

From the Chairman's Deck — Solvency II for Dummies

by Anthony E. Fienberg, CPCU, ARe, RPLU



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All insurance professionals should be able to understand Solvency II, so this article will aim to serve as a mini-handbook and put the topic on par with the rest of the "for Dummies" series, i.e., not reserved only for experts.

What Is Solvency II?

Dating back to the 1970s, Solvency I was the first pan-European capital regulatory framework for the insurance industry, following on the heels of Basel I, aimed at the banking industry. Fortunately or not, the Solvency I regime was relatively simple, with a formula related to written premium. Although premium represents one measure of risk for an insurance company, the business is much more complex. The No. 1 reason for insurance company bankruptcies in the United States is due to under-reserving, which has at best an indirect correlation to premium levels.

Solvency II is roughly the equivalent of imposing enterprise risk management (ERM) on insurance companies. It consists of three pillars:

(1) Capital requirements — modeling what level is needed.

(2) Risk management — what risks surround the business (other than underwriting).

(3) Transparency — implementing ERM and reporting on it to stakeholders.

Basically, Solvency II looks at a 1-in-200-year event, or combination thereof (99.5 percent confidence interval), that would bankrupt an insurer. Is it really possible to articulate a scenario akin to a 1-in-200-year event? Consider the world of 200 years ago: **Napoleon Bonaparte** was at the height of his power and **Abraham Lincoln** was approaching his first birthday. Given the incredible rate of change between then and now, trying to describe such an event is almost certainly liable to be met with skepticism or even ridicule by key decision makers. As an example, hindsight has shown that had NASA risk managers applied proper scenarios to space shuttle launches, they would have determined that an explosion like the *Challenger* in 1986 was at least a 1-in-100 year event. The industry has been trying to remind regulators that insurance is not banking, and insurers (or

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more precisely the business of insurance itself) were not at the heart of the financial crisis. The counter-argument is always based on the regulators' fear of a repeat of some of the behemoth financial groups pleading "too big to fail."

What Is at Stake?

Insurance is in the business of trust. Unfortunately, the political debate has been stuck on the first of the three pillars: how much capital insurance companies must hold. Below is a nonexhaustive list of issues that have arisen as problematic:

- How investing in shares increases capital requirements.
- Accounting for goodwill.
- Treatment for groups of companies.
- Groups with subsidiaries in other EU countries.
- Impact of excess-of-loss reinsurance on capital requirements.
- How much should portfolio diversity afford capital relief (line of business, life versus non-life, first-party versus third-party, long-tail versus short-tail, multicountry).

ERM is about three perspectives: scale, nature and complexity of risk. When ERM is applied to insurance companies, similar issues arise, such as modeling not being an exact science and quantifying risk as a difficult exercise when the data is not fully available. In addition, there is a correlation dimension for insurance companies that renders the risk management task extremely complex. Just take the four major disasters of the last 10 years as examples (World Trade Center, Katrina, Icelandic volcano and BP's Deepwater Horizon) — risk interdependence knows no boundaries and continuously forces risk experts to stretch their imaginations.

The European Commission's April 2010 draft technical specifications for the fifth (and final) quantitative impact study on Solvency II show more flexibility than the controversial capital proposals introduced late last year by the Committee of

European Insurance and Operational Pensions Supervisors (CEIOPS). For example, the standard capital requirement of QIS4 was estimated to be, on average, 177 percent of Lloyd's syndicate's individual capital assessments. Obviously, we are faced with a case here of the regulators' view of what is a safe level of capital and the company's own interest — keeping capital requirements low in order to increase return on equity.

Capital requirements may place some global European Union-based reinsurance giants (Axa, Allianz, Generali, Munich Re) at a huge disadvantage compared with their competitors, not to mention the Lloyd's market, where hundreds of syndicates operate across the world under a common set of accounts.

Looking Ahead

The United States and other countries are closely watching what happens in the European Union before venturing on their own crusades, but in the modern financial world, capital requirements must be on the forefront of an insurance professional's radar. The banking industry in Europe is already devising a Basel III, modeled after Solvency II, so this regulatory initiative is not going away.

Regulators will argue that there are advantages to making the insurance market safer for consumers, including

reducing the extent to which there is such an exaggerated pricing cycle. However, there is a growing list of potentially negative effects of higher capital requirements:

- Reducing competition because the barriers to entry will be higher.
- Squeezing out the smaller players, reducing the innovation they provide.
- Reducing capacity, as it becomes expensive.
- Increasing internal administration costs for insurance companies (compliance).
- Increasing government costs of following the application of the regulation.
- Reducing investment by insurers because of the cost.
- Increasing prices, especially for long-tail and obligatory lines of business.
- Coverages could be reduced or deductibles increased, independent of the pricing issue.
- The government has to pick up "the tab" (less tax revenues and more risk will not be covered).

Lastly, as purists of economic theory would argue, how can we call insurance an efficient financial risk transfer mechanism if insurance companies have no risk of failing? ■



US Commercial General Liability (CGL) versus EU General Third Party Liability (GTPL)

by Pierre Fonteyne, CPCU



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An insurance wording cannot be considered in isolation from the context in which it has been developed. Primarily, the policy contract wording addresses a specific insurance need — for instance, providing cover for liability. In addition, legal and regulatory systems, local market standards and circumstances that characterize the country (where it has been elaborated) influence its scope and structure.

Seen from such a context, the U.S. commercial general liability (CGL) policy has some unique features, in particular when compared to the EU general third party liability (GTPL) wording. In general, both CGL and GTPL insurance policies insure for bodily injury to a third party caused by the insured and loss damage to property owned by third parties caused by the insured in course of business. Let's look at the differences between the two types of policies.

Language

The GTPL's wording is issued in the language(s) of the European market where the policy is issued, whereas the CGL policy is only issued in English.

Standardization

With the exception of Germany, the GTPL's wording is elaborated by individual companies on a competitive basis. There is no uniform model, even if similarities exist. Even in Germany, companies may offer better terms than those provided under the standard AHB model, elaborated by the German Association of Liability Insurers. AHB is the abbreviation for German General Liability Insurance conditions (or Allgemeine Haftpflichtversicherung).

