although there are signs that certain areas of the market are starting to harden, this is not the case across the board, and so relying on stiffening premiums is also ruled out.

There is also a very different climate in today's boardrooms, and businesses across the UK and beyond are taking a much stricter line on risk and reward. For insurers, this has meant taking a closer look at the policies they underwrite and making sure the risks are priced appropriately. It has also meant that corporate cost bases have been thrust under the microscope.

PACE YOURSELF

For many, IT investment is a double-edged sword. It may deliver efficiencies and savings in the long term but, in the more immediate future, it creates cost. Insurance businesses are continually battling between upgrading and improving their operations, and maintaining a firm hand on the expenditure that is involved in any such work. Getting this right is a difficult balancing act, and those that under-invest will lose competitive advantage. However, it can be equally damaging to commission work that does not deliver results or costs more than firms can viably afford.

What is certain is that doing nothing is not an option, and businesses are increasingly looking at ways of maintaining their investment in IT by focusing investment on projects that deliver quicker returns.

Certainly, time is of the essence, and there is a definite trend towards projects that can be delivered quickly and provide a return on investment within a 12-month period. The idea of a rip-and-replace approach to upgrading IT has lost a lot of support, and not only do businesses remain worried about the impact of such a

Working together in trou

Igal Mayer
Chief executive
Norwich Union

We are in the worst global recession for a generation, and insurers across the world face significant challenges. Here in the UK, the economy contracted by 1.9% in the first three months of 2009, with the IMF forecasting a full-year reduction of 4.1%.

Though many forecast a growth bounce-back from 2010 onwards, we and our customers are facing difficult times ahead. Faced with such challenges at Aviva, of course, we are working hard: striving to be the most efficient in our operations, excellent in our underwriting and effective in our distribution. And our competitors are doing the same – I would expect nothing less.

However, at times like these, even as competition is fierce in this already most competitive of marketplaces, we must not lose sight of issues that impact us all and on which we need to stand together as an industry. There are a number of examples, but my mind is drawn to the issue of pleural plaques.

This is a galvanising issue for UK insurers, as it cuts to the core of indemnity and what we should be compensating customers for. A basic legal principle – that compensation should only be paid where there are physical symptoms and real injury – is being challenged. As important, our customers' anxiety, largely based on misinformation about pleural plaques, can manifest into distrust of our industry.

To briefly summarise, pleural plaques form as a result of exposure to asbestos, normally appearing around 20 to 30 years later, impacting a large

siness improvement

project, they are also nervous about the price tag that it could come with.

Fortunately, the adoption of service-oriented architecture has meant that a rip-and-replace approach is no longer the only way of going about creating wholesale changes. Projects can be smaller and more focused, offering immediate impact, low costs and fast turnaround times.

'There is no sign that the IT investment tap will be switched off in the downturn'

They can also be part of a larger drive towards creating a new IT system for the whole business.

By slowly working towards updating legacy systems, businesses can get the benefit of each and every new project as it comes online, without the risk of having to make a single migration from the old to the new. This means they continually improve their own capabilities at an ongoing cost that is manageable, negating much of the perceived risk in jumping from existing systems to new ones at a single go.

CUSTOMERS CARE

While the reaction in difficult times might be to put the breaks on IT developments, businesses cannot afford to lose competitive advantage or fall out of favour with customers looking for quicker and easier ways of buying their cover.

The threat from competing firms has always existed, but new entrants into the market have certainly raised the stakes, and non-traditional insurance brands such as Tesco are making an aggressive play on the market.

Consumers and SMEs are also managing their own time and costs better. In short, this means they want to buy and manage their policies online, but be able to pick up the phone or speak with someone should a particular issue arise.

This means insurers getting efficient systems in place to provide the necessary level of functionality and service, while also having to retain their foothold in the market and fend off the challenges being made by new rivals.

To help in this, many IT firms have changed their charging structures in a bid to make them better aligned with their clients' income streams. Software can be rented rather than having to be bought, and charges levied on a transactional basis or as a percentage of gross written premium. This should make it a lot easier for organisations to budget for IT spend and enable them to amend it in line with their business volumes.

The current climate is forcing everyone to re-examine their business, its processes and its cost base. This should not simply be an exercise in cutting costs, but rather a way of improving value and making the business better for the future.

The IT sector has worked hard to evolve the products and services it delivers and the way it charges for them. In turn, this means that brokers and insurers can work to an IT development programme that is both affordable and effective, without having to wait significant periods of time before seeing a return on their investment, or being forced into making huge step changes in the way they operate.

Historically, the insurance industry has been slower than others to adopt new technology. However, there is no sign that the IT investment tap will be switched off in the current downturn, as most companies are taking a pragmatic approach and prioritising expenditure that will deliver a faster return on investment.

bled times

number of workers, particularly in the mining, construction and shipping industries. But pleural plaques in of themselves do not cause any symptoms and are benign. If you took two workers similarly exposed to asbestos, one having pleural plaques and one not, the person with PP would be no more at risk of developing mesothelioma than the individual without. Clearly, should such a condition become compensatable, it would have significant and far-reaching impacts on our industry.

THE LEGAL STANDPOINT

Under UK law, the House of Lords ruled that pleural plaques are not compensatable, but the Scottish Executive has passed a bill to reverse that ruling, and outside of Scotland it is still very much a live debate. Needless to say, given the fundamental nature of the legal principles involved, insurers – together with the ABI – need to fight to uphold the House of Lords judgment.

That said, here at Aviva our purpose is to provide peace of mind to our customers. We, and the wider industry, should deliver against that. So, over the next 30 years, as many of those exposed to asbestos in the past develop mesothelioma, they will need to be compensated.

'The issue of pleural plaques cuts to the core of indemnity and what we should be compensating customers for'

Again, we will need to work together. Insurers and brokers will jointly have to ensure we can quickly identify the correct underwriters for each claim. An upcoming proposal at the ABI General Insurance Council is looking to create an industry database to facilitate this. Our support, both as underwriting companies and brokers, is an excellent opportunity for us to work together and demonstrate to customers that we are there when they need us most.

Pleural plaques is just one example of shared interest, but there are many others, such as claims farming and the extra cost that is being loaded onto customers. But whatever the issue, despite the tough times and the fierce competitive environment, we must stand together in order to see the industry and the customers we serve safely through to the other side of this downturn. **IT**

PRESSURE

STRATEGY

Great adaptations

Falling investment returns and shrinking profit margins, amid an economy in freefall, have combined to put the insurance market under extreme pressure. Angelique Ruzicka reports on the tactics that some firms are employing to stay one step ahead

In the past six months, the unthinkable has happened, and the global economy has changed beyond recognition forever. While AIG has been the only high-profile insurer casualty, the rest of the financial services sector has been left scrabbling to deal with the fallout. Insurers in the UK face an unprecedented set of challenges; and to survive, they must adapt.

The shape of the insurance market has not yet changed significantly, with the major players, such as Norwich Union, AXA and RSA, still leading the way. Smaller firms, though, such as Brit, Groupama, and QBE, have spotted opportunities in the changing landscape. And whether big or small, all insurers have had to look at means of maintaining profitability in the face of plummeting investment returns, right at the bottom of the cycle. Some of these methods have proved painful, with slashing distribution costs and expenses, hiking rates, and rewriting business plans all high on the agenda. The sector's willingness and ability to change, however, have positioned it well to ride out the downturn.

NUMBERS GAME

For years, income from investments has been a lifesaver for some insurers. If the underwriting side of the business made a loss or just broke even, investment income was a useful top-up to boost performance. But now in this gloomy economic climate, where stock markets have plunged and more exotic investments have underperformed, depending on this as a source of revenue is no longer an option.

"We have always relied on underwriting returns and investment return, but the latter has been a significant contributor. In the current climate, with low return on equities, it is now very modest. There have even been negative returns for those who have invested beyond equities," admits Malcolm Smith, commercial lines director of Groupama Insurances.

