PricewaterhouseCoopers

Insurance digest

AMERICAS Edition

February 2003

The **Americas Insurance Digest** is published three times a year to address the key issues driving the insurance industry. If you would like to discuss any of the issues raised in more detail please contact the individual authors or the Editor-in-chief, whose details are listed at the beginning of each article.

We would also welcome your feedback and comments on Insurance Digest, and as such, we enclose a Feedback Fax Reply form. Your feedback will help us to ensure that our publications are addressing the issues that you feel most strongly about.

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Editor's Comment

John S. Scheid

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As 2003 begins, everyone is looking forward to a brighter start in the new year. This past year brought some of the largest corporate failures in history, the demise of one of the world's largest public accounting firms, the passage of major new securities legislation in the U.S. and a difficult year for the insurance industry. With the scandals of the past year, it is not surprising that there is a renewed focus on ethics and business conduct. Transparency has become a focal point as regulators, stock exchanges, accounting firms and boards of directors seek to restore public confidence.

Welcome to the February 2003 edition of Americas Insurance Digest. This edition features articles covering a range of topics which not surprisingly reflects the difficult year just concluded, but hopefully looks ahead to opportunities in the future.

The first article, by Peter Korpacz and Jonathan Miller, gives a forecast for emerging trends in the real estate markets. As investors become reconciled to more down-do-earth returns, income-oriented investments like real estate should look increasingly attractive. Peter and Jonathan are forecasting a slow road to sustained economic recovery in late 2003 or 2004. On a relative basis, they believe real estate may sustain returns that continue to beat stocks and bonds, but robust gains are not expected.

Paul Delbridge comments on the lessons learned from the significant losses suffered by the reinsurance industry in the last year. Paul's article is based on an address given by Dirk Lohmann, Group CEO of Converium, at a breakfast seminar hosted by PricewaterhouseCoopers at last year's Monte Carlo Rendez-vous. We are grateful to Mr. Lohmann, both for his address and for his agreement to the use of his material. The extent of capital depletion in the reinsurance industry and a growing recognition of the importance of reinsurance to the insurance market stability will be debated further this year.

With a very difficult year in the insurance world, many companies have been intensifying their efforts in underwriting, asset-liability management and assessing catastrophe risk concentration. While insurers are generally good at analyzing transaction or product level risks and reacting to events after they occur to mitigate future risks, now insurers are beginning to assess how they can minimize losses in other areas of their business as well. Rich Reynolds reviews some key elements to implement an effective risk culture.

The insurance market in China is growing rapidly and China's World Trade Organization entry means that it is becoming easier for international companies to gain entrance into this large new market. David Campbell, the leader of our insurance practice in China, discusses the competitive landscape from the point of view of potential new entrants and looks at growth potential in this new market.

Accounting standard setters are looking towards convergence of U.S. and International Accounting Standards, with a shift from a rules- to- principles-based approach. With globalization of business, having harmonized accounting standards is in the public interest. As a result, insurance companies in the U.S. are now realizing that International Accounting Standards (IAS) require their attention. Marie Braverman and Sam Gutterman discuss the current status of IAS accounting for insurance contracts together with some implementation challenges facing insurers. Given the relatively short time before the 2005 effective date for IAS in Europe, we will have another article in the next 2003 edition as well.

And finally, 2002 has illustrated the consequences for the market when trust breaks down. Investors use information and analyses from many sources to make decisions and they require that information to be reliable, timely and in usable form. Our last article discusses future directions in business reporting to improve transparency and increase reliability.

Looking ahead there are some positive opportunities; however, many companies will continue dealing with the challenging investment markets and ongoing economic uncertainty. Hopefully, 2003 will bring more favorable conditions for all.

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Different world, tempered expectations…

2003 emerging trends in real estate

Commercial real estate investors watch nervously as a sluggish U.S. economy offers scant relief from weakened supply/demand fundamentals. While a continuation of lackluster performance is forecast, capital flows to real estate accelerate and on a relative basis real estate may sustain returns that continue to beat stocks and bonds.

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When plentiful capital cavorts in commercial real estate markets with eroding fundamentals, it's time for more caution. Despite the current proclivity to park money in seemingly safe property harbors instead of the bloodied stock market, an ominous trio – rising vacancies, declining rents and mounting property expenses – promises increasing pain in 2003. If the economy flounders, the year ahead will see a relatively shallow property-market downturn prolonged and core portfolio returns concentrated in the mid to upper single digits (albeit safely in the black).

With *Emerging Trends®* forecasting an anemic rebound – a gradual upturn that should gain momentum in 2004-2005 – investors would do well to continue seeking quality properties with locked-in income streams that will carry them through the market trough. Marginal properties in marginal locations could suffer material value declines, as capital and tenants steer clear.

After an unusually steep bust-boom trajectory in commercial real estate, the investment universe is reverting to the mean – the middle ground between the early '90s recession and the late '90s skyrocketing of the stock market. More recently, the vicious bear market in stock equities, collapse of the high-tech and telecom industries and ensuing corporate governance scandals have soured notions of easy money, early retirement and carefree speculation. Shock waves from September 11 have administered a long overdue dose of reality for many Americans – security and order can't be taken for granted in an increasingly complex and dangerous world, despite our country's lone 'superpower' status and dominating economy. 'It's a different world, and expectations are tempered.'

For investors, the recent tumult has been a wake-up call to concentrate once again on risk-adjusted returns and regain reasonable expectations about investment performance. Ultimately, this renewed focus should reward real estate as a steadfast haven for solid, income-oriented returns, sitting appropriately between high-grade bonds and more volatile stocks on the risk/return spectrum. 'Long-term returns for core real estate should deliver about 5% (above inflation), and over the next five to seven years we should expect total returns in the 7%-8% range,' predicts a leading real estate strategist. 'That's maybe not as dynamic as you might like, but there are coupons to clip, and in light of recent stock market experience, those returns will be quite nice indeed.'

Completing a comeback

Most indicators show real estate surviving a torpid 2003, to emerge with regained standing in the investment universe and greater structural stability. That's assuming we avoid an ugly double-dip recession or global maelstrom – read: war in Iraq, cataclysmic terrorist strike, Middle East conflagration, God knows what – in which case all bets are off for all investment categories.

Greater structural stability

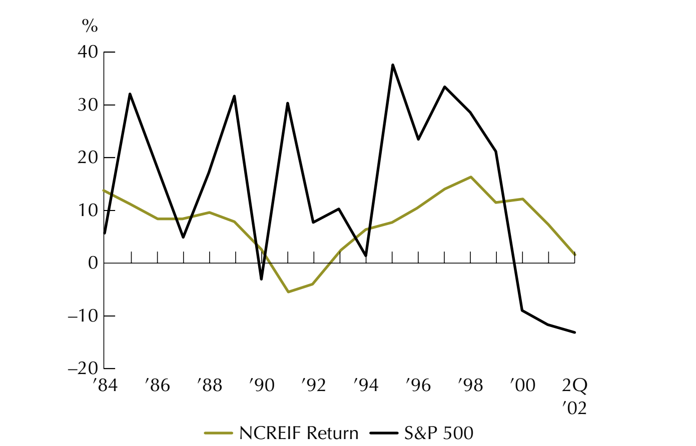
Recent REIT and pension fund dominance of the equity markets means the industry isn't as leveraged as in the past, when private owners held sway. 'Owners have more skin in the game,' and the public operating companies have brought greater sophistication to the job of understanding markets and managing investments. REITs, especially, tend to be agglomerators – buying and holding prime properties, selling only weaker assets as necessary. 'The industry's capital structure won't be as active, there's not the pressure to sell, and there's greater overall stability.'

Controlled capital flows

It's not just window dressing: Scrutiny by the CMBS B-piece cartel, rating agencies and Wall Street REIT analysts has actually imposed considerable restraint on lending activity and helped stanch unnecessary development. 'Nobody's acting stupid – you can't get away with it.'

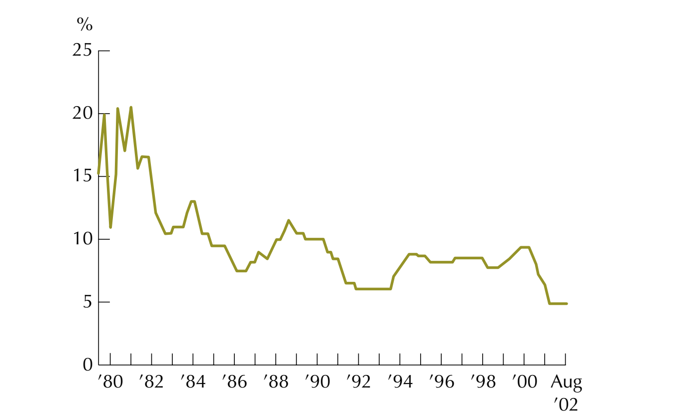
Different world, tempered expectations *continued*

Figure 1 NCREIF Returns vs. S&P 500



Source: Standard & Poor’s, National Council of Real Estate Investment Fiduciaries, Rosen Consulting Group

Figure 2 ‘Prime’ lending rate



Source: Federal Reserve Board, Rosen Consulting Group

Attractive yields

Apartments, 24-hour office, grocery-anchored retail, prime malls and warehouses have proved they can deliver 7%-8% income consistently.

Positive returns

Most importantly, real estate appears to be surviving a cyclical downturn without major dislocation. The property sector is regaining a large measure of its reputation as a reliable, less mercurial, bond-plus investment – an image severely damaged in the early ’90s market depression. ‘When you lose 35% on your stock portfolio, single-digit real estate returns look good today.’