The CGL has been drafted by the U.S. Insurance Services Office (ISO) and is applicable nationwide, even if endorsements provide enhanced coverage by carrier and in accordance with specificities of the different states.

Applicable Laws

The GTPL's wording is in conformity with the various local laws, including transposition into local law of EU directives. Disputes in respect of the wording are settled according to a specific local law, usually the law applicable to the place where the contract has been issued.

The same applies for the U.S., but the uniform wording makes it easier to understand case law, as it refers to texts known by anybody specialized in U.S. liability insurance.

Admitted Insurance

In general terms, insurers must be admitted (licensed) in the country where the policy is issued or where it covers risks.

In Europe, an exception is the freedom of services (FOS) system, whereby a policy issued in one country of the European Economic Area may cover insureds located in other countries of that area. However, providing liability

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European Economic Area

The European Economic Area (EEA) was established in 1994 following an agreement between member states of the European Free Trade Association (EFTA), the European Community (EC) and all member states of the European market. It allows EFTA countries to participate in a single European market. The participating EEA members are three of four EFTA states that have declined the EU: Iceland, Liechtenstein and Norway (without Switzerland, which has also declined here, along with the 27 EU members).

FOS states that, in principle, insurers are free to operate and issue insurance policies in any other member country without the need to create a subsidiary company or office there. They do, however, need to ensure compliance with local legislative requirements and have physical claims representation.

US Commercial General Liability (CGL) versus EU General Third Party Liability (GTPL)

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cover in other countries using a wording in a language different from the country where risks are located can prove difficult.

In addition, certificates must be issued, adjusters assigned and coverages adapted, all in accordance with the needs of the local market. Such constraints make it necessary either to be present in the country where the risks are covered or to have a strong correspondent relationship with a local insurer. Therefore, FOS is not always most practical, unless service is restricted, as is the case for high excess layers.

In the U.S., an insurer must be admitted in a definite state. If specific conditions are met, the surplus lines market allows writing in other states, without being admitted in such states. A similar system does not exist in Europe.

Scope of Coverage

It is a cumbersome exercise to compare the CGL to all GTPL policies offered in the diverse European markets. Some characteristics, however, are significant, such as:

- **Loss of Use** — European insurers include loss of use under so-called financial losses, limited to specific amounts. They do not consider loss of use as included under property damage, similar to the CGL wording.
- **Pollution** — The named perils concept is rarely used in Europe, where sudden and accidental pollution cover prevails.
- **Defense Costs** — In most European countries, defense costs are included under the main limits and not in addition, as provided under the U.S. CGL.
- **Limits** — In Europe, there is no general rule regarding limits, except for some compulsory insurances, such as clinical trials coverages.
- **Triggers** — The definition of the triggers, such as occurrence or claims-made basis, is never identical. For example, the Benelux

countries (Belgium, Netherlands and Luxembourg) traditionally stick to the occurrence trigger, even when claims-made basis is available.

Primary versus Excess

In Europe, there is no major distinction made between the primary market and the excess market. Most excess policies follow form wording with respect to the primary business. Specific wording is rarely developed to write excess business. Bermuda wording is available, mainly through Dublin, but is restricted to high excesses and rather large organizations. Most European excess coverages are written “in excess” and, if requested, on a difference-in-conditions basis, with reference to the primary policy. They cover mainly the same classification of risks.

A unique feature of the U.S. market is the umbrella liability concept, whereby not only the CGL but also the Employer’s Liability (EL) and the Automobile (Motor) Liability (AL) are covered in difference of limits and conditions. The U.S. liability market comprises the CGL and umbrella, even if they are written on separate units of insurance companies.

Albeit umbrella-type solutions exist within the framework of international programs, European underwriters practically never use similar wording when writing domestic liabilities. They regard general liability, EL and AL as independent lines. If excess capacity is needed, it is realized on an individual line of coverage basis, generally using excess follow form coverages.

Global Programs

Global insurance programs are a solution to reconcile the need for international coverage and the requirement to provide locally acceptable coverages from practical, legal and tax standpoints. Even so, the combination of the wording of a master policy and those of local policies is not always easy.



For example, policy definitions may vary from one country to another and their combination is not seamless. For example, there could be a case in which a European global policy provides no provision for defense cost, lacking the usual “cost inclusive” provision, effectively requiring the underwriters to cover the defense costs outside their policy limits, complementary to a CGL policy.

In conclusion, the assistance of foreign colleagues, or, of course, the CPCU Society International Insurance Interest Group, is most helpful to understand the multiple differences that exist between the wordings of CGL and GTPL insurance markets. ■

North Korea — Permanent Black Hole?

by Bob Beatty, Ph.D., and John L. Linantud, Ph.D.



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Editor's note: This is the sixth in a series of articles commissioned by the CPCU Society International Insurance Interest Group on Asian Country Political Risks. Previous articles addressed Vietnam, The Philippines, China, Thailand and South Korea.

Introduction

It would be a mistake to assume that the repressive, xenophobic and anti-American communist dictatorship of the People's Democratic Republic of Korea (DPRK or North Korea) is a Cold War anachronism. Instead, North Korea's nuclear deterrent, alliance with China, and successful isolation of ordinary citizens — combined with a regional preference for the status quo over unpredictable and potentially catastrophic change — suggest real staying power for this regime.

Geopolitics = Domestic Politics

To understand North Korea we must try to examine geopolitics from Pyongyang's perspective. The Korean War (1950–1953) left the unification of North and South Korea unresolved, which forced U.S. forces to stay in the South and for China to continue to protect North Korea from American “aggression.” To North Korea, the primary lesson of the war continues to be that U.S. power is hostile and overwhelming. America robbed it of victory by defending South Korea, and only Soviet and Chinese intervention saved North Korea from complete destruction.