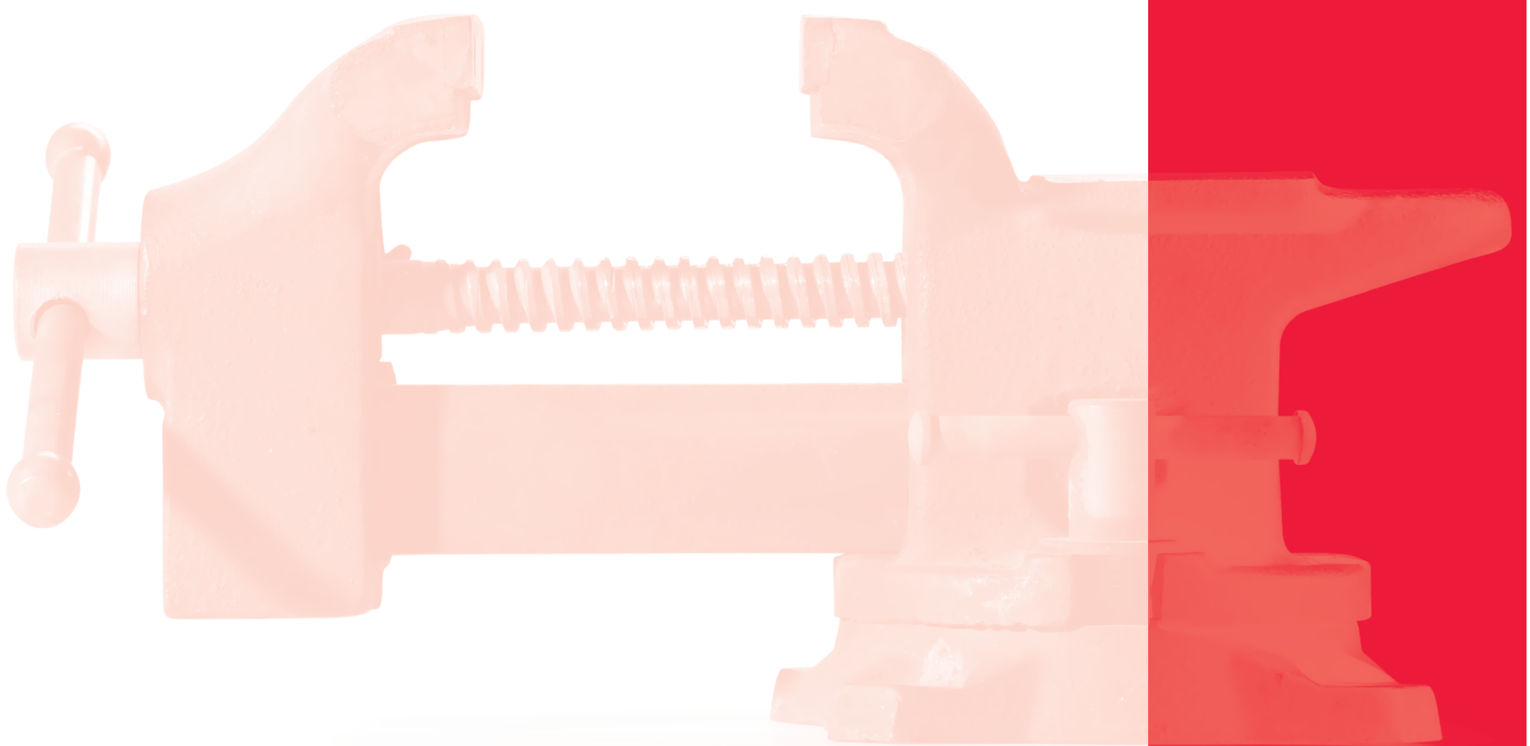
With investment income unreliable, the most obvious solution is to turn to reserves to make up the numbers. But Clare Ryder, managing director of Salient Solutions, feels that this may be going too far. "If you look at the larger insurers, you will notice that reserve releasing has been an increasing part of bolstering results. It's not a desperate measure, but it's not prudent either."

MOVING THE GOALPOSTS

One way of boosting profitability is to shift out of loss-making areas into more lucrative risks. As one of the market's more nimble players, Groupama is branching out into more profitable areas. Last month, the insurer told *Insurance Times* it would look to reduce its generalist motor book by up to one fifth over the next three years in favour of specialist motor risks.

François-Xavier Boisseau, Groupama's chief executive, says: "This market is absolutely slaughtered by the aggregators, and everyone else is piling in. We don't have the skill in the long run to compete efficiently in this market, so we have to change our underwriting footprint on personal lines." The firm's commercial strategy remains unchanged.

An even quicker win when it comes to boosting profitability is not to spend so much money in the first place. Hence the major insurers have been actively driving down distribution costs since last year. They are doing this by putting pressure on commissions – particularly for the consolidators – and pulling out of arrangements, such as manag-



ing general agents (MGAs), where money leaks out at the several stages of the distribution chain. And insurers are looking to creatively manage fixed costs, too, through outsourcing and the use of technology.

During the soft market, insurers lost a lot of control over distribution. “If you go back ten years, insurers decided who would sell their products, how they would sell them, at what rates and at what commission. They selected which agents and which routes to market they would take. What has happened over recent years is that brokers, third parties and aggregators have taken a large amount of control from the insurer, including an element of price control,” Ryder says.

Norwich Union and AXA have paved the way on cutting distribution costs. “NU has looked at a number of unprofitable schemes and withdrawn from them,” says Martyn Holman, head of UK broking at Brightside. “It has come out of MGA-type deals that weren’t making it any money and, instead of tinkering with them, it has closed them down. So a drastic action really.”

Meanwhile, smaller insurers have been quick to capitalise on their larger rivals’ changing tactics, with Brit, Groupama and Fortis among those still playing in the MGA field. Groupama’s Smith, for example, says he will look at the various areas of the business and make commercial decisions based on profitability. “There are a lot of areas of business where there are higher rates of commission that remain profitable,” he says. Meanwhile, Fortis has replaced AXA to provide capacity to MGA Primary.

Andy Watts, director of insurance at SSP, explains that, with the onus on underwriting profit, insurers need to better manage cash flow. He says that insurers face more pressure than in previous downturns due to declining investment returns. “Now it’s about doing valuable things with technology, not just IT processing,” he says.

THE PRICE IS TIGHT

Beyond this strategy, the focus for insurers is to produce profitable underwriting. Industry commentators feel investment income won’t be reliable for the next 12 to 18 months, so to compensate for that, insurers will need to raise rates.

Smith points out: “Underwriting results for us haven’t been that good over the last 12 months or so. We have had good results for several years, but in 2008 for the first time we made a modest underwriting loss on the commercial account and motor fleet as well. There have been several years of reductions on rates, which means that the results are going to be marginal at best. So, therefore, we do need to make improvements.”

‘This market is absolutely slaughtered by the aggregators, and everyone else is piling in’ François-Xavier Boisseau, Groupama Insurances

But the industry is notorious for not always sticking to its guns when it comes to pushing up rates. This could be part of the reason why the soft market has been allowed to linger for so long. Some players are currently underlining the importance of profitability over volume of business, but Ryder worries there is a lack of commitment.

"I never get a fair answer when I ask insurers 'what would you sacrifice first: volume or profit?'" she says. "Most of them generally don't like answering the question. Some insurers have largely been very public about not supporting consolidators or working with aggregators, as they don't make enough margin, but when they see the volume drop off, they head back again."

> 'Cutting out huge tranches of skilled staff is not a good way to go, as it leaves fundamental skills gaps' Clare Ryder, Salient Solutions

Keeping up the commitment to increase rates won't be easy. Already, insurers are being met with resistance. "We are finding in the current economy it's not that easy, as customers won't feel that enthusiastic about it when their own trading is more difficult," Smith says. "We are struggling to carry more than 1%-2% increases on our general commercial book, whereas on motor fleet we are carrying reasonably significant rate increases."

IMPULSE PURCHASE

Other insurers are turning to acquisitions to boost profitability and geographical reach. Zurich Financial Services recently conducted the largest bolt-on acquisition when it bought AIG's US Personal Auto Group for $1.9bn (£1.3bn). In a complex deal, Zurich's subsidiary Farmers Group acquired the auto business, which includes 21st Century Insurance, but Zurich retains management rights.

Inga Beale, head of M&A at ZFS, said: "The deal was immediately accretive for us because of the price we were able to buy the business at. We were able to buy at book value and not pay a premium on top."

But the big problem with M&A in today's economy is raising the money in the first place. Beale points out: "It depends on how you make the acquisition. If the seller wants cash then you have to raise it, but if they are prepared to take the stock route, then it would be easier."

Moreover, M&A may not be a suitable strategy for all insurers, Ryder feels. "For some of the smaller niche insurers, M&A would not be a bad thing, provided they had a proper integration process. That brings the advantages of economies of scale and potential to drive out further cost."

For larger players, however, it's not so simple. "Costs rocket as you are trying to bring together two different kinds of IT platforms and staff, and then there are rebranding costs as well," she points out. "M&A is not necessarily the best way to go now, and of course there is an issue with funding: there is not a lot of cash in the market. If you have two smaller insurers that could merge, or a large player looking to add something strategically, then yes this makes sense."

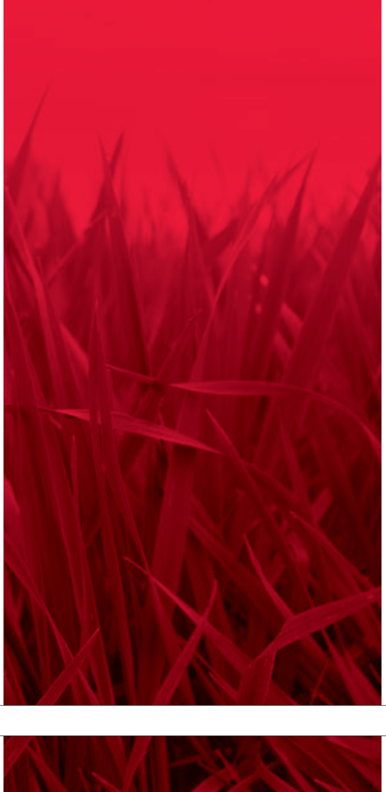
Whatever size they are, and whatever route to profitability they choose, one thing is for sure: UK insurers are in a period of unprecedented change, but the firms prepared to act shrewdly now may well emerge the other side stronger for it. **IT**

COLLATORAL DAMAGE

When all else fails, reducing expenses becomes a painful necessity. RSA is the latest insurer to slash jobs. Last month it closed its Bristol office and made 400 employees redundant as part of its UK-wide cost-cutting programme. It's not the first time it has slashed jobs, though. RSA's management has already been reduced by 15%, with around 230-240 jobs lost so far.

