Marketplace Realities and Risk Management Solutions

2004

Strategies for a Changing Marketplace

Willis

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The Quest for Certainty

It has been another remarkable, exciting and challenging year for our industry. Cost of risk, of which risk transfer is typically a majority portion, and the availability of critical coverages, continue to command boardroom attention. Striking the best deal in the marketplace is one of the core values that we bring to our clients, but today's issues go well beyond the nominal cost of insurance.

Premiums paid for insurance are more than sterile debits and credits impacting the income statements of the respective parties. The insured exchanges a liquid asset, one with unconditional value here and now, for another kind of asset – a promise to pay.

Fulfillment of the promise to pay is dependent upon the insurer's meeting its legal and fiduciary obligations, sound management, "good luck" (or the absence of "bad luck"), and reinsurers who in turn possess the same fundamental attributes.

A year ago, insurance buyers were dealing with the aftermath of a runaway hard market, having regained a measure of control. Pricing, capacity and market security were all front burner issues. One year on, as several key market segments have seen improvement and stabilization, one of these issues remains paramount: market security. Insurer downgradings and failures have removed important marketplace capacity and placed historical promises in jeopardy. In the quest for certainty – paying for insurance to meet future contingencies – there is no greater concern today than that of counterparty risk.

Why have insurers been failing at such an alarming rate? On the surface, the scissors action of falling financial asset earnings and adverse loss development provides a perfectly reasonable balance sheet answer, but one that does not touch upon root causes. The UK's Financial Services Authority, in its report "Managing Risk: Practical lessons from recent 'failures' of EU insurers" (December, 2002), examined risks that threatened the solvency of UK and European insurers over the prior six years. There were hundreds of failures and near-failures. Surveys and case studies revealed that "management failures appear to be the root cause…" Among the management problems identified were:

In the quest for certainty – paying for insurance to meet future contingencies – there is no greater concern today than that of counterparty risk.

- "Straying outside their field of expertise, or uncritically following herd instinct."
- "Excessive risk appetite or objectives that are at odds with prudent management of the business."
- "Lack of autonomy and inappropriate pressure; e.g., from the parent company."

The study identified 50 risk factors, both internal and external, that threatened insurer solvency. It is important, therefore, for the lay reader to understand that the insurance industry is one whose fate and fortune are a function of scads of variables, including formidable externalities: the legal, judicial, social and economic environments. It is precisely because insurers have responded to claims neither expected nor intended to be covered (and for which either no premium or inadequate premium had been collected) that many of them have been debilitated or ruined.

A fast, reasonable end to the nasty business of asbestos litigation and an acceleration of the nascent efforts to effect tort reform at the state level offer some hope for stabilization.

It is not only the consumers of insurance products and services that need to be heard in the halls of Congress and the legislatures of the land, it is also the collective voice of the consumer-at-large. In Tillinghast-Towers Perrin's “US Tort Costs: 2002 Update”, the authors note:

“At current levels, US tort costs are equivalent to a 5% tax on wages. The US tort system cost $205 billion in 2001, or $721 per US citizen. This compares to $12 per citizen in 1950.”

On any given day, we deal with conditions at hand while we try to influence the course of future events. Risk management has come a long way in the past 20 years, turbocharged at times by the exigencies of turbulent marketplace conditions. The amounts of risk assumed and funded by business enterprises have grown enormously, and alternative risk funding has come to be more of a mainstream activity than an "alternative".

Insurance is the DNA of capitalism. The wheels of commerce are dependent upon a well-lubricated, reliable system of risk transfer to help achieve growth and prosperity. Willis Associates around the world will continue to expend every effort on your behalf – serving as your Client Advocate in structuring and effecting risk management and insurance programs, obtaining the best value for today's assets spent on tomorrow's promises, being diligent in matters of marketplace security, and as citizens and consumers dedicated to improving the conditions that impinge on our chosen industry.

Mario Vitale
CEO
Willis North America

Contents

The 2004 edition of *Marketplace Realities* addresses "Strategies for a Changing Marketplace". We offer perspectives and practical advice on how to deal with current conditions, new developments and emerging issues. We assess the future business, legal and economic environments – all in order to obtain maximum value for money spent on risk management and insurance.

In our foreword, we have identified market security concerns as being paramount. This overview expands on that theme and treats two other headline-worthy topics. We examine:

– **Marketplace Security** – The quality of the promise to pay.
– **"The Facts of Life"** – A novel look at a front-burner issue.
– **Eye on the Future** – Expectations for the insurance marketplace.

Marketplace Security

Insurer downgradings and failures undermine confidence in the institutions of the insurance industry and exacerbate concerns regarding the value of the insurance contract as an asset promising future indemnification.

In the "Reinsurance" article (page 10), we ask and answer the question: "What steps can a prudent reinsurance buyer take to improve the prospects of avoiding non-performing reinsurance?" Table 1 in the article lists reinsurance providers and their S&P ratings before 9/11, at year-end 2002 and as of November 18, 2003. The percentage of downgradings is daunting.

Rather than recite the names of failed and struggling insurers or reproduce additional tables showing how many downgrades there have been in the past year, we devote this space to an examination of what we do to stay ahead of the curve – to maintain active and proactive awareness of carrier financial and operational conditions.

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> In applying prudent standards, providing information and updates on carriers ...and in addressing post-downgrading options on a case-by-case basis, we provide maximum value for our clients.

Skill, Care and Diligence

Brokers do not act as guarantors of the solvency of carriers with which they place their clients' business, but brokers do have a duty to use reasonable skill, care and diligence in the placement of insurance – including attention to carrier solvency.

The Willis Market Security Committee is led by the Group CFO and is supported by a dedicated 25-person Market Security Department. We maintain independent decision-making and monitoring of 2,000 insurance and reinsurance carriers worldwide. Guidelines established by the Committee are mandatory for all Willis Client Advocates: they include minimum financial strength rating (A–, "excellent" or "strong" from a major rating agency) and a minimum level of policyholders' surplus (with the amount dependent on the class).

In monitoring carrier performance, we consider all rating options, gather other public information and provide the results of our research to clients to facilitate decision-making. We produce summaries of financial results for every carrier over a three-year period, with key ratios pre-calculated. The Department prepares factual summary reports on key carrier groups and global carriers, and (subject to copyright) we are able to share certain rating agency reports.

In the event of a downgrade, we evaluate client options for affected placements: no change; change at renewal; immediate replacement; modification (endorsements or assumption of liability clauses); and portfolio transfer. In applying prudent standards, providing information and updates on carriers – particularly those in distress – and in addressing post-downgrading options on a case-by-case basis, we provide maximum value for our clients.

"The Facts of Life"

One of our New York office Associates submitted the following vignette as an illuminating example of the effect that modern media can have in turning a singular event into a pervasive cultural phenomenon and element of everyday life:

The Facts of Life

It was a conversation I had been trying to avoid for months.

Sooner or later, I thought, the kids would hear about it, and maybe from a complete stranger. You couldn't avoid the topic anyway. It was all over the place. Television. Newspapers. Periodicals. The trade press. Editorials. It was close to being a societal obsession, and somehow I felt I just had to tell my children. One day, they would be on their own in the world, and they had to know what to do and how to do it.

And what not to do.

"Robin, Julia, Mark…" It was after dinner. We were all in a circle in the living room. Robin fidgeted with a matchbox car, while Julia teased a forelock. Mark was hugging his Big Bird doll for dear life. Apprehension hung heavy in the air.

"…There's something we must talk about," I began with due solemnity.

"Children, you need to know about Sarbanes-Oxley."

The Sarbanes-Oxley Act of 2002, H.R. 3763, enacted at the second session of the 107th Congress of the United States by a Senate vote of 97-0, has as its stated aim "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." The names of some of the Title sections alone speak volumes: Auditor Independence. Corporate Responsibility. Enhanced Financial Disclosures. Analyst Conflicts of Interest. Corporate and Criminal Fraud Accountability.

The daily newspaper *USA Today*, read by nearly 5.6 million people, has become a global journalistic phenomenon. On October 20, 2003, it made Sarbanes-Oxley its business cover story. Under the banner "Dragon or White Knight?", the article cited interviews with CEOs and provided indices of incremental costs associated with the law, drawn from a survey of 32 companies.

While the CEOs generally agreed that the law is required medicine for the ills it aims to cure, they point to compliance costs as being somewhere between significant and onerous. Some complained that they were uncertain of the degree to which certain tasks and processes needed to be changed.

The survey found that D&O insurance costs had increased an average of 94.2 percent since the passage of Sarbanes-Oxley. (We recognize, of course, that along with the impact of Sarbanes-Oxley, mounting D&O losses and class action litigation have been driving price and capacity in the D&O marketplace.) Accounting costs were up 105.3 percent. Compliance personnel costs rose 266.7 percent. Total compliance costs were up by over $1 million per respondent.

The bottom line? Guidelines, order, strictures and penalties have been delineated. Yet uncertainty regarding compliance efforts, costs and consequences remain.

H.R. 3763 has changed the worlds of business and insurance. The term "Sarbanes-Oxley" has, with lightning speed, metamorphosed from the title of a law to an icon of our times. Just as the name Keyser Soze in the film *The Usual Suspects* struck fear in the hearts of those who knew of him, the term "Sarbanes-Oxley" has become a sobering reference to a new era in the realm of corporate financial behavior. Many of the articles in this report describe the immediate and expected impact of the law on corporate life and on carrier expectations, underwriting and pricing.

Eye on the Future

Perhaps a more appropriate title for this section would be the plural "Eyes on the Future". In the articles contained in our report, each author or team of authors ventures into the uncharted territory of 366 tomorrows, the year 2004.

Up, Down or Sideways? – Some markets – particularly those such as first-party Property that often lead the way from hard to softening – have already begun the retreat from altitudes of pricing that left us breathless. Others remain hard: although capacity is not scarce, the cost of risk transfer has not receded and may even be climbing. D&O comes to mind. And though we've had a relatively tame year in natural catastrophe losses, capacity for Nat Cat risk is still quite expensive.

On the Balance Beam – The marketplace has been described as"tentative" or "precarious" – susceptible to strong adverse reaction given the right (or wrong) admixture of shock losses and negative economic developments.

Getting Married – Further consolidation is a virtual given, and with it, there is a likelihood of reduced capacity.

Vowels from Hell – E (Environmental) and A (Asbestos) related claims and litigation are still rising from seemingly fathomless depths.

Heal Thyself – Tort reform, a consummation devoutly to be wished, will require much in the way of time, money and persuasion.

The New Marketplace Mantra – Dozens of established insurers have effected changes at the top. They have ushered in a new class of seasoned professional financial executives – people who have a track record of making money and keeping it in the bank (which is one way of saying that the results are expected to stand up to loss development). The charge from the boardroom is to focus on shareholder value.

How are the new carrier management teams going to effect the changes necessary to improve the security of the marketplace? We addressed the topic in the Willis *Energy Market Review* (July 2003):

– In-depth *due diligence* in the underwriting process, needing to understand customers' businesses, exposures and interdependency risks.
– Focus on *aggregation risk* of quake, flood, windstorm and terrorism.
– Focus on challenging *"new-age" perils*: MTBE, mold, computer virus.
– *Eliminate cash flow underwriting*. Higher interest rates will not be allowed to undermine underwriting discipline.
– *Assure reserve adequacy.* Take the hit now, rather than later.
– *Increase net retentions as appropriate*. Retaining more risk can be more cost efficient and reduce counterparty risk.
– *Assure transparency and rectitude.* It's a different world out there.
– *Revisit investment practices.* More conservative investing seems to be the order of the day.
– *Enhance management information systems*. Better, faster data translates into quicker responses to negative trends affecting profitability.

The good news for our industry is that carriers and governance institutions are manifestly aware of industry needs and are dedicated to effecting fundamental, permanent changes in the conduct of the business.

We will meet here in one year to report on the future in retrospect.

"Times Have Changed"

– Reinsurers' approach to ceding companies has undergone fundamental change.
– The materiality of reinsurance recoverables has increased significantly.

In this article, we address how ceding companies and their intermediaries can more effectively discriminate among reinsurers to improve the prospect of future performance and continuity.

The Face of Change

Assessing the Quality of Reinsurance Security

We have witnessed numerous reinsurance company rating downgrades. We have heard announcements of charges for reserve increases due to prior years' adverse loss development. What is the impact of these changes on assessing the quality of reinsurance security? What steps can a prudent reinsurance buyer take to improve the prospects of avoiding non-performing reinsurance?

To help answer these questions, we will first quantify the dimensions and potential impact of the reinsurance collectibility issue. Equally important, we will comment on the fundamental changes in the way reinsurance is now transacted – changes that have a material impact on the extent to which reinsurer non-performance during the past two decades might be repeated in the future. As the reinsurance industry has evolved over the past 20 years, there have been several other intangible, subjective changes that will impact reinsurance buyers every bit as much, if not more, than the more objective, observable changes in reinsurer financials. We refer to these more subjective changes as reinsurer "bedside manner".

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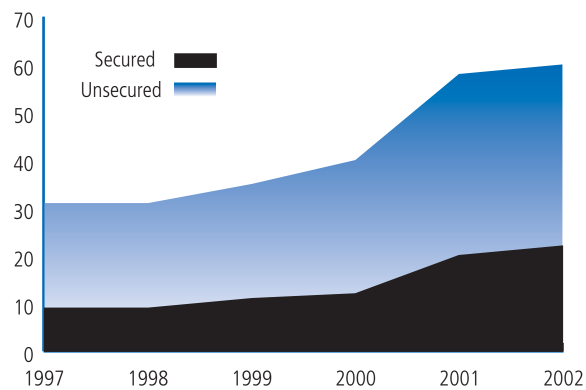
We will then proceed to outline some steps that ceding companies and their intermediaries can actively pursue to mitigate the prospect of reinsurer non-performance in the future.

Quantifying the Impact of Reinsurance Recoverables

Reinsurance recoverables have always been a material item for insurers, but the scope of the issue now commands the attention of rating agencies. Standard & Poor's vividly captured the essence of the issue in a graph (see below) that relates reinsurance recoverables as a percentage of several major insurers' policyholders surplus (PHS). On average in 2002, reinsurance recoverables represented 56 percent of their PHS. In some cases, the reinsurance recoverables were well above 80 percent. While there has been an increase in the percentage of reinsurance recoverables that is secured by collateral, the applicability of collateral tends to be primarily from "alien" (non-US) reinsurers, from whom US regulatory authorities have traditionally required Letters of Credit that enable ceding companies to take credit for the ceded reinsurance.

Dependence of US Insurers on Reinsurance (Recoverables as % of Surplus)



Collateralization Debate

As we go to press, the issue of ceding companies pushing for collateralization of reinsurance recoverables is a hot and potentially contentious topic. One can identify with large, well-rated insurers seeking to manage their counterparty credit risk posed by reinsurers whose ratings have been downgraded. Nonetheless, there is considerable variation in the financial strength of reinsurers, and a "one size fits all" approach may not be warranted. Ceding companies that pursue collateralization requirements will do so bearing in mind a reinsurer's financial strength, duration and extent of prior years' exposure, and the extent of long-tail exposures ceded to the reinsurer.

Assessing the Changes in Reinsurer Ratings

Just as insurers have been dealing with adverse loss development (with announced reserve changes that reveal significant differences between the gross and net impact), rating agencies have developed a heightened scrutiny of reinsurer reserve changes. Clearly, there is greater awareness of the volatility of exposures transferred to reinsurers, as the materiality of reinsurer performance is much more transparent today. Table 1 provides a summary of some of the more significant reinsurer rating changes following 9/11.

Table 1: S&P Rating Changes since 9/11

	Pre-9/11	2002 Yr End	2003 As of Nov. 18
Munich Re Group	AAA	AA+	A+
Swiss Re Group	AAA	AA+	AA
General Re	AAA	AAA	AAA
GE Global Holdings	AAA	AA-	A+
Chubb Corp.	AAA	AA+	AA
Allianz Re Group	AAA	AA	AA-
Hannover Re Group	AA+	AA	AA-
XL Re Group	AA	AA	AA
PartnerRe Group	AA	AA	AA-
AXA Re Group	AA	AA	AA-
Transatlantic Re Group	AA	AA	AA
SCOR Re Group	AA-	A, A-	BBB-
Gerling Global Re Group	AA-	BBB	Withdrawn
Everest Re Group	AA-	AA-	AA-
W.R. Berkley	A+	A+	A+
Lloyd's of London	A+	A	A
Converium Re Group	A+	A	A
Axis Re	NA	A	A
Odyssey Re Group	BBB+	A-	A-
CNA Corp.	A	A-	A-
PMA Capital	A	A-	BBB-
Endurance	NA	NA	A-
Montpelier Re	NA	NA	A-
ACE Tempest Re	A+	A+	A+
IPC Holdings	A+	A+	A+
Trenwick	A+	BB-	NR
Renaissance Re	A+	A+	A+
PXRE Reins.	A	A	A

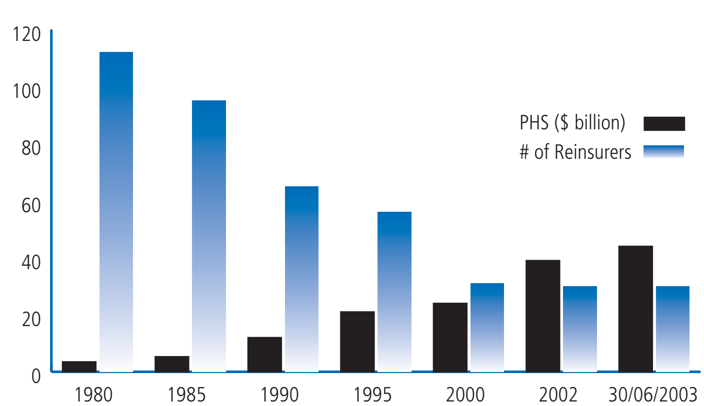
Fundamental Changes in the Reinsurance Industry over the Past Two Decades

We have seen the number of reinsurers in the US market drop from 112 in 1980 to 30 at June 2003. Interestingly, the aggregate PHS of these remaining companies has risen from $3.5 billion to $44.7 billion during the same time period. A partial explanation for this significant increase in reinsurer PHS was that foreign and domestic investors viewed the US reinsurance market as one of the more profitable sectors in the US insurance marketplace. Global players began to strategically invest in the reinsurance market, purchasing what in a number of instances appeared to be very healthy reinsurers at multiples of their net worth. Perhaps they never fully appreciated the effect that adverse loss reserve development might have on their initial investments.

The first wave of "flight to quality" in reinsurance relationships also occurred during this time frame. During the later part of the 1980s and early 1990s, a number of reinsurance buyers held the view that any reinsurer capitalized with less than $100 million in PHS couldn't offer the level of security needed to support larger company programs. In a number of cases, reinsurers may not have been fully aware of the underlying risk profile of the business they had underwritten, driving a number of highly leveraged, small reinsurers out of business. These legacy issues continue to haunt some of the longer-standing industry participants, with the impact varying according to their specific risk appetites and length of time in business.

With industry consolidation and the demise of a number of weakly capitalized reinsurers, new capital inflows from well-capitalized offshore reinsurers emerged, often offering capacity in selected markets that the established reinsurers viewed as less attractive. These new players carried a clean slate, devoid of legacy issues, often finding a market niche in shorter tail, catastrophic lines of business (which, with the absence of retrocessional protection, required a larger capital base to support the volatility assumed).

Number of Reinsurers Reporting Results to RAA



Clearly, with a smaller universe of reinsurers to choose from, it becomes all the more important for ceding company buyers to develop a more strategic marketing plan, which we will discuss in more detail later in this article.

Reinsurers Have Changed Their Approach

Professionalism Has Increased

As a positive byproduct of the influx of new capital into the reinsurance business, beginning in the early 1990s, the level of professionalism of reinsurance companies has increased considerably. The public scrutiny required in tapping financial markets has brought much more introspection as to the way reinsurance companies are managed. The impact can be seen in reinsurers' specialized expertise in diverse product lines, exposure management, and tendency to be gross line underwriters.

Expertise in More Diverse Product Lines: Whereas reinsurers in the 1980s typically wrote Property, Casualty, Marine and Aviation, today there is far greater recognition of the need to have dedicated underwriting expertise in the specific lines of business so that reinsurers can better match up with the increased specialization of primary insurers. This is manifested in specialized catastrophe units, working layer Casualty, Umbrella, Clash, Professional Liability, Surety, Workers' Compensation, Finite Risk, Accident and Health, and some other lines. While the increased level of specialization does not preclude the surprise of shock losses, the enhanced level of understanding certainly mitigates the prospect of totally unforeseen losses.

Increased Use of Exposure Management: The increased use of modeling to manage Property catastrophe, Workers' Compensation and terrorism exposures has led to far greater transparency of the more accumulative types of insurance exposures. Reinsurers, spurred on by rating agencies and capital providers, have secured much more detailed exposure data from ceding companies. That information, coupled with tighter underwriting terms, has created more certainty as to the range of potential shock losses inherent in reinsurer portfolios. Indeed some reinsurers now "roll up" their property aggregate accumulations every night so that as they enter each new day they can more accurately assess the impact of new submissions. They are able to understand more definitively their available capacity per zone and the relative cost of capital associated with the incremental catastrophe exposure in a given zone or zones.