North Korea also learned to mistrust its allies. Their wartime action, after all, did not prevent the deaths of 1 million soldiers and civilians. The Soviet air force defended the North but refused to

**Figure 1 —
Map of North Korea**



Open Source: *CIA World Factbook: Korea, North* (cia.gov/library/publications/the-world-factbook/maps/maptemplate_kn.html) accessed 21 September 2009.

attack the South, and Moscow pressured China and North Korea to sign the truce after **Joseph Stalin** died in 1953. True, China sacrificed 600,000 men to defend the DPRK, but it could not drive the hated Americans off the peninsula. And who could trust Russia or China to not meddle in North Korean politics, or someday sacrifice it for better relations with the U.S.?¹

North Korea has never escaped this wartime paranoia. State founder **Kim Il-sung** (1912–1994) was so suspicious of foreigners that he named the official state ideology “Juche,” for self-reliance, and

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Table 1 — Basic Facts — North Korea

Official Name	Democratic People's Republic of Korea
Comparative Size	U.S. state of Mississippi
Population	22,665,345
GDP per capita	\$1,800 (2008) — ranked 188 of 228 states
Transparency International Rank	Unranked out of 180 states

Source: *CIA World Factbook: Korea, North* (cia.gov/library/publications/the-world-factbook/geos/kn.html) accessed 22 February 2010; transparency.org.

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turned over power to his son **Kim Jong-il** (1941–present). Likewise, today's heir apparent is the current Kim's son, **Kim Jong-un** (1983?–present).²

To make matters worse, Pyongyang issues public threats against Seoul and the United States on a regular basis, refuses to renounce the military option for unification, and provokes its enemies via incidents such as the sinking of a South Korean navy ship in disputed waters in March 2010.³

Regional geopolitics makes North Korean bellicosity more than a simple irritant. But as a poison shrimp among whales, Pyongyang actually gains leverage over putative allies and enemies from its status as a physical and symbolic buffer between authoritarian China and the democratic troika of South Korea, Japan and the United States. Of most importance, the savvy leadership knows that an actual U.S. invasion is unlikely as long as China promises to defend North Korea.

Furthermore, it gambles that regional governments much prefer the status quo to a war caused by an air strike against North Korean weapons of mass destruction (WMD) or a mad scramble to secure the country if it degenerates into a failed nuclear state with millions of refugees. By exploiting these dire scenarios, Pyongyang has created space for internal socioeconomic mal-development.

The More Things Change

North Korea has therefore survived one crisis after another since the end of the Cold War — without being forced into a real development strategy or foreign investment. Instead, it has invested in the risky formula of trading nuclear threats for aid. This high-stakes brinkmanship almost provoked a U.S. air attack in 1994 before Pyongyang agreed to weapons inspections in return for aid and energy assistance from South Korea, Japan, the U.S., China and Russia. The North tested weapons anyway in 2006 and 2009, resulting in new sanctions.⁴

Figure 2 — North Korea at Night



Note: Photo includes China, Japan, North Korea and South Korea.

Open Source: NASA, "Visible Earth: Earth at Night, 8 June 2006 (<http://veimages.gsfc.nasa.gov/13874/east-4096.png>), accessed 2 May 2010.

Daily life for ordinary people thus depends on the ebb and flow of sanctions, aid, man-made famine, humanitarian relief, local agriculture and bartering. As figure 2 indicates, the public electrical grid is virtually non-existent outside Pyongyang, and in early 2010, the South Korean Red Cross planned to ship tons of medicine, skim milk and corn northward. All the while, Kim has directed profits from arms trafficking, narcotics, automobiles and counterfeit goods to himself and the military.⁵

In recent years, however, North Korea has been exposed to the outside world as never before. The North Korean Economy Watch (nkeconwatch.com) and Google Earth publish satellite images that give the world a chance to "see" the country. The best journalistic exposé is **Lisa Ling's** *Inside North Korea* (2007); Ling's sister Laura was held in 2009 after getting caught at the China border.⁶ Interested observers may even study the communist party line at kcna.co.jp/index-e.htm.

Where do we go from here? Assuming that a new war does not destroy Korea,

the worst case scenario is that internal problems spiral out of control and create a repressive but failed state. One such pressure is the poor health of Kim Jong-il. Second is unrest over crackdowns on black and farmers markets. Third are political prisoner camps filled with the tortured, sick and dying. Fourth is the remote chance of a mass refugee exodus through China.⁷

In the best case scenario, North Korea stays intact but is transformed by interaction with outsiders. The North Korean Gaesong (Kaesong) Industrial and Tourist Park, just one hour north of Seoul, is the real and symbolic linchpin of this opportunity. The city was originally in the South, but was annexed by the North after the war. Since late 2004, the two governments and Hyundai have tried to make it an export and tourist center that combines South Korean capital and management with North Korean labor. To understand the significance of this opportunity, consider that construction of the relevant border checkpoint in South Korea required the removal of 1,700 land mines.⁸

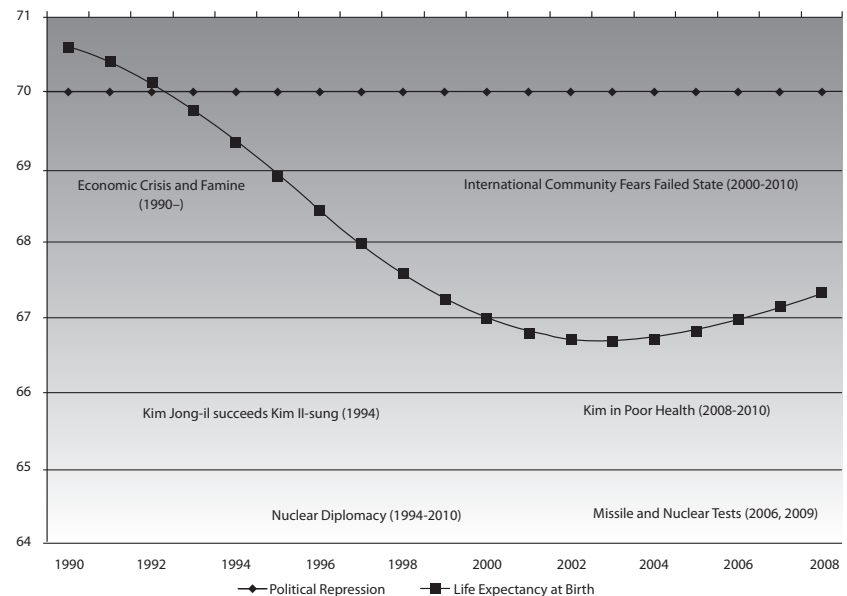
U.S. firms, however, are banned from direct investment in the North, and the U.S.-South Korea free trade agreement of 2007 has stalled in the respective legislatures partly over the question of whether Gaesong exports may enter the U.S. Pyongyang has also dragged Gaesong into nuclear diplomacy by threatening to close the complex unless its demands are met. Even worse, in 2008 a South Korean tourist was killed by a North Korean soldier at the Mount Geumgang (Kumgang) tourist site in North Korea, which had been developed by Hyundai as a companion to Gaesong. In response, South Korea has discontinued the tours.⁹

On-the-Ground Intelligence

North Korea is called the “hermit kingdom” for good reason: It is the most closed and secretive country in the world. In the last few years, some Americans have been allowed to visit, although under constant supervision by government minders.