It was back in February this year that the firm announced it would make 14% of its 8,700-strong workforce redundant, to achieve an expense ratio of about 14% by the end of 2012. It hopes to save £70m by cutting 1,200 jobs before the middle of 2010.

But Salient Solutions' Clare Ryder feels that slicing staff numbers is not the answer. "In my experience, cutting out huge tranches of skilled staff is not a good way to go, as it leaves fundamental skills gaps, which may leave them without enough capacity to manage underwriting, claims and pricing in order to select risk properly and drive up rates in a consistent way," she says. "And some insurers are in that position already. There has been a huge drain on skill. Now is the time when it will start to hurt, when insurers are up against the wall."



KEY LESSONS

Wise words

PRESSURE

Stephen Haddrill, director-general of the ABI, outlines the issues at stake for insurers during this time of economic upheaval

Any assessment of the effect of the financial crisis on insurers, or indeed the wider economy, must take into account the fact that insurance is different from banking. It is a less leveraged and more capital-rich industry. Many of the solutions being applied to banking are not appropriate to insurance and should not be extended to it.

Indeed, the fact that insurers base their business on detailed risk assessments could now have a wider application. The crisis has demonstrated that better risk assessment and risk management of the kind insurers undertake are needed in good times to prepare for bad times. This should influence the future of banking regulation, which needs to be more sophisticated than at present in its assessment of, and reaction to, risk.

JUDGING THE JUDGMENTS

We must certainly be vigilant in scrutinising and responding to the substantial body of work that has examined the fallout from the crisis. Aside from the Turner and De Larosiere reports, to name just two, there are currently scores of consultations, commissions and working groups looking at the regulation of financial services. In a recent conference, which we co-hosted with the CBI, it was clear that the balance of opinion amongst leading figures in the financial services world was that current failures are "seismic" in nature and will change the nature of regulation. The theme of the conference was restoring confidence in the markets – a substantial challenge for insurers, regulators and government.

The perception of financial services by consumers is particularly crucial. We cannot assume that consumers recognise that problems affecting banks do not affect insurers. But this misconception will inevitably lead to a general attitude of apathy or even hostility towards financial services firms. Insurers need to continue to show consumers that they can have confidence in the products provided by the industry, and in the strength of the sector overall.

Insurers have the advantage that the Solvency II Framework Directive has now been agreed. Despite it not going as far as we would like on certain aspects of the group approach, it is still a modern, sophisticated set of prudential rules. At a time when other sectors are bracing themselves for a new wave of regulatory reviews, insurers can point to the work done and still being undertaken to make Solvency II a success. Of course, there can be no complacency and we must remain robust in defending the existing prudential regulation of insurers.

GLOBAL CONCERNS

There is a clear direction of travel towards a change in cross-border regulation. Much of the financial services sector, including the insurance industry, operates internationally. Regulation, therefore, needs to be conducted on a global basis with coherent and co-ordinated action being taken at national, EU and international levels.

We cannot revert to national markets overseen by national regulators because the businesses and even individuals that the sector supports are themselves international in their operations and needs. Instead we need to ensure that regulation neither adds unnecessary cost to consumers by duplicating requirements (for example, the same international risk does not need to be backed in full by capital in every market), nor misses risks that cannot be seen from the perspective of a single national regulator.

The world does not need a global supervisor of national markets. Such a body would be too remote from national problems and too bureaucratic. But some things can only be done through international co-operation, as the G20 has shown. We need concentric, not overlapping circles of regulation: international, regional and national, with each concentrating on their strengths and ceding responsibility to whichever is in the best position to act, rather than duplicating or frustrating such action.

The challenge, therefore, is for governments and regulators to back up their words with sensible measures. In particular, the implications for insurance of some of the proposals in the G20 recommendations – for example IMF guidelines on systemic institutions, and work on monitoring asset prices – must be fully thought through. Insurers must play a full part in debates in the international financial institutions, even if those are largely dominated by banking concerns. **IT**

PRESSURE

KEY LESSONS

Those who forget the past are doomed to repeat it, as they say. With that in mind, here are ten key lessons learned from the last recession that will help keep your business on the up through this downturn

When experts predicted a possible recession, financial institutions did not imagine that things would get so bad so quick. With the UK economy at its weakest in 30 years and a startling number of financial institutions facing hardship, this recession has sent shockwaves throughout the entire industry.

Experts argue that this recession is far worse than the last one, which hit in the early 1990s, particularly in the context of the financial services market. Its causes are more systemic, and it is more global in nature. The rapidity has also left people with little time to adjust.

With banks still refusing to lend to each other, this recession is set to get deeper; in April, the International Monetary Fund (IMF) said it expected the global economy to decline by 1.3% in 2009 and projected that the UK economy will shrink by 4.1% this year, and by a further 0.4% in 2010. In fact, the IMF goes as far as describing this downturn as "by far the deepest post-World War II recession".

But there are clear lessons that can be taken from the 1990s; here, we outline the top ten:

1 BOOST CONSUMER CONFIDENCE

During a recession, consumer confidence is often at its lowest. For insurance firms, this is a major concern. Barry Smith, chief executive of Fortis UK, says: "Improved consumer confidence is essential in rebuilding the economy. If consumer confidence follows the same pattern that it did in the previous recession, we will need to see a significant increase before the market starts to recover."

"Know your customers," he adds. "It is important to understand customer requirements and respond to their changing attitudes to saving and spending. Insurance can be perceived as a discretionary item and, therefore, the need for clear understanding about how insurance can protect customers, especially at this time, is paramount."

4 DIVERSIFY AND MANAGE RISK

Diversification has been a key lesson that can be taken from the 1990s. If there's one thing insurers know today, it is not to put all your eggs in one basket.

Many insurers will have relied heavily on the equity markets for superior returns, but stock market crashes have meant this is no longer the case. The stock market crash of 19 October 1987 – also known as Black Monday – will have been a valuable lesson for all firms.

Nick Stanton, head of UK global carrier management at Aon, says insurance firms have been lucky, as they have not had a high exposure to equities, CDOs and the whole subprime situation, leaving many with strong balance sheets.

7 CHOOSE YOUR PARTNERS CAREFULLY

Insurance businesses are also paying closer attention to which firms they do business with. "Certain offshore companies are particularly relevant, and we would urge caution when members are using markets that do not have acceptable security," Biba's Peter Staddon says.

Insurance firms have to apply this to their risk strategy where necessary, and those companies that pose a higher risk are being avoided in this current climate.

2 FIGHT FRAUD

History teaches that fraud rises during a recession. The latest figures from the ABI show that this time is no different. In 2008, 107,000 fraudulent claims were exposed, an increase of 17% from 2007. The value of these claims rose by 30% from the previous year. But the benefit of past experience is that insurers have become a lot better at fighting fraudulent activity.

"Fraud has been with us a long time, regardless of what the economy is doing," a spokesman for the ABI comments. "But, since the last recession, insurers recognise that they have to up their game against fraud, particularly against commercial fraud. One of the lessons learnt last time round was that there was a rise in commercial arson, for instance."

3 MAINTAIN LIQUIDITY

Graeme Trudgill, technical and corporate affairs executive at Biba, argues: "Insurers must not unreasonably overextend their finances, no matter how tempting. There are always financial cycles, and you must be responsible and think of the long term, even if cheap credit is easily available at the time. Rates can and will change over time."

He adds that past experiences prove that liquidity is also vital for insurers during a recession. "Cash and liquidity are king," he says. "Always have your emergency pot so you can pay your creditors on time if credit is less accessible. Ensure that the reserves and reinsurance programs are robust and can withstand potential disasters like hurricanes and floods."

5 COMMUNICATE CLEARLY

Previous recessions prove that upholding best practice and clearly communicating financial stability is vital when it comes to maintaining stakeholder trust. Particularly today, the financial stability of a firm is hugely important, as many investors fear just how strong businesses are. The near collapse of AIG has clearly made the market very nervous when it comes to doing business with insurance companies.

Fortis's Smith says it is crucial for the insurance industry to remain focused and confident through delivery of first-rate service along with open and timely communication to customers, stakeholders and the market as a whole.

6 INNOVATE

Product development and innovation also play an important role during a recession.

Since the last downturn, the insurance industry has undergone some significant changes and today faces increased competition, particularly during these difficult times.

With customers having more choice, insurance firms clearly have to work harder to meet customer demands. Although some may argue that product development should be ongoing, during a recession insurers have learnt that it is even more vital to not lose trust and keep developing, or they may find themselves drowning amongst the competition.

8 MANAGE YOUR TECHNOLOGY

Andy Watts, director of insurance at technology provider SSP, points to how the downturn will change the way insurers manage IT costs. With falling investment returns, they no longer want to take the risk of buying expensive systems. He predicts that, within five years, the approach of renting software will have taken off, and that this approach will be prevalent within the next decade.

Watts adds that insurers should use and manage their IT systems more creatively; that the current climate has created an opportunity for the financial services sector to operate in a much leaner, agile way. "Insurers should demand their suppliers be more creative in how they can help them," he says.