Gross Line Underwriters: Whereas in the 1980s many reinsurers, direct and broker market alike, utilized extensive amounts of retrocessional protection for property and casualty exposures, transferring working level exposures as well as catastrophe exposures, today's reinsurers purchase relatively little, if any, retrocessional protection. For example, in the early 1980's it was not uncommon to arrange casualty retrocessional protection for a reinsurer, for say $750,000 excess of $250,000 per loss occurrence with several reinstatements, if not unlimited protection, with multiline "global" type catastrophe or clash protection applying above $1 million.

Though underlying casualty retrocessional protection appeared to be relatively inexpensive, the counterparty credit risk may ultimately prove to make such purchases very costly, as the level of reinsurer non-performance, or at least slow payment, will extract its price. The good news, going forward, is that today's reinsurers have sufficient capital and tighter underwriting controls so that, instead of purchasing significant retrocessional protection, many are utilizing risk management techniques focusing on portfolio optimization to achieve better spread of risk. There is still a role for retrocessional protection. The sophistication of the retrocessional market has increased considerably, with vastly improved reinsurer security providing retrocessional protection with focused territorial or product-specific coverage either on a traditional risk transfer, industry loss warranty, or finite basis.

Reinsurer "Bedside Manner": Changing Approach to Ceding Companies

With the increased influence of new capital providers and rating agencies, there have been some noticeable changes in what we refer to as reinsurer "bedside manner". Simply translated: reinsurers' approach to ceding companies has evolved to the point where *uberrimae fidae* (utmost good faith) may have given way to a focus on *utmost good underwriting information*. Without intending to pass judgment on the merits of sound business practices, one can point to some anecdotal examples of this shift.

As reinsurers' underwriting resolve has stiffened in the face of adverse loss development, the push to avoid surprises and to reduce the level of uncertainty regarding ceded exposures has manifested itself in an increased level of reinsurer audits, imposition of tighter sub-limits, or outright exclusions as reinsurers push to better quantify, if not influence, the original underwriting, or at least the basis of risk transfer.

Relationship or Commodity? Much has been said about how reinsurance is now a commodity rather than a relationship arrangement. One can argue that continuity of reinsurance support is hardly a certainty. And the concept of "follow the fortunes" is not universally embraced by reinsurers, particularly on non-proportional placements. Skeptics can point to reinsurers' focus on generating returns for their capital providers, which is a reality, but as we will discuss later, there are still ways for ceding companies to forge strategic relationships with reinsurers. Unlike the past, however, a somewhat greater diversity of reinsurance suppliers is necessary to provide better spread of the counterparty credit risk, and to mitigate the risk of non-continuity.

Reinsurance Marketing Strategies for the Future

To improve the prospect of reinsurer performance and continuity, Willis Re is encouraging clients to think strategically about the reinsurers with whom they place their programs today, next year and five years from now.

There are five areas that Willis Re is actively addressing with ceding company clients to better position them for the future:

– Increased qualitative information about reinsurers.
– Continuous monitoring of reinsurer willingness and ability to meet obligations.
– Transparency of the ceding company's underwriting information.
– Enhanced clarity of contract language.
– Development of a strategic reinsurance marketing plan.

Increased Qualitative Information about the Reinsurer: As rating agencies strive to improve their scrutiny of reinsurers, reliance upon rating agencies is no substitute for ceding companies and their intermediaries doing "their homework" by asking more probing questions about reinsurers. Willis Re is working to develop more qualitative information about reinsurers, addressing subjects not previously discussed, such as catastrophe management controls, asset quality, reinsurance recoverables (the extent of and the quality of collateralization), and change in loss reserves (with specific focus on asbestos and environmental loss reserves). Naturally, the extent of these questions will vary depending upon the reinsurer's time in the business and the volume of casualty, retrocession and multiline business underwritten from the reinsurer's inception of trading.

Monitoring Reinsurer Willingness To Pay: Since 9/11, the speed of reinsurer claims payments in general has been more uneven. Willis Re has been closely monitoring payments; not for just high-profile claims, but for all claims made to each reinsurer. As part of our semi-annual survey of reinsurers' performance, we evaluate each reinsurer based on:

– Timely approval
– Timely payment
– Payment method
– Cooperation
– Expertise

Transparency of Underwriting Information: To reduce a reinsurer's uncertainty, to improve pricing, and to ensure that the reinsurer fully understands the risks being transferred, the reinsurance intermediary generally needs to expand the quality of the underwriting information.

By developing expertise in several specific lines of business, and by promoting strong underwriting and actuarial skills, Willis Re has developed its broking staff's expertise so that input can be provided on a more technical basis. By using combined facultative and treaty broking personnel, Willis Re is better positioned to anticipate reinsurers' underwriting concerns so that more thorough exposure information is developed in our reinsurance submissions.

Clarity of Contract Language: To reduce the prospect of arbitration, Willis Re is working with its clients to create more explicit contract wordings. In an era of fewer reinsurance markets having greater leverage, it has never been more important to express clearly each party's intent to avoid falling back on the "follow the fortunes" spirit of reinsurance, as its influence may be waning.

Reinsurance (continued)

Strategic Marketing Plan

Our strategic marketing focus includes a number of factors, of which two key components are our program to educate and cultivate reinsurance markets for specific lines of business, and our Reinsurer Evaluation Survey.

Educating and Cultivating Markets: With the onset of more challenging reinsurance market conditions post 9/11, we have invested considerable time in educating reinsurance markets about the qualitative differences in our clients' underwriting processes. In diverse lines of business including Auto-Liability, Construction, Energy, Environmental Liability, Industrial Property and Workers' Compensation, Willis Re has developed educational forums in which we have worked closely with our clients to enhance reinsurers' understanding of what makes our clients' business plans different.

Reinsurer Performance: For several years, Willis Re has been conducting a survey of reinsurers' performance, semi-annually, after the two major renewal dates, January 1st and July 1st. Our survey is done electronically, canvassing Willis Re brokers throughout the US, ranking reinsurers on a scale of 1 to 5 (1 = poor, 5 = excellent). We evaluate reinsurers based on the seven underwriting categories:

– Capacity
– Commerciality
– Continuity
– Market Leadership
– Pricing
– Product range
– Responsiveness

In conducting our survey, we break down a reinsurer's performance by line of business (Property, Casualty, Professional Liability, Workers' Compensation, Life, Accident & Health, Healthcare, Marine, Aviation, Retrocession and Surety & Fidelity). We also assess the reinsurer on several criteria focusing on its performance in contract documentation and client services (claims payment and accounting responsiveness).

In an era of fewer reinsurance markets and therefore greater security risks, we believe that devoting more time to managing our reinsurance relationships gives us broader insights to guide our clients in the selection of appropriate reinsurance partners. The extent of feedback to and interaction with the senior management teams at reinsurance companies regarding our reinsurer surveys affords us and our clients a better view of the differences among reinsurers.

A Final Thought

Those ceding companies who recognize how reinsurance has changed are already moving swiftly to adapt their approach to selecting reinsurance partners. By working with their intermediaries, ceding companies can develop a well-designed marketing plan. While there is no perfect antidote for the perils of changing fortunes, there is much more ceding companies can do to mitigate the prospect of reinsurer non-performance. As insurers look to the future, while addressing reinsurer performance is certainly important, it is equally essential to look for ways to improve the prospect of reinsurer continuity, (i.e. renewing their support, not just paying claims that are contractually required). Ultimately, the ability to maintain continuity of reinsurer support will enhance ceding companies' ability to succeed – and not just survive – over the long term.

Headlines and Highlights

– Rate reductions should continue through 2004.
– Competition should also yield softening of terms and conditions, but likely only for select cases.
– Multi-year program options are returning.
– Terrorism coverage remains available, even for overseas hot spots.

2003 – The Market Cycle Shortens

One might have thought that the withdrawal of Kemper, the exit of AXA Corporate Risk Solutions and Royal & SunAlliance from the US market, and the downgradings of Atlantic Mutual and SCOR Re, among others, would have served to stabilize the Property market in 2003. *Au contraire*.

Beginning in the second quarter of 2003, we saw the Property market ease perceptibly for those accounts that had been the hardest hit over the previous two years – large national and multinational companies. This first took shape as a willingness to renew accounts at expiring rates and accelerated in the third quarter, bringing outright reductions in rate, some easing of terms and conditions, and profuse oversubscription of programs.

None of this was lost on markets looking at an account from the outside, with an eye toward getting a foot in the door. To unseat incumbents, their terms had to be better and delivered earlier. This was particularly true of some of the Bermuda start-ups that had held back in 2002, either taking "watching lines" or standing on the sidelines entirely so as not to be perceived as undermining underwriting discipline. They seemed to be concerned that if they didn't get on the train in 2003, it would likely leave them in the station in 2004.

But Bermuda companies were not the only factors contributing to the softening marketplace.

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Lloyd's once again found its feet and began to regain its historical prominence in the Property sector. Other markets increased their available capacity, among them XL Global Risk and Lexington, hoping to take advantage of strong financial ratings and of prevailing market rates before the rates descended further.

The past year also saw isolated instances of mid-term cancellation and policy rewrites by incumbent carriers looking to ward off otherwise inevitable competition at the normal renewal date. Some of those who could not quite see their way clear to taking this step offered their proposals 60 to 90 days prior to the renewal date in a similar effort to stay ahead of the competition.

Yet another important factor was the absence of major insured catastrophic events for the second year in a row, generating another year of acceptable pure underwriting loss ratios for commercial Property risks.

All of this, taken against a background of unmet premium budgets, stirred the pot to deliver a fourth quarter environment of hearty competition for Property business.

Will This Continue in 2004?

Although underwriting budgets may have been brought more in line with market realities in the past year, as of January 1, 2004 risk transfer capacity still outpaced demand. Those carriers who arranged increased treaty protection in July of 2003 will want to avail themselves of this increased capacity (their "raw material") at least until its normal expiration.

It is of course hard to say exactly how far rates will descend in 2004. Those accounts coming up for renewal in the first quarter should expect to see at least the same reductions their peers got in the latter half of 2003: 10 to 20 percent on average. We would expect to see a further 10 to 15 percent average rate reduction for later renewals, unless investment income improves substantially or a catastrophic event occurs. Taking a broader perspective, these reductions are still relatively small compared to the increases of the recent hard market. Many accounts will pay rates well in excess of their most recent historical lows. For most carriers, the reduced rate levels anticipated for 2004 should still prove profitable.

Property (continued)

What remains to be seen is the extent to which underwriters will begin chipping away at the discipline they have shown in managing terms and conditions. Will deductible wars break out? Will coverage be expanded? Will sublimits be increased?

Rather than an overall abandonment of underwriting discipline, we anticipate account-specific opportunities in these areas. In fact, we encourage our clients and prospects to continue to focus their attention on addressing those increases in deductibles or reductions in coverage that have been the most troublesome aspects of their programs over the last two to three years. We believe that underwriters, still working under management orders not to "give the store away" yet again, will be cautious, but they should respond favorably to an appropriate list of well-articulated arguments for reduced deductibles and additional coverage grants. Perhaps more than rate differentiation, these may become the criteria for ultimate carrier selection.

A Return of Multi-Year Programs?

We expect to see selected offerings of two- and three-year programs as underwriters try to retain or gain business. There are two divergent lines of thought on this:

– Why should a client or prospect be interested in this arrangement just when the market seems to be moderating? On the surface, this would seem to cater only to the underwriters' best interests.
– If such an offer is made with few opt-out provisions for underwriters, a client or prospect might view program stability over the next several years as having greater value than the potential savings that might be generated by a further downward swing in rates over the same period.

One size does not fit all when looking at this issue.

Terrorism in 2004

The further we distance ourselves, at least in calendar terms, from the events of September 11, 2001, the more time the traditional market has to mend itself and more consistently and reasonably provide terrorism coverage, particularly in the US and other developed countries. Regardless of such steady progress, TRIA coverage must continue to be made available by "eligible insurers" for all 2004 Property renewals, although this requirement will cease on December 31, 2004 unless the Department of Treasury extends the deadline. (While the government backstop for eligible insurers continues until December 31, 2005, the "make available" provision must be reviewed by Treasury to see if it is still necessary given prevailing market conditions.)

> Those accounts coming up for renewal in the first quarter should expect to see at least the same reductions their peers got in the latter half of 2003: 10 to 20 percent on average.

Even where traditional markets are unwilling or unable, given lack of treaty support, to provide terrorism coverage, the stand-alone market remains robust – and extremely profitable. Using this market in combination with the Overseas Private Investment Corporation (OPIC), we have been able to develop a number of attractive terrorism programs even in the most exposed territories of the world. We encourage those companies who have viewed themselves as "unexposed" to revisit the issue in 2004. Current pricing may prove incentive enough to buy the cover as "sleep insurance".

Headlines and Highlights

- Both Primary Casualty and Umbrella / Excess Casualty are beneficiaries of new capacity.
- Rate increases of the past few years are moderating, though attachment points are climbing.
- Carriers continue to look to tighten coverage, terms and conditions, especially in long-tail classes of business.
- Opportunities are arising for program enhancements and premium reductions for superior risks.

The Casualty marketplace is unprecedented in its complexity. While there are forces in place that continue to cause hardening of pricing, terms and conditions, there are also competitive forces providing ample capacity and serving to dampen rate increases. Increased capacity, however, is typically provided with higher attachment points and fewer broad coverage grants than in the past.

Capacity

Many of those forces impinging on the Casualty marketplace are well chronicled elsewhere in this report, with adverse loss development and plunging investment returns impacting almost all marketplace segments. Despite these macro factors, available capacity and market options continue to increase. Both Primary Casualty and Umbrella / Excess Casualty are the beneficiaries of relatively new Bermuda-based providers and the growth of capacity from established "legacy" carriers – to levels not seen since the first half of 2001.

Underwriting

Insurance buyers will continue to face increased underwriting scrutiny, particularly as respects Workers' Compensation, Commercial Auto, and – for certain classes of risk – General Liability (petroleum, chemical, auto manufacturing and pharmaceutical industries). Underwriters are drilling down to determine the extent of exposure to use of non-owned automobiles, concentration of employees, latent products liability, mold and MTBE.

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Competition – with Caveats

Another development providing some stabilization is simple competition. The sudden and dramatic change in rates that were imposed during Q4 2001 and most of 2002 had the effect of making many program placements highly profitable and extremely desirable risks in 2003. At the same time, however, we see a trend amongst carriers to maintain or increase attachment points (deductibles or retentions) and to boost aggregate stop-loss thresholds.

Discrete premium level reductions were achieved month-on-month in Q4 2003. Certain classes of risk that had renewed "flat" (in lay terms, essentially the same premium for same risk) on October 1 were garnering rate reductions one month later. On a selective basis, we expect to see reductions in specific premium levels as we progress through 2004.

Exclusions and Limitations

Exclusions for mold, sexual abuse, domestic terrorism, and cross-suits are common on many General Liability quotations, regardless of whether or not the insured is considered to be exposed to these perils or conditions.

For several long-tail classes of business such as chemicals, medical products and pharmaceuticals, carriers are no longer willing to offer ISO occurrence coverage as the basic policy form. Many of those insureds who had managed to maintain occurrence coverage were faced with making the migration to a claims-made or occurrences-reported form. While such a change may provide additional capacity and lower premiums than are found in the traditional occurrence market, past experience shows that premium savings tend to evaporate as successive claims-made policies are purchased while keeping the retroactive date constant.

Umbrella & Excess

Insureds will generally benefit from increased Umbrella & Excess capacity from maturing Bermuda-based insurers (including AWAC, Arch, Endurance and Max Re) and from a cautiously interested Lloyd's / London marketplace. Global

> Terms and conditions that were embellishments easily obtained in the 1990s, often without explicit additional premium charges, have been stripped away.

capacity may exceed $1.5 billion.

Lead umbrella carriers – and there are fewer of them – set the tone for the entire placement, as they have historically. Carriers that are perceived as offering preferred nesting places in the flight to quality are able to command a premium – an extra premium, that is – for their capacity. The number of members in the lead layer club has shrunk not strictly due to general marketplace conditions, but rather more because several marquee members became more risk-averse, having acquired other insurance companies that turned out to be managerial and financial drains.

Nevertheless, we are encouraged that ACE, Zurich and XL have "recommitted" themselves in 2003, and this should provide insurance buyers with more options in 2004. AIG will continue, of course, to be a major market force, and Arch will continue to strive for its market share of well-managed difficult risks.

Policy forms – In 2004 and beyond we see the market insisting on its tested forms:

- For the most difficult risks, Excess rather than Umbrella forms
- Use of XL 004 (which has become somewhat of a market standard), although there is some "push-back" on its integrated occurrence provisions
- London claims-made wording
- Selective acceptance of manuscript wording (by endorsement)

We do not expect these conditions to change anytime soon.

Terms and conditions that were embellishments easily obtained in the 1990s, often without explicit additional premium charges, have been stripped away. Coverage for Employment Practices Liability, Professional Liability, Named Perils Pollution or Product Recall is available – sublimited or stand-alone – for hard dollars.

For **certain classes of risk,** such as ethical pharmaceuticals, the marketplace is unable to offer capacity below the stratosphere. Attachment points of $250 million or more are not uncommon, and those carriers providing capacity to new insureds are offering integrated occurrence language with a retroactive date set at inception of the policy. Other challenging classes of risk (such as energy and petroleum companies) have experienced some market softening. A major oil and gas exploration company had no problem achieving its target attachment point and elected to take a higher one because of premium savings available in the marketplace.

Finally, **capacity is also a function of reinsurance** in two respects: the amount available, and the amount that the ceding carrier desires to cede. Insurers are generally retaining more risk and ceding to fewer, preferred reinsurers.

The Casualty Marketplace of 2004

Opportunities for program enhancements and premium reductions are at hand. Positive differentiation, always a vital component in minimizing cost of risk, is once again producing readily identifiable and substantial savings.

Headlines and Highlights

- Premium increases have produced marginal profitability.
- Declines in frequency have mitigated severity increases for lost-time claims, but will have a smaller impact going forward.
- Rising medical costs, driven by increased utilization, continue to drive loss costs higher.
- Funding obligations for reserve deficiencies will continue for many years.
- Insolvencies and withdrawals are concentrating 60% of market premiums in the hands of 15 carriers.

Workers' Compensation premiums continue to rise at a double-digit rate for the fourth year in a row. After rising 14% in 2000, 12% in 2001 and 18% in 2002, it appears that the increase in 2003 will fall in the range of 10 to 13 percent. These successive rate increases have returned Workers' Compensation to a position of marginal profitability (after investment income) in 2002 and 2003, following three years of large losses.

The calendar year combined ratio for an insurance carrier is determined by dividing all costs (losses, loss adjustment expenses, underwriting expenses and dividends) by earned premium. For all but one year of the past decade, the combined ratio exceeded 100%, and for the years 1999 through 2001, it exceeded 118%. Except in these three years, high investment returns allowed insurers to make a net profit. "Cash flow underwriting", however, has proven to be undependable. We estimate that the industry's combined ratio for Workers' Compensation will be in the vicinity of 108% for 2003.

Behind the Numbers

Frequency and Severity of Lost-Time Claims

One very positive development over the last decade has been an ongoing decrease in the frequency of lost-time claims.

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The cumulative change from 1990 through 2002 calculated by the National Council on Compensation Insurance (NCCI) is a decrease of 38 percent. Credit should be given to the safety and loss-control programs and return-to-work programs of many companies. The decrease in frequency of lost-time claims has served to offset a major portion of the increase in average indemnity for lost-time claims. Some increase in severity was to be expected, given that a large number of smaller indemnity claims have in effect been eliminated through risk management programs.

Any further reductions in the frequency of lost-time claims will be progressively smaller moving forward. Increases in average claims severity – which have been running in excess of seven percent per year over the last four years – will therefore have a greater net impact on loss costs and will likely result in pressure to increase premiums.

Severity – Average Medical Costs

The Medical Consumer Price Index (CPI) measures the percentage change in the cost of medical care for the public. The Medical Cost per Lost-Time Claim Index develops the same statistic for medical costs. In 1995, the gap between the two was less than one percent – Workers' Compensation-related medical costs had risen 5.1% while the Medical CPI rose 4.5%. In 2001, the gap was 6.1, and both indices had risen sharply – 10.7% for Workers' Compensation and 4.6% for the general public. For 2002, we estimate that both indices will rise again, and that the gap will have increased to a startling 7.3%.

The gap between the change in the Medical CPI and the change in medical cost per claim is attributed to "increased utilization" – injured workers, per capita, consume more medical services than do members of the general public. Included in increased utilization are such things as greater use of expensive diagnostics (CAT scans and MRIs), more expensive pharmaceuticals and, in certain states such as California, increased use of chiropractors and other specialists. For states in which the NCCI provides rate-making services, the estimated ultimate average medical cost per lost-time claim rose from $8,432 in 1994 to $15,315 in 2002 – a compounded increase of 7.7% per year over the past eight years. During the same period of time, the average ultimate medical cost in the state of California rose from $9,689 to $31,767 – a compounded rate of 16% per year.