2003: More risk, little upside

The flip side is a host of challenges that will make 2003 a problematic year for investors. Investors need to focus on the ‘three Ds’ – dividends from quality properties, discounts and diversification. ‘Real estate’s attractiveness has been income security, and that security could come under stress the longer the economy stays down.’ Here’s why:

Sublease overhang

Although real estate execs crow about development staying in relative check across most sectors (and it has except in suburban office), the impact of office overleasing by companies with unrealistic appetites for expansion at the height of the tech bubble caught ‘everyone by surprise’. Post tech-wreck, the flood of sublease space has been dramatic and unprecedented, pushing office vacancy rates up even more sharply than in the late ’80s deluge of overbuilding.

Corporate belt-tightening and phantom space

While advertised as a mild economic downturn, the 2001-2002 recession – coupled with stock market contagion, 9/11 wounds and fallout from Enronesque meltdowns – has hit many companies hard. Bosses continue to redline budgets, whacking expenses (including travel) and imposing hiring freezes. Empty cubes populate many offices on top of the sublease surfeit. When an economic recovery gains steam, plenty of leased and underutilized ‘phantom’ vacancy will need to be absorbed before tenants can expand into new space. ‘This has been a corporate depression after a corporate boom, and the effects haven’t fully played out yet,’ warns a well-known real estate researcher. ‘Any recovery in office occupancy could be very slow.’ A portfolio manager adds: ‘I’d be tickled to death if someone told me we’d be headed up by 2004.’

Downward rents, rising expenses

Increasingly, empty sublease space will roll over, hurting property revenues. ‘It’s real estate’s version of the bear market.’ Rents in many markets have backed off their late ’90s spikes entirely and then some. In some markets, concessions have returned, including free rent and lavish tenant allowances. Expenses, meanwhile, march up – especially for insurance and security, courtesy of 9/11. Cash-strapped local governments are raising taxes and labor costs continue to increase. Pinched rent rolls and higher operating costs aren’t a favorable combination, even if office owners can pass on some major expenses to existing tenants under lease terms. But the more vacancies increase, the more costs landlords must absorb directly.

Passing on expense hikes is even harder for apartment and hotel owners – their soft occupancies make raising rates practically impossible. Recessions are notorious for driving apartment renters to double up or move back in with Mom and Dad. It’s been no different this time. In addition, intoxicatingly low mortgage rates have encouraged some renters to buy. Overall, demographic trends remain sound for multifamily, but 2003 will be less than robust until job and wage growth start to kick in.

Hotels wobbled after the September 11 terrorist strikes literally shut down business and tourist travel. But operating efficiencies introduced over the past decade, plus reduced development and a gradual rebound in bookings after flying jitters subsided, have cushioned the downside – the lodging industry has remained profitable. Still, cost-conscious corporate customers put downward pressure on room rates. Until companies start expanding operations again, hotel revenues will grow only moderately. Airline route and service cutbacks won't help either in the short run. Overall, the impetus to travel has waned for road warriors.

Stressed consumers

Retail properties have benefited from enduring consumer confidence and spending. 'It seems Americans were put on earth to do one thing – shop – and they've been doing it no matter what.' Discounters have been the big winners at the expense of mall department stores. Grocery-anchored strip centers – despite continuing supermarket chain consolidation and Wal-Mart's incursion – also have held up well. Relatively low unemployment rates (well below those in previous recessions) and historically low interest rates have kept shoppers in stores. But the record levels of consumer debt are worrisome. 'At some point the individual has to get stressed – look at the levels of consumer debt, plus mortgage debt and all the depleted stock portfolios out there.'

Interest rates: nowhere to go but up?

Low interest rates have been 'an intravenous line' for the real estate markets – 'delaying distress,' 'masking performance issues,' propping up returns, and possibly inoculating investors against any severe impacts. Owners aren't forced to put flagging properties up for sale or into delinquency – they can refinance and still meet low floating-rate debt payments in periods of weakened cash flow. Put another way, low rates raise returns, making sales unappealing. But rates have fallen about as low as they can go, unless the Fed starts worrying about those two particularly bad-news scenarios, double dips and Japanese-style disinflation.

Plainly, 'an unexpected rate rise is the market's biggest risk.' Increased government borrowing and deficits could push interest rates higher, and most observers expect some modest and manageable hikes in 2003. While unlikely, 'hit the panic button if rates go up too fast.' That would mean heartache for investors who have been counting on low interest rates and attractive floating-rate leverage to weather cyclical squalls, especially if sublease space starts dropping off the rent rolls and rates slide further. 'You're gambling that interest rates stay low. In the end it's 'where's the beef, where's the tenant.' You've got to work the properties – keep the tenants in line and paying rent – or you could be in trouble.'

The capital crutch

Real estate's other crutch has been a heady flow of capital looking for high ground in the wake of stock market devastation. Most investors have been reasonably disciplined, buying prime income-generating properties – well-leased 24-hour offices, apartments, warehouses and grocery-anchored retail. 'All the capital means there are no steals out there.' The flight to quality has sustained values, lowered cap rates and, paradoxically, created a great 'sellers'' market for quality properties in the midst of rising vacancies and economic doldrums. Buyers have looked to lock in 7%-8% yields and leverage up with cheap debt. Solid credit tenants and rent rolls should see them through any near-term market hiccups. Properties with these 'reliable' risk-adjusted returns, albeit pricey, are just what the doctor ordered after a bad case of WorldComitis. 'I'd make these deals all day.'

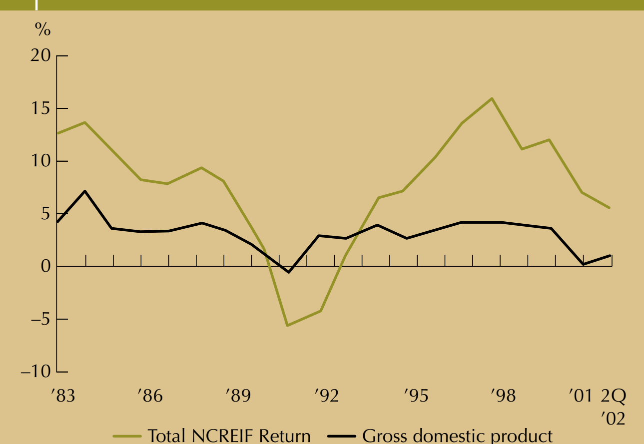
Weaker properties in fringe markets remain off investor radar screens entirely. Investors who take a step down from premier holdings – bidding for B malls and office buildings with more questionable rent rolls, using a leverage formula – could be courting trouble over time. 'This is *The Picture of Dorian Gray* scenario. What looks good today will show up ugly tomorrow. You could be cooked in a heartbeat if you miscalculate. There could be disintermediation between pricing and value. These deals won't meet return expectations down the road without debt staying down.'

Overall, a key for 2003 'will be monitoring capital flows. Where capital flows go, values will hold up. Where capital pulls out it could be a difficult year, because the fundamentals aren't that good.'

Anemic economy

If an economic recovery starts sooner rather than later, any damage to real estate markets should be very manageable. 'The dream is that the economy rebounds before we need to recognize the crummy fundamentals' – companies grow and absorb vacancy, unemployment declines, wages go up, spending increases…the good things in life, like hotel stays and mall splurges, return in force. Realistically, while *Emerging Trends®* interviewees do

FIGURE 3 Real estate vs. economy



Source: U.S. Department of Commerce, National Council of Real Estate Investment Fiduciaries, Rosen Consulting Group

Different world, tempered expectations *continued*

anticipate an economic recovery in 2003, an overwhelming majority – more than 90% – expect low to moderate growth, and nearly 60% are in the slow growth camp. Optimism is in short supply.

Indeed, after a go-go decade where many businesses overindulged and overreached, the roar seems to be out of the economy. Most observers are 'perplexed' and hard pressed to identify the next growth engine. Tech and biotech will rebound, but not immediately. The Internet is still a driver, but its impact will be more restrained than during its frenzied start-up phase. Telecom is flat on its back. No doubt, a 'new-new thing' will evolve, but it's not discernible on the horizon. A defense build-up will help markets with military contractors and suppliers, and a stock market rebound would put more juice back in the system, helping frazzled financial companies in particular.

Expected 2003 scenario: doldrums, not despair

Interviewees keep their fingers crossed that office vacancies will start dropping in the second half of the year, with some modest upward pressure on rents in stronger markets by early 2004. Properties with solid tenant rosters and little near-term rollover exposure should sail through. 'Those leases provide embedded value.' Expect the major, supply-constrained 24-hour cities and subcities to bounce back faster. Suburban office has weaker prospects and few adherents. Warehouses, apartments and grocery-anchored retail should hold their own. These sectors have softened, but not dramatically; they're positioned to muddle along, rebounding with any economic growth. Hotels, having survived 9/11's aftermath, can only get better. 'We're in for more doldrums: not much of a recovery, no real despair.' But don't be fooled about 2003 – there is more downside risk than upside potential.

Whither opportunity?

The *Emerging Trends®* forecast for a return to historic norms and a reversion to mean implies that real estate performance in the next up-cycle will be driven primarily by current income – not so much by value appreciation, which contributed to prodigious gains in the late 1990s. Clearly, appreciation will be hard to come by in 2003. 'Investors are now looking for preservation of capital, not shooting the lights out.'

In last year's report interviewees warned that opportunity funds were flagging – their claims of future 20%-plus returns essentially 'marketing hype' and 'wishful thinking'. This year, some interviewees are calling for last rites. 'The opportunity phase is over. Maybe you can pump up returns with high leverage (up to 90%) into the mid to high teens. We're not in a get-rich-quick business today. We're in a get-rich-slow one.'

Even some opportunity fund managers grudgingly admit that 'it's hard to put money out.' A few fringe niches exist – freezer warehouses, assisted-living homes and other senior housing. But whispers abound that funds are returning new commitments to investors, with some managers getting whipsawed in declining markets as they try to cash out mature funds. 'The world has changed. Investment banks are actually talking about starting core funds now.'