Professor Beatty took advantage of this opening to travel into North Korea for

Figure 4— Political Repression and Life Expectancy



Notes: There are no United Nations Human Development scores for North Korea. Freedom House ranges from 10–70; 70 designates the maximum repression of political and civil rights.

Sources: Freedomhouse.org; United Nations Economic and Social Commission for Asia and the Pacific Data Centre-Annual Core Indicators, unescap.org/stat/data/index.asp, accessed 1 March 2010.

Figure 3 — Timeline 1990–2010

- 1990–1991:** Loss of Soviet Bloc aid.
- 1993–1994:** First suspected test of nuclear weapons.¹⁰
- 1994:** Kim Jong-il succeeds Kim Il-sung; government agrees to international energy aid and nuclear inspections after U.S. threatens war.
- 1990s:** Famine kills 1 million.¹¹
- 2000–2010:** Emergence of black and farmers markets.¹²
- 2003:** Official withdraw from Nuclear Nonproliferation Treaty.
- 2006 and 2009:** Two announced nuclear tests; regime has six to 12 nuclear devices and other biological and chemical weapons.¹³
- 2008:** New York Philharmonic performs in Pyongyang.
- 2010:** Kim's health in question; son Kim Jong-un the heir apparent.¹⁴

one week in 2009, allowing a rare chance of first-hand observation.

Pyongyang is a city reminiscent of Moscow or Beijing in the 1950s — wide, spotless boulevards but few to no cars, the lonely expanses broken only by buses and some pedestrians. Blackouts occur and electricity is a precious commodity. The regime encourages economic diligence with propaganda rather than material rewards. An example in the summer of 2009 was the “150 days of hard work,” during which all citizens were expected to work feverishly to push their country to “further greatness.” State officials explained that the people needed morale boosting during this period, so groups of schoolchildren were sent out into the streets to sing or play music.

Many of the bands were led by student conductors as young as 12 years old, and it was common to see groups of schoolchildren dressed in blue and white uniforms chanting propaganda slogans

or blasting trumpets, clarinets and tubas as they marched through town. During this and other propaganda campaigns, every Friday all white-collar workers nationwide are instructed to leave their offices and engage in manual labor such as cleaning up their streets, painting buildings and repairing roads.

Pyongyang is a city of monuments, billboards, plazas, buildings, murals and banners dedicated to the leadership and wisdom of Kim Il-Sung, Kim Jong-Il, and the Korean Workers Party. The Tower of the Juche Idea honors the official principles of self-reliance and independence. More broadly, Juche represents the idea of North Korea maintaining a system — economic, political and cultural — that is largely at odds with world trends toward market or quasi-market economies and freer information flows that are transforming erstwhile communist countries such as Vietnam and China.

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Pyongyang also features a towering 65-foot bronze depiction of Great Leader Kim Il-sung. Built in 1982 upon orders of Kim himself, it is the largest statue of any modern political leader in the world. Displays of reverence for the elder Kim are omnipresent. At every single site we visited, the guide would recall when the Great Leader had called, where he had walked, and what he had said to help the people there become better citizens. North Koreans realistically cannot escape the gaze of the Great Leader. Not only does his visage adorn every apartment, but all citizens wear a button with his picture on it — daily.

Only in the past few years have Americans been able to visit Kumsusan Memorial Palace, where Kim permanently lies in state. Kumsusan is massive, easily dwarfing the mausoleums of Mao, Lenin and Ho Chi Minh. After checking our bags and cameras, we stepped four abreast onto the longest continuous moving walkway in the world at more than half a mile. Visitors are required to walk over automatic shoe-cleaning machines before they stand and bow before a 15-foot gold statue of the Great Leader.

Next was the sublime experience of the “Hall of Lamentations,” which featured walls covered with bas-relief murals of people throwing themselves on the ground in painful mourning over the death of Kim. Over speakers (and in our ears in English via an audio guide) came the grief-filled voice of a man who described the “pain felt deep into humankind’s core” at the death of the man who “provided light, guidance, hope, wisdom and strength to all of humanity.”

After this experience, visitors are led through a portal consisting of massive blowers that remove any dust particles from their clothing, etc., before they see the Great Leader. We then formed lines of four and entered the room to observe the “Eternal President of the DPRK” in a glass-domed sarcophagus. The Koreans around us looked as if in a daze, with many of the women overcome with grief, dabbing their eyes to wipe away the tears.

They bowed at the head, feet and sides of the Great Leader. For many ordinary citizens, Kim Il-Sung appears to be not only a former head of state, but a religious icon. The cult of personality surrounding the Great Leader is immensely powerful.

North Koreans’ attitude toward the United States is straightforward. As one guide told us, “You are the enemy.” He then cited two reasons. First, “you want to destroy our system and impose your system on us. Second, you occupy the South and prevent Korean unification.” More than the anti-U.S. attitudes, however, on-the-ground observation deeply impressed upon us how strongly the idea of Juche and belief in the system permeated society and the encompassing level of state control over individual lives. For example, there is only one full-time TV station for a country of about 23 million, which only shows news and films touting the state.

Watching South Korean television or videos is against the law. And there is no Internet as we know it, but instead an intranet controlled by the government. To North Koreans, what we would see as system failures (such as the famines of the 1990s) are caused by U.S. policies, and therefore used as tools by the government to strengthen the people’s resolve to “defend their independence” rather than hold the regime accountable. This rather unique blend of a closed society, respect for the Kim family, police state control and focus on the U.S. as the enemy has allowed North Korea to survive the world democratization wave that occurred after the fall of the Soviet Union.