US Workers' Compensation (continued)

The Burden of Underreserving

From 1997 through 2000 accident-year losses grew faster than the losses recognized on the calendar year financial statements of the insurance carriers, resulting in underreserving on the books of the insurance companies. Earlier in the 1990s, reserve deficiencies were offset by releases from redundant reserves from the prior decade. Those redundancies no longer exist to assist in funding the current reserve deficiencies. The NCCI estimates that the reserve deficiency for Workers' Compensation on the books of insurers peaked at $21 billion at the end of 2001. We estimate that the deficiency today is in the neighborhood of $14 billion.

Workers' Compensation carriers are therefore facing a bill for prior years' underreserving that will have to be paid off at a rate of approximately $2 billion per year for the next seven years – and that assumes that current year reserves are being set adequately. The implication is that six to seven percent of earned premium for each of the next seven years will be needed to cover costs associated with claims that occurred prior to 2003. A large portion of these reserve deficiencies no doubt resides on the books of insolvent insurance carriers. As such, they will have to be paid by guarantee funds, which in turn levy assessments against the viable insurance carriers. It is reasonable to assume that much of the burden of these assessments will ultimately fall on buyers of Workers' Compensation insurance.

The California Story: the Latest Chapter

As noted above, medical costs have skyrocketed in the State of California. There have been many carrier insolvencies, and national carriers have stopped writing new business and/or reduced their participation in the California Workers' Compensation market by not renewing accounts.

While the latest round of rate increases and cost cap measures may significantly narrow the gap in California, the Workers' Compensation Insurance Rating Bureau (WCIRB) estimated that the combined ratio for accident-year 2002 in California remained at 120 percent.

In 2002, the State Workers' Compensation Fund of California grew by 51% and wrote $5.5 billion of premium, which was more than 50% of the California premium and 12.7% of the Workers' Compensation premium in the US. The California State Fund in 2002 was the largest writer of Workers' Compensation in the US, almost 50% larger than Liberty Mutual. Solvency questions concerning the State Fund – as well as the California Insurance Guarantee Association – are headline issues.

> In the first half of 2004, most buyers of Workers' Compensation insurance will be facing rate increases in the range of eight to 12 percent.

Industry Concentration

In August 2003, A.M. Best listed the 15 top carriers that accounted for 59.4 percent of the Workers' Compensation marketplace. The top five – California State Fund, Liberty Mutual, AIG, Zurich/Farmers and Travelers – accounted for 37.3 percent. Kemper, number eight on the list, is gone, and Royal & SunAlliance, number nine, has announced its withdrawal from underwriting US commercial Casualty business. The "new" list of top 15 carriers for 2003 will account for at least 60% and perhaps as much as 63% of the total market.

While such concentration may bring short-term pricing stability to the Workers' Compensation market, these same carriers will have to shoulder the burden of the industry's reserve deficiencies – whether those deficiencies reside on their own books or in the form of surcharges from state guarantee funds. If one or more of the top writers of Workers' Compensation were to exit the market, it is questionable whether the remaining carriers would be willing or able to assume the additional business.

Premium Forecast

In the first half of 2004, most buyers of Workers' Compensation insurance will be facing rate increases in the range of eight to 12 percent. As the year progresses, competition will increase for preferred risks. Companies that are able to demonstrate positive differentiation in the quality of operations management, risk management, loss control and claims management will begin to enjoy the benefits of such competition.

Headlines and Highlights

– Exorbitant price increases of the past two years are easing, but no soft market lies ahead.
– Underwriters are still putting up strong resistance to coverage extensions and negotiations are long and difficult.
– Losses and claims in the billion-dollar-plus range are becoming more common.
– Recent SEC action points to closer enforcement of punitive rules.

Is the Landscape Green Yet?

Last year at renewal time, many clients faced exorbitant price increases coupled with evaporating policy terms, rising retentions and reduction in limits of liability. This punitive atmosphere was the direct result of a well-documented string of corporate debacles and financial restatements against a backdrop of under-priced underwriting portfolios. We believe that the 2004 D&O underwriting landscape will eventually show signs of restoration, a return to at least a pale shade of green. We point to two main factors: first, new capacity is entering the marketplace, unburdened by past claims. Second, there are many well-run, large market capitalization companies out there, and they are desirable risks in any marketplace.

"Risk differentiation" is the catch phrase of the day for clients and brokers alike, as individual account underwriting is expected to yield some favorable opportunities in 2004. Some if not most accounts can also anticipate benefiting from good old-fashioned marketplace competition.

Relative Stability for Premiums

Primary premium levels continued to increase in 2003. For most, this followed record increases the previous year, even for firms whose risk components reflected solid financial performance, stable stock trading levels and sound corporate governance. Placing coverage was an exhaustive exercise for all involved. Carrier competition, in essence, was dead.

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Average D&O Changes in 2002-2003
(RIMS Benchmark Survey)

Premium Rates	Retentions
+206%	+223%

Conditions began to change in the second half of 2003 as more usable capital became available on a primary as well as an excess basis. We believe that in 2004 the D&O marketplace will stabilize to the point where rates will rise by 20 percent to 35 percent in most cases, and in some cases not at all.

Anticipated 2004 D&O Average Rate Increases

Risk	Rate Increase
Low Risk	Flat – ↓
Medium Risk	Flat – 20+%
Stable High	25% – 50+%
Volatile High	75% – 100%

An examination of the current claims inventories held by D&O insurers, however, would likely reveal that losses are still outstripping earned premiums in spite of rate increases that began in 2000. The current softening in D&O pricing may therefore end before it brings any sustainable price reductions.

For companies with more active claims histories and financial challenges and for those in high-risk industries (i.e., high technology, energy, telecommunications, financial services, healthcare and pharmaceuticals) increases of 75 percent to 100 percent should be expected in 2004. If there are no losses for these companies and if the economy recovers, rate increases might ease into the 25 to 50 percent range, depending upon program structures, i.e., retention levels, coinsurance features and the percentage of pre-set allocation.

Excess Pricing – Reflecting Signs of Flexibility

Although pricing rates on excess programs have not returned to the 50 percent levels of years past, improvement should be coming. The 90 to 95 percent price ranges of the last year are slowly giving way to levels of 75 to 85 percent, although those in the more volatile risk industry groups may continue to see the higher excess pricing ratios of the past year.

Directors & Officers (continued)

Though not seen as widely as in the recent past, the "peek-up provision" is still used selectively by some markets. This allows excess carriers to review their layer's pricing after reviewing the rates of excess layers above them. However, with more and more capacity being freely available for all risk classes, this provision may not be as prevalent in 2004 as it was last year.

Capacity – Some New, Some Old and Some Gone

The marketplace last year saw capacity constrictions followed by expansion. Capacity was temporarily restricted by the withdrawal of some prominent insurance carriers such as Allianz, Kemper and Royal Insurance. This void was quickly filled by the Bermuda capital markets and the formation of new D&O insurers, including: Quanta (staffed by experienced former CNA underwriters) and Darwin (headed by ERMA's former CEO Stephen Sills). The combination of fresh capital and experienced leadership, we believe, will help create a more competitive underwriting climate.

In 2003, we witnessed a major expansion in the purchase of A-side coverage. We expect this trend to continue in 2004 as more and more companies provide added protection for their directors and officers. The A-side policies historically offered by the Bermuda markets are now offered in the domestic markets as well. Not all A-side policies are alike and careful review of the contracts is required in order to ensure that breadth of coverage is achieved.

On the merger and acquisition front, St. Paul's $16 billion acquisition of Travelers Property & Casualty, announced 4Q 2003, will precipitate some shrinkage in capacity on layers where both companies participate. It is premature, however, to comment on the impact this merger will have on Travelers' subsidiary company, Gulf Insurance. Despite this announcement and the continued limits management being implemented by various underwriters, there is no shortage of D&O capacity today, given the $1.5+ billion available. More mergers and acquisitions are expected in the coming year, complicating the efforts of buyers seeking long-term stable partner markets as they negotiate strategic placement of the layers in their D&O programs.

The table below depicts a sampling of the current D&O Liability marketplace. Capacity is abundant from both domestic and international carriers.

Domestic Companies	International Companies
Arch USA	Arch Capital (Bermuda)
ACE USA	ACE (Bermuda)
Axis Capital	Endurance (Bermuda)
XL USA	Allied World Assurance Company (Bermuda)
Great American	XL (Bermuda)
**Gulf	Starr Excess (Bermuda)
Chubb	Max Re (Bermuda)
Houston Casualty	*Quanta
Hartford	Swiss Re
National Union	* Lloyd's of London
RLI	
Zurich American	
CNA	
Navigators	
*Darwin	
**Travelers	

*Sources of new capacity in 2003
**Merger pending

Underwriting Struggles

While premium levels are clearly – if slowly – easing, negotiating policy terms and conditions is anything but easy. Even the most basic of all extension requests are being granted only after exhaustive negotiations. We attribute this action to underwriters pooling risks and their reluctance to acknowledge risk differentiators. As a result, clients are struggling over standards for personal conduct exclusions, claims triggers and timing, preset allocations for SEC claims, six-figure retention levels for publicly-traded companies and the evaporation of foreign extensions.

Most bothersome of all has been the widespread restrictions placed on severability as to the application for essentially all classes and accounts regardless of their risk quality. We believe that 2004 will bring a major push-back from clients across the board, particularly as to the narrowing of severability provisions and tightening of personal conduct exclusions.

Treaty Restriction Struggle

Over the last year, underwriters increasingly sought treaty exceptions in order to participate on certain risk classes that were otherwise prohibited by their reinsurance agreements. Today, some markets are still unable to write certain classes of business without restrictive policy terms – or under any conditions at all. This is especially prevalent with companies seeking to write Fiduciary Liability insurance on accounts where they participate on the D&O program. Some treaties require massive separate retentions for employer securities claims on Fiduciary Liability programs. Certain classes of business, such as financial institutions, are simply precluded from some carriers' portfolios.

On a more positive note, the October 1 treaty renewal date brought some enhanced capacity to various carriers such as ACE USA (whose limits were bumped up from $15 million to $25 million) and Max Re (a Bermuda D&O and EPL insurer whose levels also increased from $15 million to $25 million).

One Year After Sarbanes-Oxley

During the first half of 2003, 158 financial restatements were announced by publicly traded US companies, with a total of 354 companies restating during the 12-month period ending June 30, 2003. This would seem to confirm the fears of D&O underwriters, who worry that while positive steps are being taken as a result of the new focus on corporate governance, financial transparency and accountability, more troubling revelations still lie ahead.

Casual observers reading newspaper headlines might assume that restatements occur only at Fortune 500 companies. Statistics provided by the Huron Consulting Group indicate that for the 12-month period ending June 30, 2003, 44 percent of the companies that restated their financials had less than $100 million in revenues.

The continued trend of more restatements and fewer public companies has startled a few industry watchers who had predicted a leveling off of this ratio. Since 1999, the number of public registrants fell from 10,500 to under 9,000, but restatements rose steadily from approximately 200 to 375.

Size Counts: Billions and Billions and Billions

Until recently, the numbers associated with D&O claims or settlements rarely hit 10 figures. A review of recent events shows that this is no longer true.

– $1.4 billion settlement between the SEC, the New York State Attorney General and 10 investment banks
– $2.25 billion penalty assessed by the SEC and approved by the bankruptcy court against WorldCom
– $1.3 billion settlement by JP Morgan to end certain litigation over its involvement with Enron
– $4.5 billion after taxes – the amount by which Freddie Mac may have understated profits
– $1 billion industry settlement between the issuing companies, investors and D&O carriers on "laddering claims" (but watch for a looming, multibillion dollar settlement with the associated investment banks)
– $1 billion – the amount that a private company, National Century Financial Enterprises, Inc. (NCFE), and its executives may have defrauded investors, according to the SEC
– $1.4+ billion alleged overstatement of earnings by HealthSouth Corp. and its executives
– $19.4 billion assets held by Mirant Corporation at the time of its bankruptcy
– $5 billion+ sought from hundreds of banks in connection with the Adelphia Communications bankruptcy

…losses are still outstripping earned premiums in spite of rate increases that began in 2000. The current softening in D&O pricing may therefore end before it brings any sustainable price reductions.

Widening Impact of Financial Institutions

US financial institutions have been among the hardest hit in terms of D&O and E&O claims and this trouble seems to be spreading. International market watchdogs are now undertaking or concluding their own investigations into financial analysts and mutual funds. Not only can losses be anticipated, but some of them are likely to fall on the foreign operations of those same US D&O/E&O underwriters who already paid these claims.

Some "Good" News for Carriers

Times are tough when a $1 billion partial settlement of the so-called "laddering claims" is referred to as "good" news. These claims involve some 300 companies that went public through initial public offerings (IPOs) from 1998 through 2000 and allegations that the stocks' offering prices were artificially inflated. The settlement limits the liability of the companies, their directors and officers and their D&O insurance carriers. This is indeed good news if industry intelligence calculates correctly that these claims were reserved for an aggregate of $1.5 billion. In any case, there is no doubt that this cash outflow will have a significant impact on the major D&O underwriters. Claims and settlements of this magnitude can only serve to harden market conditions. It will also serve to focus the plaintiffs' energies (and the carriers' further resources) on the investment bankers involved in the IPOs.

Looking Forward: Legal and Regulatory Issues To Watch

– Heightened corporate governance standards are coming on line for companies listed on the New York Stock Exchange.
– Expect the unexpected as the SEC continues to work on its long-range goal of moving from a rules-based to a principles-based accounting approach as required under Sarbanes-Oxley (SOX). The SEC says that "neither US GAAP nor international accounting standards, as currently comprised, are representative of the optimum type of principles-based standards."
– The SEC settled its first action under Section 302 of SOX in which a CEO and CFO certified their company's financial statements before their accountants had signed off on them, only to later determine that the statements contained material classification errors.
– The first million-dollar fine was assessed against a corporate officer for speaking out of turn to certain investor representatives in violation of Regulation FD on financial disclosures, signaling that the SEC's patience is at an end and a new era has begun.
– The principle of loss causation is being debated in the courts. Loss causation refers to the need to prove a direct link between the loss in value and wrongful conduct; that is not something that defendants, and their D&O carriers, want to see thrown out. If it is lost, then the heightened pleading standards of the Private Securities Litigation Reform Act will have been weakened.
– Attorney-client and work-product privileges are being tested.

Headlines and Highlights

- Widespread underfunding of pension plans means continued hardening of the market.
- High-risk pension plans are facing higher retentions and exclusions in addition to higher premiums.
- Cash-balance conversions and high proportion of employer securities in employee plans are red flags for carriers.
- ERISA suits specifically targeting corporate executives as pension fiduciaries are increasing in number.
- Mutual fund investigations affect pension plans that invest heavily in such funds.

If the Fiduciary corner of the financial world was ever a quiet, out-of-the-way place, it is no longer. People are talking about pension plans, and most of the news is not good. Pension plan financial performance is now a board-level issue at 90 percent of major global companies, according to a recent survey of Fortune 1000 chief financial officers. Approximately 75 percent of US CFOs reported that their companies' pension plans are now underfunded. It is not only the biggest companies that are feeling the pinch.

According to another survey, pension funding obligations are taking a large toll on the corporate balance sheets of mid-sized firms; 22 percent of mid-sized companies said that increased pension obligations are forcing them to reduce their capital expenditures; 32 percent said they are planning to change business plans in response to their growing pension requirements. In total, 68 percent of respondents said pension funding obligations have had a negative impact upon their corporate financial statements; one quarter reported cash flow problems as a result.

What does this mean for the Fiduciary Liability market? The hard market is continuing, and to some extent accelerating, as Fiduciary Liability insurance underwriters scan a landscape filled with large recent settlements and adverse judgments and see no immediate improvement in sight.

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Premiums and Rate on Line

While there has been some leveling out in pricing for Directors and Officers (D&O) Liability insurance, the same cannot be said for Fiduciary Liability insurance. In fact, just as the D&O market began to ease, the Fiduciary Liability market began to further constrict. The average rate on line (cost per million dollars of coverage) has gone up for the third straight year; the trend began to accelerate sharply at mid-year 2003 renewals.

Average Fiduciary Changes In 2002-2003 (RIMS Benchmark Survey)

Premium Rates	Retentions
+137%	+500%

For most Fiduciary renewals in 2004, we expect a continuation if not an acceleration of the hard market. This spells pricing increases in the range of 20 to 75 percent for most companies.

Willis Anticipated 2004 Fiduciary Rate Changes

Risk	Rate Increase
Low Risk	Flat
Medium Risk	Flat – 20+%
Stable-High	35% – 75+%
Volatile-High	75% – 100+%

The forces driving the market are continued pension funding deficits, recent adverse decisions regarding cash-balance plans, and the uniform sense that employer securities-related lawsuits based on the Employee Retirement Income Security Act (ERISA) are not a passing fad. As a result, fresh capital has not entered the market and existing markets may be reluctant to use their available capacity.

In comparing D&O and Fiduciary Liability markets, it must be acknowledged that, historically, rates have been much lower for Fiduciary cover. While today's percentage increases are high, Fiduciary rates in many cases are still catching up to D&O rates. In fact, it is likely that prices will have to climb considerably to entice new capacity and bring some competition to the marketplace.

Carriers / Capacity

In the past, most major primary D&O carriers could be counted on to extend terms on Fiduciary Liability insurance, but many are now reluctant, especially for what they view as high-risk accounts.

For large public companies, the core group that actively writes primary Fiduciary Liability insurance includes AIG/National Union, Federal/Chubb, Hartford and, to a lesser degree, Zurich. The Bermuda and London markets show very limited interest. ACE, Arch, ELU and others do become involved in excess placement, but they divide limits carefully between D&O and Fiduciary accounts. Mid- to small-size companies can look for additional primary or excess participation from Great American, Liberty Mutual, St. Paul / Travelers and others.

Six Signs of High Fiduciary Liability Exposure

1. Substantial plan underfunding
2. Cash-balance plan conversion intended or undertaken
3. Significant portion of employer securities in employee benefit plans (> 10% of plan assets or $1 billion)
4. Substantial reduction in benefits
5. Extensive corporate M&A activity and possible plan mergers/termination
6. Poor corporate financial performance and/or corporate reorganization

Terms and Conditions

When employer securities are a key component of an employee benefit plan, underwriters are seeking more information. Where carriers perceive a heightened exposure and are still willing to write the risk, insureds can expect:

– Higher retentions (closer to D&O levels than those historically found on Fiduciary Liability policies)
– A common claims tie-in-of-limits provision with the D&O policy (if the carrier writes both coverages)
– Higher premiums
– An (occasional) exclusion for claims relating to or arising from employer securities

When plans are involved in cash-balance conversions, the treatment is similar. Carriers that do not decline the risk outright are seeking higher premiums, exclusions and retentions. Where there is a significant amount or percentage of company stock in pension plans and/or a cash-balance plan conversion is involved, carrier declinations are almost the rule rather than the exception.

Other red flags for carriers are plan mergers, terminations or spin-offs. At least one carrier is restricting its automatic run-off coverage for sold or terminated plans.

Are there any coverage extensions to be found in Fiduciary Liability insurance? A few. Some carriers have introduced express Health Insurance Portability and Accountability Act (HIPAA) coverage and at least one (Travelers) is occasionally willing to cover some of the associated penalties. Some would argue that HIPAA claims regarding employee benefits would automatically be covered under most Fiduciary policies; others find the express coverage desirable.

Another enhancement becoming available is an order of payments provision. The order of payments issue surfaced in the Enron case, when it was found that such a provision was included in D&O but not Fiduciary policies. Primary carriers are now including the appropriate language – one (AIG) has made the modification mandatory – on Fiduciary Liability policies.

Decreased Plan Funding = Increased Likelihood of Fiduciary Liability

ERISA does **not** require plans to be fully funded at all times. US pension plans can be, and usually are, underfunded without a breach of fiduciary responsibility. But serious or unexpected plan underfunding is of concern to company creditors, rating agencies, plan participants, pension regulators and, course, insurance carriers. Underfunding may be a sign of broadening trouble at a company, and carriers are leery because some of the most contentious ERISA litigation today is being heard in corporate bankruptcy hearings. In cases where pensions are well funded, fiduciaries are much less exposed: even if they are found to have made terrible decisions regarding management of a fund, they often pay nothing in damages if the fund remains strong.

Today, fully funded pensions are the exception and over-funded plans are rare. The number of companies in the S&P 500 with underfunded pensions at the end of 2003 was put at 340. Meanwhile, according to Credit Suisse, pension expenses for these companies are expected to skyrocket, rising from $4 billion in 2002 to $37 billion in 2005. Two-thirds of US companies have underfunded pensions, with higher concentrations in the steel, airline and auto industries.