Although shallow recessions and real estate troughs seldom precipitate the widespread market dislocation that opportunity vultures crave, we can expect enough distress to provide some higher return possibilities in formerly hot tech markets – Silicon Valley, Seattle, Austin and even the Boston suburbs. 'The next wave of opportunity will consist of highly leveraged owners who borrowed on floating rates, or have been hanging on because of low interest rates, and get caught as rates go up again. When fundamentals take over, leverage can bite you in the butt.'

Some mistimed office developments could also be hurting in a slow leasing environment, requiring a bailout or recapitalization in the face of see-through vacancy. While pro forma rents were more conservatively underwritten than in the late '80s overbuilding binge, empty buildings still don't generate cash flows.

Cyclical or secular?

Weary of their second-class status, many real estate pros are viewing the recent Wall Street carnage, and the ensuing tide of flight money heading their way, as retribution – a sign of redemption. They hope 'cap rate compression is here to stay' and point to stabilized markets like Europe's, where yields are lower and capital is plentiful.

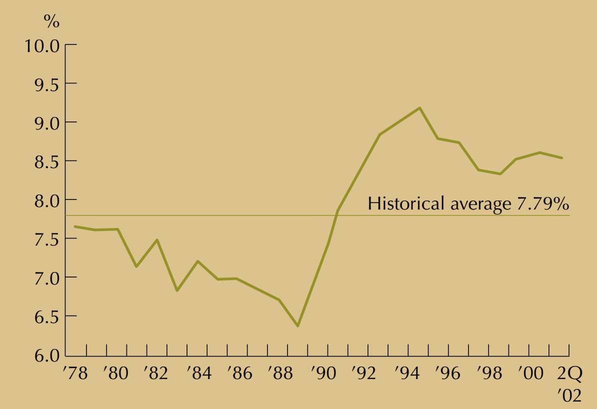
Most interviewees see the flood as temporary. When the stock market recovers, they say, money will pull back from real estate. 'The secular talk is coming from guys making a deal who want approval from the investment committee,' says a leading broker.

Some worry about an extended Wall Street hangover. 'If the stock market doesn't recover – then it's a lose-lose for everyone, including real estate. If the stock market does heal, then capital will move back into stocks.'

But real estate should hold its own and continue to enjoy an improved image – absent from any nasty surprises from investor overpaying and overleveraging in the current down market. In time, further real estate cap rate compression wouldn't be surprising as various asset classes, including stocks, return to more 'normalized' returns in this reversion-to-the-mean process. 'Cap rates have been too high, because capital was overallocated to stocks for so long.'

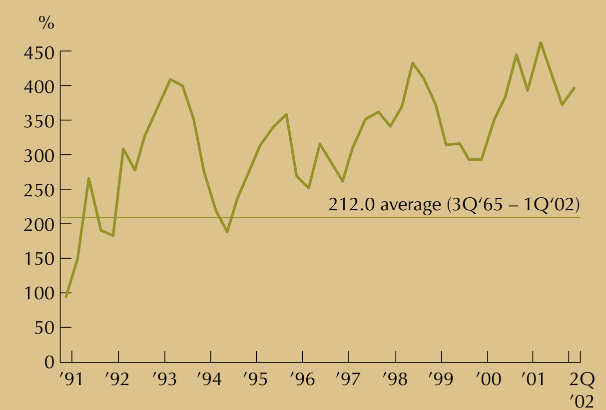
In fact, cap rates have room to fall further – they're still above historical averages (see Figure 4 overleaf). Real estate yields, meanwhile, continue to enjoy a very favorable spread over Treasuries, providing investors a comfortable premium (see Figure 5 overleaf). Attention will also come from pension funds and other institutional investors looking for solid income oriented returns to meet the retirement entitlements of graying baby boomers. 'Sympathy for real estate is very strong. Where do you get yields today other than real estate?'

Figure 4 NCREIF cap rates



Source: National Council of Real Estate Investment Fiduciaries, Lend Lease Research

Figure 5 Spreads between real estate yields and 10-year treasuries



Source: Haver Analytics, American Council of Life Insurers, Rosen Consulting Group

Also, foreign investment is increasing, retail investors are coming back and, increasingly, companies are establishing real estate 401(k) options in investment plans. Solid income performance and disciplined markets will guarantee greater liquidity for the asset class. Rather than a paradigm shift, real estate is experiencing a 'back to the future' return to the roots of its traditional investment allure.

What's a credit tenant?

A year ago a landlord with WorldCom, Arthur Andersen and Enron signed to long-term leases could rest comfortably – no Internet startups without balance sheets on this roster. These guys were all certified credit tenants. Suddenly, sound sleep turned into nightmare. Office markets got a turbulent taste of what retail real estate owners had been experiencing for years from the likes of Kmart (in bankruptcy), Ames (in liquidation) and Montgomery Ward (long gone), to name a few of the vanished stalwarts. 'A great name isn't everything anymore.'

Understandably, the question of how to protect against sudden carnage has most interviewees flummoxed. 'You've got to look at an established, long-term track record,' ventures a portfolio manager. Well, that might have worked for dismissing an E-wannabee or dot.gone, but not for a Big-Five accounting firm.

Simply, real estate owners need the same protection that stock investors require in evaluating the soundness of companies – more reliable and honest accounting of company performance and balance sheets. Until corporate reporting shakes out, claims about credit tenants can't be taken for granted.

Keep a tight rein

If investment discipline starts breaking down in the real estate markets, look for lenders to lead the way in bad underwriting. Debt accounts for more than quadruple the volume of equity investments, and lenders have historically greased the development skids, leading to oversupply in past market downturns. But fortunately, the last market nadir preceded and helped give rise to the CMBS business, and CMBS buyers – in particular the B-piece cartel – now rule the roost. 'If B-piece buyers refuse to take loans made on properties where there may be overbuilding, then loans won't get made.'

CMBS issuers know loans that don't meet tough cartel underwriting standards will get rejected from pools; whole-loan lenders – commercial banks and life insurers – who want a future securitization option for their portfolios are following CMBS structures and standards in fairly close lockstep. 'Capital is more plentiful than ever for real estate, but it's extremely disciplined,' says a top conduit executive. 'The B-piece cartel is doing its job.'

Even some former skeptics admit that expanding commercial mortgage market influence can help control capital flows and tamp down irrational investing. 'I'm finally buying into the concept that the public markets reduce volatility and help stabilize the markets,' says a top transaction executive. Another adds that REITs and pension funds 'don't have the gunslinger developer mentality,' and lenders are holding the reins on construction loans. The development business just isn't as profitable as it used to be when easy money, high loan-to-value ratios and low debt service coverage were the norm.

Despite ample capital, the majority of equity players have remained reasonably careful and have focused on bidding up mostly the crème de la crème, effectively bifurcating the transaction market between 'have' properties (with tenants and

Different world, tempered expectations *continued*

delayed rollovers) and 'have-nots' (with higher vacancies and inferior locations). 'Everyone who measures transaction volume will have seen another down year in 2002, and that's due to discipline and sheer lack of opportunity. But we need to look out for overpaying in this sort of environment where the money is flowing.'

High-net-worth investors have been a force in the capital markets, but more concern is trained on syndicators, who are back after a 16-year hiatus, raising money from individual investors for various partnership deals. The last syndication bubble burst after a tax-shelter-driven buying spree fueled a development round of questionable hotels and office buildings, most of which went bust. Commissioned brokers are out raising money again, now pitching the 'safe haven' story instead of the tax shelter line. 'The investors are unsophisticated – many are old ladies in tennis shoes.' The various private real estate players marketing these investments through banks and money managers bear scrutiny. 'There's been some buying above replacement cost.' Have you read that Oscar Wilde novel about Dorian Gray?

There's not much slack for making mistakes and ignoring market fundamentals. Smart money will be very selective during the year. Dumb money doesn't have much of a safety net. □

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Focusing on what you do best

– the future shape of the reinsurance market

Faced by poor returns from their traditional business, many reinsurers spent the latter half of the 1990s in a scramble to diversify and speculate in 'new' markets. Yet, it is now clear that the apparent rewards may have blinded them to the potential risks. Against the background of a continuing hardening of rates, the reinsurance industry is now refocusing on its core business, as Paul Delbridge reports.

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Nothing could better encapsulate the current travails of the European reinsurance industry than Swiss Re's announcement earlier this year of its first net loss since 1868, followed by its recent credit downgrading by Standard and Poor's. Even the most rock solid of institutions like Swiss Re have been shaken by what has been described by Benjamin Gentsch, CEO of Converium Zurich, as the 'double whammy' of a sharp decline in investment returns and the record losses from the attack on the World Trade Center.

It is thought that reinsurers will eventually have to shoulder around two-thirds of the estimated $40 billion claims payments arising from September 11. Clearly, it would have been virtually impossible to foresee such a terrible event. Yet, the scale of these and other major losses from a spate of recent catastrophes, including the chemical plant explosion in Toulouse and the floods in Eastern Europe, have heightened concerns about the quality of risk selection, technical pricing and control of risk aggregation within the reinsurance sector.

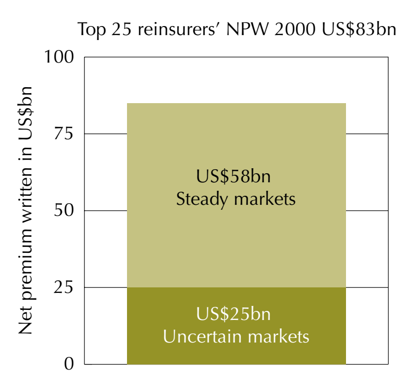
With admirable candour, Warren Buffett, CEO of Berkshire Hathaway, admitted that 'I allowed General Re to take on business without a safeguard I knew was important, and on September 11, this error caught up with us.' Many other companies believed that investment income could offset any underpricing, though such expectations have now been dispelled by the continuing fall in share values.