Kim Jong-Il also receives a great deal of hero-worship. It was obvious from our short trip, though, that Kim, when not too ill, understands that one key to a smooth-running dynastic dictatorship is hands-on supervision. So, the North Korean newspapers, magazines and billboards are full of pictures of “The General” touring factories, farms, military facilities, public buildings and construction sites. Like his father, he provides “field guidance” or “on-the-spot consultation,” pearls of



wisdom that are immediately reported in the news but eventually make their way onto the walls near where he gave the advice. From talking to a few North Koreans, we sensed a feeling of relief that the General was reportedly back at work after his illness. In a country that has been structured on the Kim family, no doubt there is worry about a leadership transfer from Kim Jong-Il to his inexperienced and secretive son.

There is probably no greater demonstration of the collective mentality than “Arirang,” the mass performance of song, dance and gymnastics staged in the national stadium every night for six weeks in the summer. With more than 100,000 performers, it involves more than 30 different performances (or chapters) detailing the tale of Korea, from ancient roots to Japanese invasion to the rise of the Great Leader to the building of the current Juche-based society to a future of reunification and happiness.

Each chapter involves several thousand dancers and/or rhythmic gymnasts performing highly choreographed routines, framed by a backdrop of massive mosaic pictures created by 18,000 very well-trained schoolchildren holding colored cards. Arirang is really a summation of the state itself — a demonstration that the North Korean people are of one mind, striving together for what they believe to be the strength and happiness of the whole nation under their unique system.

In a country that is so closed to outsiders, how deep that feeling exists among the population is impossible to know, but there was no indication that the 100,000 Arirang performers do not share in this fervent belief.

Conclusion

In conclusion, the DPRK is compelling but dangerous. The geopolitics of the region, combined with the isolated and collective nature of North Korean society, have allowed the regime to survive the economic and political liberalization that are transforming the rest of the world. The collective ethos and religious-like worship of the Kim dynasty have also stripped most people of the critical thinking skills they would need in a global economy. And the pugnacious outlook of the state has turned the Korean peninsula into a permanent crisis. This risky status-quo will be hard to change. We will likely continue to have a North Korea that threatens the peace but never completely endangers it, a China that presses North Korea to behave but never demands it, and a United States, South Korea and West that hope for liberalization, but never expect it. ■

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The EU's Environmental Liability Directive and New Insurance Solutions — Germany

by Mathias Schubert



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Editor's note: This is the third in a series of articles on the European Union's (EU) Environmental Liability Directive (ELD). Schubert discusses the impact of the ELD on the various EU insurance markets, and then discusses in detail the response in Germany to this legislation. He based this article on his Gen Re's Topics No. 16 paper, "The Environmental Liability Directive — A Challenge for the European Insurance Industry." It is reprinted with permission. © Gen Re Corporation and Kölnische Rückversicherungs-Gesellschaft AG 2008.

What is the current situation in European Union (EU) countries? In France, Italy and Spain, reinsurance pools supporting Environmental Impairment Liability (EIL) coverage offered by member companies have existed for some time. In these countries, products that also respond to the Environmental Liability Directive (ELD) are available. In the remaining countries, the insurance industry has so far, for the most part, shown limited or no reaction to this topic, partly because of the delay in the legislative process. In such countries, the market context is very different from that in Germany and the pool countries; dedicated environmental coverage is not "institutionalized" but a highly specialized field reserved for a few niche players who have small books of business with insurance buyers outside the mainstream, such as environmental consultants or contractors.

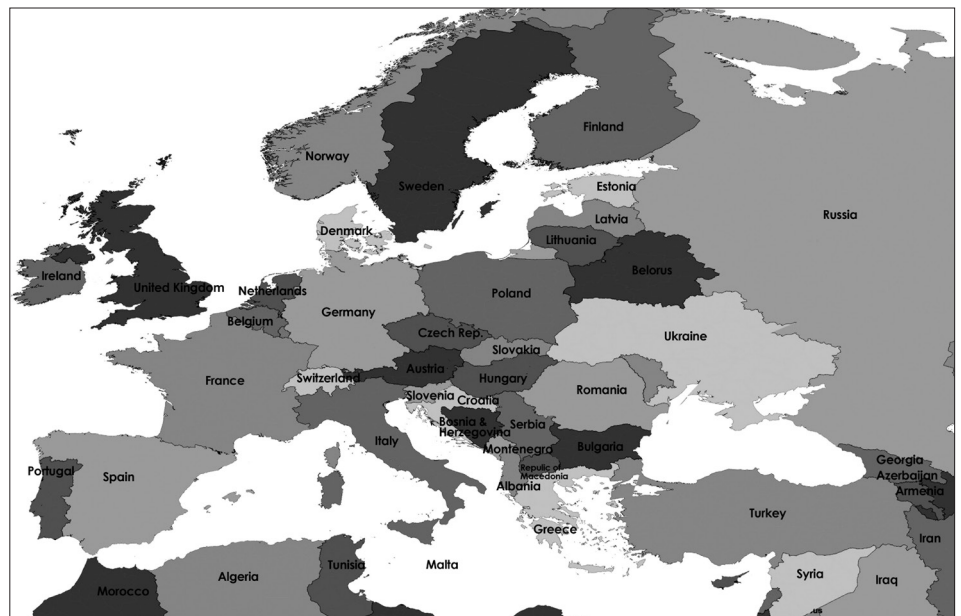
Here, individual insurers will often be left to their own devices in a terrain that is truly novel to them. As stated earlier, they will need to ask themselves whether existing standard liability policies, which normally provide coverage for sudden and accidental pollution events, will be exposed to "environmental damage" within the meaning of the ELD.

Whatever the finding, the next question that arises is whether it is desirable or perhaps necessary to modify the standard liability policies, either by restricting coverage or expanding it. Thirdly, the question comes to mind whether dedicated environmental coverages are needed.

Without a doubt, developing new coverage concepts and formulating corresponding policy wording in the area of environmental liability is a technically challenging task for the insurer that decides to pursue this path.

