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Regulating Product Design is Changing

An underwriter recently mentioned to me that he was developing a new product. Naturally, his starting point for the project was some research, but the starting point for that research, he explained, was to be the scoping of cover provided by his competitor's wordings, rather than a study of the peculiarities of the risk he was preparing to underwrite, like the legal and regulatory landscape.

He seemed to be suggesting that he was going to skip the legal and regulatory due diligence, and his approach was not novel. It relied upon the assumption that his competitors had already undertaken the research he may have been about to skip, and that their products were drafted to reflect the results of that research. But was it safe for him to make that assumption?

It is difficult to gauge how common this type of approach to "new" product development really is in Asia. It undoubtedly goes on, however, and may explain why 'new' products are usually new in the sense that they simply add more features, in a bid to 'out gun' the competition on the scope of coverage, rather than provide an innovative insurance solution to an identified need. Sadly, some sections of the market seem to have settled for a product development process which involves cutting and pasting, rather than research and innovation. No wonder that policies tend to look alike and the market finds itself competing fiercely on price because there is no true product differentiation.

A cutting and pasting approach to product development leads to the problem of 'cloning'. The near certainty that the competition will have 'cloned' all the technology in a new product within

three to six months of its launch must surely discourage many from innovating in the first place. Yet, truly original coverage can and should be protected by copyright. It will only take one or two successful copyright infringement claims, with all the reputational damage that such outcomes will inflict upon the infringer, to establish recognition that cloning is simply bad for business.

One might argue, of course, that stiff price competition should benefit the consumer. In a sense it does, but that's a short-term view for several reasons. First, price competition is a race to the bottom and the only winner of that race will be the insurer with the biggest reserves of capital, leaving no competition. Second, consumers need intelligent solutions to transfer the risks they face, not a supermarket shelf which offers 20 fundamentally identical products which are differentiated only by their branding and their price. Third, the continual addition of coverage to products represents an unsophisticated gamble that the benign claims environment in Asia will always stay that way (and experience elsewhere suggests that it won't).

On this last point, Hiscox's chief executive was recently quoted as having said, during a speech at the *Insurance Day Summit* in Bermuda, that an

implicit assumption has developed within the insurance industry that, as models are refined in the face of real-life events, they get better and better, until one day they are perfect. But they are only models, after all, complete with flaws; past claims experience in Asia may therefore turn out to be a thoroughly unreliable guide to the future, at least for some unlucky underwriters.

The key to progress lies in innovation, which requires thorough research, the drafting of new coverage and a broking response which embraces change, rather than views it with suspicion and a desire to revert back to the familiar 'old' wording. The need for innovation was a central theme that emerged from the recent Airmic and RIMS conferences in the UK and Canada, with calls for products covering intangible assets, like reputation.


Coverage for intangible assets is as relevant to Asia as it is to the rest of the world: Chaoda Modern Agriculture, a vegetable grower listed on the Hong Kong stock exchange, recently lost almost a third of its value after doubts (later disputed) surfaced in the Hong Kong press about the amount of farmland it controls. Sino-Forest Corporation, a Toronto-listed forestry owner, seems to have encountered similar issues, with its stock down 80% in response to recent (disputed) reports about ownership of its assets. Both episodes provide useful illustrations of how reputational issues can impact upon the financials of listed companies. Maybe this type of cover can provide the margins that continue to elude the D&O market in Asia?

The UK's Financial Services Authority has been focusing more on product development more recently. Since the pensions review in the 1990s, the FSA's regulatory approach has been based upon the assumption that effective consumer protection could be achieved at point-of-sale, by fair processes and transparent disclosure of product features. Yet this assumption has proved misplaced, because mis-selling problems have persisted: personal pensions and endowment policies were early and very visible examples, but more recently problems with home equity and payment protection insurance have come to the fore. Neither is Asia immune from these problems: minibonds have been a problem of late, so what the FSA is doing in the UK ought to have some resonance here.

What is the FSA doing in the UK, exactly? It has signalled a fundamental shift in policy towards intervening at the design-stage, to ensure that products function as intended and reach the right customers. The overall aim of this policy shift is to reduce the frequency with which large-scale market problems occur, whilst not over-stepping the market

in a misguided attempt to create a zero-failure regime. The FSA's stated belief is that there are benefits for everyone in its new approach. In a recent discussion paper, it identified increased consumer confidence that a product had been designed in their interests as one beneficial effect of its new policy. For the financial services industry, the list of beneficial effects was rather longer: fewer product failures, less reputational damage and less compensation paid out to aggrieved customers. If the FSA's new policy direction proves right, therefore, there are real and compelling reasons for Asian supervisors and market participants to follow the trend. Product governance initiatives in Europe have yet to be matched by Asian supervisors, however.

Lastly, something for those who are interested in innovation; as noted earlier, a survey of members published at the recent Airmic conference put reputational risks at the top of concerns voiced by risk managers and insurance buyers. The next biggest concerns were compliance issues relating to so-called 'global' insurance programmes for multinationals, followed by supply chain and cyber risks. Although there have been a few attempts to deliver a solution to the 'global programme' issue, none has been comprehensively successful. This is - and will be for the foreseeable future - a key issue for product governance in Asia, containing as it does so many unevenly regulated markets, so I will end with the topical thoughts of XL's General Counsel for Global Programmes, when he said recently:

"... providing consistent and globally compliant risk management solutions to multinational corporations might not be first on a company's to-do list, but it is unlikely to be too far down, either. How can international corporations obtain integrated and consistent cover worldwide, while at the same time complying with local law and market practices and accessing local coverage and loss adjustment solutions? This apparent conflict can only intensify as multinationals turn to emerging markets to supply their service and manufacturing requirements, connecting on the way with unfamiliar legal systems, and regulators who may not be geared up to their needs." 

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