Worrying outlook

Few doubt that Swiss Re and its comparably well-capitalized peers will eventually bounce back, with CEO Walter Kielholz insisting that 'Swiss Re is now in an excellent position to capitalize on improving markets.' However, the outlook for other less secure organizations looks more uncertain in the light of recent events. The Japanese reinsurer Taisei Fire & Marine went into liquidation last November. Closer to home, Copenhagen Re closed its books to new reinsurance business shortly after September 11. Gerling Ruckversicherungs has been looking for new investors, following SCOR Re's withdrawal from a possible deal. Many other reinsurers have been forced to exit particular countries or classes of risk.

In September 2002, PricewaterhouseCoopers hosted a breakfast briefing on the future shape of the industry at the Monte Carlo Rendez-vous which brought together a number of leading figures from the European reinsurance market. The keynote address was given by Dirk Lohmann, Group CEO of Converium, who suggested that 'around $25 billion of reinsurance premiums written in 2000 were issued by companies with an uncertain future' (see Figure 1).

Figure 1 Net premium written in U.S. $ bn



Source: Converium

Focusing on what you do best *continued*

Mr Lohmann went on to argue that many of the problems now faced by reinsurers stem from injudicious underwriting and new business decisions made in the latter half of the 1990s, when poor returns from a soft market in their traditional business led many companies to diversify into seemingly more lucrative convergent financial services markets.

Some sought to compete with investment banks by offering innovative 'insuritization' solutions such as credit derivatives (see Figures 2 and 3). According to a survey of worldwide credit derivative (CD) turnover, carried out by the British Banking Association in 2000, insurers, a high proportion of them reinsurers, accounted for 23% of sales in 2000, up from 10% in 1997. Some insurers even went so far as to delve into risky enterprises such as film financing without necessarily understanding the full nature of the risks involved. Residual value guarantees, such as car fleet resale guarantees, have also proved to be poor performers in certain sectors.

According to Mr Lohmann, much of the diversification and 'new risk' ventures in the 1990s are now 'coming home to roost'. The diverse businesses within many of the new financial services conglomerates have made uneasy marriages, with the anticipated economies of scale and opportunities for cross-selling often failing to live up to expectations. The bull market of the time may also have blinded some companies to the inherent risk and volatility of capital market instruments.

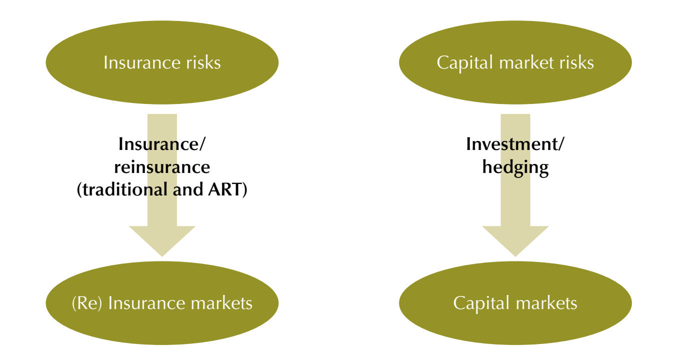
Insuritization appears to have been especially hazardous. According to a report by rating agency Fitch, much of Enron's debt was held in now worthless credit derivatives, with reinsurers among those most heavily exposed. The current global economic downturn could lead to more such costly losses, especially as many of the five year 'credit swaps' held by reinsurers were written when the likelihood of default was far less acute. There is certainly evidence to suggest that the risk analysis carried out by reinsurers before issuing such contracts was often far less thorough than that undertaken by more experienced investment banks. Mr Lohmann believes that many reinsurers were also bedazzled by the apparently high earnings from structured finance business, which recent accounting scandals have exposed as largely misleading.

Pendulum swings back

Overall, such painful experiences have taught insurers and reinsurers to stick with the business they know best. The creation of Converium is itself an example of this accelerating trend towards divestment and concentration on core competencies, with ZFS also selling some of its asset management businesses. Similarly, CNA Re, St Paul, Generali and Royal&SunAlliance have either reduced reinsurance writings in specific markets or have withdrawn from the market or specific territories altogether. Our recent survey of operational drivers in *The London Insurance Market Blueprint for the future* also confirmed that many players within Lloyd's are gradually reverting to their primary business of insuring large, specialist risks.

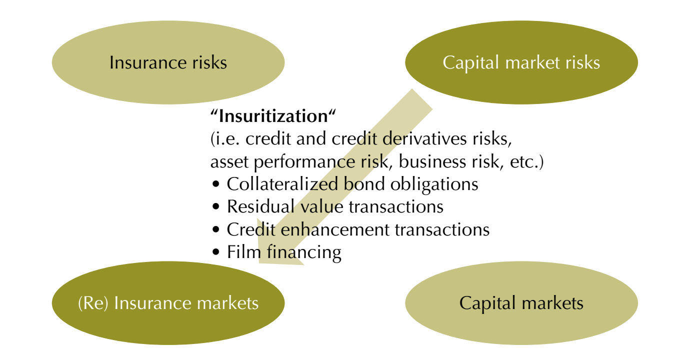
For reinsurers, this refocus on core business has come at a time of a continuing hardening of rates, which in Europe has generally outstripped rating increases in the primary sector. Despite a recent influx of capital into reinsurance markets worldwide, most notably Bermuda, restructuring and withdrawals, combined with increasing demand for reinsurance in many key sectors, seem to have absorbed this extra capacity (see Figure 4 overleaf).

FIGURE 2 Traditional risk transfer avenues



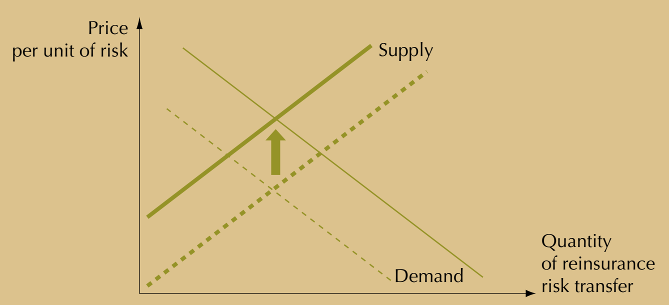
Source: Converium

FIGURE 3 Another Direction of ART – 'insuritization'
A path littered with failures



Source: Converium

Figure 4 Supply/demand



Source: Converium

Mr Lohmann believes that the rising demand for reinsurance stems in large part from the 'decline in primary insurers' asset values, which in turn increases their vulnerability to adverse underwriting results'. Such pressures are being intensified by tougher regulatory and solvency criteria, with recent corporate failures placing more requirements on insurers to prove they have sufficient reserves to meet their liabilities within a far broader spectrum of risk and loss scenarios than ever before. With relatively dry capital markets limiting their ability to raise fresh capital, reinsurance is stepping in to fill the void.

Demand is especially strong at the upper end of the reinsurance market, with our survey of the London Insurance Market highlighting a growing 'flight to quality' among primary insurers, as they seek greater reinsurance security in the wake of September 11. Over two-thirds of respondents have upgraded the quality of their reinsurer panel, despite the higher costs and credit downgradings. A credit rating of 'A' now appears to be the minimum threshold, with one in ten now insisting on 'AA' or above.

This is certainly good news for Swiss Re, Munich Re and the other 'AA' and 'AAA' rated institutions. Mr Kielholz believes that this 'flight to quality' will 'accelerate the turnaround in Swiss Re's property & casualty business'. In this chastened environment, however, reinsurers are mindful of past errors. Improved analysis and modelling are helping to enhance technical pricing and the control of aggregations of risk. Policy terms and conditions have been tightened, deductibles increased and the proportion of individual risks accepted have now become generally more prudent.

Continuing challenges

Nevertheless, many problems remain. The pressure and anxieties about the adequacy of claims reserves and shortages of capital that are affecting many primary insurers are also now bearing on reinsurers. In September, SCOR announced a $395 million rights issue. Others have already followed suit.

Reinsurers also need to be mindful of continuing legacy issues. The full extent of the September 11 losses is yet to emerge. In particular, many sizeable business interruption claims are still in the pipeline. Asbestos-related liabilities continue to haunt the industry. While many European insurers still believe that asbestos-related claims are primarily a problem for the more litigious U.S. market, the Fairchild test case in the UK confirms that this is an issue now coming to the fore on this side of the Atlantic. PricewaterhouseCoopers own estimate of future asbestos-related payments in Europe suggests that the bill for the insurance and reinsurance markets could be in excess of $30 billion. This follows a continent-wide study carried out by the UK Cancer Research Campaign, which estimated that up to a quarter of a million people in Western Europe could die from asbestos-related mesothelioma over the next 35 years. The rating agency AM Best has expressed concern over the insurance industry's ability to meet these liabilities.

Shake-up

Although the current hardening market has yet to reach its peak, some leading figures believe that the eventual softening could be no more than a year away. The Financial Stability Forum has now joined many rating agencies in expressing anxieties about the problems faced by reinsurers, including catastrophe losses, poor investment returns, the impact of legacy issues and underpricing. The coming downturn is likely to fuel further withdrawal and restructuring within the reinsurance sector, both voluntary and involuntary.

'The remaining conglomerates are likely to dispose, close or spin off non-core reinsurance activities over the next two years', said Mr Lohmann. 'The continued emergence of past liabilities will add further pressure to results.' His advice to his fellow professionals is to avoid the mistakes of the past by concentrating on what they do best, and ensuring that the risks they accept are economically viable and properly controlled. The days when reinsurers could rely on the cushion of investment income, or seek new markets to make up for the stagnation in their own, are long gone. Reinsurers now need to focus on delivering better and more consistent underwriting results in their core markets. □

This article is based on a PricewaterhouseCoopers-hosted breakfast briefing given by Dirk Lohmann, Group CEO of Converium, at the Monte Carlo Rendez-vous, 2002. Our thanks to Mr Lohmann for sharing his insights.