A meaningful scope of coverage, a high degree of clarity and a suitable trigger of coverage are best achievable on the basis of a dedicated product, be it a stand-alone policy or a separate coverage section. If purchased, this dedicated product should be the virtually exclusive basis of coverage for all environmental liabilities, both third-party liabilities and statutory liabilities, meaning that the general liability (GL) policy or section should be endorsed with a total pollution exclusion.

Unfortunately, insurers — notably in the United Kingdom — feel tempted at times to develop special coverage extensions, or subsections, in the context of the



GL policy while leaving the traditional pollution coverage for “sudden and accidental” scenarios in place. This would seem not only to perpetuate current ambiguities in policy wordings, but also to create additional difficulties. The application of two different coverage triggers (occurrence plus claims-made/manifestation) to scenarios covered partly under the traditional GL context (“sudden and accidental” as far as third-party liability is concerned) and partly under the extension (for statutory liabilities) is likely to cause practical and perhaps even legal difficulties.

The simplistic approach — offering extensions for statutory liabilities including liabilities under the ELD on an occurrence basis — is not a solution that common sense would suggest.

The Development in the German Market

Without negating the challenges the ELD poses as a result of partially unprecedented liabilities and compensation mechanisms, the German insurance industry has managed to respond to the new legislation in a timely and effective manner. German liability insurers were able to benefit from prior developments. In the early 1990s, the predecessor of the German Insurance Association (GDV — Gesamtverband der Deutschen Versicherungswirtschaft e.V.) had developed a modern, dedicated Environmental Liability Insurance product (UHV model wording) in response to the Environmental Liability Act 1991 (ELA). This wording provided coverage for the insured’s civil liability for losses sustained by a third party as a

result of pollution conditions, and became the fully accepted basis of a product broadly available throughout the German market. This situation proved to be quite helpful going forward in the face of the new legislation: On 27 April 2007, the GDV published a new noncommittal model wording for the Insurance of Environmental Damage (Allgemeine Versicherungsbedingungen für die Umweltschadenversicherung, hereinafter referred to as “USV model wording”). This coverage quickly started to be phased in.

For light environmental risks, which do not require the very detail-oriented manner in which environmental liability insurance applications and policies are processed in Germany, a model wording “environmental Damage Insurance/basic coverage” (“USV-Basic model wording”) has also been made available.

Someone with a basic familiarity with the German market might be surprised that the GDV developed a stand-alone insurance product to cater for the new liability regime. Against the background of the already existing UHV model wording and its acceptance throughout the German market (as well as the fact that commercial and industrial insureds, which have faced an absolute pollution exclusion in respect of their premises and operations since the early 1990s, generally view this cover as a necessity), would it not have been the intuitive solution to rely on the existing product, under which liability for third-party injury and damage arising from a pollution event is covered, as a basis, and to create “add-ons” extending the cover so as to respond to the new liabilities under the EDA?

Indeed, the GDV working party considered such an approach at the beginning of its project. During the ensuing substantive discussions, however, the group identified not only similarities between the issues, but also differences between environmental liability for third-party injury and damage on the one hand

The Environmental Damage Act

The Environmental Damage Act (abbreviated German title: “Umweltschadensgesetz”, hereinafter referred to as EDA) is the core element of the implementing legislation, which also brought about a number of amendments to the Water Resources Act and the Federal Soil Protection Act. In accordance with a requirement under the Federal Constitution, the new legislation was to come into effect six months after its official promulgation, which occurred on 14 May 2007. The purpose of this delay was to enable individual States (Bundesländer) to pass complementary legislation in the areas of Nature Protection and Water Resources. There is, however, an element of retroactivity in the sense that a responsible party who causes environmental damage by an emission, event or an incident that takes place before the effective date but on or after 30 April 2007, will not be exempted from liability. Generally speaking, the German legislature has decided to adopt the requirements of the ELD, without broadening or extending the liability regime beyond these requirements. Interestingly, a provision contained in the previous draft, which would have authorized the issuance of a regulation rendering insurance coverage compulsory, was not retained later in the legislative process.

Another aspect worth mentioning is related to the damage to protected species and natural habitats, which the ELD defines as any damage that has significant adverse effects on reaching or maintaining the favourable conservation status of such habitats or species. Here, insurers had hoped that the legislature would develop a more concrete description of the criterion of “significance,” to which the ELD refers in the somewhat general criteria set out in Annex I. Very late in the process, this wish was at least partially fulfilled. An amendment of the Federal Nature Preservation Act states three types of scenarios in which adverse effects are generally not considered significant: adverse effects of a lesser extent than natural fluctuation that is considered normal for the habitat or species concerned; adverse effects arising from natural causes or current or past land use considered normal in the area; and adverse effects on species or habitats that will regenerate themselves in short time without intervention.

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and liability for environmental damage on the other. While a single wording would have been possible in spite of these differences, it was felt that such a wording would have turned out to be overly complex and difficult to understand, particularly from the point of view of the insurance purchaser.

The USV model wording can be summarized as follows:

- (1) The USV model wording makes available a stand-alone coverage that can be purchased alongside General Liability and Environmental Liability coverage. It is designed as a special coverage for those public law liabilities that were introduced via the EDA. This new liability exposure is channeled to the new coverage in two ways. First, a new exclusion contained in the GL model wording — Section 7.10(a) of the AHB — restates that claims based upon the EDA or other national legislation implementing the ELD are not covered and excludes claims that are brought against the insured under private law in order to recover costs incurred as a result of environmental damage. Second, the last paragraph of Section 1.1 of the USV model wording states that any claim that could also be brought in the absence of the EDA or other national laws transposing the ELD on the basis of liability provisions under private law is not covered; such claims would remain covered under a GL policy or an Environmental Liability Policy, depending on the circumstances.
- (2) The way in which the coverage is structured is similar to the concept found in the Environmental Liability model wording, which means a modular approach and the familiar manifestation trigger (“verifiable first discovery”).
- (3) The standard cover will respond to environmental damage, i.e., damage to protected species and natural habitats, land damage and water

damage (Section 1.1), unless the environmental damage occurs on the insured's premises (Section 10.1). Damage to ground water is also excluded from the standard cover (Section 10.2).