9 PROTECT YOUR REPUTATION

Maintaining your firm's good name during a recession is also vital. Some experts argue that it is too easy for companies to get distracted from their core business, which, according to Biba, has been a "weakness" for many. Today's recession has harmed the reputation of the financial services sector severely, and no firm can afford to damage their reputation in the current environment.

10 BE FLEXIBLE

The changing times put heavy demands on all businesses, and it is tempting just to bury your head in the sand and keep on doing what you have always done – even if it is becoming less profitable.

But it is those businesses that bend to the economic wind that will survive this downturn – as they did the last time. **IT**

POWER

INDUSTRY VIEWS

Strengthen your ERM

Brendan McManus
Chief executive
Willis UK and Ireland

There are certain elements in the client-broker-insurer relationship that will remain constant: good service, and quality advice and products. In an ever-evolving marketplace that has been rocked by the financial crisis, however, a new, more sophisticated client has emerged.

This type of client seeks a full understanding of all the risks that threaten their organisation. Brokers and insurers are rapidly developing the enterprise risk management (ERM) and analytics capabilities that are necessary to meet this demand.

The general increase in the sophistication of clients' needs has been driven in some sectors by additional regulation and industry codes of practice on better risk management. This is coupled with the effects of the credit crunch and the desire of companies to only spend money where they will get more value.

Large clients have recently changed their focus from the transactional insurance arrangement to utilising a broker's analytical capabilities and claims consulting. I can see this moving down the food chain to the middle market, where clients increasingly want to understand the enterprise risk that they are taking on and to utilise analytics to make much better decisions about how they manage their own risk and place their insurance.

Brave new world

Philippe Maso
Chief executive
AXA UK

The insurance industry is now operating against a background of unprecedented change within financial markets worldwide and in the UK. The long list of bailouts – from RBS, Northern Rock and other high street banks, to AIG, ING and Fortis – will undoubtedly lead to significant changes in the regulation of financial institutions in future.

The recent de Larosière and Turner reports point in particular to the need for more focused and closer supervision, for joined-up regulation (especially between regulators in different jurisdictions), and for better trained regulators with more efficient risk assessment tools.

As an industry, we can expect the FSA to be taking a much closer interest in our strategic approach and in the way in which we do business. In particular, it will be focused on the effectiveness with which we manage the risks inherent in operating in the insurance market.

Perhaps the most important driver of the new environment will be the implementation within the UK of the Europe-wide Solvency II regime. It is based on the three pillar "Basel" principles for banking, and will be implemented in the UK by the FSA. Solvency II will bring substantial changes within the three areas covered by the regime: provisioning standards and quantitative capital requirements; supervisory review by regulators (which incorporates the ability to set excess capital requirements); and the requirements for supervisory review and disclosure.

Another area where I think we can expect to see most change is around directors' responsibilities. The approved persons regime, which came into effect in 2001, already sets out a degree of expectation in this respect, and the FSA is likely to take a keen interest in personal objectives and the balance between risk and reward within these objectives. It may well make wider use of its ability to take action and to fine individuals where their performance falls short of expected standards.

'In the next two to three years, ERM will become the norm in organisations'

In the next two to three years, ERM will become the norm in organisations and, in response, brokers are currently ploughing millions into the development of their ERM and analytical capabilities. For example, at Willis we have developed our analytics capability over a number of years to a team of around 140 people, which is now in a position to deliver an analytics proposition in both the reinsurance and direct market.

In order to be successful, brokers must take on the role of consultants, advising clients on the full spectrum of their risks. While this will significantly change the client's relationship with the broker, I do not think that their relationship with the carrier will change that much. Clients will still be looking for placement of a product when and if they decide to insure, but their decisions about when and how to insure are going to be different – more forensic.

Clients will have a much more detailed understanding of the risks they face in their business and whether they can afford to retain them. This is, of course, likely to be driven by the often-predicted hard market.

The challenge for insurers is how they can develop a value proposition in the ERM and analytics space, and how they can present their products in a different way to cater for clients' developing needs. I think brokers are best placed to provide this and the insurers' relationships with clients are therefore unlikely to be closer as a result.

Whilst there is an understandable increase in the focus on prudential requirements by the regulator, the fair treatment of the customer will remain very much at the centre of the regulatory framework. The requirement to treat customers fairly (TCF) did not end at Christmas; it's with us for life, and there is likely to be significant action from the FSA where there is customer detriment that a regulated firm should have picked up as a result of their work on TCF.

Within all of these areas, the industry will have a substantial opportunity to shape the future of the regulatory framework. The detail of Solvency II will be worked out over the coming months, and the FSA needs our industry's support to help focus its constrained supervisory resource and to decide what tools to use to assess risk.

It is in all of our interests to work towards the most efficient outcome of this process, as our objective should be to ensure that we do not find ever-increasing resources being applied to regulation. Getting the regulatory focus and risk-based approach right will provide a framework that will benefit us all.

'The most important driver of the new environment will be the implementation within the UK of the Europe-wide Solvency II regime'

This focus on quality, rather than quantity, will allow our industry to deliver the necessary change to the way in which we are regulated without unnecessarily hampering innovation and efficiency across the UK market. **IT**

POWER

GLOBAL REGULATION

Putting it right

A tightened regulatory framework may be inevitable following the unprecedented events of the credit crunch. But how will this affect insurers? Katie Puckett reports on the potential fallout, and the endeavours within the industry to take a multiregional approach

How could this have happened? That's the question ringing around a shell-shocked financial services sector, and the search for answers has inevitably turned to the regulators. Glaring holes have been exposed in the wake of the financial crisis, not only in failed institutions around the world, but in the watchdogs that were supposed to make sure they were being run properly.

With the arcane workings of financial regulation suddenly top of the news agenda, anyone who's ever been anyone is coming forward to express an opinion. London's G20 summit in April saw an unprecedented gathering of world leaders step out of their armoured cars in the mood to get to grips with terms like procyclicality, macro-prudential and quantitative retention. After much political posturing, they shocked the world by actually agreeing to work more closely together to regulate cross-border institutions, even if such grand rhetoric is in marked contrast to the more protectionist stance they have so far tended to adopt when at home.

There has also been a flurry of reports into what went wrong, with many more on the way, and several *éminences grise* calling for more international co-operation. In February, former International Monetary Fund head Jacques de Larosière advised the European Commission that there should be a pan-EU regulatory authority to co-ordinate member states' activity, and in March FSA chairman Lord Turner reported back to the Treasury on banking regulation, also arguing for a new European authority.

THE SECTOR'S RESPONSE

For the insurance community, the rush of regulatory zeal has brought a corresponding round of frantic lobbying on the part of the ABI and its European equivalent, the CEA. Multinational firms are all in favour of greater co-ordination across countries, because it will reduce the duplication currently involved in compliance. What they very much don't want is to be lumped in with the banks that caused all the trouble in the first place, when their business models – and approaches to risk – are entirely different.

"There has been financial contagion, and that may become regulatory contagion," warns Professor Jan Monkiewicz, vice-secretary general of The Geneva Association, a global insurance thinktank, supported by 80 chief executives.

Insurers' risk management practices have been largely vindicated during the current crisis: there are no insurers on government life-support in the UK, despite AIG's well-publicised woes. But it is inevitable that, just as the banks' risk-taking eventually spilled over into the insurance sector, so the crackdown will too. There is already mission-creep among the many reports into the banking sector, with throwaway clauses applying sweeping conclusions to insurance as an after-thought. Insurers may not be too familiar with the Walker Review, supposed to investigate corporate governance in the banking sector and due out later this year, but the ABI has been alarmed to see the much broader term 'financial services' creeping into its remit.

LEGISLATIVE CHANGE

There has already been a movement to improve insurers' risk management and harmonise standards across the 27 member states of the EU, through the Solvency II Directive, which is ten years in the making. This has just been approved by the EU parliament, and is on track for a 2012 implementation. The UK was considered to be ahead of the game on this, but the fallout from the banking crisis has violently shaken the FSA from its laurels.

Under Solvency II, EU states will move from a regulatory model focused on firms' dealings with consumers, to prudential regulation, which is concerned with their internal management and governance, and whether they are reserving sufficient amounts to pay policyholders. "If you compare the FSA's approach to that of other European regulators, it's been the only one with a robust risk-based capital regime," says Jane Portas, a director in KPMG's insurance regulatory advisory practice. "It's been ahead of other regulators in this area."

"Going into the credit crunch, there was confidence that existing UK risk frameworks would go a long way towards Solvency II compliance," adds

SOLVENCY II: CROSS-BORDER CONSISTENCY

There is no prospect of a pan-European regulator in the near future, but Solvency II is a good first step. It lays much of the groundwork for an overarching regulatory authority, as outlined in the de Larosière report in March. The plan is not for a single European regulator, but a "supervisor of supervisors", which would rule on disputes between national bodies, co-ordinating their actions and checking that standards were being properly implemented.

"It's definitely not on the agenda today, but there is some momentum around that idea," says Sophie Lloret, regulation policy adviser at the ABI. "The Solvency II framework is going in the direction of having more harmonised, more consistent co-operation between supervisors, and a consistent standard for setting capital, solvency and risk management. It already ticks a lot of boxes."