How effective is your risk culture?

A sub-optimal risk culture can undermine a company's ability to manage risk across the organization. This article outlines the key signs that could indicate a potential cultural problem in your organization.

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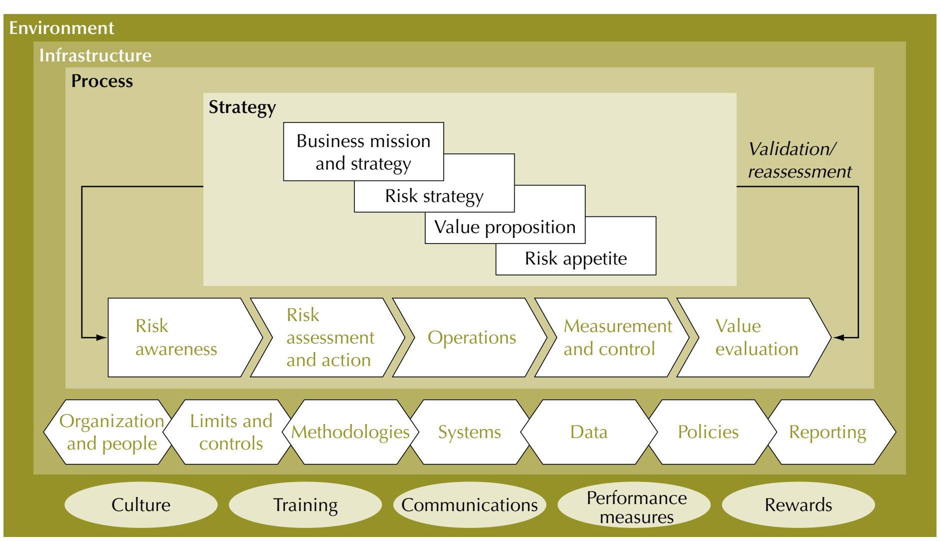
With increasing public scrutiny on corporate values and ethics, new regulation on corporate governance mandated by Sarbanes-Oxley, and recent events such as Enron, WorldCom and September 11, many insurance companies are re-evaluating their overall risk management culture, philosophy and approach. While traditionally good at bottom-up, transaction or product level risk analysis, many insurers are recognizing a need to improve the way they approach risk from a top-down, proactive perspective. The key first step to implementing a top-down risk management approach is the formation of an Enterprise-wide Risk Management (ERM) Framework.

Figure 1 depicts an ERM framework that has four dimensions Strategy, Process, Infrastructure and Environment. Many leading financial and non-financial companies around the world have successfully implemented this model. The robustness of this model springs from its simplicity and its top-down approach to meeting the following risk management objectives:

- Link the business strategy to the risk management strategy to ensure consistency with the enterprise's competitive advantages to assume, distribute and retain risks;
- Institute a risk governance process that is well-understood within the organization and proactively supports the execution of business strategy;
- Enhance risk management conduct through proper alignment of personnel, organizational guidance and support infrastructure with risk-taking activities;
- Establish rational and dynamic boundaries across all risk types in a manner that reflects the business strategy and the external market environment; and

FIGURE 1 **Enterprise-wide risk management framework**



How effective is your risk culture? *continued*

- Institute a risk and performance measurement framework that aligns individual behaviors with business strategies and risk management objectives by being transparent, credible, timely and actionable[1].

Perhaps the most important and often overlooked aspect of the ERM framework is the risk culture. Many institutions have spent millions of dollars implementing risk management systems and processes, but without an effective risk conscious culture throughout all levels of the organization these systems and processes will inevitably fail.

Gauging the effectiveness of a company's risk culture can be challenging. The signs can be subtle and often it is not one major issue that causes risk management break-downs but rather a combination of several factors which might be insignificant on a stand-alone basis. Additionally, management is often made aware of these issues only after an event has occurred. Following is a listing of the key signs that could indicate a potential cultural problem in an organization:

Lack of awareness and understanding of business risks throughout the enterprise:

- Understanding of risks is inconsistent or nonexistent;
- Lack of emphasis on risk management and control by management;
- Inconsistent direction by management;
- Ineffective change management;
- Controls lacking or not working; and
- Lack of risk management training.

Business risk and control perspectives at the 'top' not linked to the perspectives of people on the front lines:

- Messengers of bad news are not well received by management;
- Lack of individual accountability for objectives;
- Misalignment of objectives from Corporate to Business Units;
- Lack of understanding of policies; and
- Internal Audit approach focused more on 'gotcha's' than on providing value.

Inability to operationalize risk management strategies through action plans that align key business initiatives with systemic risks:

- Process redesign projects do not consider risks;
- No explicit identification and analysis of risks in asset management plans; and
- No performance measures.

Improper Ethics and Compliance Practices:

- Questionable sales practices;
- No disciplinary action for misconduct; and
- Improprieties.

People strategy is not working well:

- High turnover is affecting achievement of objectives;
- Inconsistent treatment of employees by management;
- Lack of skilled resources;
- Lack of consistent application of incentive programs;
- Incentives focus only on short-term objectives; and
- Lack of timely completion of performance reviews.

Implementing an effective risk culture is not easy. To help companies gauge the effectiveness of their investment in risk management or their need to initiate a formal risk management framework, PricewaterhouseCoopers has developed a diagnostic tool called the *Risk Culture Survey*. The survey is distributed to targeted managers and employees throughout a company via a secure proprietary Website. The core questions are divided into four key attributes, eight sub-attributes and 19 indicators of effective risk management as depicted in Figure 2.

Results of the survey are reported showing the results and comments provided by the participants. Analysis by PricewaterhouseCoopers professionals with recommended action items, next steps to address key issues and survey findings are also provided.

In today's environment of increased management and Board accountability, the PricewaterhouseCoopers Risk Culture Survey can be a valuable tool for assessing the effectiveness of a company's risk management processes. To learn more about the Risk Culture Survey, please contact:

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Figure 2 The foundation for the risk culture survey

Leadership and strategy	People and communication
• Demonstrate ethics and values – 'Tone at the top' – Personal ethical practices • Communicate mission and objectives – Policies and procedures – Top-down alignment of strategy	• Promote competence – Employee competence – Training • Share information and knowledge – Information quality – Top-down communication – Communication across processes
Accountability and reinforcement	**Risk management and infrastructure**
• Assign individual accountability – Assignment of ownership – Demonstrated accountability • Measure and reward performance – Performance indicators – Incentives and discipline – Monitoring	• Assess and measure risk – Risk assessment practices – Risk tools and processes • Establish processes and controls – Process reliability and efficiency – Control effectiveness and efficiency – System access and security

1 Shyam Venkat *Implementing a Firm-wide Risk Management Framework*, The Practitioners' Handbook of Financial Risk Management, published by Global Association of Risk Professionals, November 1999.

The insurance market in China

The insurance market in China is growing rapidly. How sustainable is this growth and will international companies be able to benefit in the same way as domestic insurers? In this article, we explore the growth potential and the competitive landscape from the point of view of potential entrants.

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The insurance market in China is booming. Over the five years to December 2001, life insurance premium income grew at an average rate of nearly 70%. Non-life premiums grew at around 15%.

Is this boom an attractive opportunity for foreign insurers? For those with a long view, it probably is. There are three good reasons to expect that large amounts of new capital will be drawn into the market over the next few years:

- Growth;
- Demands of international financial reporting; and
- Burdensome negative spread liabilities.

International insurers are best placed to provide long-term capital combined with professional expertise. This article looks at the prospects for the market and the entry routes for foreign insurers.

Growth

Government figures put China's recent economic growth around 7 or 8% per annum. This growth can be seen in the Eastern Cities in new infrastructure, newly built domestic property and new cars on the roads. All of these new assets, increasingly privately owned, require non-life insurance.

On the savings side, about three quarters of China's retail savings are held in bank deposits. Short-term deposits are now paying less than 2% in annual interest; so there has been a rapid flow into other forms of saving, mainly equities and life insurance. Bancassurance distribution of life assurance has grown rapidly from a standing start as a result of this trend, although agent distribution is still the dominant channel.

The longer term driver in the life insurance market is the growing recognition by all parties that private pensions will form a key part of retirement provision in the future in China.

Figure 1 **Life insurance premiums as a percentage of GDP in selected Asian countries (1999)**

Source: 2001 Almanac of China's Insurance, handbook published by China Insurance Regulatory Commission

International comparisons make the potential clear. Life insurance penetration is low by comparison with other markets in Asia-Pacific (see Figure 1).

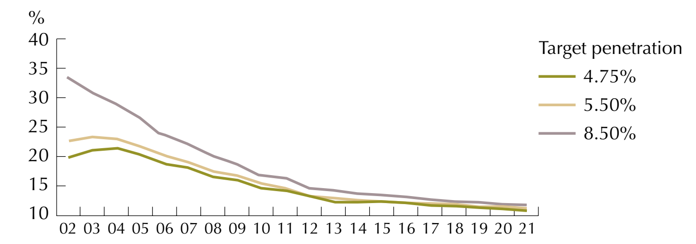
By taking a view on the likely long-term penetration in China, one can hypothecate some long-term growth rates: Figure 2 (overleaf) gives some examples.

If one accepts this type of analysis then average growth rates in double digits can be expected in the medium-term.

In the short-term, the rapid flow of funds into life insurance could easily be checked by changes in sentiment and competition from other forms of retail savings. If economic growth continues at present levels, however, even if some of the switching of existing funds falls away, both life and non-life insurers can expect to see healthy increases in business volumes.