The problem is not limited to North America: in a recent Greenwich Associates survey, 60 percent of European pension fund officials said their funds were technically insolvent.

Questionable Funding Methods

Another cause for carrier concern is the unusual ways plans are sometimes funded. A major steel company applied its timber rights to its plan; some companies contribute their own shares or those of their subsidiary. While these methods are approved by government agencies, Fiduciary Liability carriers see the potential for future increased ERISA fiduciary exposure.

A Future for ERISA Employer Security Suits

The increasing number of Fiduciary Liability suits involving employer securities proves that these claims are not a short-term aberration. These cases began to appear two to three years ago as "copycat" suits. Plaintiffs in D&O cases involving securities saw that they could sue, and possibly win, by filing separately under ERISA. Settlements in those cases fell to Fiduciary Liability carriers.

2003 Fiduciary Liability Settlements (Employer Securities)

Defendant	Settlement	Settlement Cash Value
Computer Associates	5.7 million shares	Valued at $51.5 M
IKON	$56.5 M	None Fiduciary Insurer Bankrupt
Lucent	$68 M	$45.75 M (remaining to be cash or stock or combo)
Providian	$8.6 M	$8.6 M
Rite Aid	$67.8 M	$10.8 M
United Companies Financial Corp	$10 M	$10 M
Totals:	**$210.9 M**	**$126.6 M**

Fiduciary Litigation: Cash-Balance Conversions

In late 2003, courts handed down two significant decisions that appeared to broaden company exposures in cash-balance conversions of pension funds. (See Willis' *Executive Risk Newsletter* of November 2003 for a more in-depth discussion). Especially troubling to carriers was the IBM decision, currently on appeal, which may have serious ramifications for a broad range of plans and plan sponsors.

Little action to reverse this trend is likely any time soon from legislatures or regulatory bodies. The Treasury Department proposed cash-balance plan regulations in December 2002 clarifying that the basic cash-balance design does not violate age discrimination, but these are unlikely to be implemented in 2004. Instead, according to Janice Gregory, Vice President of the ERISA Industry Committee in Washington, DC, "Employers face another year of regulatory chaos and an increased and intensified exposure to litigation."

Cash-balance litigation hurts Fiduciary carriers through enormous defense costs, plaintiff legal fees, possible back interest charges and other ancillary losses. Total costs on any one claim can reach tens of millions of dollars – an amount likely to exhaust several if not all available layers of Fiduciary Liability insurance for any given company.

Mutual Fund Spillover?

Recent front-page investigations into mutual fund management have affected the Fiduciary Liability market due to the widespread investment by pensions in mutual funds. Several large public pension funds have withdrawn from specific mutual funds altogether; but there is no promise that the next mutual fund the plans select will be immune from problems in the future. Fiduciaries clearly have a responsibility to be vigilant regarding involvement in mutual funds and Fiduciary Liability underwriters are watching this situation as closely as the plan sponsors themselves.

Pension Disclosures

Management transparency is coming to pension plans sponsors; requirements for financial disclosure are likely to increase significantly in 2004. In annual statements, fiduciaries will likely to need to divulge:

– The percentage of plan assets held in major asset categories (stocks, bonds, real estate, etc.)
– Target allocation percentages for plan assets
– Expected long-term rate of return on assets.

The Financial Accounting Standards Board recently released rules for quarterly disclosures concerning the impact pension plans will have on earnings statements. Investors are pleased because companies previously made such disclosures on a yearly basis. The new reports will detail how pension plan decisions affect line items on company income statements. With new disclosure responsibilities will come yet more potential for increased liability.

Employment Practices

Highlights and Headlines

– The market remains stable, and premium increases remain moderate.
– Retentions are rising in the face of growing claims.
– The success rate of single-plaintiff suits is climbing, as are the damages.
– Whistleblowing appears to be on the rise, and with it comes suits alleging unfair retaliation against the whistleblowers.

Carriers, Capacity and Pricing

After significant retraction in 2002 and early 2003, carrier support and capacity in the Employment Practices Liability (EPL) market is stabilizing. Recent entrants include Max Re and Endurance in Bermuda. Despite available capacity, however, few carriers are pressuring their underwriters to write new business, and the benefits of rate competition are not yet with us. Premiums are likely to rise, but increases will be modest compared to the large jumps of the past three years. Those premium hikes seem to have brought carrier income in line with claim costs – hence the relative stability in the market today. We expect average premium increases will range from 15 to 35 percent for stand-alone EPL insurance.

Pricing by Sector

Small-to medium-size privately held companies traditionally purchase their EPL coverage in combination with Directors & Officers (D&O) coverage. They can expect slight rate increases in the coming year – up to 15 percent. Some will see no increases at all.

2004 EPL Expected Rate Changes

Privately Held	Flat to 15%+
Nonprofit	20% to 35%+
Public (Small / Medium)	15% to 35%+
Public (Large / High Risk)	20% to 50%+

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Nonprofit organizations, especially in the healthcare field, can still expect premium increases in the range of 20 to 35 percent as frequency and severity of claims continue to outpace inflation. These buyers also typically purchase EPL coverage in combination with their D&O, but losses have counteracted the moderating effect of the joint coverage.

For publicly traded companies, carriers are pushing to eliminate shared risk policies where EPL coverage is bundled with one or more Executive Risk lines (D&O, Fiduciary, E&O and Fidelity). Charging separate premiums results in a net income gain for carriers. Those buyers seeking to maintain or create combined programs will generally first have to obtain monoline quotations and then negotiate reduced premium levels for shared limits. This is likely to involve considerably more expense than most expiring combo programs. Buyers may also face difficulties in finding carriers willing to write all desired lines of coverage. As a means of managing their limits across their Executive Risk portfolios, a number of carriers are reluctant to write all coverages for a given account, at least not on a primary basis or at a low excess attachment point (below $50 million, for example).

Terms and Conditions

While rate on line (price per million in coverage) is stabilizing, retentions are still rising, especially for employers of more than 1,000 employees. This is a direct response to the climbing costs of mass or class action litigation. Companies with more than 10,000 employees have been and will continue to be especially hard hit.

Some Executive Risk lines, namely D&O, have seen carriers impose sophisticated cost-shifting methods such as co-insurance or eliminating coverage for the company / entity and introducing pre-determined allocation. EPL has been untouched so far by this trend, but some companies have sought these arrangements as means to contain premium and / or retention increases, or to retain or expand control over defense or flexibility in policy notice provisions.

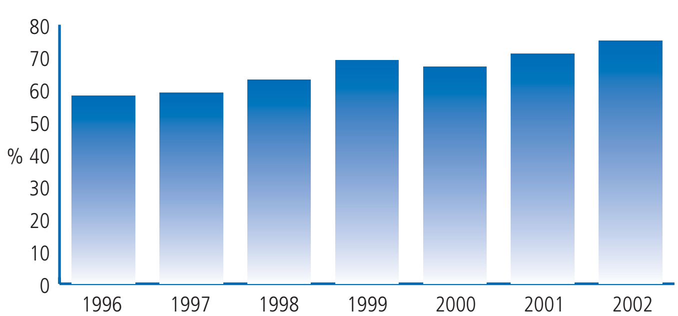
Claims continue to be a major focal point of negotiations: how they are defined, when they occur, when the carriers must be given notice, who controls them, and who defends them. For example, a number of carriers want to narrow the time period during which notice of a claim must be presented and to exert increased if not exclusive control over the selection of defense counsel. Insurance buyers, alternatively, wish to maintain if not expand their control over their claims. This is one of the main reasons Bermuda carriers, who have traditionally allowed more flexibility in this area, continue to be preferred by US buyers. Chubb, once known for its flexible claims policies, has tightened up in this area on all of its Executive Risk coverages, including EPL.

A new coverage limitation that may be relevant for global organizations in 2004 is an exclusion for claims brought under the US Alien Tort Claims Act. This essentially allows non-US nationals to utilize the US court system for claims originating abroad when the defendant is a US national or US company. Most commonly, EPL claims brought by non-US nationals involve alleged violations of international human rights laws. One major carrier has warned that this exclusion will be coming in 2004.

Employees Continue Winning Streak

For the third straight year, employees continue to win an increasing number of single-plaintiff cases. According to recent Jury Verdict Research data, employees are winning an all-time high of 75 percent of all cases going to final adjudication.

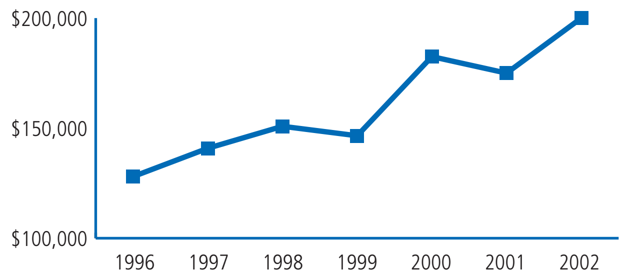
Plaintiff Recovery Probability for Employment Practice Liability Overall (1996–2002)



Source: Employment Practice Liability: Jury Award Trends and Statistics 2003 Edition

Not only are employees winning more single-plaintiff cases, they are also winning more money. The size of the average award won in single-plaintiff EPL actions has also reached new heights, as shown in the chart below.

EPL Compensatory Award Medians



Source: Employment Practice Liability: Jury Award Trends and Statistics 2003 Edition

The only news carriers and buyers may find more distressing is the progress in class action suits, where severity (as measured by size of class and outcomes) continues to break new ground.

Significant Class Actions

2003 Significant EPL Class Action Developments

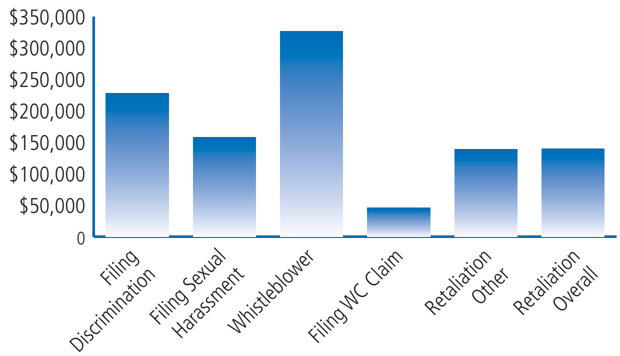
Company	Allegation	Development	Magnitude
Allstate Group	Age discrimination	EEOC determines violation occurred	6,400 agents
Boeing	Gender discrimination	Class certification granted	4,800 women/ $50 M
California Public Employee's Retirement System	Age discrimination	Settled	$250 M
Canadian public service workers	Equal pay adjustments	Settlement	100,000 women/ CA$414 M
McDonnell Douglas	Age bias	Partial settlement	$36 M
Sodexho Marriott Services	Glass ceiling/ gender bias	US Supreme Court permits class status	2,600 women
Sunoco	Race discrimination	Class certification granted	300-500 professionals
Wal-Mart	Glass ceiling/ gender bias	Pending class certification	1.5 million women

The formation, certification and announced settlement of a number of significant class EPL actions in 2003 helped set the trend for continued increases in retentions and tightening of terms in 2004. Virtually all of the noteworthy cases implicated coverage by more than one carrier as layers today rarely meet or exceed $25 million from any one carrier. The chart above surveys some of the leading cases.

Employment Practices (continued)

Whistleblowers and Retaliation Suits

Median Awards for Single-Plaintiff Retaliation Cases (1996-2002)



Source: Employment Practice Liability: Jury Award Trends and Statistics 2003 Edition

In 2003 we saw the first wave of whistleblower cases under the Sarbanes-Oxley Act (SOX) as well as more cases in the fertile area of retaliation. A total of 131 public-company employees have reported violations under SOX's whistleblower provisions. Sixty allegations have been investigated so far, and 50 of these, or 83%, have been withdrawn or dismissed. (In the future, this percentage is likely to drop as the initial crop of cases included some ineligibles, such as allegations of wrongdoing that began prior to the effective date of SOX or that don't fall under the securities code). As seen in the chart above, whistleblower cases consistently yield higher payouts than other EPL suits. The only offsetting factor is the extreme unlikelihood that these cases will evolve into class actions.

The social value of whistleblowers has led to statutory protections for them across the globe. The Canadians, the Dutch, the British and the Americans (via SOX), to name but a few, have all issued guidelines supporting the whistleblowing process.

Since the passage of SOX, there is evidence that more US employees are becoming comfortable with blowing the whistle. The Network Inc. reported that only 48 percent of callers asked for anonymity when calling ethics hotlines, down from an average of 75 percent over the previous two decades. Changing perceptions of ethics in the workplace may be part of this trend as well. According to a 2003 business ethics survey conducted by the Society for Human Resource Management (SHRM) and the Ethics Resource Center, nearly a quarter of the 462 HR respondents said they felt pressured to compromise ethics standards all the time, fairly often, or periodically, compared with just 13 percent in 1997. Nearly half said that ethical conduct is not rewarded in business today.

> Not only are employees winning more single-plaintiff cases, they are also winning more money.

Some notable recent whistleblower cases include:

– An ex-controller of a major car rental company won $4 million in compensatory damages when courts agreed that he was fired because he would not commit illegal acts pertaining to a planned initial public offering by the company.

– A former senior manager at an accounting firm alleges that he was fired because he failed to sign off on illegal tax shelters sold to a client; this case is ongoing.

– A soft drink company agreed to pay $540,000 to a former finance manager who sued for wrongful termination following his accusation that his employer rigged certain marketing tests to inflate the popularity of a new product.

– A pending wrongful termination suit against a Fortune 100 company involves an individual who pointed out accounting and financial reporting errors as part of an SEC suit against the company; the SEC suit ended in a $10 million fine against the company and roughly $20 million in fines against certain executives who were charged with fraud.

– A major state university system paid $989,000 to settle a case brought by a former employee who claimed she was mistreated and forced to quit after she uncovered billing abuses; this settlement followed a $930,000 settlement with another whistleblower who was fired after uncovering financial abuse in one of the university's labs.

Headlines and Highlights

- As losses mount and Fidelity underwriters struggle for profitability, markets will remain hard.
- Capacity is stable, although the St. Paul / Travelers merger will likely reduce the number of markets.
- Price increases will moderate in 2004; the 20 to 50 percent prices hikes of 2003 will give way to increases in the 10 to 30 percent range.
- Coverage may be harder to find for international exposures and risks related to the property of the client of an insured.

A winning formula that will improve loss ratios for the majority of Fidelity markets remains elusive, with most underwriters still looking to find the right balance of pricing, deductible and breadth of coverage that will return the product line to profitability. Although the industry's 2003 numbers will not be released until early in the second quarter of 2004, we know that large losses continued to plague the Fidelity marketplace in 2003. As a result, most insureds should expect continued premium increases and a focus on deductible adequacy in 2004.

Loss Ratios

Although pricing and deductibles have continued to increase for the past three years, results between 2001 and 2002 worsened for most of the top 10 Fidelity markets, as evidenced in the results posted by the Surety Association of America (see below). When reviewing these figures, it is important to note that the loss ratios are "net" and, as a result, do not include the insurers' expenses, which average 25 to 35 percent of written premium. Combined loss ratios for 2002 therefore show that the majority of leading Fidelity underwriters were either unprofitable or marginally profitable at best.

Lastly, the 2002 numbers demonstrate that seven of the top 10 Fidelity insurers' results worsened rather than improved, in spite of the increases in pricing and deductibles obtained in the 2000 and 2001 policy years. Until loss ratios improve, it would be unreasonable to expect a softening of the Fidelity market.

Capacity

On a positive note, capacity remains stable. None of the leading Fidelity carriers withdrew from the market in 2003 and one new insurer, Quanta, recently announced its entry.

Top 10 Writers of Fidelity Bonds – Preliminary

Source: The Surety Association of America

	Group/Company Name	Countrywide Calendar Year 2002 Direct Premiums Written ($)	Direct Loss Ratio	Net Premiums Earned ($)	Net Loss Ratio	Countrywide Calendar Year 2001 Direct Premiums Written ($)	Direct Loss Ratio	Net Premiums Earned ($)	Net Loss Ratio
1.	Chubb Group of Insurance Companies	204,930,976	41.7	190,276,523	41.3	155,759,163	57.6	154,274,322	54.6
2.	American International Group	184,364,875	108.0	189,302,354	104.5	154,354,253	89.3	158,398,404	64.3
3.	Travelers Property Casualty Corporation	137,322,581	53.9	100,002,495	49.7	121,283,852	28.4	94,261,911	25.3
4.	Cumis Insurance Society, Inc.	113,292,657	72.5	105,980,639	73.8	112,650,203	69.7	107,842,607	70.8
5.	Zurich Group	103,788,010	42.6	55,743,208	44.1	69,116,965	86.1	52,658,693	62.8
6.	CNA Insurance Companies	66,315,283	13.6	51,562,546	57.4	58,915,905	87.1	42,389,405	41.3
7.	The Hartford Insurance Group	47,958,242	38.7	44,065,388	21.7	46,693,938	49.2	42,034,509	57.2
8.	The St. Paul Companies	40,357,837	61.4	57,033,849	101.9	46,156,335	57.9	42,886,477	52.7
9.	Great American Insurance Companies	29,221,187	27.0	19,603,313	29.7	17,454,020	13.1	11,221,582	11.5
10.	Liberty Mutual Group	19,370,215	150.5	3,194,911	536.2	10,438,535	53.3	8,815,499	57.8

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Fidelity (continued)

The merger of St. Paul and Travelers, however, may adversely affect Fidelity market capacity, as St. Paul, Travelers and Gulf (owned by Travelers) are included in the top 10 fidelity markets. It is likely that two, if not three, of these companies will merge their operations, resulting in the loss of one or two Fidelity Bond markets.

Fidelity Bond Capacity

Insurer	2002 Capacity (US $)
ACE USE	15 M
Chubb Group	25 M
CNA	15 M
Fidelity & Deposit	25 M
Great American	25 M
Gulf Insurance	25 M
Hartford	25 M
Liberty Mutual	10 M
Lloyd's of London	130 M
National Union	50 M
RLI	25 M
St. Paul Group	30 M
Travelers	25 M
Zurich-American	25 M
Total	**470 M**

The capacity outlined above is not representative of the limits insurers actually provide to many insureds. A better indication of capacity is as follows:

– Insurers are far more likely to offer a $25 million limit to an existing client for whom they have already provided their full capacity. New accounts or existing accounts looking to increase their limits beyond $15 million will likely require more than one market to participate in the placement.
– Fortune 500 accounts and large financial institutions will find only five or six of the top Fidelity markets willing to lead their bond programs. The remaining insurers will look to provide capacity on an excess basis only.
– Capacity is limited to $15 million for most new lines.

Pricing

The majority of insureds experienced premium increases of 20 to 50 percent during the 2003 year. For some buyers, price increases were offset by the application of large deductibles and / or the use of coinsurance. Insureds can expect Fidelity premiums to continue to rise during the 2004 calendar year, albeit not as sharply. Only the return to profitability by the leading Fidelity markets will allow pricing to flatten. Finally, as noted above, assuming the St. Paul / Travelers merger is ultimately approved by shareholders and regulators, there will be less competition within the market.

Insureds can expect Fidelity premiums to continue to rise during the 2004 calendar year, albeit not as sharply. Only the return to profitability by the leading Fidelity markets will allow pricing to flatten.

Claims Experience

Both the commercial and financial institution industries have contributed significant losses to the Fidelity Bond market.

On the commercial front, vendor fraud continues to be the most frequent cause of loss. The majority of vendor fraud losses involve an insured employee either colluding with an actual vendor or creating a fictitious vendor and submitting invoices for goods or services that were never provided.

For financial institutions, underwriters have experienced a spate of losses caused by non-employee registered representatives. The inability of an insured institution to control non-employee registered representatives makes the coverage difficult to underwrite.

In the case of commercial entities or global financial institutions, US Fidelity underwriters find the greatest number of claims emanate from non-US locations. Cultural and logistical barriers require a strong effort on the part of insureds to carefully monitor global operations.

The numerous CEO fraud scandals publicized recently are being carefully monitored by senior Fidelity underwriters, particularly those alleging theft of corporate assets. The size and nature of some of the allegations have raised the bar as respects the potential for catastrophic Fidelity Bond losses.

Coverage Issues

Carriers continue to underwrite global operations and vendor controls carefully, but coverage remains available. Some Fidelity markets will no longer cover entities that have a large number of international locations, resulting in more limited capacity for these buyers.

> Those insureds that provide services for a fee or have access to their clients' property are often covered for such exposures by a modified standard bond form.

Another area of coverage being more carefully scrutinized by the Fidelity market relates to insureds that have exposures related to their client's property. Those insureds that provide services for a fee or have access to their clients' property are often covered for such exposures by a modified standard bond form. Several leading bond underwriters now look to write this exposure with a sublimit of liability or will not offer the coverage at all. Other leading underwriters have modified the ownership provision in the bond to specifically exclude the exposure, thereby obligating insureds to purchase a separate client property insuring agreement.

Outlook for 2004

Underwriters will continue to drill down on exposures relating to global operations and vendor services.

Premium increases may range from 10 to 30 percent. Depending on individual program characteristics, increased deductibles and / or coinsurance may mitigate such increases.