When the directive was approved by the EU parliament, insurers were dismayed that plans to allow multinationals to diversify across the region while being regulated in their home country were dropped after opposition from smaller states. This is just one example of insurers wrongly being tarred with the bankers' brush, critics complain: the tendency of multinational banks to raid their subsidiaries for cash undoubtedly contributed to the crisis, but insurers don't behave like that.

Optimists say that much of the framework for group support remains in the directive, and there is a review scheduled for two years after implementation. Cynics ask why those reluctant national regulators would capitulate then when they have fought so hard against it now.

De Larosière envisioned a stepped approach. First, the three committees that oversee banking, securities and insurance supervision across EU member states would be strengthened with more power and resources, then transformed into something with binding powers such as an EU authority, before becoming an integrated supra-supervisor. "The G20 summit can only have helped," Lloret says. "It's a good thing to create momentum around it. However, having such a large institutional change at EU level is going to take time. It's one of these once-in-a-generation opportunities to get it right; you don't want to be rushing. You want people to buy into it."

Clive Martin, reinsurance partner at Ernst & Young. "But the financial crisis has raised questions about some aspects of those frameworks. There is now increased realisation of the scale of the challenge and the complexity of the tasks ahead. There are also still some uncertainties about future regulatory expectations and market developments, so Solvency II programmes need to be able to cater for those too."

'The FSA has been the only EU regulator with a robust risk-based capital regime'

Jane Portas, KPMG

THINK GLOBAL

Solvency II presents a positive move towards harmonisation across Europe (see box, above). It also reaches beyond the EU, introducing the concept of "equivalence" or "mutual recognition" for regulatory regimes in other states. This would make it easier for insurers domiciled outside the EU to do business there, because they would already be considered compliant with Solvency II. "Firms and groups of firms want as far as possible to do things once, and once only," says Janine Hawes, director of KPMG's insurance technical practice. Portas continues: "If a group is based outside of the EU, for example Bermuda or the US, and operates within Europe, its operations within Europe will have to comply with Solvency II. But if the local non-EU regime has equivalence, they wouldn't have to recompute the whole group on a Solvency II basis, so it would avoid duplication."

The prospect of a streamlined and improved European regulation system has already drawn much interest from other jurisdictions around the world. Regulators in the USA, Canada, Latin America and Australia are looking at Solvency II, aware that for their own firms to be competitive, they will have to raise their standards.

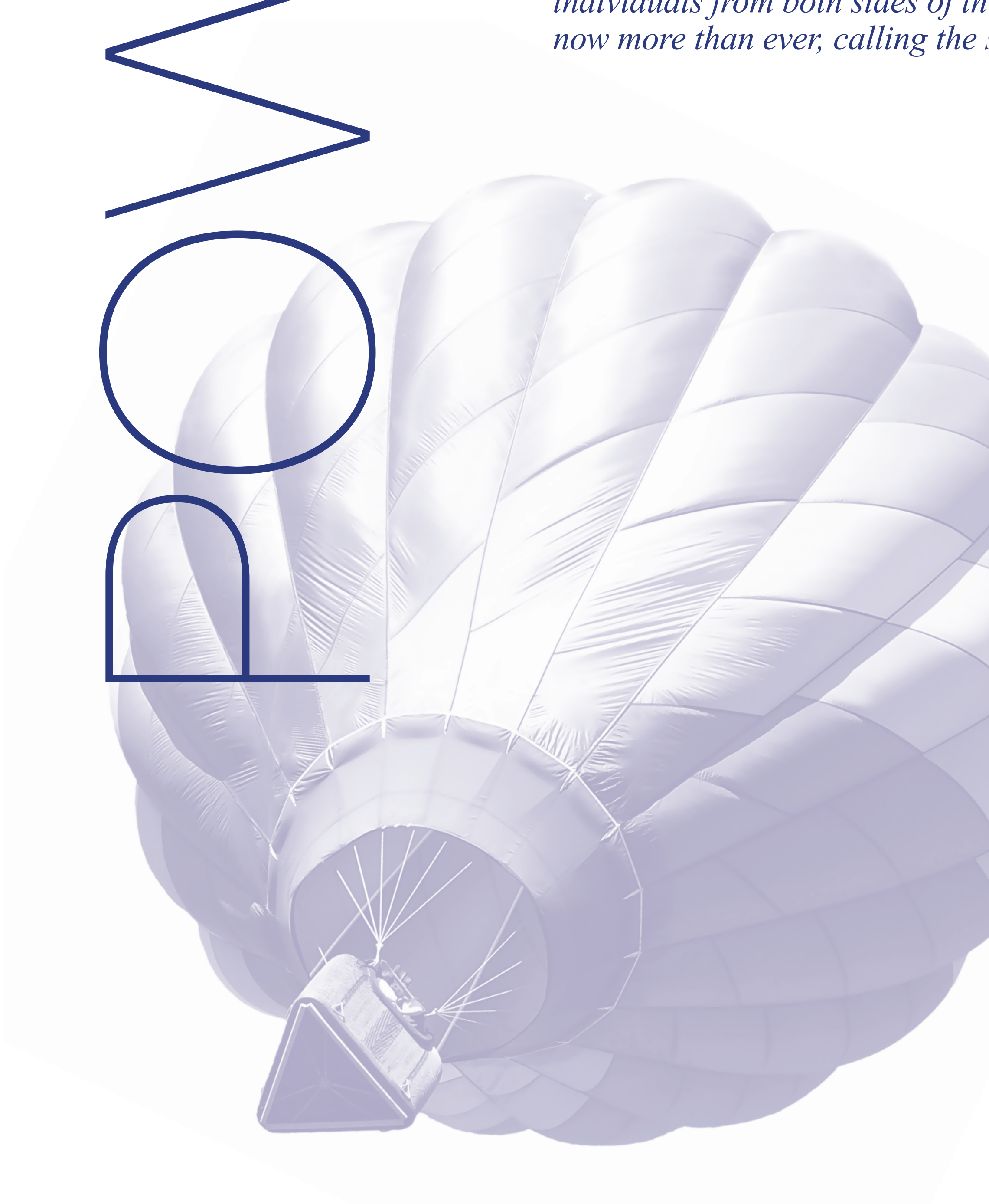
It's probably too much of a leap to say that this is the start of a global regulatory regime, but there are some very good reasons why the trend for co-ordination across borders will continue, as Monkiewicz points out: "We think that, with the growing globalisation of business, this needs to be reflected in regulation and regulatory co-operation. Business and, consequently, the challenge of regulation are growing ever more complex – everybody only knows a piece of the truth." **IT**

POWER

HIGH FLYERS

Top of their game

The credit crisis has shaken the financial world, challenging even the most savvy and resilient among it. Kalpana Fitzpatrick looks at two individuals from both sides of the pond who are, now more than ever, calling the shots



WARREN BUFFETT
UNFLAPPABLE, BUT FALLIBLE

One of the richest men in the world, with an influence in the insurance industry that rarely goes unnoticed, Warren Buffett is undeniably one of the world's most famous investors.

Having started earning his pennies selling chewing gum at the age of six, the 78-year-old made his first million when barely into his 30s.

Often referred to as the "Oracle of Omaha", Buffett has become well known in the general insurance market because of his influence and knowledge, and was said to have predicted the credit crisis seven years ago.

He is the largest shareholder of conglomerate Berkshire Hathaway and comes second only to Bill Gates in the world's rich list, as featured in *Forbes* magazine.

Buffett's investment in Berkshire Hathaway, where insurance is the core business and he is chief executive and chairman, has contributed

ADAIR TURNER
ONE WISE MAN

Adair Turner is no stranger in business, public policy or academia – so much so, he was made Lord Adair Turner in 2005. A visiting professor at the London School of Economics at Cass Business School, City University, Turner has gained recognition primarily through a variety of high-profile roles in industry, such as director-general of the CBI, vice-chairman of Merrill Lynch Europe, and chairman of the Committee on Climate Change.

In 2003, he became chairman of the Pensions Commission, an independent body set up by the UK government to look at the long-term trends in pension savings. But Turner's most recent position is arguably his toughest one yet, as chairman of the FSA.

Turner took up the post last year, when the recession was just starting to bite following the events of the global credit crunch. It has come at a time when the watchdog is under immense pressure to address concerns over regulation and financial instability.

Known for his fierce intelligence, charm and determination, Turner is nonetheless facing demands from numerous directions to fix the financial system, at a time when confidence is at an all-time low. It is hoped that his influence will lead the FSA in the right direction for the insurance sector as well as the consumer.

Ros Altmann, an independent investment banking professional, who has worked closely with Turner, says although he is a decent and highly intelligent man, "he is also a canny political operator". She believes Turner will be pragmatic and try to save the system, helping insurance companies survive by letting them delay writing down their losses, for example.

Commenting on how Turner will address the recession and the consequent impact on the insurance sector, she adds: "He is an intellectual, a deep thinker, but ultimately guided by political judgment. Rather than doing 'what's right', he will do what is expedient if push comes to shove. He can analyse a situation brilliantly, see all the options and then decide what to do.

"Unfortunately, however, it is not clear whether he will be sufficiently on the side of the consumer. He may bow too much to industry pressure."

His FSA report last month – The Turner Review – identifies three underlying causes of the crisis: macro-economic imbalances, financial innovation of little social value, and important deficiencies in key bank capital and liquidity regulations.