The insurance market in China *continued*

FIGURE 2 Projected annual growth rates derived from 20 year target penetration



Source: PricewaterhouseCoopers estimates

International financial reporting

Recent months have seen a surge in sales of the newly introduced participating life insurance products. These promise capital security combined with returns in excess of those currently available from bank deposits. Their success has been underpinned by recent disillusionment with investment-linked products as a result of a combination of mis-selling and poor equity market performance. The graph shows PricewaterhouseCoopers estimates of the share of new life insurance business by product category. (see Figure 3).

It is likely that the guarantees built into these products will demand greater capital support under proposed new International Financial Reporting Standards for insurance. As many of China's companies will be listed in the near future and are required to provide IFRS accounts, the capital needs will be exposed.

Legacy liabilities

Until recently, life insurance savings products tended to offer a guaranteed return. The rapid fall in interest rates from mid 1998 to mid 1999 has left the industry with very substantial negative spread liabilities. Unlike many markets, however, China's rapid growth allows an escape route through funding legacy liabilities with new business profits.

Current products must be priced assuming 2.5% future investment earnings or less. On the current yield curve these products show a positive spread.

Under the terms of China's entry to WTO, market competition will intensify, as a result of new life insurers and the growing funds industry. Essentially the market is engaged in a race against time to fund the negative spread liabilities while new business margins are high. The switch to participating business is making this race harder, and it is likely that capital injections will also be needed through strategic investment and IPOs.

Growth, the potential impact of new International Accounting Standards and negative spread liabilities suggest that there will be substantial demand for capital in the China life insurance industry for many years to come.

Competitive landscape

The complexities of the market and doing business in China mean that potential foreign entrants need to take a long-term view.

China's non-life markets are dominated by the state owned Peoples Insurance Company of China, although two newer domestic companies China Pacific and Ping An have significant market shares (see Figure 4).

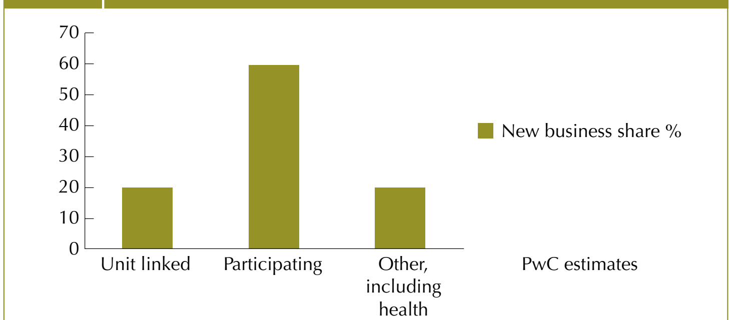
Foreign insurers will become increasingly free to operate in China's non-life markets over the next three years, although the largest line, motor, may continue to be difficult for foreign insurers to penetrate for regulatory reasons.

The life insurance market is dominated by two companies, China Life and Ping An who have 80% to 90% of the market between them. Foreign insurers have made only a limited impact (see Figures 5 and 6 overleaf).

Foreign insurers may participate in the life insurance market in two main ways: by operating a joint venture with a domestic company, or through a strategic stake in a domestic life insurer.

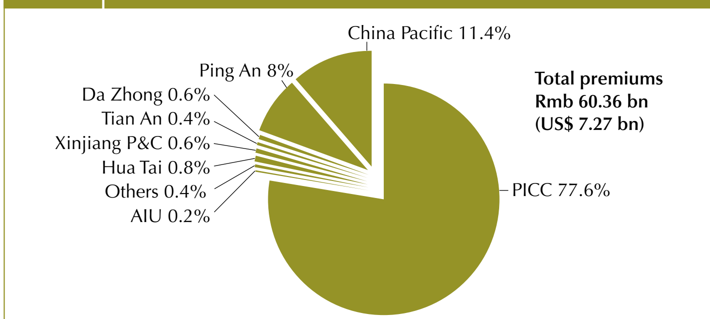
Restrictive licensing has limited the number of foreign joint venture life companies in China's market to less than 20 and restricted each company to a narrow range of operation, both geographic and in terms of product.

FIGURE 3 Life insurance market new business share (%) (July 2001 to June 2002)



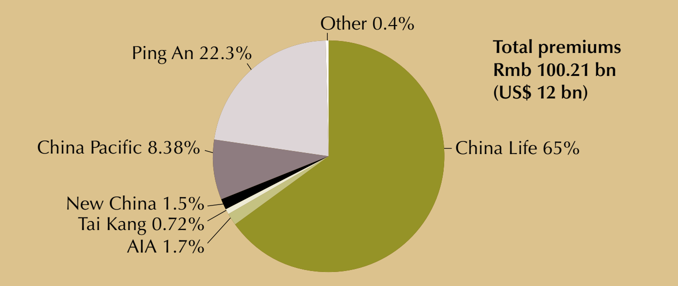
Source: PricewaterhouseCoopers estimates

FIGURE 4 Property/casualty market in 2000



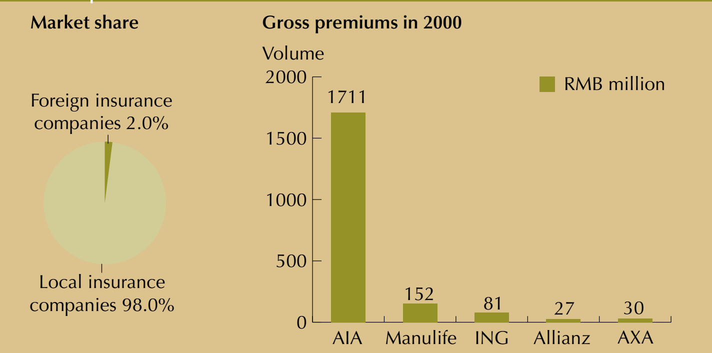
Source: 2001 Almanac of China's Insurance, handbook published by China Insurance Regulatory Commission

FIGURE 5 Life market in 2000 (including accident and health)



Source: 2001 Almanac of China's Insurance, handbook published by China Insurance Regulatory Commission

FIGURE 6 Foreign life insurers



Source: 2001 Almanac of China's Insurance, handbook published by China Insurance Regulatory Commission

The joint venture partner need not be a life insurer. Both AXA and Sun Life of Canada have partners which are not insurance companies. ING in contrast has a joint venture with China Pacific. Establishing a joint venture involves a long regulatory process at this stage, with limited transparency. As part of the process of joining WTO, this will change. China will award licenses for new joint ventures solely on prudential criteria from 2006. The requirement to operate as a joint venture will remain however.

The newer domestic companies, such as New China Life, have either found or are usually seeking involvement from a strategic investor. Foreign companies may strictly only hold up to 10% of a domestic life company, but in practice this can be stretched up to 24.9%. The larger domestic companies may also seek strategic investment on the way to IPOs.

Strategic investments may well be a good route for foreign investors to test the water and position themselves to take advantage of any relaxation of ownership rules which may come about in future.

Conclusion

The opportunities in China are potentially very great for insurers prepared to take a long-term view and adapt their business model to the local environment. The regulatory environment is still developing and will go through a great deal of change over the next three to five years. The two main entry methods have their pros and cons and present very different windows onto the China Market opportunity. □

International Accounting Standards:

The new U.S. GAAP?

Faced with the increasing possibility that we are moving toward one set of global accounting standards, U.S. insurers need to wake up to the potential implications of the proposed model for insurance contracts under IAS.

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If there was any question about the commitment of the Financial Accounting Standards Board (FASB) to the future convergence between U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), the standard setter has taken further action to quash them. Last October, in a joint press release, the FASB and the International Accounting Standards Board (IASB) issued the 'The Norwalk Agreement', a memorandum of understanding that emerged from their joint meeting on September 18, 2002, reaffirming their commitment to developing one set of high quality accounting standards.

At that meeting the two standard setters agreed to place a high priority and commit resources to three practical steps toward achieving that goal:

- A joint short-term project to reduce the differences between U.S. GAAP and IASB standards in certain areas that are not already addressed by major projects;
- Remove other differences through the coordination of future work programs and continued progress on the joint projects already underway; and
- Encourage further coordination of the separate activities of their two interpretive bodies.

The boards agreed to use their best efforts to issue an exposure draft of the proposed changes to U.S. GAAP or IFRS for some or perhaps all of the differences now being addressed by the short-term project during 2003.

On the heels of this announcement, the U.S. Securities and Exchange Commission (SEC) and European Commission issued statements confirming their support of the Norwalk Agreement. They have expressed views that convergence is good news for investors worldwide because it will result in the development of 'best of breed' accounting practices and provide for greater comparability of financial information.

What does this mean for U.S. insurers?

All of these positive signs that convergence is coming may meet the approval of standard setters, but they serve as an alarming wake up call for U.S. insurance companies suddenly faced with the possibility of having to adopt new rules for insurance accounting. The IASB effort to develop a set of standards for insurance contracts is now entering its fifth year, evidence of the Herculean and controversial task of developing one unified standard for insurance accounting. At the heart of the controversy is the position taken in the Insurance Draft Statement of Principles (DSOP) that was developed by a Steering Committee of the IASC (the predecessor of the IASB) that lays out a framework for a new accounting standard for insurance contracts.

If the principles set forth in the DSOP are applied in a new standard, the IFRS will 'measure the assets and liabilities that arise from insurance contracts, rather than to defer income and expense', a radical departure from the deferral and matching approach currently followed by many insurance accounting systems around the world, including U.S. GAAP. As a result, the proposal has raised considerable interest and debate around the world. The adoption of such a radical new approach will require substantial effort by most insurers, including not only accounting values, but also other areas including product design, capital allocation, systems development and financial communications.