St. Paul's (pending) acquisition of the Travelers Insurance Company may result in the loss of Fidelity market capacity, but the market's ability to complete the overwhelming majority of Fidelity Bond programs should not be affected.

Surety

Headlines and Highlights

– Increasing concentration and reduced capital / capacity are expected to prolong the hard market through 2004.
– Loss development continues to plague Surety industry performance.
– Co-surety arrangements, percentage bonds and other structural tools will be required for those needing large program limits.
– Setting strategies and goals far in advance will, as ever, pay dividends.

An Unsettled Environment

Those buyers and users of Surety credit looking for a return to a relaxed environment have longer to wait. Managers of Surety capital and reinsurers still concerned about the industry's disappointing results may not yet have seen the worst. In short, the Surety marketplace will remain unsettled well into 2004. Conditions may very well worsen and could do so very quickly.

Today's circumstances require strategic preparation on the part of contractors and commercial buyers of Surety bonds. For those hoping to find a silver lining, it may be possible to convert such turmoil into a competitive advantage.

Capacity and Pricing

For large contractors and corporations seeking large Surety programs (above an aggregate total of $200 million), capacity remains the single most important issue. The Surety industry's 2002 results, while marginally better than those of the prior year, reflected losses equaling roughly $1.30 for every dollar of premium. Surety reinsurers fared even worse and have now experienced five consecutive years of losses in the Surety line.

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Early indications for the first half of 2003 showed a loss position of between $1.10 and $1.20 for every dollar of premium written, virtually assuring that Surety reinsurers' results for 2003 would remain in the red. While loss frequency leveled off as the second half of 2003 moved forward, loss severity remained an issue. In addition, loss development of prior year claims was significant – indicating that the industry's very poor results in 2000 and 2001 were actually worse than initially posted.

In the past three years, sureties have incurred well over $6 billion in losses – an amount higher than the total losses of the prior 13 years. Underwriters and Surety reinsurers remain very wary of additional losses that may result from the impact of the global economic slowdown on certain Large Contractor and Commercial Surety programs.

While overall industry performance remains poor, some of the major sureties enjoyed good results in 2002. In 2002, a number of sureties again raised the overall rates on their books of business, but at lower percentages than they had the prior two years. We do not anticipate across the board rate increases to continue in 2004. Some sureties, however, have begun implementing surcharges for capacity, extended warranty obligations, and other risk-specific considerations – such as long-term contracts (e.g., those with durations beyond 24 months).

Despite these rate increases and capacity restrictions, pricing levels still have not yet proven widely attractive to new Surety reinsurance capital. Large buyers of Surety credit or those that have experienced poor financial results can therefore expect the cost of available Surety credit to continue to rise and involve additional security or collateral.

A tempering factor on inflation of the overall rate level is significant competition for middle-market contractors' business (defined as those with work programs between $20 million and $200 million). Competition is being driven by the cost of reinsurance and the changes in some major sureties' business models. The middle-market sector has also seen an influx of competition from regional sureties who have benefited from a migration of Surety reinsurance away from national writers. Even these contractors, however, will experience some increased underwriting scrutiny and requirements for information. Due to the nature of Surety and the inability of Surety underwriters to employ a variety of risk attachment points, we expect Surety providers to pursue sustained profitability through underwriting discipline. Broadly speaking, premium growth will be increasingly dependent on increased economic activity rather than rate increases.

Access to Capital

Access to capital remains the issue for surety managers. Unfortunately, the capital base from which they draw declined again in 2002. According to the Insurance Services Office, Inc., the US Property and Casualty industry's statutory surplus now sits 14.7 percent below year-end 1999's level, despite a record $17.3 billion of new capital raised by insurers in 2002. The competition for capital has changed a fundamental consideration in how reinsurers view the Surety line of business. In the past, capacity was allocated based primarily on the prior loss experience and underwriting practices of the Surety underwriter. Since the Surety losses of 2001, reinsurers have viewed the line in terms of the exposure and the potential dollar loss any single risk might generate, regardless of a surety's underwriting track record.

This exposure-based modeling has the potential to impose even greater demands for capital to support the same level of written premium. It has also increased reinsurers' scrutiny of individual accounts within a surety's book of business, and it has precipitated the withdrawal of support for certain types of surety bonds. Primary examples of this are Commercial Surety obligations for financial guarantees (such as self-insured, deductible or retro bonds), a curtailing of the support for international Surety business, and a withdrawal of capacity for Subdivision Surety.

There remain only four Surety writers that will entertain aggregate work programs of $500 million for contractors and, at these levels, a co-surety partner(s) is preferred. Many contractors with work programs of $100 million or more would be well served by a co-surety structure.

Reinsurance and New Capital

Surety Reinsurance

For Surety reinsurers, the management of the aggregate exposure for any single account remains a very high priority. (The credit quality of risks is, for now, a secondary consideration.) Aggregate exposure considerations will continue to affect the ability of sureties and their clients to obtain capacity for large Surety programs or large single bonds. Percentage bonds are becoming increasingly common for very large construction contracts.

…we expect Surety providers to pursue sustained profitability through underwriting discipline. Broadly speaking, premium growth will be increasingly dependent on increased economic activity rather than rate increases.

The number of professional reinsurers active in the industry currently stands at around a dozen. Of these, three have curtailed their support for national Surety writers in general, and their participation on large buyers' programs in particular. Some others are new participants whose long-term commitment to the industry is unproven.

Overall, Surety reinsurance rate levels are now between 50 and 100 percent higher than they were three years ago, but Surety reinsurers may find further gross rate increases difficult to implement. Rates alone, however, do not reflect the full cost of reinsurance to Surety underwriters. Some sureties are being forced to retain substantially more of each risk they write (potentially creating capital exposure issues of their own) and repay reinsurers for past-year losses on an accelerated basis (putting sustained pressure on the surety's own return on capital demands). Some sureties are now faced with the prospect of reinsurance costs equaling or exceeding premiums received for the reinsured capacity. For any business, such a cost structure is not a sustainable model and could result in the withdrawal of some primary writers of Surety in 2004 or 2005.

New Capital

During 2003, there were indications of new Surety capital putting a toe in the water. Arch entered the business by retaining Kemper's Surety team. Berkshire Hathaway established a shared reinsurance facility with AIG to support Large Contractor programs with capacity of up to $600 million. In the second half of the year, a newly capitalized underwriter, Quanta, announced the formation of a Commercial Surety team.

While encouraging, these actions do not indicate any near-term softening of the underwriting environment. Such initiatives may represent impatient capital that, in a search for acceptable returns, will be employed opportunistically in underserved markets, and with discipline. The AIG facility, according to its press release, is predicated on Surety pricing "at rates and under terms that realistically reflect the business and credit risks."

Although less prominent, another major factor affecting Surety industry capacity is the financial ratings of sureties, their parent groups and reinsurers. During 2002 and 2003, a number of major insurance groups and some reinsurers were confronted with changes to their debt or financial strength ratings. Downgradings affect companies' ability to write business, as clients and surety obligees are more closely scrutinizing the financial resources behind the paper. Also impacted are these companies' ability to raise capital needed to sustain the business – and the cost of that capital. Certain sureties are employing strict financial rating criteria as a condition for accepting co-surety partners or for participating on certain joint venture obligations.

An increasingly high-profile issue for clients in 2004 and 2005 will be the financial conditions of Surety companies and their parent companies. Rating agencies that have come under criticism in recent years will be more diligent in examining the adequacy of loss reserves insurers have established and the valuation of the insurers' investment portfolios.

Underwriting 2004

Sureties have been increasing security requirements. A number of underwriters now incorporate security interest provisions in their General Agreements of Indemnity and require that their security package be on par with a client's lenders. The requirement for personal indemnity is on the rise. Users of Surety credit that are prepared to work with their Surety underwriters as they would with investors or lenders will find a more receptive audience, but the terms of support today cannot be taken for granted as the basis of support in the future.

Surety industry capacity, as noted above, is in effect being rationed. Those clients who provide clear, comprehensive, concise and thorough reporting of their performance are more likely to receive attention and support. For large contractors and buyers of Commercial Surety credit, it will remain a sellers' market for the time being.

The Outlook: Consolidation

Today's Surety marketplace conditions will continue, we believe, into late 2004. Some analysts expect to see a softening of the broad commercial insurance market in early 2005, indications of which are evident in some insurance pricing today. Where Surety is concerned, it is clear the primary driver of capacity today (and the terms and conditions under which it is offered) is the nature of exposures present in a client's Surety program. This fundamental shift in emphasis, along with capital / capacity limitations, explains why the Surety marketplace will likely remain constricted beyond the inception of the softening of the general insurance market.

We anticipate further consolidation will also act as a curb on the Surety industry's ability to expand capacity. Over the past four years, the list of the dozen largest sureties has seen five name changes. In that time, the market share of business written by the top dozen has increased from 63.1 percent to 71.3 percent.

We expect that the capital demands of the industry, driven by the requirements for increased retention of risk at the primary Surety level, will force further economies of scale. The quality and frequency of underwriting information will remain a key to clients' success in retaining the support of surety partners. Proactive communication, roll-up-the-sleeves preparation, comprehensive analysis and full disclosure are the keys to unlocking capacity and minimizing the cost of Surety risk.

Headlines and Highlights

– As anticipated, the market softened in 2003, with ample capacity...
– ...but individual risk attributes – exposures and loss records – still drive the renewal process.
– The impact of the Homeland Security Act was felt in 2003, as airlines cancelled commercial war risk coverage in favor of federal programs, and providers of anti-terrorism products and services began to deal with the mandates and protections of the SAFETY Act.

2004 Global Aviation Market Capacity

During the past year, increases and decreases in capacity have been somewhat offsetting. Market shifts brought lower capacity in Lloyd's and in Germany, and higher capacity in the US, London, France and the rest of the world.

The table below provides indications of potential global Aviation Liability insurance capacity. Potential program support is listed, by carrier, as a percentage of theoretical program limits – $1.5 billion for Airlines liability and $1 billion for Aircraft Products liability.

Markets Based on Limits of $1.5B for Airlines & $1B for Products

Region	Market	Airlines (%)	Products (%)
US	AIG	12.50	15.00
	USAIG	15.00	25.00
	XL	6.00	7.50
		33.50	**47.50**
US & London	Global Aerospace	**17.50**	**20.00**
Lloyd's of London	ACE Global Markets	8.00	10.00
	Amlin	5.00	7.50
	Catlin	2.00	2.00
	Faraday	4.00	4.00
	Generali	1.00	2.50
	Markel	2.50	1.00
	St. Paul	2.50	Nil
	Wellington	5.00	12.50
		30.00	**39.50**
London	Allianz	15.00	15.00
	Wurttembergische	1.50	2.00
		16.50	**17.00**
France	AXA	5.00	5.00
	La Reunion Aerienne	10.00	10.00
		15.00	**15.00**
Germany	Frankona	10.00	10.00
	Munich Re	10.00	10.00
		20.00	**20.00**
Rest of the World	AXIS – Bermuda	5.00	5.00
	Converium – Switzerland	3.50	3.50
	Inter Hannover – Sweden	5.00	5.00
	Partner Re – Switzerland	3.50	2.50
	Swiss Re – Switzerland	5.00	5.00
	Tokio Marine & Fire	1.50	1.00
		23.50	**22.00**

Market Sectors

Airlines

A year ago, we saw signs that the Airlines market was beginning to soften. This proved to be the case in 2003 – so much so, in fact, that capital providers began exhorting underwriters to hold firm at expiring terms in an effort to stop any further decline in overall premium income. This was particularly true with the approach of Q4, when approximately 75 percent of the world's airlines renewed their policies. As of this writing, some Q4 renewals of major US carriers showed reductions, but underwriters have been adamant that differentials (e.g., variance from lead terms) are to be minimal. Renewal underwriting, of course, is not a one-way street. Individual airline exposures and loss records drives the renewal process at least as much as underwriter intention.

Products

In early 2003, underwriters realized 10 to 30 percent price increases on already sharply increased post-9/11 premiums. Undercutting these increases was possible only for those able to clearly demonstrate a significant decrease in exposure base. During the second half of the year, conditions eased. While far from a soft market, increases are less steep. Accounts with static exposures and limits and a decent loss record are now renewing much closer to expiring prices. Capacity levels remain high. Selective underwriting and account differentiation remain the market's focus, especially given the long tail on aviation industry exposures.

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General Aviation

The market has stabilized. There have been no significant changes in capacity and no new entrants during 2003. Competition for Industrial Aid risks with good loss experience is as intense as ever and has kept premiums flat. In the case of the most desirable fleets, we have seen small reductions and even coverage enhancements. For commercial operators, there is less capacity available. They are experiencing flat renewals or marginal increases. Loss history remains critical for this class of business. Some operators with unfavorable loss records are adopting higher deductibles in an effort to defray increased premiums costs. High limits of liability continue to be expensive. Pilot training remains a critical factor in differentiating risks.

Legislation

SAFETY Act

As a part of the Homeland Security Act (HSA) of 2002, the US Congress enacted certain broad liability protections for providers of anti-terrorism products, services, systems and technologies. These sections of the HSA are referred to as the "Support Anti-terrorism by Fostering Effective Technologies Act of 2002" or the SAFETY Act. The purpose of the SAFETY Act is to ensure that the threat of potential liability claims and suits does not deter the private sector's development and deployment of technologies that could save lives. The SAFETY Act is separate and distinct from the Terrorism Risk Insurance Act (TRIA).

The SAFETY Act provides broad liability protections, limitations and affirmative defenses for "qualified" providers of anti-terrorism products and services. In order for the liability protections under the Act to apply, both the provider and the specific anti-terrorism technology must be pre-qualified by the Department of Homeland Security (DHS) through an application process. Providers include designers, manufacturers or distributors – any entity involved with the sale, maintenance, modification or actual use of the technology.

The legislation was designed to work in combination with commercial liability insurance. Applicants are in fact required to buy policies that cover terrorist acts from the time the qualified technology is deployed. The minimum amount and scope of the insurance required by the DHS is based on multiple factors such as cost, the nature of the technology involved and the applicant's role in that technology. The individual applicant's liability "cap" equals the limit of terrorist insurance required by the DHS.

> Accounts with static exposures and limits and a decent loss record are now renewing much closer to expiring prices.

We will be keeping a close eye on the insurance and risk management issues that are likely to arise as the industry enters the implementation and qualification phase of the SAFETY Act.

FAA War Risk Insurance

FAA War Risk Insurance (a/k/a Chapter 443), which was amended by the Homeland Security Act to provide first-dollar coverage for third-party and passenger liability, hull and spare parts insurance, was finalized in February of 2003. As a result, most US airlines cancelled their commercial war risks insurance and entered the federal program. (For some smaller airlines and some non-passenger fleets, the economic benefits did not warrant the switch.) Additional legislation has extended this program to at least August of 2004, with the option to further extend until December 31, 2004. The policies are reviewed every 60 days by the FAA. This is another area of public-private intersection we will be monitoring for our clients.

Headlines and Highlights

– The Construction market is complicated by the confusing variety of products offered by different markets and by the coverage issues surrounding the contractor-subcontractor relationship.
– In several lines of coverage, carriers are tightening terms and conditions.
– Several hot-button coverage issues – mold, construction defect, and Workers' Compensation – work to counteract the general softening of the marketplace.
– New capacity and capital is available, most notably in the umbrella / excess area.
– Loss history will be watched closely by underwriters.
– Industry consolidation continues and will have a significant impact on alternatives.

Lack of Uniformity in Coverage

Construction insurance is characterized by each carrier having its own menu of coverage offerings. This can be frustrating for contractors – for anyone – as it can be quite difficult to compare and assess coverage differences. The situation is further complicated by the relationship of contractors and subcontractors. Subcontracting agreements often require subcontractors to obtain specific coverages, but there is no guarantee that the coverage will be available from a given carrier, or that other carriers will be willing or able to provide comparable policies.

Several lines of coverage present their own complexities.

General Liability

– Additional Insured provisions that follow the contract term can be problematic. Many carriers are reluctant to grant coverage to an additional insured party for completed operations exposure without substantial underwriting. There is often an additional premium charge.
– Insurance on a primary basis for the additional insured party can likewise be contentious. Carriers want to maintain the right to have the additional insured's policy share in settlements where liability is shared.
– Grants of waivers of subrogation were nearly universal several years ago. Many carriers are pushing back on yielding subrogation rights.
– Mold is almost universally excluded now. There are opportunities to buy this coverage back via pollution coverage, but not all pollution underwriters are willing to provide it.

Property: Builder's Risk and Contractor's Equipment

This line of coverage was most unpredictable over the past two years. Limits were substantially decreased, mold coverage disappeared, and long-standing carriers withdrew as new ones entered. Coverage concerns include:

– Carrier ability to grant adequate soft-cost limits.
– Stricter underwriting of values of equipment and property in the course of construction.
– Lower sublimits for perils such as earthquake, flood and windstorm in coastal areas.
– Unwillingness to include waivers of subrogation against architects and engineers – an issue that can be substantial. Design errors resulting in damage to the work are often very expensive, and underwriters want to have the ability to subrogate.

Umbrella Liability

During the course of the long soft market, umbrella and excess policies were frequently expanded to include degrees of coverage for professional liability, environmental liability and other exposures more typically insured through stand-alone policies. Such extensions of coverage are for the most part no longer available in umbrella placements.

Umbrella liability coverage is even less standardized than general liability coverage; it is therefore essential that alternative umbrella forms be closely scrutinized. Critical coverages that typically do not follow the primary policy include subsidence, mold, EIFS, defect, wrap-up follow form and professional liability.

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Carrier Appetites and Hot Buttons

Although the general insurance marketplace is stabilizing for certain lines, the cost of insurance for contractors will continue to reflect loss experience, safety programs and the nature of the work performed. Those contractors doing residential or other habitational work will be closely underwritten, with fewer carriers willing to entertain the risk. For those operations that face such challenges in the marketplace, group captives, self insurance and other alternative funding methods will continue to be important.

Increased deductibles, higher rates and coverage restrictions are all being employed by carriers to address insureds whose experience and operations are more troubling. Territories where carriers are being particularly cautious include New York, Illinois, California, Texas and Nevada.

Although there are fewer competing markets, carriers are still quite interested in wrap-ups. Increasingly, they seek to provide loss-responsive (as opposed to guaranteed cost) programs.

Several hot-button issues, some mentioned above, tend to figure prominently in the underwriting process:

– **Mold:** The industry is moving toward defining mold as a pollutant and providing coverage through environmental placements. Limits are beginning to increase, and $5 million-plus limits are available, subject to demonstration of effective water intrusion plans.

– **Construction Defect:** The exposure has been a huge concern for insurers as losses continue to develop. Carriers are carefully underwriting firms with any history of habitational work. Exclusions for prior property damages are becoming standard for most carriers, and the issue has caused significant diminishment of coverage and lack of appetite for insuring residential contracting firms.

– **Workers' Compensation in certain states:** Rate adequacy is an ever-present issue. The NCCI is predicting a need for major reserve increases as loss trends are outstripping rate increases. (We refer the reader to Greg Alff's article on Workers' Compensation.)

Capacity, Carrier Financial Strength, New Capital and Reinsurance

New capital and capacity has had some direct, positive effect on the availability and pricing of insurance for Construction risk, most notably in the umbrella / excess area. Although primary casualty lines should also feel the impact of the new capacity as more carriers enter the Construction marketplace, the merger of St. Paul and Travelers will have a dampening effect.

Reinsurance requirements and restrictions have had an impact on coverages and limits offered by front-line carriers. Extensions of coverage for contractor re-work and professional liability in general liability policies have become much harder to obtain. Another impact of reinsurance can be seen in the push by many excess liability markets for higher limits on primary policies. One example is automobile liability, where demands for $2 million underlying limits have become commonplace.

Going Forward

Many recent reserve increases affecting the industry at large have been attributable to construction-related issues, including those mentioned above. As difficult markets evolve and stabilize, we expect contractors to see a variety of alternatives for addressing risk. Coverages will remain tight for an extended period as underwriters are being charged with identifying long-term liabilities and containing them wherever possible. This will speed the rise of alternative risk funding mechanisms; we have already seen pronounced interest in taking risks "in house", aggressively managing them contractually, and being more involved with the key drivers of cost of risk. This approach will continue to be the best way to lower costs and protect assets over time for construction entities and projects.

A frequent question our clients pose is, "How long will marketplace conditions persist?" The answer depends on the context of the question. From a pricing standpoint, the market is stabilizing and competition is returning in several areas. From the standpoint of breadth of coverage, however, the market has a long way to go before it resembles anything like the marketplace of the 1990s. Finally, underwriters will continue to discriminate based on quality. Contractors with tough exposures and / or troubling loss experience may not find the market softening at all.

Headlines and Highlights

– Exclusions for Cyber Risk exposures are now commonplace in traditional insurance policies.
– Many markets offer Cyber Risk coverage; there were no withdrawals in 2003.
– Breadth of coverage, terms, conditions and exclusions vary considerably.
– Premium increases are expected to average 10 to 25 percent in 2004.