It is likely that the watchdog may move towards tighter regulation under Turner's reign as he attempts to see the financial services industry through this economic turmoil.

heavily to his wealth. His annual letters to shareholders are always well read, providing valuable insight into his views of the markets.

But despite his savvy business ways, even Berkshire Hathaway fell victim to the current financial crisis, which saw its shares tumble.

In his annual letter to shareholders in March this year, Buffett revealed that the company's net earnings had dropped 62% to $4.99bn (£3.54bn) last year, from $13.21bn in 2007. The letter also disclosed an $11.5bn decrease in net worth during 2008, which reduced the per-share book value of both the company's class A and class B stock by 9.6%.

Buffett admitted that his actions in 2008 contributed to the company's worst year on record, saying he had made some "dumb" moves, which included his mistimed purchase of Conoco Phillips stock last year when oil prices were at a peak (they have since dropped dramatically). His purchase of $244m of shares in two Irish banks that looked a bargain were also a mistake, as the company made an 89% loss on the investment.

But despite some lapses in judgment, Buffett's confidence has not been dampened, and he continues making predictions. Shareholders, more often than not, still hang on the legendary investor's every word.

Looking ahead, Buffett sees a gloomy outlook for 2009. "The economy will be in shambles throughout 2009 – and, for that matter, probably well beyond," he wrote in his shareholder letter.

He has little hope of a quick recovery and, although he agrees with the US government's strong and immediate action with its multibillion-dollar bailouts, he believes there will be an "onslaught of inflation" going forward.

"Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once unthinkable dosages will almost certainly bring on unwelcome effects," Buffett wrote.

The tycoon is more optimistic about the long term, however, and believes the US economy will overcome the challenge of recovery. After all, this is not the first time it has battled through a recession. **IT**

INDUSTRY VIEWS

Set our own agenda

Richard Ward
Chief executive
Lloyd's

Intense debate is currently taking place over how best to regulate global financial markets. Initiatives developed now will shape the future framework in which the financial services industry, including insurance, will operate.

The G20's "Declaration of the Summit on Financial Markets and the World Economy" will help to shape that debate with its messages on strengthening transparency and accountability; enhancing sound regulation; promoting integrity in financial markets; reinforcing international co-operation; reforming international financial institutions; and maintaining an open global economy.

It is vital that countries do not simply pay lip service to the concept of keeping the global economy open, but resist the siren voices of creeping protectionism. A successful conclusion of the current WTO Trade Round will help to achieve that goal and could boost the global economy by at least $150bn a year.

An important contribution to the debate on regulation is being made by the Organisation of Economic Co-operation and Development (OECD) via its work to develop general guidance on a sound policy framework for regulation. Lloyd's has been working closely with the OECD on this, and I welcome this initiative.

The framework, to be finalised later this year, recognises the primary role played by the financial system in the pooling, management and transfer of risks in the macro-economy, and the global and integrated nature of financial and economic systems. It will provide countries with valuable and cautionary guidance when contemplating the introduction of new regulatory rules.

KEY ANALYSIS

The EU has also been making its own contribution to the debate. The recently published De Larosière Report, aimed at revamping aspects of

Squaring up to the prici

John Neal
Chief operating officer
QBE Insurance
(Europe)

Those few notables examples aside, where forays into non-core financial products have cost essentially sound property-casualty businesses dear, non-life insurance currently stands out as a rare beast in the financial services community: a sector that is still as much about managing opportunities as it is about managing threats.

However, the sector's relative strength should not blind underwriting entities to the fact that we are facing some very interesting challenges, which will prove a real test of the industry's much signalled, new-found skills in cycle management.

Taking the UK as an example, there is no doubt that rates need to shift. By the beginning of 2008, a string of "good" underwriting years meant that most UK commercial products were increasingly marginally priced. One year on, and capacity is tighter, investment returns are lower, reserve releases are dwindling and reinsurance rates, at least, are on the move.

At the same time, evidence is coming thick and fast of the expected, recession-driven, rises in claims experience. Not only have recent ABI reports highlighted increases in theft, fraud and arson, but also the casualty sector is seeing increased claims frequency on various lines, including professional indemnity and employers' liability business.

SUPPLY AND DEMAND

Basically, unless decisive action is taken soon, erosion of underwriting capital due to rising claims and inadequate pricing is now a real threat. What's more, given the current question mark over the availability of fresh capital with which to "reload" capital, it is a threat that impacts both ongoing profitability and the potential ability of insurers to make the most of significant future rate rises flowing from a market changing event.

So much for the supply side of the equation. By contrast, on the demand side the supervisory framework in Europe, has been welcomed by the insurance industry. It recommends the creation of a European Systemic Risk Council and various changes to the current EU system of financial supervision.

Another valuable contribution to this debate was made earlier this year by the Group of Thirty, a non-profit, international body composed of senior representatives of the private and public sectors. Its report "Financial Reform: a Framework for Financial Stability" comments on flaws in the global financial system and provides specific recommendations on how to improve supervisory systems by redefining the scope, boundaries and structure of prudential regulation.

'The insurance and reinsurance industry cannot be an idle bystander as new financial services initiatives emerge'

With specific regard to reinsurance, the International Association of Insurance Supervisors, the global standard-setting body representing supervisors, is particularly to be praised for its excellent guidance paper on the mutual recognition of reinsurance supervision, which identifies criteria that supervisors should consider when deciding whether to recognise reinsurance supervisory regimes of other jurisdictions.

The insurance and reinsurance industry cannot be an idle bystander as these and further initiatives emerge. There are many key messages that policymakers need to be constantly reminded of as they develop new legislation and regulation that will affect the insurance sector.

Not least of these is the fact that the current financial turmoil is the result of a banking crisis, not an insurance one. When policymakers reflect on the design of future supervisory frameworks, the differences between insurance and other financial service providers need to be borne in mind. Reforms appropriate to the banking sector should not automatically be applied to other financial services sectors.

Greater co-operation between supervisors is desirable. Convergence of national and international rules has to occur at sensible and proportionate levels. Crucially, whatever the temptations, there must not be a retreat into regulatory protectionism by individual countries.

More regulation is not the same as better regulation. Regulatory rules should be developed in an open and transparent way, in consultation with stakeholders. They have to be fit-for-purpose, proportionate, of high quality – and enforced.

These are the foundations of a financial system on which the global economy depends. So let's build them sensibly and to last.

ng issue

many commercial policyholders have businesses that, under immense pressure to reduce costs, are being forced to contract; a trend that is leading to an expectation of premium reductions at the very time when underlying exposures are actually rising.

All of this makes the current business environment a difficult challenge to manage, so further underlining the vital need for insurance businesses to achieve far greater internal "intimacy".

Simply put, underwriters have to be properly empowered if they are to be able to make the right calls. Only by arming them with the right information – including, critically, a common understanding of the key issues and goals among both those underwriting the business and those managing it – can we expect our underwriters to be able to strike a sensible balance between the needs of clients and pricing imperatives.

Today's underwriting environment is a very stark example of what cycle management means in practice. It is also a critical test of the industry's ability to deliver the consistency of performance and service that it has promised to both shareholders and policyholders.

If this sector is serious about creating a long-term, sustainable offering that achieves double-digit returns on equity for shareholders in every part of the cycle, combined with consistency of service to policyholders in both good and tough markets, the answer is clear. This industry can no longer afford to duck the pricing issue. **IT**

'Erosion of underwriting capital due to inadequate pricing is now a real threat'

LOBBYING

Spheres of influence

The ABI and CEA have been busy pushing the agenda of the insurance industry through the corridors of power in the UK, Europe and beyond. Katie Puckett outlines the key initiatives

AGE-OLD PROBLEM

THE EU ANTI-DISCRIMINATION DIRECTIVE AND THE UK'S EQUALITY BILL

■ **The issue:** This concerns two pieces of law, at a UK and European level. The UK government's Equality Bill, published on 27 April, promised secondary legislation about how financial services companies can discriminate on the basis of age. Meanwhile, there is an EU anti-discrimination directive, published by the European Commission last July and currently going through the Council of Ministers and the EU parliament.

Looking ahead, there is no question that underwriters will be banned from taking age-related information into account, but there are still areas of concern in both the conditions set in the EU directive and in the "objective test" likely to be included in any UK legislation.

Insurers fear that the legislation will insist premiums are too strictly related to available data. In outlying cases – critical illness or motor cover for very old people, for example – there will be little data and an average would be misleading. Insurers would usually also extrapolate from data for lower age groups to produce a more realistic quote, but the legislation could proscribe this.

The age lobby is also campaigning for it to be illegal to refuse to give someone a quote on the basis of age. The ABI has been arguing that, when you force insurers to quote, they tend to quote high. Instead, it wants a counter-referral or "signposting" system, where if one insurer couldn't quote, they can suggest others that will.

■ **The action:** The ABI is consulting on possible amendments to the UK bill and holding discussions with opposition parties and government. It has successfully proposed amendments in the EU parliament, widening the data that can be used, and is explaining the case to the UK government.

COMMON KNOWLEDGE
EXEMPTION FROM EU COMPETITION LAW

■ **The issue:** New EU antitrust legislation threatens to end insurers' ability to work with each other without breaking competition laws, one of a few block exemptions left. There are four elements currently exempt from competition law: statistics and data-sharing; common terms and conditions, often used in wholesale insurance policies; insurance pools covering risks like terrorism or nuclear; and co-operation on technical standards for security devices like sprinklers and burglar alarms.