A two-phased approach

Given the number of complex and controversial issues still to be vetted and resolved, the IASB has acknowledged that implementing a full recognition and measurement standard for insurance contracts by 2005 is not realistic. The lack of a comprehensive standard could cause severe problems for EU-listed companies and those in other countries, such as Australia,

International Accounting Standards *continued*

that have imposed a 2005 deadline for adopting IFRS. As a result, the IASB has split the project into two phases, with the objective of implementing some components of the project to be in place by 2005 – Phase I, without delaying or disrupting the completion of a comprehensive insurance-specific standard in Phase II.

Phase I currently includes the following subjects:

- Definition of insurance contracts for Phase I and related exclusions from the scope of Phase I;
- Guidance on the application of IAS 39, Financial Instruments: Recognition and Measurement to contracts that do not transfer enough insurance risk to qualify as insurance contracts but contain features commonly found in insurance contracts;
- Temporary exclusion of insurance contracts from the hierarchy in draft IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors;
- Elimination of a limited number of existing practices including catastrophe and equalization reserves that are inconsistent with the IASB Framework and are simple to eliminate; and
- Presentation and disclosure issues related to the above.

Those insurers required to implement the IFRS in 2005 will be able to continue to account for insurance contracts under their local accounting practices until the completion of Phase II, currently projected to occur in 2007. However, they must apply all other aspects of the IFRS, including IAS 39, to their assets and investment contracts that do not meet the definition of insurance contracts by the 2005 deadline.

Definition of insurance contracts

The Insurance DSOP focuses on all insurance contracts, and not solely on insurance entities, under the premise that similar contracts should have similar accounting requirements. The definition of an insurance contract and importantly what constitutes 'insurance risk' has been included in Phase I of the project, although it might be revisited in Phase II. The IASB tentatively agreed to the following definition at their October 2002 meeting:

'An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk by agreeing with another party (the policyholder) to compensate the policyholder or other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.'

The IASB has also excluded from its scope both employee benefit plans and product warranties offered directly by manufacturers without insurance company involvement. More controversially, despite Phase I, it is proposed that certain clearly distinguishable embedded derivatives in or attached to insurance contracts will remain covered by IAS 39 and may need bifurcation, or separate measurement on a fair value basis. The most significant outcome of Phase I for many insurers will be whether annuities and separate account contracts will be classified as financial instruments under IAS 39, contracts that in the U.S. are generally covered by FAS 97.

Current application of IAS 39 to insurance contracts

The Phase I definitions will have a significant impact regarding the accounting treatment of investment contracts, such as variable or fixed annuities. To what extent will these be treated in a manner consistent with insurance or with banking products? If the currently proposed exposure draft changes to IAS 39 are adopted (note that public discussion regarding IAS 39 will occur in March), the liability for these contracts subject to current IAS 39 will be measured at either 'amortised cost' or at 'fair value' (dependent on a one-time election of the company at time of policy issue). It is uncertain now how the two types of values for these contracts will be addressed, although further guidance on this topic might be added to IAS 39 within the next year during Phase I.

Recognition and measurement of insurance contracts

Some of the current proposals of the DSOP for recognition and measurement of an insurance contract that will be addressed in Phase II are very different from U.S. GAAP. As previously mentioned the DSOP calls for one approach to valuation of all insurance contracts, without regard to their duration or whether they are life, annuity, property and casualty or health. Two key concepts are incorporated in this accounting framework:

1. **Asset/liability system.** This incorporates independent measurement of assets and liabilities, except in the case of performance-linked products (see below). Unlike most current accounting standards, this may result in a reported profit or loss at policy issue.
2. **Entity-specific basis.** The entity-specific liability value of a pool of insurance contracts is 'the present value of the costs that the enterprise will incur in settling the liability with policyholders or other beneficiaries in accordance with (their) contractual terms over the life of the liability.' The application of this approach will always reflect an appropriate level of risk and uncertainty or risk margin, preferably in conjunction with the estimation of cash flows. This contrasts with a pure fair value system, in which exit values would be applied as measured by the market place or estimated on the basis that a market will not be required.

Entity-specific assumptions used would consist of:

- Economic assumptions for factors such as interest rates would be market-based, using risk-free (or possibly high grade corporate bond, an alternative that will be discussed later in the project) rates for discount factors; and
- Non-market (non-economic) assumptions as to future contract performance would be consistent with the market assumptions if possible, but more likely would be consistent with management's most recent financial

budgets/forecasts (as long as these represent neutral estimates) on a non-locked-in basis.

The current value of options and guarantees contained in inforce insurance contracts would be reflected. For example, historically the cost of interest rate guarantees have been reflected only when they are in-the-money (under current conditions, subject to payment). Under the new accounting standard, option pricing and stochastic models may be required to measure the cost of these contract features. In many cases, actuaries will have to enhance their existing models.

The key characteristic of this measurement system is that the measurement of the liability is done on a prospective basis, with periodic unlocking as warranted which will present companies and their actuaries with a number of challenges that will have to be addressed to make this system achieve its objectives. For instance, some of the most important accounting objectives are to achieve reliable, comparable and meaningful financial reporting. The IASB and the International Actuarial Association (IAA) are considering how best to facilitate these objectives in the design of the principles underlying both accounting and complementary actuarial standards that will be developed.

A new category of contracts is being created by this insurance accounting project – performance-linked contracts, that will likely include many participating (with profits) and variable (unit-linked) contracts. The scope and methods used to value these products that in many markets make up a substantial share of business are still being discussed. The issues involved include the limitation to management discretion that will be permitted to classify a contract as being performance linked, how to account for and disclose the extent of policyholders' interests and how to reflect the link between assets and liabilities, i.e. the extent to which future investment margins can be anticipated. One possible approach being discussed for investment margins is that as long as such margins are specified contractually (i.e. through an investment management fee), these margins may be anticipated, while if not contractually provided for, they will not be permitted.

As of now, contract renewals will only be reflected in current liability values to the extent that they represent valuable policyholder benefits. The definition of what constitutes a valuable policyholder benefit is still being explored. Although it is likely that such benefits as term conversion benefits/costs and costly annuitization benefits will have to be taken into account, it is not clear whether or to what extent such features as future premiums to be paid on flexible premium contracts will be reflected. According to the current DSOP, for example, future premiums for universal life contracts in excess of those required to continue the insurance until maturity will not be able to be anticipated.

Two issues that will likely be among the most controversial for property/casualty coverages are the level of risk adjustment for loss reserves (the fact that they will be discounted appears to be an all-but forgone conclusion) and the use of unexpired risk reserves rather than unearned premium reserves. Although most loss or claim reserves are currently based on prospective values, they usually are not discounted with respect to interest rates. The standards necessary to provide actuaries guidance as to the extent of the discount to be applied have not yet been developed. In most cases, unexpired risk reserves are now only used if a deficiency situation is involved.

One of the most controversial issues confronting this project is the perception that greater financial volatility in financial results will arise compared with that generated under the current system. No company and few investors like excessive income volatility. Based on several case studies that have been run on a fair value based system, the greater the mismatch between assets and liabilities and the less accurate the expected assumptions regarding future experience, the greater the extent of the resultant financial instability. Nevertheless, volatility may be warranted as long as it effectively reflects company performance. On the other hand, unless clearly disclosed, volatility due to factors such as sudden changes in future experience expectations or discount rates may not be desirable.

One of the most important, yet uncertain, aspect of the proposed approach is how to recognize revenue, how to measure performance (the income statement) and the extent of disclosures that will be required. At the same time that the insurance contract standard is being developed, other IASB projects on performance measurement for all entities, business combinations, and reporting and disclosure of banking-related activities are in the development stages. Conclusions reached in these projects will have a significant influence on the ultimate application of the IASB insurance project.

As can be seen, there are a number of important issues that have yet to be agreed upon – stay tuned to their resolution over the next two years, and be prepared for them ultimately to affect accounting. For those interested in taking an active part in shaping the upcoming proposals related to insurance IAS, please contact:

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Future directions in business reporting

The corporate reporting supply chain, ranging from company executives, board of directors, independent auditors, information distributors, third-party analysts and investors, must work together for the information to be transparent, reliable and appropriate. This article looks at a Three-Tier model for such transparency.

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Investors are the final link in the Corporate Reporting Supply Chain, comprised of all those who produce and use the information on which the capital markets depend. The chain begins with *company executives*, who prepare information for both internal and external reporting purposes. The *board of directors* then approves the information issued in external financial reports. *Independent auditors* provide audit opinions on the financial statements. *Information distributors*, including data vendors and the media, deliver information from companies and other sources to a wide variety of users. These users include *third-party analysts*, who recommend stocks to investors, (See Figure 1).

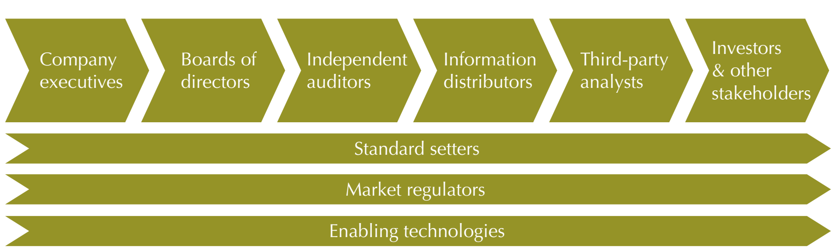
All supply chain participants depend on standard setters – organizations that establish accounting and auditing standards, professional associations and industry trade groups – and on market regulators, such as national and transnational agencies, legislative bodies and stock exchanges, to set and enforce the rules. And enabling technologies – such as XBRL, support the entire supply chain by facilitating accurate and timely distribution of information to the many stakeholders.

All supply chain elements must work together across organizational, industry and geographic borders, for the information supply to be reliable and appropriate.

Three-Tier model of corporate transparency

Investors and other stakeholders in today's capital markets need much more information than current regulations require companies to provide. What kind of information? Information envisioned by the Three-Tier Model of Corporate Transparency, which provides an integrated model for improving corporate transparency, (see Figure 2 overleaf).