- (4) By specific agreement, the standard cover can be enhanced in two ways:
 - Optional coverage extension 1 is meant to extend the coverage to environmental damage that occurs on-site, which also comes within the scope of the EDA. An additional option under coverage extension 1 is the inclusion of damage to ground water. This coverage extension is subject to a sub-limit which is part of, and not in addition to, the general policy limit.
 - Optional coverage extension 2 makes available a further enhancement of coverage of environmental damage that occurs on-site. This extension affords coverage for liabilities that can be incurred under the Federal Soil Protection Act. These liabilities can go further than ELD liability inasmuch as on-site remediation may be required due to soil contamination, even if human health is not at risk. If this coverage extension is purchased, it is included within the sub-limit of coverage extension 1.
- (5) The policy covers the legal obligation to remediate environmental damage pursuant to the EDA. Furthermore, coverage exists for claims against the policyholder by a public authority or a third party seeking to recover remediation costs.
- (6) In relation to protected species, natural habitats and water, the policy covers primary, complementary and compensatory remediation (Section 5.1). Compensatory remediation is subject to a sub-limit, although the model wording contains no

monetary indication in this respect. Coverage is also afforded in respect of loss avoidance costs incurred in order to avert or reduce imminent environmental damage; loss avoidance costs are also sub-limited (Section 9).

- (7) Within the standard cover, the risk-specific modular coverage components (hereinafter referred to as risk modules) correspond to the seven risk modules that already exist in the Environmental Liability model wording. An additional risk module was, however, included in order to cater to the risk of liability under the EDA for environmental damage arising from the manufacture or supply of conventional products.
- (8) Generally, a sudden and accidental disruption of the insured's normal operations is a prerequisite of coverage (Section 3.1). This is different from the Environmental Liability model wording, where there is no such prerequisite but only an exclusion in respect of environmental impacts that are, in light of the insured's operations, unavoidable, necessary or expected (“normal operations”). This prerequisite was included due to the need for requiring the insured to show a discrete “event” in order to be able to compare the pre-damage and post-damage conditions, especially as regards protected species and habitats. It is important to understand that this prerequisite has no bearing on the nature of a discharge or escape of a pollutant; the policy does not set any criteria as respects the latter, so the discharge or escape may be of a gradual nature.
- (9) However, the prerequisite of a sudden and accidental disruption of the insured's normal operations does not apply when it comes to environmental damage arising from the manufacture or supply of conventional products (i.e., products that are not environmentally-

relevant facilities, or parts thereof; examples for such “non-conventional” products include manufacturing or processing plants and storage tanks), as well as the use of conventional products. Here, coverage hinges on the existence of a design, manufacturing or instruction defect, and coverage is limited to situations in which no development risk has materialized (Section 3.2 of the model wording).

- (10) Exclusions are generally in line with the exclusions found in the Environmental Liability model wording. An additional exclusion pertains to environmental damage arising from the production, supply, delivery, use or dispersal of sewerage sludge, sullage, manure, plant protection products, fertilizers and biocidal products (Section 10.9). The reason for this exclusion lies in the fact that these substances are intentionally or knowingly introduced or released into the environment in massive proportions, which means that an adverse impact on the environment is inevitable. Consistent with this rationale, the exclusion will not apply where these substances are unintentionally released as a result of a sudden and accidental event, suddenly washed away by precipitation or blown onto neighbouring land by wind.

Unlike its counterpart in the Environmental Liability model wording, the exclusion of losses arising from the undisrupted operations is absolute: There is no exception to the exclusion relating to development risks. This is consistent with the coverage prerequisites outlined under Point 8 above.

The USV model wording features the modular approach already known from

Modules According to Section 2 of the USV Model Wording

- 2.1** Facilities of the policyholder that are intended to produce, treat, store or place into storage, handle or dispatch substances that are harmful to water (WRA-facilities; German: WHG-Anlagen).
- 2.2** Facilities of the policyholder that are names in Appendix 1 of the Environmental Liability Act (ELA-facilities; German: UHG-Anlagen Anhang 1).
- 2.3** Facilities of the policyholder that do not fall under Sections 2.1 or 2.2 but are subject to permit or reporting requirements pursuant to environmental regulations (other facilities that must be declared; German: sonstige deklarierungspflichtige Anlagen).
- 2.4** Sewage treatment facilities of the policyholder, or the discharge of substances into water, or of the water by the policyholder (sewage facilities and interference with water; German: Abwasseranlagen – und Einwirkungsrisiko).
- 2.5** Facilities of the policyholder that are named in Appendix 2 of the Environmental Liability Act (ELA-facilities; German: UHG-Anlagen).
- 2.6** The designing, manufacturing, supplying, assembling, disassembling, maintaining and servicing of facilities or of component parts that are recognizably intended for such facilities as described in Section 2.1 through 2.5, where the policyholder is not the operator of the facilities.
- 2.7** The manufacturing or supplying of products that do not fall under Section 2.6, after being brought into circulation.
- 2.8** Other facilities, plants and operations on or away from the insured’s premises, to the extent that the foregoing do not fall under Sections 2.1 through 2.7, regardless of whether or not these risk modules were stipulated.

the UHV model wording. According to Section 2 of the USV model wording — “Scope of coverage/insured risks” — coverage extends exclusively to those risks and activities that are listed in the schedule. Coverage can be selected, and must be expressly stipulated, for the following up to eight specific risk modules (see sidebar above).