The ABI argues that insurance is a special case because, in many areas of risk, the customer will know more than the companies do – about their health or the condition of their property, for example. Sharing information with other firms redresses the balance.

It wants the block exemption to continue so that its members are not at risk of competition investigations. But, there's a heavy presumption it will be removed, and that firms will individually have to get each area for co-operation vetted by lawyers. This would cost millions in legal fees.

■ **The action:** The European Commission has sole responsibility for competition law; the Council of Ministers and the EU parliament aren't involved. The ABI has already won back exemption for joint studies and statistics, and continues to lobby to have it extended to other areas. Director of public affairs Hugh Savill will be appearing at a public hearing in Brussels on 2 June.

INSULT TO INJURY
COMPENSATION FOR PLEURAL PLAQUES

■ **The issue:** Pleural plaques are scars on the lungs caused by exposure to asbestos, but they have no associated symptoms, and there is no link to fatal conditions like mesothelioma and asbestosis. In the US, insurers have paid out billions since the early 1980s after opportunistic lawyers set up "scan vans" in shopping centres, searching for people with "million-dollar lungs".

In the UK, insurers used to pay sufferers small amounts under public or employers' liability policies, to compensate them for anxiety or distress, but a House of Lords ruling in 2006 decided pleural plaques should no longer be compensatable. The Ministry of Justice issued a consultation paper on this last year, and is expected to make an announcement soon. The Scottish government has already decided to make pleural plaques compensatable in the Damages Act, which comes into force in June.

■ **The action:** Four members of the ABI that have the majority of exposure to plaques are in the process of launching a judicial review of the Scottish Damages Act, which will be heard in a court in Edinburgh later this year, in the hope that it will be overturned.

A POINTLESS SOLUTION
REFORMS TO THE PERSONAL INJURY CLAIMS PROCESS

■ **The issue:** The legal costs for settling personal injury claims in the UK often dwarf the eventual compensation payouts, and the defendant's insurer must foot the bill. The current system is too slow and delays early access to rehabilitation for the claimant. The government appeared to be addressing the issue, and a consultation document in April 2007, proposing a fast-track system for undisputed claims, was welcomed by insurers.

> 'There is no question that underwriters will be banned from taking age-related information into account'

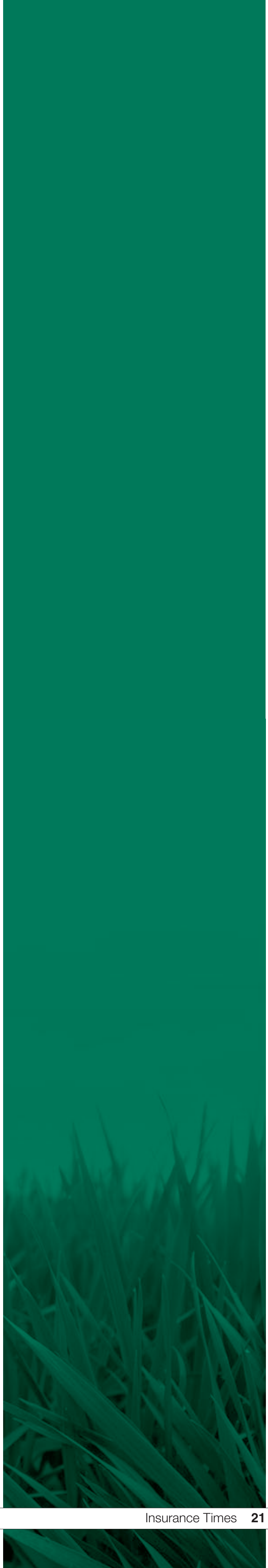
When the reforms were finally proposed last July, however, it was a massive letdown. Not only did they fail to reform the system in any meaningful way by only addressing motor personal injury claims, they were skewed very much in favour of claimants' lawyers. Now they have been delayed yet again by ministers, to April 2010.

In fact, by introducing an enormous potential cost in going outside the limited fast-track process they proposed, they made it uneconomic to claim contributory negligence – a dangerous warping of the legal rights of every driver on the roads.

■ **The action:** With the new process due to come in next year, the ABI is continuing to monitor the situation and campaigning that they should go much further and be extended to employers' liability claims too.

BILL OVER TROUBLED WATER
FLOOD AND WATER MANAGEMENT

■ **The issue:** On 23 April, the government published a draft Flood and Water Management ▶



LOBBYING

▶ bill, which sets out a framework for managing flood risk. The consultation is now open. This should enshrine in law the recommendations from the Pitt Review into the 2007 floods. The ABI wants the Bill to put the Environment Agency in

> 'The ABI constantly has to point out that insurers shouldn't be subject to the same regulatory knee-jerk reaction as the banks'

overall charge of managing flood risk and assessment of surface water drainage, and for local authorities to be responsible for drafting surface water management plans in their area.

■ **The action:** The ABI will be responding to the consultation on the bill in the coming months. Meanwhile, at a European level, the CEA has been contributing to the European Commission policy debate on the role of the insurance markets in responding to climate change, and has published several reports on the insurance industry's efforts to manage and mitigate the risks of natural catastrophes. It has also been helping to draft a European-wide flood mapping handbook, known as EXCIMAP (European exchange circle on flood mapping).

INDUSTRY ACTION
FINANCIAL REGULATION: THE TURNER, WALKER AND DE LAROSIÈRE REPORTS

■ **The issue:** The issue of financial services regulation takes up more of the ABI's time than anything else right now, and no wonder. With an ever-increasing number of reports on the banking failings that led to the financial crisis, it constantly has to remind the powers-that-be that insurers are not the same as banks, and so shouldn't be subject to the same regulatory knee-jerk reaction. It is also making the case that regulators should co-operate better at both a European and international level to reduce the duplication and compliance burden on multinational firms, something recommended in the De Larosière Report for the European Commission in February.

■ **The action:** This is more about campaigning than lobbying. The ABI has published a number of papers, and senior staff have taken part in debates in the UK and internationally, and appeared in front of a Treasury select committee and a House of Lords committee. It held a conference with Lord Mandelson as the main speaker earlier this month. The CEA is also leading European insurers' input into new accounting standards for insurers in Europe, called IFRS 4 Phase II, replacing the IFRS 4 interim standard that was introduced as a stopgap in 2004. The bodies concerned are the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in the US. A draft is expected during late 2009 at the earliest.

IN PURSUIT OF HARMONY
SOLVENCY II DIRECTIVE

■ **The issue:** The Solvency II Directive will improve and harmonise prudential regulation of insurers across the 27 member states of the EU. Ten years since its conception, it was finally approved by the EU parliament in April, and by the Economic and Financial Affairs Council in May. UK insurers broadly welcome the directive, but were dismayed to see the key "group support" clause had been dropped after impassioned lobbying by smaller states. This would have allowed multinational companies to use their parent company capital to support their subsidiaries.

The other bone of contention is the extension, under Solvency II, of mark-to-market or fair-value accounting rules, which would assess insurers' assets at current market values. But insurers accept that the purchase cost of an asset is not enough, and there is a danger of irrational optimism without the rigour of a market-based approach.

■ **The action:** Only the framework directive has been agreed so far; the detail will be down to secondary legislation. The ABI and the CEA are lobbying the Commission and Ceiops (the Committee of European Insurance and Occupational Pensions Supervisors), which oversees regulators across Europe. Over the summer, there will be more than 50 consultation papers on different aspects of the regulation.

GLOBAL INTERESTS
PROMOTING BUSINESS OVERSEAS

This key issue brings together several strands of activity. The CEA is campaigning for changes to the US's collateral requirements for non-US insurers, which are much more stringent than for US insurers, and put them at a disadvantage.

It has also expressed support for a federal regulation regime, in addition to the current system of 50 state regulators, which would co-ordinate laws, licensing requirements and regulatory examinations across the country and make it much easier for European firms to operate there. The National Insurance Consumer Protection Act, better known as the Optional Federal Charter, was introduced in the House of Representatives on 4 April.

Meanwhile, the ABI's director-general Stephen Haddrill will be accompanying the Lord Mayor of London on a visit to China at the end of the month to promote the interests of UK insurers. **IT**

POLITICS

TAX HAVENS

Treasure islands

Loud condemnation from the world's most powerful politicians notwithstanding, low-tax jurisdictions can offer legitimate benefits to insurance firms. Katie Puckett considers their pros and cons, and looks at the tax-efficient structures still available here in the UK

Tax havens have been under sustained fire in recent months. President Obama has been a longstanding opponent of the jurisdictions that help US citizens hide their dollars from the taxman, and he wasted no time in backing anti-tax evasion legislation when he took power in January.

In the UK, Gordon Brown has added his voice to a growing list of world leaders, including Pope Benedict XVI, against around 40 secretive low-tax regimes that withhold £180bn a year from the world's leading economies. And, of course, leaders of the 20 most powerful nations, at the G20 Summit in London in April, promised sanctions on those that refuse to share information on their account holders.

You could dismiss the G20 announcement as political grandstanding – there is as yet little detail – but it does show that tax havens are under an unprecedented level of scrutiny. "The combination of the G20 and the OECD has definitely forced some of the tax havens to get off their laurels and stop thinking everything's okay; to be a bit more proactive," says Miles Walton, tax partner at law firm Allen & Overy.