Figure 1 **The corporate reporting supply chain**



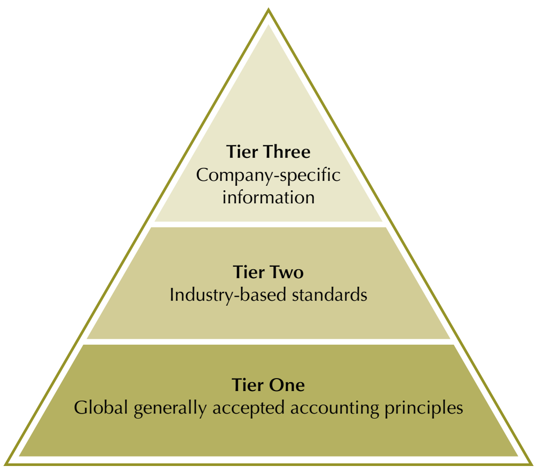
Tier-One: Global GAAP

Creating truly global generally accepted accounting principles – combining the best of international financial reporting standards, U.S. GAAP and other major national standards – would give companies easier access to capital markets throughout the world, at lower cost. Global GAAP would allow investors to compare companies' performance more easily and accurately, regardless of industry or country, thus broadening their range of investment options. And it could ease the administrative burden on market regulators when foreign companies apply to list on exchanges in their jurisdictions.

Creating Global GAAP would require the Financial Accounting Standards Board and the International Accounting Standards Board to collaborate in setting standards, which now for the first time appears to be a real likelihood. Along with progress in harmonized standards, also required are mechanisms for creating

Future directions in business reporting *continued*

FIGURE 2 The three-tier model of corporate transparency



interpretative and compliance functions on a global scale.

Tier-Two:
Industry-based standards
These industry-specific standards include both financial and non-financial performance measures. Investors need them to compare companies within an industry, in ways they cannot today. Industry-specific standards also would allow executives to compare their company's performance against their peers, using the Tier-Two standards based on the critical value drivers unique in their industry. This industry-specific information would be reported as a supplement to GAAP.

Tier-Three:
Company-specific information
This tier includes information unique to an individual company – its strategy, projections and plans, risk management practices, corporate governance, compensation policies and performance metrics. General guidelines for content of this information, as well as external standards governing reporting format, could be developed.

Within the Three-Tier Model, companies need a system for organizing and reporting information in a coherent, comprehensible way. The ValueReporting™ framework[1], developed by PricewaterhouseCoopers, provides a structure for internal and external reporting of both financial and non-financial information along broad categories. For example, much of the Tier-Two information falls into the Value Platform category of the framework, including intangible assets such as human and intellectual capital and non-financial value drivers such as customer relationship management and product development processes.

ValueReporting™ Review 2003: Transparency in Corporate Reporting tracks progress toward a global forward-looking reporting model and includes best practices from around the world of how companies are achieving greater transparency by disclosing information beyond the traditional reporting model[2].

The auditing profession's role in rebuilding public trust

The Three-Tier Model describes suggested disclosure content. But whether the information is relevant and reliable depends on the standards developed for its preparation and reporting, together with the independent audit or assurance work performed. But the scope of assurance provided often is lacking.

Auditing firms focus primarily on auditing historical financial statements – Tier-One financial information. Even at this basic level, there is an 'expectations gap' between what an audit opinion actually means (assurance that the financial statements present fairly, in all material respects, the company's financial performance in accordance with generally accepted accounting principles) and what some believe it means (validation of the company's soundness). Providing a broader audit opinion covering elements like management estimates, the possibility of fraud, risks, liquidity and future scenarios will help to close the expectation gap. Also needed are global generally accepted auditing standards, to establish required procedures supporting this broader audit opinion.

However, expanding the Tier-One audit alone will not close the expectations gap completely. Doing so will require auditors to express assurance on Tier-Two and Tier-Three information as well. This, in turn, hinges on resolving legal liability issues related to both companies and their auditors.

Foundations to public trust

But content and reliability together still will not suffice. Three key elements are vital to rebuild public trust:

Spirit of transparency
Participants in the Corporate Reporting Supply Chain must be as forthright in their communications, providing information investors want and need. For example, rather than trying to manage the market's expectations and outcomes by playing the 'earnings game,' company executives should report honestly and completely on all critical value drivers in their business. Similarly, other supply chain members must foster the same level of transparency as they use or shape the information.

Culture of accountability
Supply chain members must accept accountability – management to produce relevant and reliable information for shareholders, boards of directors to oversee that management lives up to this obligation, independent auditors to ensure the objectivity and independence of their audit opinions and analysts to produce high quality, unbiased research. Investors and other stakeholders also must play their role – obtaining understanding and

1 The ValueReporting™ framework is discussed in the PricewaterhouseCoopers report, *Current Developments for Audit Committees 2002.*
2 See www.valuereporting.com for more information.

analyzing information on which they base their decisions.

People of integrity

Transparency and accountability will not work without individuals who are truly committed to doing the right thing. Rules, standards, frameworks and theories can support, but cannot ensure, success. Ultimately, the actions of individuals matter most. When individuals demonstrate personal integrity, the markets and society will reflect it by proffering their trust.

Principles-based accounting standards – new FASB direction

In the aftermath of Enron, there's been a great deal of discussion about the need to move to 'principles-based' accounting standards. Some charge that the complex, detailed, rules-based standards currently in use allow those pushing the boundaries of proper reporting to structure transactions to circumvent the standards' intent. And many say the complexity allows aggressive financial executives to challenge auditors to 'show me where it says I can't do this'.

What are principles-based accounting standards? There's no official definition, but clearly they are broad in nature and differ from existing standards in two key respects. First, they would allow few, if any, exceptions to the stated principles and would provide less interpretive and implementation guidance. Second, given less guidance, the extent of professional judgment needed in applying the standards would increase.

Why adopt them? Primarily, to make it more difficult for users to circumvent rules and the standards' intent. Proponents say principles-based accounting standards also would be easier to understand and implement, and the increase in professional judgment would result in more transparent financial information – that more clearly conveys the economic substance of underlying transactions and events. And in one sense comparability would be enhanced, because such standards would be more responsive to a dynamic business environment, and adopting them would facilitate convergence with international standards, which follow a principles-based approach.

As expected, the FASB – the main source of accounting standards in the United States – has joined the dialogue. The FASB notes that the detail and complexity of current standards result from attempts to balance differing needs and concerns and mitigate transitioning effects, but recognizes that the detailed, rules-based standards add greatly to the complexity of applying accounting principles, and such standards don't provide the important benefits of a principles-based approach.

With this backdrop, in October 2002 the FASB issued a proposal discussing a principles-based approach to standard setting[3], designed to improve the quality and transparency of financial accounting and reporting. Under a principles-based approach, fundamental recognition, measurement and reporting requirements would continue to be developed following the FASB's conceptual framework, but would apply more broadly to transactions and other events covered by standards. Under such an approach, we can expect to see that:

- Many exceptions would be eliminated – keeping in mind it is unlikely all scope and transition exceptions would be avoided. With few or no exceptions to established principles, similar transactions and events would be accounted for more uniformly, and in that sense comparability would be enhanced; and
- Interpretive and implementation guidance would be substantially reduced – instead, guidance would focus on significant matters addressed in the standards, and preparers would exercise professional judgment in applying them to analogous situations and to industry- and entity-specific situations not specifically covered. For this reason, depending on judgments applied, comparability might be reduced.

To be successful, the FASB will need to determine which situations truly warrant guidance, and resist pressures to provide guidance in others. This will likely require coordinating with other standard setters to ensure they adhere to the same approach.

There are benefits and challenges to applying principles-based standards, and also possible roadblocks. With preparers and auditors exercising greater judgment, would the SEC and other financial information users be willing to accept some level of divergence in practice that could arise? This has serious implications for SEC enforcement actions and related litigation. Indeed, the SEC's approach to addressing these concerns will be critical to the success of a principles-based approach.

What happens next? The FASB acknowledges that principles-based standards require improvements to the current conceptual framework, to clarify certain incomplete, internally inconsistent, or ambiguous aspects. The FASB also expects to consider the need for an overall reporting framework that would address such issues as materiality assessments, going-concern evaluations, professional judgments and consistency. The FASB is seeking comments on a number of these issues, and will continue discussions into 2003, and likely beyond.

For further information on this subject and related topics see *'Current Developments for Audit Committees 2003'* which can be found on the PricewaterhouseCoopers website: www.pwcglobal.com/corporategovernance ☐

3 The proposal is available on the FASB's website: http://www.fasb.org/proposals/principles-based_approach.pdf

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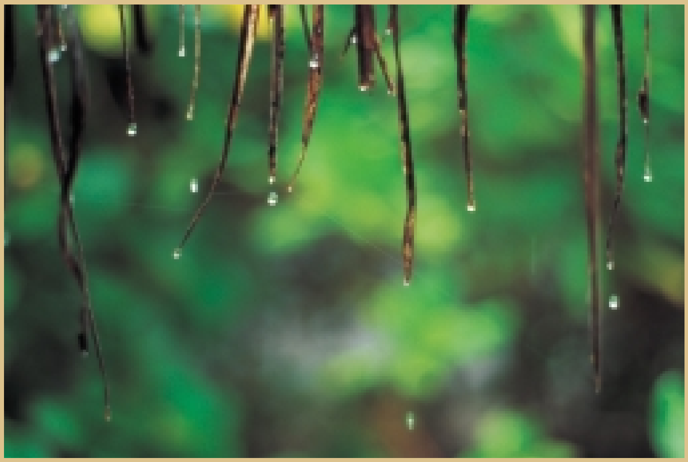

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