A Clear and Present Danger

Most companies depend on computer networks to some degree – a dependence that varies from company to company and within companies as well. Companies that had relied on networks solely for email and brochureware web sites are rapidly moving toward a greater reliance on interconnectivity with their clients and partners. Customer relationship management software, as a prime example, helps companies manage their customer information to improve service and increase business. However, along with the benefits of better use of customer information comes the responsibility of safeguarding that information and the liability arising from not protecting it sufficiently.

The relevance of Cyber Risk is nothing new. According to a recent study on protecting company value, financial executives said the top two earnings drivers for their companies were customer support and IT / telecommunications systems. Two-thirds of respondents reported that a major disruption to their top earnings drivers would cause a sustained hit to earnings or threaten business continuity.

Companies are all too familiar with these perils. Although most firms try to keep any type of information security breach out of the press, a survey conducted by the Computer Security Institute and the FBI determined that 90 percent of large corporations experienced at least one computer security breach in 2002, with 80 percent of those breaches resulting in financial loss. The greatest financial loss reported was from theft of proprietary information, followed by denial of service.

Some incidents over the past year include:

– In February 2003, eight million credit card numbers were reported stolen by hackers from a credit card transaction firm.
– A class action suit was brought against a healthcare alliance for failing to adequately protect personal information.
– A large consumer database company that maintains private and confidential information on millions of consumers for many clients was penetrated by hackers. The company was not even aware the information had been compromised until notified by a law enforcement agency.

Finding Protection

It has become common practice for insurers to exclude Cyber Risk exposures from traditional insurance policies. There are a number of factors driving this trend:

– Post-9/11 focus on terrorism and information security
– Evolving legislative and regulatory landscape, with aggressive enforcement of privacy laws
– Rapid changes in technology
– Lack of uniform standards and assessment processes

To fill this gap, insurers have developed either stand-alone Cyber Risk policies or Cyber Risk modules that can be added to more conventional coverages such as Media Liability and Technology Errors & Omissions. Breadth of coverage, terms, conditions and exclusions vary considerably. Each carrier's policy must be reviewed in relation to individual business exposures of each insured.

There is growing interest in these offerings as a majority of companies now review their Cyber Risk exposures and consider e-risk insurance coverage as part of their due diligence process. The legal responsibility of companies to protect private information is growing with the passage of laws such as the Sarbanes-Oxley Act, the Health Insurance

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Portability and Accountability Act (HIPAA), the Gramm-Leach-Bliley Act (GLBA), the Homeland Security Act (HSA) and sections of the California Civil Code addressing disclosure of personal information.

Traditional P&C Lines

Over the past two years, most Property and General Liability underwriters imposed restrictions on Cyber risks. In 2003, many insureds faced renewals with Property policies bearing strict exclusions for damage to or corruption of data caused by viruses or hackers. This state of affairs has now been cemented in place by several court decisions concluding that data does not constitute tangible property.

The Cyber Risk Market

The offerings in the Cyber Risk insurance market are quite varied. They include first-party only, third-party only, a combined first- and third-party policy, and traditional liability policies (i.e. media and technology) to which a Cyber coverage insuring agreement can be added. Although many insurers add "cyber" or "e-risk" to the name of products, the coverage provided varies, as noted above. In addition, there are differences in the security assessment procedures.

Insurers currently offering third-party, first-party or combined first- and third-party Cyber Risk coverage include:

- ACE
- Admiral
- AIG
- Arch
- Chubb
- CNA
- Gulf
- Hartford
- Liberty International
- Zurich
- Media Pro
- St. Paul
- Lloyd's (various syndicate programs)

There were no major withdrawals from the market in 2003.

Available Coverage

Coverages available under these policies (although not all from all insurers) are:

- Security breach (hackers)
- Malicious code (virus)
- Malicious acts by employees
- Denial of Service (DoS) attacks
- Business interruption
- Data restoration
- Downstream liability (use of a network to launch DoS attack against others)
- Internet media liability for dissemination online
- Privacy violations for misuse, theft or failure to protect personal information
- Internet technology products and services liability
- Internet professional services liability such as hosting or e-commerce
- Cyber extortion demands

> ...90 percent of large corporations experienced at least one computer security breach in 2002, with 80 percent of those breaches resulting in financial loss.

The Outlook

We expect premiums for these coverages to increase 20 to 25 percent in 2004. Pricing will depend upon the client's use of the web, reliance on information systems and security profile. We expect that overall limits in excess of $100 million will continue to be available for the determined buyer.

We see the demand for e-risk coverage growing in 2004 as companies progressively expand their reliance on computer networks for e-business and enterprise efficiencies. Legislatures are drafting laws on responsibility for the security of company networks. Security expectations are rising, and markets are responding. Some insurers have already reported the number of applications for Cyber insurance increasing by 75 percent compared to the previous year.

Headlines and Highlights

- No relief is in sight regarding healthcare cost increases that continue to outpace general inflation.
- Implementation of HIPAA proceeds at great cost to health providers.
- Passage of Medicare legislation holds out the possibility of easing burdens on retiree medical plans but may bring uncertain consequences down the road.
- Expect further shifting of the cost burden from employers to employees.

Virtually every company in the US faces the same challenge: how to maintain a competitive benefits program in the face of healthcare inflation that is rising faster than every other component of our economy. Big, mid-sized and small, companies are all in the same boat: employees expect coverage even as program costs are spiraling. No magic fix appears to be coming around the corner. To be successful, companies will need to be creative and aggressive in attacking this very critical problem.

What to Expect in Healthcare in 2004

Unfortunately for those footing the bill, the marketplace of 2004 will be all too similar to that of last year. We expect average price increases to continue to climb in the range of 12 to 15 percent. For point of service (POS) plans, we anticipate 12 percent average increases; for indemnity (non-managed care) plans, we see 15 percent average increases. Price hikes for preferred provider organization (PPO) and health maintenance organization (HMO) plans are also expected in the vicinity of 12 percent. Prescription drug costs will continue to be one of the fastest growing cost components, with expected increases of 18 to 20 percent. Fixed costs of self-funded plans will experience ongoing increases. We anticipate a continued hard stop-loss market with some difficult renewals and tightening of coverage provisions.

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Employers with retiree medical plans (usually PPOs or HMOs) can again expect even greater cost increases, largely because of greater use of prescription drugs by retirees. We project costs for the pre-65 retiree plans to increase by 15 to16 percent in the coming year. For the post-65 group, we expect costs to increase 16 to 17 percent next year, driven again by prescription drug use. Employers continue to assess the design, eligibility and cost-sharing aspects of these plans. Many have eliminated these types of plans altogether.

Employers are also evaluating the design and structure of their Dental plans, which for the most part utilize some form of managed care. We anticipate increases of five to six percent for dental coverage in 2004.

The Long-Term Disability (LTD) marketplace has seen upward price movement in base rates in recent years. This will continue in the primary market; along with it will come limited capacity in the excess and specialty marketplace. We do see some carriers still aggressively pricing LTD plans with significant contract concessions.

(For discussion of Accidental Death and Dismemberment (AD&D), high limit AD&D, and Business Travel Accident plans see the article on Specialty Benefits.)

Healthcare Legislation

Everyone in the healthcare delivery cycle has been affected by the implementation of the privacy provisions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Those provisions require all healthcare providers to protect patient medical information so that it is used only for permitted purposes and by people who have a right to see it. A further major goal of HIPAA is to safeguard the privacy rights of employees and families covered by employer-sponsored health insurance plans. While the intentions are noble, the mechanics of HIPAA have become extremely burdensome to providers, employers and administrators, further driving up costs in the healthcare arena. Employers and health plans can expect to continue to spend substantial time and money to comply with the law. It is safe to assume that the cost of compliance will be passed along through increased premiums or administrative fees.

A Patients' Bill of Rights remains stalled over differences on liability issues and limits on punitive damages, but patients' rights issues are being addressed. Managed care plans have been changed to waive many gatekeeping requirements. Other recent mandates have eliminated some of the so-called "abuses" in managed care. One example is the Newborns' and Mothers' Health Protection Act, which requires plans to permit hospital stays of at least 48 hours after childbirth.

In the area of mental health parity, a leading current proposal would require all plans to provide coverage for any diagnosis in the Diagnostic and Statistical Manual for Mental Disorders (DSM IV), which contains all the potential diagnoses that psychiatrists and psychologists use. This includes conditions such as antisocial personality and avoidant personality, which, to some, push the boundaries of what should be considered a problem requiring treatment and what should be considered a fact of life. Such questions feed into the larger debate regarding health parity and its ultimate operational and financial impact on the healthcare system. Most politicians are against such broad mandates, but Senator Pete Domenici (R-NM), a champion of this issue, has obtained an agreement that it will be considered in the next session.

Prescription Drug provisions in Medicare making their way through Congress as of this writing may ease burdens on retiree medical plans and reduce costs. Not all of the ultimate consequences of the legislation are clear, however. Many retirees with private coverage (i.e., employer plans) fear that the Medicare entitlement will permit their current plan provider to drop or reduce the coverage in their plans (which are typically more generous than the proposed Medicare coverage). The American Association of Retired Persons (AARP) and the senior citizen lobby have been pushing for a so-called "maintenance of effort" requirement in employer-provided plans. This would prohibit employers from eliminating coverage in their plans. Such a rule would fly in the face of the voluntary underpinnings of the current benefits system and is opposed by most legislators. This type of requirement might have the effect of reducing employee benefits because employers would be more likely to retreat from benefit programs altogether in an effort to avoid potentially burdensome obligations.

The re-importation of prescription drugs from Canada (and elsewhere) continues to attract employers and individuals who want to save money. The FDA maintains that the practice is illegal and has begun to enforce the laws against those large re-importers that they can reach. One proposal in Congress has been introduced to legalize the practice. While such a move might appear to be a good way to save money by taking advantage of the Canadian system's price controls, the practice might well result in drug shortages. Shortages are, in fact, arising in Canada now. The political prospects for this legislation are not clear, but proponents may gain some momentum in the next session.

> One of the answers continues to be shifting costs to employees, but this is still no easy task to accomplish. To make the transition work, employers need to form a partnership with employees in managing changes in benefits.

Regulatory Update

Recent IRS rulings have made the use of certain benefits more attractive for employer-provided health plans. The rulings permit plans to use debit cards for making payments associated with flexible spending accounts (FSA). The IRS has also expanded the list of medicines and procedures that are reimbursable. Costs for over-the-counter drugs such as aspirin, Claritin (allergies), Prilosec (heartburn), etc., can be considered medical expenses. Treatments prescribed for obesity, breast reconstruction after surgery and LASIK surgery are reimbursable under an FSA. These developments should make the use of health FSAs much more attractive to employees.

With a US presidential election coming in 2004, healthcare will once again be a prominent topic of public debate. We can expect to hear impassioned support for the current employer-sponsored health plan model. We will also hear proposals for creating a full government-sponsored healthcare delivery system. And we will probably hear several options that fall somewhere in between. The private sector will be actively participating in an effort to influence the platforms of the political parties.

Trends to Watch

Companies faced with ongoing price increases will be under increasing pressure to manage their benefits programs more effectively. We expect to see more effort devoted to several areas:

– Shifting a greater portion of costs to employees, in the form of higher premiums, plan design changes and tightening eligibility rules
– Aggressive intervention into employee lifestyles and managing risk factors – changing behavior
– Better monitoring and analysis of medical costs
– Clearly and efficiently communicating information to employees
– Using technology and the web to eliminate waste and paper in the enrollment and administration process
– Efficiently monitoring employee compliance with company policies
– Minimizing operating expenses for chosen benefits programs and aggressively managing all vendor relationships

There is no relief in sight for healthcare inflation, but the demand for quality healthcare benefits remains high. Companies may need to spend more time and care with employee benefits issues than they have in the past. Evaluating plan options may no longer be a once-a-year event, but instead may require more consistent attention and development of a long-term strategy. The issue of the breadth and cost of Benefits programs is one that has gone beyond the HR department – it has for some time now been a matter for the CEO, if not the boardroom.

One of the answers continues to be shifting costs to employees, but this is still no easy task to accomplish. To make the transition work, employers need to form a partnership with employees in managing changes in benefits. In many industries, employees will have more say in how their plans are structured going forward.

*In this article, we excerpt key overview portions of the **July 2003 edition of the Willis** **Energy Market Review**. Readers are invited to visit www.willis.com and click on "Publications" to download and read the entire publication.*

The Energy insurance business has been very profitable for carriers over the last 12 to 18 months. As a consequence, competition has started to increase. Onshore property premiums have been drifting downward, and offshore property rates appear to have peaked. By Q1 2004, casualty premiums may also be drifting downward.

It would be imprudent, however, to forecast an eventual return to the premium levels of the mid-1990s. The insurance industry's fundamental changes should have long-lasting effects on risk assessment and pure risk pricing, and shareholders and directors are no longer willing to swallow inadequate rates of return.

On the positive side for insurance buyers, underwriters need to write premium to grow income to meet budget and investment targets. Competition, so the theory goes, will remain "responsible", even with non-legacy markets.

All of these developments amount to reasonably good news, with one important caveat: if there is a "supercat" loss – or a series of large, energy-related "human element" losses – the marketplace reaction could be swift and sharp.

Market Overview: the Game Moves On

Each year a boat race takes place on the River Thames in London between the UK's two most famous universities, Oxford and Cambridge. Conditions (wind, tide, current) vary widely from year to year, and the extent of victory is consequently measured by the marginal advantage that the winning boat gains over the loser, rather than by the winning time.

Many energy specialists at Willis contributed to the *Energy Market Review*. The principal contributors and editorial associates are as follows:

Guy Bessis, Alan Brooks, Charles Burnett, David Clarke, Martin Daniels, Claude Gallello, Jon Hughes, Andrew Jackson, Mike Newsom-Davis, Dave Scott and Sandy Vietor.

In insurance generally, and in the Energy sector in particular, conditions are highly changeable, with the market moving at different speeds from one year to another. But in both hard and soft markets winners emerge, and they do so because they gain a marginal advantage over their competitors. In the previous issue of *EMR*, we defined the market as being comprised of "legacy" and "non-legacy" insurers, and went on to describe the advantage that the latter were gaining over the long-established players, burdened as they are with the sins of the past. In this edition, we continue to chart the progress of these two "boats", and look at the prospects for the market as a whole.

The Challenge Today

The pressure on Energy insurers to make underwriting profits continues to build. Historically, that pressure has come from the liability side of the balance sheet, from losses and under-reserving, and this continues to grow. Lately, however, with the major correction in world stock market indices, additional pressure has been piling in from the asset side of the same balance sheet. Ratings agencies are in the forefront of the push for higher rates and tighter underwriting. To quote Ronald W. Frank, a Smith Barney analyst, in a recent research note, "It appears to us that, by limiting the operating and financial leverage which insurance companies can assume, the agencies are forcing insurers and reinsurers to focus ever more intently on capital allocation and on marginal returns from underwriting, which is very positive for the prospective duration of the hard market."

All well and good in theory, but in practice there is currently more than enough capacity for many lines of business, and, with massive top-line budgetary pressure on underwriters, the challenge for the Energy insurance market today is this: How do you maintain underwriting discipline when everyone, including even Hank Greenberg, the Chairman of AIG, says that underwriting conditions have never been so good?

The Energy Market

As recently as a month ago, we would have said that pricing was easing within the context of strong underwriting discipline. Writing this now, in the middle of the July 1 renewal season, price competition is very much more pronounced, though for the time being enough discipline remains to ensure that the fiercest competition is only for the most profitable business.

However, the specter of that ominous word "freefall", if still in the distance, looms larger. Is the market heading towards the edge of the abyss? Have any of the lessons of the recent past truly been learned?

While 2002 produced a particularly good pure underwriting result this was perhaps exaggerated by an exceptionally low incidence of loss, both in terms of frequency (where increased deductibles have clearly had an effect) and severity. There is no question that the 2002 result is both an excellent and timely one for Energy insurers. It does not, however, necessarily signify a trend; we estimate that total premium has only just returned to the level it reached a decade ago, and any reduction in this level, when combined with a more typical loss picture, could easily plunge the market back into the red.

Although the substantial increase in deductibles and self-insured retentions of the last two years has undoubtedly had a positive and enduring effect on the Energy sector's overall insured loss record, it should not be forgotten that recent years have been significantly marked by a high incidence of catastrophic loss. Any return to such a frequency of catastrophe would mean that the higher retentions which have been established will have only a minor positive effect on the overall insured loss picture.

So on the face of it there would appear to be a strong need for all Energy insurers to continue to grow top-line revenue through rating rather than market share, despite current profitability. With prices falling, we feel that we are not exaggerating the dangers that may lie just around the corner for the market.

Of course, all the foregoing relates purely to Energy insurance. For many insurers the historic problems of the wider insurance industry heavily outweigh the positive aspects of current Energy market conditions. For instance, most analysts reckon that the insurance industry as a whole is massively under-reserved for asbestosis. For some of the legacy companies it may already be too late, and a softening of the market could merely hasten their demise. But the warning signs are there for all insurers in the Energy market, not just for the legacy companies but for the non-legacy entities as well, despite their freedom from the burden of the past.

Ratings and Restructure

As we have noted, the ratings agencies are at the forefront of the push to a return to underwriting profitability, and the following chart clearly demonstrates how they have downgraded the whole industry:

Insurers	pre 9/11/2001	07/07/2003
ACE	A+	A+
AIG	AAA	AAA
Allianz	AAA	AA–
Axa	AA	AA–
Generali	AA	AA
XL	AA	AA
Zurich	AA+	A+
Reinsurers		
Berkshire Hathaway	AAA	AAA
GE Frankona Re	AAA	AA–
Munich Re	AAA	AA–
Scor	A+	BBB+
Swiss Re	AAA	AA+

Source: Standard & Poor's

Today there are no more than three insurance and reinsurance groups (AIG, Berkshire Hathaway and CCR) rated AAA by Standard & Poor's, and it is likely that we shall see no early increase in that number. Indeed, it is probable that we shall never witness a return to the significantly higher ratings of the market pre-9/11. If this is to be the case, do ratings really matter anymore? In our view they remain important, but only up to a point. There must be a minimum acceptable rating – after all, to return to our boat race analogy, no boat can compete if it is holed beneath the waterline. Above that, we believe that the marginal advantage in rating of one insurer over another is more important than its rating per se, but, with so little choice for the insurance buyer, rating is for the moment increasingly of academic interest. However, let us look forward and consider this possible sequence of events:

– Further rating agency downgrades cause a capacity crunch.
– A major reinsurer collapses leading to a domino effect across the insurance industry.
– There is a US-led stock market recovery.
– A restructure and renewal of the insurance market follows, with many legacy markets dying.

We believe this scenario, or something along the same lines, to be not unrealistic, although current economic conditions would not seem to favor any imminent restructuring. In the last few years, mergers and acquisitions (M&A) activity has dropped

> So on the face of it there would appear to be a strong need for all Energy insurers to continue to grow top-line revenue through rating rather than market share, despite current profitability.

off sharply. Standard & Poor's, however, has recently predicted a pick-up in M&A activity in the European insurance market following a period of several years during which "M&A transactions have been conspicuous by their absence". S&P analyst David Anthony noted that "some European groups are now admitting to a growing appetite for acquisition", though participation in M&A deals is still seen as slow, being limited to opportunistic acquisition while remaining hampered by groups' stretched finances.

Who's Winning the Boat Race?

At the moment the non-legacy crew clearly has the advantage, as they put blue water between them and the struggling legacy boat. However, this advantage may yet count for little if the prevailing conditions become altogether too much for boats designed for calmer waters, and neither boat is able to complete the course. They will have to be redesigned on a larger scale and rebuilt, using tougher materials.

Despite current conditions, the outlook for the Energy insurance market is at best uncertain, particularly given serious doubts over insurers' ability to maintain underwriting discipline. Although there is plenty of capacity, conditions could change rapidly, especially if there are further major losses, and a sudden collapse in that capacity is also a distinct possibility. So, while the big issue has until recently been the maintenance of insurers' ratings, we see the interesting story today as being structural reform of the insurance industry. The game has moved on.

Headlines and Highlights

- Carriers differ significantly as respects target clientele, capacity, policy terms and special-purpose Environmental coverage offerings.
- Finite programs associated with legacy Environmental liabilities continue to grow, driven by corporate governance activities.
- Mold remains a major issue for the US real estate and construction industries.
- Property-related transactions are heating up as M&A activity rebounds with the recovering economy.
- Capacity is strong despite the loss of a major market (Kemper) and the retrenchment of another (Chubb).

State of the Market

An Overview

Despite some changes in the cast of carriers playing on the Environmental stage, capacity remains strong, and this sector continues to avoid the remarkable premium increases seen in the recent past in other insurance market segments. At the same time, the Environmental market is now exhibiting a form of hardening as challenges appear in underwriting terms and engineering requirements.