In conclusion, the already familiar environmental issues in general liability insurance have taken on considerable urgency as a consequence of the Environmental Liability Directive. The insurance industry is called upon to review and refine the existing product landscape. While the course has in principle already been mapped out in some markets, in many countries both the destination and just how to get there are

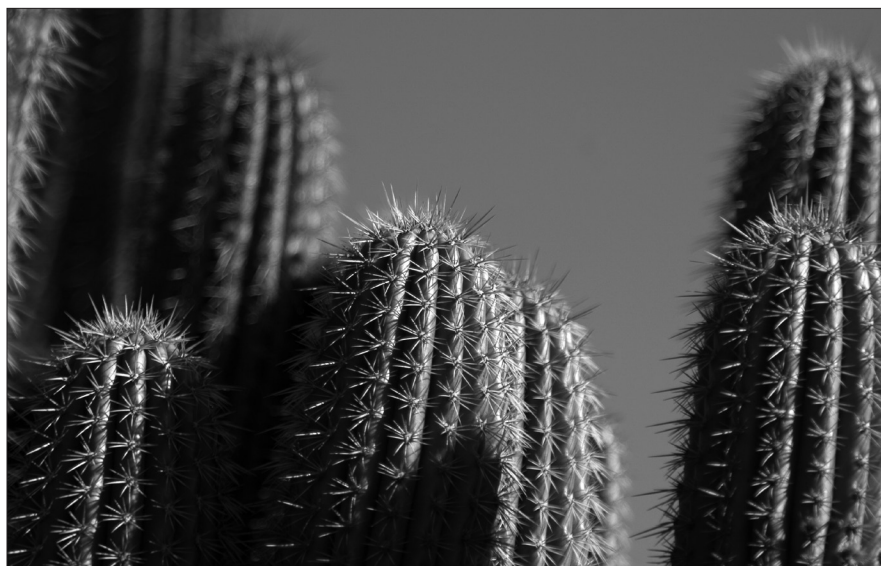
still under discussion or indeed entirely up in the air. Depending on the specific market context, this may mean breaking new ground — not only for smaller and mid-sized insurers. ■

Working Abroad in Insurance — I Was Promised Cactus

by Tony Hughes, CPCU, AIC, AU, ARe



Tony Hughes, CPCU, AIC, AU, ARe, is a product underwriter with the Trucking Division of Great American Insurance, Cincinnati, Ohio. He has bachelor's and master's degrees in engineering and has been working in the insurance industry since emigrating to the U.S. in 2003.



Moving to the United States was the best decision I never had to make. There was just never really a choice!

Option No. 1 involved my American wife-to-be moving to Scotland and me continuing as a frustrated and average engineer. Engineering shares few parallels with insurance; however, both do involve lots of numbers. Engineering isn't about numbers alone,¹ but it is always about the sum of the numbers, and for me, they just didn't add up. I was spending my workday in a career for which I had no love. The best news was that it only took me 12 years to realize² this position.

Option No. 2 was to move to America and then go find something I wanted to do with the remainder of my working life.

Up until the late 1990s, the image I had of the United States was culled by your friend and mine, television. Thus, movies I watched as a kid in the 1970s — made in the 1950s and pretending to depict the 1880s — formed the idea of what, years later, I would come to call home. (When reality bit, though, there were fewer cacti and way more problems than I expected.) It was often hard to reconcile the glorious first few months of married life with the queasiness I felt from an uncertain future by finding myself unemployed in a foreign city.

Originally, I'd had grandiose ideas of obtaining a well-paying job right off the bat; however, about an hour into my first day of job searching, I knew that would be mission implausible. OK, so the office with secretary, *en suite* bathroom and mini-golf set as standard looked to be out. Could I just have a job doing something — anything — that paid a decent wage? The answer, it seemed, was no ... no you can't. We had a large mortgage and a small savings account. Also, I was tiring of daytime television. I'd even stopped returning my Playstation's calls.

After a summer of constructing retaining walls for relatives in Kentucky, I was keen to swap my sweaty blue collar for a crisp, clean white one. It seemed, however, that no one wanted me, despite Kinko's announcement of record profits that quarter based partly on the number of photocopies I was making of my résumé.

After six months of mandatory unemployment, I was offered an entry-level position with an insurance company in downtown Cincinnati. I was to be a claims processor III. The afternoon of the first day on the job was spent learning how to push a mail cart around the office. It was a sobering experience to sit there and watch someone almost young enough to be my son explain in some detail the correct method and application to

maneuvering around the maze of cubes that was to be my domain for the next couple of years.

It was tough, but I had no choice but to knuckle down, study whatever I could get my hands on and see where it took me. It was also tough because I had to re-learn things I had already grown accustomed to knowing. Consider the following everyday insurance terms: binder, deductible and comprehensive coverage. I had used different words for binder and deductible, and comprehensive coverage has a different meaning altogether in the U.K. So I didn't start from the bottom; rather, I started from underneath the bottom, having to unlearn things before I could learn them.

Even though I've found a home in America and a career that appears to work for me, because of my circumstances, I find myself still feeling somewhat like a local in neither place and a stranger in both. Upon my infrequent trips back to the old country, I find an entire new lexicon of words being used by my friends, family and erstwhile work colleagues. I always have to remember to swap out an "s" for a "z," depending on the nationality of the person with whom I am corresponding.

I've come a long way from my days as the fastest mail collector in the company (unknown to me until lately, I was dubbed The Flying Scotsman), but I realize³ that I still have a long, long way to go in this industry. However, so far, I'm enjoying the ride. ■

Endnotes

1. Most engineers will disagree with this statement.
2. In the U.K., it's "realise."
3. Ibid.

International Recipe — Scotch Eggs

by Tony Hughes, CPCU, AIC, AU, ARe

You'll see many differing varieties and recipes for Scotch eggs. I'll give you mine, done the way my mother would make them when I was a kid. Recipe serves 4.

Ingredients

- 1 lb. Jimmy Dean-type bulk sausage meat (preferably hot sausage)
- 5 eggs
- Flour
- Breadcrumbs/panko
- Salt/pepper to taste

Methodology

Hard boil four of the eggs most of the way (about 8 minutes instead of 10). Peel and dust each of them lightly in flour (seasoned with pepper and a little salt).

Separate the sausage into four equal amounts and cover all four eggs with the sausage meat. The sausage should cover the eggs entirely and be about one quarter of an inch thick.

Beat the remaining egg and place in a bowl. Roll the four sausage-covered eggs in the beaten egg and then immediately in the breadcrumbs/panko, making sure they are thoroughly coated.

Place on a tray in the oven @ around 400 degrees for 15–20 minutes — basically enough time to cook the sausage casing and turn the coating golden.

Done.

Traditionally, the Scotch eggs would be served with something fried and unhealthy; however, this was Scotland in the 1970s and frying anything was still socially acceptable. Nowadays, you may desire to serve with flavored rice, noodles or some other starch.

Enjoy!





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