The G20 focused mainly on the secrecy of certain low-tax jurisdictions, as they prefer to be known. They have already been under pressure to sign up to the OECD's "internationally agreed tax standard". Within hours of the G20 agreement, the OECD ruffled international feathers with a progress report that put 38 jurisdictions and financial centres, including Switzerland, Austria, Belgium and Luxembourg, on a "grey list" of ▶

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places that have yet to fully implement the anti-secrecy measures.

This renewed assault on tax havens' transparency is only one aspect of a multi-pronged attack that will challenge their regulatory systems, really hitting where it hurts, and force tax law changes that could destroy their whole reason for being.

THE ATTRACTIONS

Tax havens are much used in the insurance world, although not for their secrecy. Firms are driven from the UK to destinations such as Bermuda, Guernsey and Gibraltar by the Treasury's complex double-tax regime, where profits brought in from overseas subsidiaries are taxed as if they were made in the UK, and also by the UK's complex regulatory system.

According to the ABI, UK insurers pay £2.9bn a year in corporation tax. In recent months, several have announced that they will be redomiciling to more tax-friendly climes. Beazley and Zurich are heading for Ireland, where the rate of corporation tax is less than half of the UK's; Brit is going Dutch; while RSA and Amlin have spoken of joining the rush for the airports.

There are also ways to take advantage of tax havens without redomiciling. Insurers may keep their headquarters on the mainland, but set up offshore subsidiaries – or "sidecars" – to reinsure some of their risk, which extend their capacity quickly by offering third-party investors the chance to profit from a particularly busy year's business.

Using a tax haven is not only more profitable, it's much easier too. Offshore jurisdictions have designed their regulatory regimes to be more user-friendly, more responsive and much less bureaucratic than, say, the FSA. The costs of setting up and running a compliant business are therefore much lower.

"Working under the FSA is a nightmare," says an expert on these captive companies. "It is a very, very autocratic regime. In many ways it has to be, because of what it is and where it is. If you wanted to go and have a chat with a regulator in Guernsey or the Isle of Man, you can pick up the phone and pop round and have a coffee. You'd never have that with the FSA. They'd want a month's notice and there would have to be three people there. It's a much harder regime to do business in."

RED TAPE

Tax havens, and the lawyers and accountants who use them, claim that the system of regulation there is just as effective as anywhere else, but not everyone buys that. Richard Murphy founded the Tax

CHALLENGING TIMES

Tax havens have been hit by the financial crisis worse than many places, because of their exposure to the more complex and risky deals, raising questions about their long-term stability.

In last autumn's pre-Budget report, the government announced a review of the UK's interdependence on tax havens, headed by Michael Foot, chairman of Promontory Financial Group in the UK. "Offshore financial centres must play a responsible role in the global financial system," financial services secretary Paul Myners said. "This review will take a serious and constructive look at the challenges these centres face in the current economic climate, and how they can best respond to these."

Foot was less combative: "After working as a financial regulator in the UK and overseas, I have direct experience of the achievements of the Crown dependencies and overseas territories. I am looking forward to working with them to see how best the important contribution of their financial sectors can be underpinned and strengthened for the future in these challenging economic times."

Perhaps, then, it was little surprise that the interim report, published on 21 April, failed to fulfil predictions of the demise of tax havens. It was warmly welcomed by the havens themselves. "I had lunch with Michael [Foot] two weeks ago, and he explained his approach to me," says Peter Neville, director-general of Guernsey's Financial Services Commission. "His review provides an excellent opportunity for Guernsey to demonstrate that … Guernsey's financial services business generates substantial benefits for the UK."

Unsurprisingly, however, the anti-tax haven lobby, including TUC general secretary Brendan Barber, denounced the interim report. "This leisurely review is more focused on helping tax havens through their current financial difficulty than addressing the serious threat they pose to the global economy," Barber said.

Justice Network to campaign against tax havens, and is a director of Tax Research LLP. "I simply don't buy it. If it was tougher, why would people go there? There would be a business cost. If the regulator is someone you know from the gym or the supermarket, it's a very much more relaxed environment. It creates a very different type of regulation when you know the people you're regulating. This familiarity is unavoidable in these places."

As calls for better regulation of financial institutions resound around the world, this lighter touch will inevitably come under threat. "That's going to be very difficult now, because of the emphasis on stricter regulation of financial services across the board," says Robert Viney, a partner at law firm Davies Arnold Cooper, who advises on insurance regulation. "These smaller island jurisdictions are going to come under pressure to increase regulation of insurers and other financial institutions the same as mainland jurisdictions."

Agreeing to share information was an easy first step for tax havens, but Viney believes that meeting regulatory pressures will present a more fundamental challenge. "The dilemma they're now facing is how to keep these companies they've attracted while at the same time not upsetting the likes of Europe and the US. It's going to be difficult," he points out. In the short term, the costs of doing business there will probably go up.

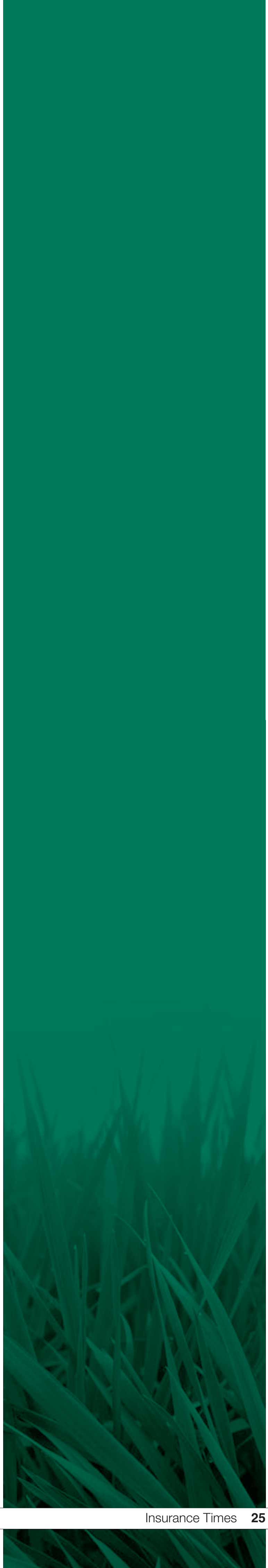
Walton thinks tax havens have been unfairly scapegoated. "That's not to say there haven't been abuses going on, but they're not really at the heart of the current troubles. Complicated deals haven't helped, but there can be complicated deals anywhere. The G20 think if they can see the end of tax havens, everything will be solved, and that's not the case. They also need to distinguish a little bit better between "good" tax havens – ie those that have for some time had good regulation and disclosure – and those that haven't yet gone far enough."

Those jurisdictions have an important role to play in making onshore businesses more efficient too. "All big tax systems have problems and are quite inflexible," Walton says. "On an ordinary deal, a securitisation for example, prior to recent changes there was a risk of a tax charge in the UK where there hadn't been any economic profit. So many deals were routed through tax havens to smooth out the idiosyncrasies."

HOMEGROWN MEASURES

An interim report from a government review of tax havens, released on 21 April with the Budget, has not revealed a targeted attack on these jurisdictions (see box, above). However, the Budget itself does threaten tax havens in a more fundamental way. Rewarding concerted lobbying by the ABI, Gordon Brown said that dividends received by multinational groups from overseas would be exempt from UK tax from this July. This would remove one of the main reasons for insurers to redomicile. But there are still several areas of uncertainty, pending the release of the Finance Bill 2009, due late April/early May.

Financial services firms, including insurers, will also be exempt from the introduction of a ▶



POLITICS

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worldwide debt cap. This reverses one of the more competitive features of UK tax law, and would limit the tax deductions that members of a multinational group could claim for interest on debts. There is further uncertainty around the controlled foreign companies rules that affect the taxation of overseas profits, and could potentially make the UK more competitive. They are also under review, but no legislation is expected for two years.

These measures are unlikely to influence companies that have already redomiciled or are in the process of doing so, but it might stop the rush for airports, temporarily at least. “My hunch is that companies will put off the decision until we've had a chance to consider the detail of the worldwide cap, and many will probably change their minds,” Walton says.

There’s a knock-on effect that could also benefit insurers, if corporates decide that, rather than self-insuring by setting up captive subsidiaries in low-tax jurisdictions, it is more cost-effective to place the risk on the open market with insurers.

> ‘The dilemma tax havens now face is how to keep these companies they’ve attracted while at the same time not upsetting the likes of Europe and the US’

“I have certainly noticed a number of companies reviewing whether or not it remains beneficial for them to have captives,” says Charles Gordon, a partner at DLA Piper’s insurance and reinsurance practice. “They’re bringing them back onshore or not having them at all. A lot of the reason for having captives has been driven by tax, but tax changes in the UK make it less valuable.”

But he doesn’t think the tax havens have had their day: “I don’t see a flood of people coming back here having gone to Bermuda. It’s a well-established insurance centre and will continue to be one.” The message is: if tax-efficient jurisdictions can maintain their beneficial tax and regulatory regime, while still adhering to the G20 and OECD’s demands of transparency, they can continue to attract the interest, and business, of UK insurers. **IT**