The scope of required engineering information has increased significantly, in particular with cost cap (remediation stop loss) products. Phase I surveys are often the minimum requirement. If there are no surveys available, carriers are looking for protocols – such as self-audits – to be established by the insured.

Conservative underwriting attitudes are also reducing appetites for unusual placements. More effort – and more management involvement – is required by organizations seeking complicated types of coverage.

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The Markets

During 2003, we lost a major market as Kemper struggled with financial challenges and put its environmental business into run-off. We also witnessed an exodus of Chubb senior managers, who left to join a start-up, Quanta Insurance.

Primary market capacity is now provided by major markets that include: ACE, AIG, Chubb, Gulf, Liberty International, XL (formerly ECS) and Zurich. There are also a number of small and new markets servicing environmental program needs.

The following survey of the major insurance carriers highlights new products, coverage enhancements and other hot topics.

ACE Environmental

ACE Environmental Risk (AER) offers a range of pollution products targeted at both the largest organizations and the middle market, and continues to work closely with the traditional primary and excess casualty units of ACE USA to offer a whole-account approach to environmental risk.

In the coming months, look for ACE to expand into additional regions where ACE USA maintains a presence, and to expand its offerings for the Energy and Construction sectors. Efforts in these large-risk areas will likely be balanced by high-volume, lower risk business with small contractors and those with underground storage tank (UST) exposures. To this end, ACE recently launched a web-based UST underwriting platform called ACE Tanksafe.

AIG Environmental

The passage of Sarbanes-Oxley has created a need for companies to reconsider their approach to reporting environmental matters in SEC filings, especially when it comes to the required certifications of financial controls and "fairness" of financial reporting. Pressure is growing for industrial companies with environmental exposures (known or unknown, past or future) to take a proactive approach in communicating meaningful and useful information to shareholders and prospective investors concerning their environmental liabilities.

AIG views this as a major growth opportunity over the next few years, as companies strive to be more transparent in their accounting and to demonstrate adequate financial control over

Environmental (continued)

potential loss scenarios. Accordingly, AIG is positioning itself as a provider of appropriately structured Environmental insurance programs that demonstrate compliance with clients' corporate governance obligations while also building certainty for shareholders regarding the potential maximum costs of contamination at specific sites.

AIG is still the largest Environmental insurance carrier, with a capacity of $100 million and the ability to write a range of multiyear contracts. AIG can also develop combination finite programs that support long-term multiyear policies. The carrier offers a combination Errors & Omissions and Contractors Pollution Liability product for medium to small projects.

Chubb and Quanta

Chubb lost a significant number of its Environmental underwriters this past year, but remains committed to writing Environmental business.

The parting of the ways occurred when Chubb shut down its credit derivative business, which housed the Environmental underwriters. A number of the Environmental staff took the opportunity to join a new start-up operation called Quanta Capital Holdings Ltd., a Bermuda-based holding company that provides specialist insurance and reinsurance products, as well as risk management and consulting services.

Chubb, meanwhile, is reconstituting its Environmental resources in key areas and will continue to offer Environmental insurance from within Chubb Commercial Insurance.

Gulf Insurance

Gulf Insurance Group continues to focus on contractors and consultants of varying sizes, targeting accounts with revenues ranging from $1 million to $25 million.

Gulf is also seeing increased opportunities in site policies as the market picks up for traditional risks such as shopping centers, office complexes and property transfer accounts.

Liberty International

Liberty International is a growing Environmental market for industrial, commercial and contracting industries. Its capacity is $25 million per loss and in the aggregate.

Liberty underwrites on a traditional annual basis. While it maintains the capacity to write more complex deals, this business tends to be a much smaller part of its portfolio. Within these parameters, the hazard level of any particular class is not a limiting factor for Liberty. It is willing to write difficult Environment Impairment Liability (EIL) classes, with appropriate attachment points, pricing and risk management controls. Liberty participates as an excess underwriter on otherwise acceptable risks.

> As organizations approach Environmental risks with increasing sophistication, the implementation of programs grows in sophistication as well.

Liberty is also a Professional Liability market, focusing on environmental service firms rather than broadly diversified engineering service providers.

XL Environmental

XL will continue its strategy of offering clients fully integrated Environmental risk solutions. One of its key growth objectives is to expand its international business by nurturing relationships with global brokers. Domestically, XL will look to differentiate itself by maintaining a high service posture and capitalizing on its strong internal risk control and claims management resources.

XL is enjoying strong growth and is expecting to report a revenue increase of over 20 percent for 2003 and an increase in its US market share to over 15 percent. XL has been pushing to consolidate its position as the second largest Environmental insurer in the US market.

Zurich North America

Zurich North America is continuing its strategy of offering straightforward and affordable protection to corporations, municipalities and local governments against the full range of potential environmental liabilities. This includes everything from compliance with underground storage tank regulatory requirements to complex Superfund or legacy contamination liabilities.

In the past year, Zurich has experienced significant growth in business related to the redevelopment of previously contaminated land, working with local governments, developers, environmental regulators and contractors to resolve difficult liability issues and stimulate brownfield development.

The growing acceptance of risk-based corrective actions means that it will be more commonplace for contamination to remain at remediation sites following a negotiated agreement between the party responsible for the clean up and the local government, regulators or other involved parties. Zurich views this as a driver for further growth, as organizations seek protection from potential "re-openers" that could, after redevelopment of the site in question, expose them to additional risk.

Environmental Coverages

Mold emerged as one of the hot topics of 2002 and showed no signs of abatement in 2003. Headline cases such as the $55 million Hilton Kalia Tower remediation kept the issue front and center. Mold exclusions to Liability and Property policies are now a fact of life, but all major Environmental markets offer some form of coverage under Pollution Liability forms.

A similar pattern is also evident for **Bioterrorism** coverage. The risk is excluded from virtually all terrorism coverage outside of TRIA; environmental carriers have stepped in to offer coverage via site-specific EIL policies.

Long popular, **Contractors Pollution Liability** came into play in the past year as a key coverage instrument through which builders can address mold risks that have been excluded from their general liability policies.

Blended Finite Programs for Legacy Liabilities continue to be a focal point for the Environmental insurance market, driven by several factors:

– Corporate governance issues are driving organizations to fully evaluate and address the balance-sheet impact of their environmental liabilities.
– Companies seek financial strategies that allow them to "walk away" from environmental liabilities associated with remediation and long-term operation, maintenance and monitoring (OM&M) activities.
– With carriers becoming increasing reluctant to provide closure/postclosure or reclamation financial insurance (due to their inability to withdraw from a program once they enter into it), self-funding (finite) options are playing an increasingly important role in the financial assurance arena.

The beginnings of economic recovery appear to be stimulating renewed mergers and acquisitions activity, and with it increasing demand for **Property Transfer Coverage**. PTC policies back environmental representations, warranties and indemnities and protect both buyers and sellers from the financial consequences of unknown environmental contamination. Coverage enhancements such as Natural Resource Damages, Non-Owned Disposal Sites, and contingent protection in the event of financial failure of any of the parties to a transaction will likely remain popular.

As organizations approach environmental risks with increasing sophistication, the implementation of programs grows in sophistication as well. For **Remediation Cost Cap** programs, probabilistic cost modeling is now commonly used to set attachment points, establish co-payments, and compute premiums.

As predicted, **Underground Storage Tank** coverage re-emerged as a significant issue in 2003, driven by the insolvency and sunset provisions of many state UST funds. Coverage ranges from individual tanks operated by contractors to multi-site convenience store portfolio programs.

Healthcare Professional

Headlines and Highlights

– HPL coverage costs have skyrocketed, causing financial and management stress for healthcare providers.
– Some HPL market sectors have seen new entrants, but for the most part 2003 was a difficult year for carriers, with withdrawals, liquidations and downgradings.
– The Physicians and Surgeons segment will be the most distressed in 2004.
– Pricing increases continue, but at much lower percentages.
– Some attempts at tort reform are meeting success at the state level.

An Overview

Continued Tumult

The medical malpractice insurance industry continues to be in a state of turmoil. Much like previous years, 2003 witnessed malpractice insurance company failures, ratings downgrades and withdrawals. The past year also saw the continued entry of new capital and a corresponding decline in premium percentage increases for a number of segments, especially institutional risk for hospitals and nursing homes. According to A.M. Best, however, the outlook for the industry is negative.

The most notable carrier failure in 2003 was the Reciprocal Group of America, placed in liquidation in February by state regulators. The most notable withdrawal was Farmers Insurance Group. Ratings downgrades were visited on many of those who remained. Carriers receiving downgrades by A.M. Best to ratings less than A- included: ISMIE (B+), AP Capital (B++), MLMIC (B), OHIC (B), Princeton (B-), PMSLIC (B++), SCPIE (B), TIG (B+) and Physicians Insurance (B++). Carriers that were downgraded but maintained at least an A- rating included GE Medical Protective (A), and The Doctors Company (A-).

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Soaring numbers of large verdicts and settlements over the last five years continue to drive increased premiums for institutional and individual providers. The affordability and availability of malpractice coverage has directly impacted the affordability and availability of healthcare, as many physicians have left practices, relocated, curtailed services or retired, as a result of what they perceive as exorbitant malpractice premiums. Institutional buyers and many larger physician groups have adopted various alternative risk financing strategies, ranging from increased deductibles, self-insured retentions at or above $1 million, and the creation of captives and risk retention groups. In addition to capital, many healthcare providers are spending more time than ever before on insurance renewals. The malpractice problem has become a major distraction for healthcare providers.

The Underwriters' Response

Malpractice carriers have responded to market conditions as they have for the past two years. Some withdraw from HPL coverage altogether. Others strain to improve results through rate increases and tightening of terms and conditions. Typical coverage restrictions or exclusions include punitive damages, terrorism (available on a buyback basis), mold and sexual abuse claims. The bar for underwriting submissions remains high. Underwriters, particularly the new capital entrants, desire to be above the working layers on any type of healthcare account.

Rate increases of the past few years have had one positive effect: most of the damage has been done and the increases anticipated for 2004, while in solid double digits, are modest by comparison. Higher rates have also attracted new carriers, at least in some HPL sectors, and some market competition is beginning to return.

HPL Sectors

Primary HPL

No new players have stepped into the dominant role played in the past by St. Paul and CNA. On the contrary, carriers are retreating. Those who do want to participate must face significant regulatory and operational barriers. New entrants are often electing to use surplus lines paper.

The provider-owned (both physician- and hospital-sponsored) carriers continue to control larger market share, but may be challenged in this segment by competitors who want to write community hospital and miscellaneous healthcare business. Commercial carriers such as AIG, Zurich, Chubb, CNA and GE ERC, will write primary HPL within their own guidelines, which are driven by account size, territory and loss history. Newer players in this segment include Darwin Professional Underwriters, Hudson Insurance Company, and ACE USA. OneBeacon has expressed its intent to enter the market in 2004 as well.

More careful scrutiny of submissions and risk management structure has led to a major push to have insureds retain risk through deductibles. First-dollar coverage is difficult to find for this line, with most carriers requiring a minimum deductible of at least $25,000. This market segment is in a pricing plateau phase, meaning that buyers can expect rate increases from 10 to 20 percent – much lower than in recent years. Competition will help pricing in the primary HPL segment as new entrants seek to gain market share.

HPL Excess and Reinsurance

The HPL excess and reinsurance segment has experienced extreme hardening since the year 2000. Besides higher rates, this has meant more careful underwriting, with special attention to attachment points and careful utilization of capacity. Geography and the local tort environment are critical to these decisions. Newly enacted tort reform legislation in Texas, for example, will almost certainly reduce rates to insureds, especially considering the passage of a state constitutional amendment protecting the statute from being overturned by the courts. The Texas example proves to other states that effective tort reform can provide an immediate reduction in rates.

As often happens in a hard market, more capacity has become available in this segment as opportunistic entrants seek to capitalize on the rising tide of pricing. Though pricing increases continue, there was clearly some leveling off in 2003, which we expect will continue into 2004. Buyers should see price increases ranging from 10 to 30 percent, a relief after the hikes of recent years.

In 2004, many excess and reinsurance underwriters will be motivated to gain market share through product differentiation. Those institutional risks that have entered the alternative risk transfer arena will see underwriters trying to entice them with innovative program design, including but not limited to: swing programs, inner aggregates, buffer layers, finite risk, and a limited return to integrated risk. Significant markets include: AIG, Zurich, Chubb, CNA, ACE, XL, Max Re, GE ERC, Arch, Berkley Medical Excess Underwriters, Darwin Professional Underwriters, Endurance Specialty, Catlin, OneBeacon, Hanover Re, Am Re and AWAC.

Physicians & Surgeons

This market segment is one of the most distressed due to adverse underwriting results and has been severely impacted by liquidations, withdrawals and downgrades. Capacity is a problem in a number of states and affordability has become a veritable battle cry for medical professionals in all but a few states.

Provider-sponsored companies continue to dominate this market segment along with one commercial carrier, GE Medical Protective. Almost all physician carriers have eliminated discounts and credits and are writing at manual rates. With recent shifts in underwriting focus by GE Medical Protective and The Doctors Company, no physician carriers are now willing to write on a national basis. Few companies are willing to serve as fronting carriers.

Larger physician practices are considering such self-insurance vehicles as captives and risk retention groups. New physician carriers have been created or will be created in Florida, New Jersey, Ohio and Missouri.

Hospitals and health systems are considering the creation of sponsored physician programs so that physician recruitment, retention and on-call coverage are not adversely affected. Some are simply employing physicians and providing coverage under the hospital's insurance program. Any solution must withstand legal scrutiny under the Medicare and tax laws.

Long-Term Care (LTC) Facilities

The double- to triple-digit increases of recent years will decline in 2004, with risks experiencing anything from no increases at all to 25 percent rate hikes. Prices and terms will depend on the type of risk, retentions and territory. Nonprofits are viewed by underwriters more favorably than for-profits. High retentions may be mandated in certain territories. The number of carriers willing to write this line of business, especially for-profits, continues to be limited. AIG is a major player here. CNA prefers nonprofits. OneBeacon will also entertain nonprofits in select territories. The London market is still active for LTC accounts.

Managed Care Organizations (MCOs)

Until 2003, Chubb and AIG were virtually the only carriers with capacity. The recent entry of Darwin Professional Underwriters added capacity and injected some much-needed competition in this segment. MCOs will see increases of zero to 20 percent in 2004.

Underwriters continue to be concerned about erosion of the ERISA preemption laws as well as class-action lawsuits brought against MCOs. Most state tort reform laws enacted over the last two years do not include protection for MCOs, thereby leaving them with potentially deep exposures in malpractice litigation.

The Major Trends

A Period of Uncertainty

New entrants in the marketplace are causing price increases to abate, but there is concern that pricing could fall below responsible levels as new carriers seek market share. If this scenario unfolds, the industry cycle may repeat itself more quickly than ever. The number of healthcare organizations employing alternative risk financing vehicles has gone from a trickle to a flood. The question that self-insured entities face is whether their results will prove to be better over the long-term than the results of those who remain in the commercial market.

Pricing trends are not uniform across the field. While there does appear to be a leveling off of pricing for hospital and nursing home facilities, the same cannot be said for physicians and surgeons. Hospitals are clearly struggling to deal with the fallout, as they are often stuck with the bill when physicians do not buy coverage or purchase inadequate limits. Hospital budgets are further stretched when they must subsidize malpractice premiums to recruit physicians or obtain on-call coverage.

Claims Severity

The question that self-insured entities face is whether their results will prove to be better over the long-term than the results of those who remain in the commercial market.

Some contend that severity may be leveling off. The evidence is anecdotal, but this is the first such talk the industry has heard in a long time. Others, however, argue that forces at work for the past few years are still operative. Jury attitudes will drive excessive awards. The number of paid claims over one million dollars is continuing to rise. Double-digit medical inflation will continue to drive up the economic damages, especially in cases involving catastrophic injuries. In any event, accelerated claims payout patterns will maintain pressure on carriers already reeling from lower investment returns.

Tort Reform

The industry has succeeded in obtaining tort reform in more than 20 states since 2002. Some of the most distressed states (Texas and Florida) enacted legislation in 2003. However, the legislation varies greatly by jurisdiction, and many efforts fall short of the standard set by MICRA laws enacted in California, especially the cap on non-economic damages of $250,000. Some states, like Florida, have sought immediate rate rollbacks at a time when the industry's rate adequacy is in question. These actions may prevent carriers from doing business in those states. In 2003, the AMA listed the following states as being in crisis due to the Medical Liability climate: Pennsylvania, Texas, Florida, West Virginia, Mississippi, Nevada, Ohio, New York, New Jersey, Oregon, Washington, Georgia, Missouri, Arkansas, Kentucky, Connecticut, Wyoming and Illinois. Despite the backing of the Bush administration, federal tort reform efforts modeled on the MICRA laws stalled in the US Senate in 2003. Proponents intend to reintroduce legislation in 2004, but again face an uphill battle to persuade Congress that malpractice reform is linked to the affordability and availability of healthcare for Americans.

Headlines and Highlights

– There were relatively few major Marine losses in 2003.
– The number of reinsurance markets is declining, but capacity is holding.
– Rate movements vary for specific segments of the Marine market.
– The largest risks continue to raise the ceiling on limits...
– ...making carriers more reliant on reinsurers.
– The disappearance of a large Marine player could dramatically alter the Marine map.

A Complex Marketplace

The Marine marketplace is ever developing, always trying to meet an enormous diversity of requests for insurance. The risks involved range from fishing vessels to state-of-the-art passenger vessels, from furniture in vans to cars in lots, from small yacht liabilities to oil-tanker pollution. The underwriting limits vary accordingly, as markets adapt to accommodate this huge range of requirements. This breadth of business, in turn, provides a constant challenge to insurers (and their reinsurers), who are seeking to manage a balanced portfolio of Marine business.

The larger risks, of course, garner the most attention, offering the greatest prestige, and setting new precedents for the scope of coverage. It is the exceptionally large risks that need to be monitored most closely to ensure that risk accumulations and realistic disaster scenarios are properly recorded and that potential exposures are thoroughly addressed. For Hull underwriters, for example, the new Queen Mary II is setting new limits and may well set a trend for the future. Cargo container vessels are growing in carrying capacity, posing similar challenges to underwriters. Specie and exhibition covers require huge limits, usually from the Marine market. Marine Liability limits are also increasing in certain areas. Protection and Indemnity (P&I) capacity is under pressure owing to the increased awareness by the mutual underwriting clubs (and their reinsurers) of the potential impact of a disaster on a huge passenger-carrying vessel or an oil tanker. Of these lines, P&I provides the clearest case of the worldwide demand for capacity coming into conflict with the supply offered by the insurance and reinsurance markets.

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While limits increase, the underwriting pressures in the Marine market do not always produce price increases. Marine Hull underwriters are under well-publicized pressure to continue to increase premiums. Cargo underwriters, meanwhile, have maintained steady and reasonable results. Energy business, which comprises a large portion of many Marine portfolios, is seeing price reductions; insurers active in this sector are focused on maintaining reasonable control of premiums and terms. Marine Liability premiums remain steady. P&I business, facing its own set of pressures from its mutual underwriting basis and its collective reinsurance program, will likely require substantial premium rises in 2004.

Hull

Hull business was a major focus of concern at 2003's IUMI Conference in Seville, Spain. The highlight – or lowlight – was an appeal, or rather a warning, by the Chairman of London's Joint Hull Committee, Simon Beale, who pointed out that all the major markets (other than Japan) have been producing negative results. Investor patience, he predicted, will wear thin very soon unless the sector sees serious improvements. The recent demise of Antra in Hamburg, Germany, underscored the vulnerable state of the Hull market. The need to increase rates will, however, continue to conflict with the Hull market's overcapacity.

Cargo

Cargo results have generally been sound. The Cargo market is customarily more local than Hull, with insurers throughout the world offering coverage to domestic clients either as a stand-alone Marine product or as an additional service line of business to industrial clients. Coverage obtained outside the client's home country is often specialist, distressed or requires major capacity (either larger risk carriers or insurers with global wherewithal). In the current market, transparency is key, with full information being requested by insurers – often with little tolerance for inadequate answers – and increased premiums and / or deductibles for underperformance. There are some new markets for Cargo business, including Beazley Syndicate and Axis.

Liability and P&I

Liability and P&I classes differ in many respects but overlap in two key areas: they are both long-tail Marine products and they are often treated jointly within the reinsurance market. The Marine Liability market is dominated by Lloyd's and the US and Bermuda markets. There is plenty of capacity for loss-free business and rates are often under some downward pressure, but, once again, poor results are being treated severely. P&I is mostly placed into mutual clubs. While these groups enjoy advantageous joint reinsurance terms, they have been severely tested by the recent performance of the investment markets around the world. Initial premiums – likely to rise by an average of 12.5 to 15 percent at next renewal – have been followed recently by supplementary calls at considerable expense to group members. The combined reinsurance protection for the International Group of P&I Associations renews in February each year. The 2004 renewal is facing pressure from reinsurers that could mean a premium rise roughly in line with increases on the original business.

Coordination with Reinsurance Markets

A substantial part of the management of a Marine portfolio depends on effective coordination with the reinsurance market. The higher values and / or exposures (as described above) are reliant on the Marine reinsurance market, usually on an Excess of Loss basis, which has its own independent cycle. Reinsurers choose any number of methods for controlling their own risk:

– Increasing the retention of the insurer (the reassured)
– Increasing premiums
– Imposing limitations (reinstatements)
– Exclusion clauses

Marine reinsurers usually offer a combined risk and occurrence product, either as specific coverage (of, say, a Hull or Cargo portfolio) or in the form of Whole Marine Account or Limited General protections. Reinsurers may in turn buy protection for their own portfolios (retrocession).
Entering 2004, the Marine reinsurance market should benefit from higher subject matter premium incomes. In the recent market cycle, however, the reinsurance market started to harden before the insurance classes. When it started to harden in earnest during 1999, it did so rapidly and regularly at each renewal thereafter. For 2004, sufficient available capacity should cause the upward pressure on prices to ease. For those insurers that have produced good records for their reinsurers in the past few years and can supply their reinsurers with a compelling business reason, reinsurance rates may decline in 2004. Reinsurers, meanwhile, are hoping to maintain some of the recently acquired momentum to continue to increase rates wherever possible. The two contradictory trends should meet somewhere in the middle, keeping rates for the most part at their 2003 levels. Reinsurers, in their turn, are likely to see a similar balance in their own retrocessional protections.

Along with pricing considerations, reinsurers are also becoming more particular about what type of business they will cover. Customarily, reinsurers protect their interests through exclusion clauses, and together with insurers, they have been focusing on several current risk concerns, namely terrorism, and in particular "dirty" bombs, and cyber attacks. Continental European insurers and reinsurers have focused on stand-alone storage as a potential problem area for accumulations of risk that are essentially non-marine in nature. The terrorist threat has led the markets to re-examine the intended scope of terrorist cover regarding storage (extended storage and stock-throughput policies). The accumulation of exposures for the Olympic Games in Athens, where several expensive passenger vessels are scheduled to dock, is also a source of concentration for insurers and their reinsurers.

A Better Loss Record in 2003

The loss experience of reinsurance programs is usually a crucial factor in determining whether prices rise or fall in renewal negotiations. Fortunately, 2003 did not see a continuation of major losses that surged in Q4 2002 (mostly in Hull). The major losses were the grounding of the *Tasman Spirit* and the Hull, Cargo and Building Risk losses wrought by typhoon Maemi. The full financial impact of the Staten Island ferry disaster in October may be substantial. Some of the 2002 losses have not yet been taken into consideration under reinsurance programs as the losses were reported after renewal. This will influence reinsurance renewal terms for 2004,

> Given this tentative balance, it is possible that further contraction could dramatically alter the Marine map.

but in general, 2003 was a good year for the Marine market.

In the Lloyd's Marine market, the Goshawk Syndicate was closed by the Lloyd's Franchise Board, as Goshawk failed to find a buyer or partner for the syndicate following the much-publicized difficulties with The Accident Group, the failed claims management company that Goshawk covered. This demonstration of power by the Lloyd's Franchise Board added substance to the threat of action against syndicates that failed to produce viable business plans for 2004. The impact has also been felt by Dex Syndicate, which has cited the Lloyd's Franchise Board's actions (restricting Dex's participations on individual risks, in particular) as a driving force behind its decision to withdraw the Syndicate's business from Lloyd's and to underwrite with fresh support from Groupama.

The Marine reinsurance market is in period of high activity. The Gerling saga is reaching a resolution: once US authorities sanction the sale of Gerling Globale for run-off, Gerling Allgemeine will be free to continue business as usual. In other areas, the market landscape is changing, and for the most part contracting. Travelers has moved to expand its Marine business by absorbing those lines from Royal & SunAlliance and from Atlantic Mutual. Hart Re ceased writing all reinsurance; Alea stopped writing Marine Reinsurance; Europa Re has closed down; Lloyd's has an increased capacity for 2003 and again probably for 2004, but little of this extra is concentrated in Marine lines. Several syndicates have stopped or reduced their Marine operations in Lloyd's, such as Advent and Greenwich.

Despite the reduction in the number of markets, overall capacity seems to holding steady. For the Marine lines, trends are varied, some showing price increases, others decreases. Given this tentative balance, it is possible that further contraction – the exit of a large market, be it an insurer or reinsurer – could dramatically alter the Marine map and offer unexpected opportunities for surviving participants.

Mergers & Acquisitions

Willis recently launched an expanded Mergers & Acquisitions Group based in New York. We take this opportunity to introduce the Marketplace Realities readership to the new practice, and we provide excerpts from recent Practice publications outlining M&A transactional products and describing recent client success stories.

Willis is a leader in providing insurance transactional solutions and due diligence services to the financial sponsor community. Our M&A team has participated in over 1,000 transactions. This experience gives us the ability to deploy resources swiftly in a transactional environment in an effort to overcome obstacles and accurately determine insurance effects on the enterprise value of potential investments.

The Willis M&A Group is comprised of professionals whose sole focus is responding to the transactional demands of our clients. Drawing from a wide range of backgrounds, including indemnity, brokerage, risk management and legal, we are able to respond rapidly to a wide range of M&A challenges.

M&A Transactional Products

Representation & Warranty Insurance

M&A transactions generally require indemnification by the seller for breaches of the representations and warranties made in the purchase agreement. The representations and warranties may require that a material percentage of the indemnification be held in escrow. The seller or buyer may object to this arrangement, for example, when the seller does not want to maintain an escrow account or the buyer wants more protection than the seller will provide. A Representations & Warranty insurance contract can be structured to respond in lieu of an escrow or in replacement of or excess of the indemnity obligations.

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This coverage can allow acceleration of the distribution of funds to the seller – funds that would ordinarily remain in escrow. This can be of particular value in private equity firms' portfolio companies as freeing these funds can have a direct impact on the investors' IRR. These policies are highly manuscripted contracts. With proper guidance from an insurance broker experienced in negotiating these placements and legal counsel, significant modifications can be made to meet the needs of buyer and seller in placing coverage.

Tax Treatment Insurance

The feasibility of many corporate transactions (M&A, LBOs, reorganizations, etc.) may depend upon a specific tax treatment model. If the IRS were to later rule against the basis upon which the transaction is built the transaction could be adversely affected. This coverage insures against the financial impact of an adverse ruling of the tax basis on which a specific transaction is based.

The prospect for favorable tax treatment is often a deciding factor in the success or failure of many corporate transactions. Tax Opinion Liability Insurance can help a company reduce or eliminate an unwanted contingent liability arising from a successful IRS challenge to a company's tax treatment of a transaction or investment. We can place coverage giving insureds protection against tax losses that may arise in spite of a favorable tax opinion. The policy provides that if the insured receives an adverse tax ruling benefit, the carrier will indemnify the insured for the full amount of any tax loss sustained, plus certain specified ancillary expenses.

Loss Mitigation

Open, uninsured or under-insured litigation of any type can prevent a buyer from accurately determining the potential liabilities they will face post closing. The uncertainty surrounding future liabilities often presents unacceptable risk. A specific risk management evaluation prior to closing a transaction is an important component of due diligence and is needed to develop solutions to address risks that may affect a company's valuation.

The insurance market has responded with several innovative approaches termed "Loss Mitigation," "Contingent Liability," or "Post Event" contracts that include risk transfer of these liabilities on a "first dollar" or a "cost cap" basis to reduce or eliminate the uncertainty. Generally, an insurance product transfers risk of existing or expected litigation for a premium, which is often considered an expense at deal closing. The risk is transferred to an insurance carrier. This eliminates the risk from the target company's balance sheet, and the uncertainties of open liabilities. The two basic approaches are as follows:

– An adequate reserve is determined for insurers by an independent firm of lawyers, actuaries or other professionals and the insurers then offer conventional insurance in excess of the reserve amount plus a self-insured cushion. This type of insurance is usually arranged on a pure "risk transfer" basis with some premium adjustment to reflect a "no claim" situation.
– The insurer will review the circumstances of the reserved item and may then offer to guarantee an amount of the reserve for a premium and in doing so provide full indemnity from the "ground up" for anything that may flow from the item concerned. In such cases much of the structure will be on a "finite" basis so "profit sharing" becomes an important feature.

Future due diligence is much less complicated when the target company is brought public or spun-off when these liabilities are contained through insurance. Properly structured, these loss mitigation products also can provide preferential tax treatment since they are considered risk transfer insurance policies.

These programs address risk arising from litigation in areas including shareholder (securities), environmental, employment practices, general liability, and patent infringement. Generally, litigation with expected valuation in excess of $5 million is necessary to get the attention of select insurers offering this product.

Loss Portfolio Transfers

Prospective acquiring companies often find that a target company has maintained many years of self-insured insurance programs or has purchased insurance products with either high deductibles or self-insured retentions. Insurance accruals on the financial statement are often inadequate and understated. It is difficult to value a company's worth with these open liabilities. Loss portfolio transfers offered by insurance carriers convert these open liabilities for a single premium payment. The target company on a post-closing basis is no longer in the insurance business and can divert resources to other core areas for strategic growth. Loss portfolio transfers convert high deductibles to traditional guaranteed cost insurance arrangements shifting the financial and administrative burden to an insurer.

Other transactional products offered by the group include Successor Liability Coverage, Environmental Liability Insurance, Pollution Legal Liability Insurance, Cleanup Cost Cap Insurance, Secured Credit Insurance, and Blended Risk Finance and Risk Transfer Programs.

Client Success Stories

Telecom Assets Purchase – Representations and Warranties Insurance Placement

Willis was engaged by the creditor consortium of a bankrupt telecom services company to assist in the stock sale of a division that was held out of bankruptcy to a private equity firm. Buyer was insisting on an indemnity cap equal to the purchase price and a significant escrow. An impasse was reached in negotiations between buyer and seller over limit and term of indemnity for certain representations. Willis was able to secure a Buyer Side Representations and Warranties policy with a limit of $20 million and a three-year term to reduce escrow and back sellers' indemnity allowing the creditors to maximize available proceeds from the sale with limited exposure to alleged breaches post-closing while providing buyer with security it desired.

Portfolio Company – Workers’ Compensation Collateral

Willis was recently appointed broker for a $100 million revenue food services business acquired by a buyout firm client. In due diligence, we identified and quantified the issue of "stacking" letters of credit to support a large deductible Workers’ Compensation and Auto Liability program. In transitioning the property and casualty brokerage from Marsh post closing, Willis was able to replace the insurance at a lower cost and negotiate an alternative collateral structure using Treasury Bills held in an escrow account to reduce the draw on the company's credit line.

Loss Mitigation Responds to Allegation of Preference Payment After Sale

Shareholders in a closely held business sell company with an earn-out. Contingent payments of approximately $13.5 million are made subsequent to closing. The company later files for bankruptcy. Former shareholders received demand by counsel for debtors and debtors in possession threatening litigation to make preference claim under Section 547(b) of the Bankruptcy Code forcing them to disgorge all, or part of, contingent payments. Sellers approach Willis to secure commitment to insure this known risk of litigation. Coverage was obtained with a limit of $10 million excess of $3,500,000 retention triggered by actual litigation filed with an option offered to hold terms open to end of statute of limitations. Litigation was subsequently filed the day prior to the expiration of the statute of limitations, premium was paid and coverage effected to respond to the suit.

Energy Concern Caps Uncovered Exposure

A company owning a fleet of tanker ships specially modified to transport natural gas sold off these assets and restructured itself as a consulting firm advising on the operation of such tankers. A former director and officer of the firm claimed that under the terms of his severance agreement from the company he was entitled to a portion of the proceeds of this transaction. The firm's Directors and Officers policy excluded coverage for such litigation brought by a former director. Senior management at the firm approached Willis to cap this exposure using an insurance solution. We obtained a policy that provided $25 M in limits (double the estimated maximum exposure) excess of $750K in limits for any liability resulting from this litigation effectively capping the exposure at $750K and allowing the firm's accountant to properly account for this exposure.

Waste Disposal Firm Acquires Liabilities

In a large acquisition made by a waste disposal firm, the entity being acquired came with significant balance sheet liabilities for several items related to historic operations. These included: (1) reserves for losses under self-insured workers' compensation and automobile liability programs spanning a period of twelve years; (2) future retrospective premium adjustments for excess automobile and general liability and workers' compensation policies that were still open covering a ten-year period; (3) environmental liabilities associated with discontinued hazardous waste disposal facilities that had been closed or sold more than eight years before; and (4) post-closure care obligations associated with the closed landfills where the maintenance and operations phases would run as long as 30 years.

In the aggregate, these liabilities exceeded $165,000,000, and they were a problem for the purchaser due to its highly leveraged financial structure. These and other liabilities were threatening to stand in the way of additional acquisitions that were being considered. A Finite Risk Insurance policy was developed to allow the corporation to cleanup its balance sheet and address currently uninsured risks of loss.
The coverage features of this program included the following:

- Transfer of all losses under self-insured automobile and workers' compensation programs from the date of acquisition backward (including incurred but not reported [IBNR] claims for the same period).
- Transfer of all future retrospective premium adjustments for excess automobile and general liability, and workers' compensation policies from the date of acquisition backward (including IBNR claims for the same time period.)
- Transfer of all post-closure care costs for closed landfills incurred during the next 30 years.
- The single-payment premium for the Finite Risk insurance program was $121,700,000. An alternative would allow the premium to be paid in five annual installments.

The primary purpose of this program was to remove liabilities from the balance sheet and to transfer the administration of self-insured programs to a third party (eliminating more than 20 people from the risk management department).
Closing out the retrospectively rated programs also simplified the administration of the insurance program going forward. The premium was paid in a lump sum with the funding being provided from a restructuring of debt associated with the acquisition. This left the balance sheet relatively clean and allowed the firm to immediately seek additional acquisitions. The effect of this transaction was to convert a liability on the balance sheet to long-term debt.

Headlines and Highlights

– Outside of volatility in certain countries, 2004 will see a generally stable marketplace.
– Claims will bring technical policy wording issues to the fore.
– Buyers will continue to find the market flexible, client-focused and open to new buyers.

Political Risk insurers remain divided into two types: public sector (government providers and multilateral agencies) and private sector. The private sector is comprised of numerous commercial insurance companies from Bermuda, France, the UK and the US. Both sectors are important providers of Political Risk insurance (PRI), each with its own strengths and weaknesses.

Expanding Coverage

PRI includes a broad array of named-peril policies. These policies have been tailored over the years to reflect the multitude of ways in which organizations acquire emerging market political risks. The standard perils are: expropriation, currency inconvertibility or non-transfer, and political violence (a broader form of terrorism coverage). Each transaction is unique; given the variety of client needs and coverages available, programs must be tailor-made for each circumstance.

PRI was designed originally to cover only the political risk of a transaction in which the insured retains a direct and straightforward commercial interest. As the market expanded, broader PRI coverages became available to protect against indirect commercial or credit risks, such as non-honoring of an international arbitration award and non-payment of government obligations. As one might expect, the more comprehensive coverages have correspondingly tighter underwriting criteria and higher costs.

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2004 Market Changes

Two insurers will no longer underwrite this class of business: Sirius International and Goshawk Syndicate. Although they were not among the major PRI markets, they did provide much needed capacity for certain niche PRI coverages – the former in long-term non-payment coverage and the latter in the aircraft non-repossession market.

We expect that 2004 reinsurance renewals for private-market PRI providers will not materially change the availability of coverage currently offered in the marketplace. Overall PRI market pricing is likely to be stable in 2004, with premiums to be determined by the specifics of each transaction.

We do expect, however, that a number of recent claims will impact the type of coverage normally available from the market. For example, we expect some markets will attempt to exclude what is being called "denial of justice" coverage from the expropriation peril. This matter came to light in an arbitration ruling against the Overseas Private Investment Corp. (OPIC) arising from protection it provided to US sponsors of the Dabhol power plant in India.

In some places we anticipate a broadening of coverage. For example, some markets may expand their currency inconvertibility / non-transfer coverage in reaction to recent currency non-transfer claims in Venezuela.

Market Timing

Some organizations with emerging market exposures, whether they are companies, trading houses or banks, see PRI as a discretionary purchase and seek coverage only when a problem arises in an emerging market. Unfortunately for them, PRI markets are usually quicker to react to such events and may retract capacity suddenly. Companies seeking PRI coverage in reaction to newspaper headlines or difficulties with a specific emerging market may be disappointed to learn that the PRI market is unwilling to cover their exposures.

PRI supply has been withdrawn in several recent cases:
– Material adverse change of country risk (most recently the Dominican Republic and Venezuela)
– Limited remaining, highly selective country capacity (Brazil and Turkey)
– Ongoing PRI claims activity (Argentina and Venezuela)

Organizations facing potential risks arising from an investment or a loan in an emerging market are advised to implement risk mitigation well before there are any clouds on the horizon.

Placements may be possible in the above countries, but only on the most selective basis.

Organizations facing potential risks arising from an investment or a loan in an emerging market are advised to implement risk mitigation well before there are any clouds on the horizon.

Multi-Year Policy Periods

PRI policies can be written on a multi-year basis. Private market insurers can issue policies up to 15 years in which the only policy cancellation provision available to the insurer is non-payment of premium.

The option of long-term policies can be quite attractive (primarily by reducing renewal risk) but it can come at a cost. The longer the policy period, the fewer the available markets and therefore the fewer competitive forces in the marketplace. Generally speaking, the most competitive transactions in the market are for three- to five-year policies. Extending policies beyond five years begins to restrict the number of possible providers. A careful cost-benefit analysis is recommended.

Product Development

In addition to the possible expansion of currency inconvertibility coverage mentioned above, we also expect the PRI market will continue and may expand its support of capital market transactions. Insurers are now being approached about offering PRI product to the capital markets, especially for Brazil-related risks.

With the return of investor demand for emerging market debt securities, most recently in Brazil, PRI can enhance foreign currency public debt issuances of well-rated emerging market corporations. This allows them to borrow funds at or near their higher local currency credit rating, therefore reducing their borrowing costs. Bond issuers have an option between the extremes of an un-enhanced bond and one fully wrapped by a financial guarantee insurer.

In one recent example, Latin America's largest beer brewer sought to issue a $500 million bond. Backed by a PRI policy to protect the note issuer's ability to convert Brazilian reals into US dollars, the issue received investment grade ratings significantly higher than would have been possible without the policy – thereby enabling the brewery to reduce its financing costs.

Headlines and Highlights

– Premium increases have abated and capacity is widely available.
– More rigorous underwriting remains in place.
– In choosing markets, risk managers should consider the widely varying capabilities of incident response consultants that partner with the carriers.
– Kidnapping as an economic crime is increasing in frequency and severity.

Overview

The impact of September 11, 2001 and the subsequent war on terrorism have focused attention on the increased dangers of business travel and operational exposures overseas. Terrorists linked to Al Qaeda have clearly targeted Western interests worldwide, prompting the US Department of State and British Foreign Office to warn their citizens of threats that include kidnapping, political detention and hijacking.

Although these conditions did bring on significant premium increases immediately following September 11, 2001, pricing is now relatively stable and capacity still widely available. Those companies coming off of a multi-year program will likely see increases if they have operations in countries of concern.

While premium pressures have eased, underwriting requirements have not. Understandably, underwriters continue to undertake detailed evaluation of special contingency risks. Those seeking coverage must often provide site-specific data and details of security precautions in high-risk countries, along with comprehensive business travel schedules. Underwriters are also increasingly attentive to policy conditions such as waiting periods, exclusions and coverage extensions that now have a potentially material impact. Some of the changes in these terms can be attributed to new reinsurance requirements.

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Carriers

The Hiscox Syndicate at Lloyd's is the largest underwriter of Kidnap and Ransom and related coverage, representing 60 to 70 percent of worldwide premium. Hiscox capacity is fronted by Gulf in the US. Other stable, long-term providers of the coverage include AIG, St. Paul and Chubb. PIA, acting as an intermediary, is also a significant supporter, providing capacity through Lloyd's or Liberty Insurance Underwriters.

Kidnap & Ransom Capacity

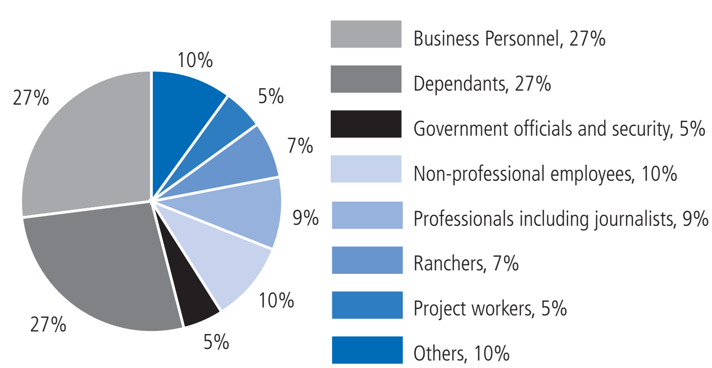
Hiscox	AIG	St. Paul	Chubb	PIA
$25M	$50M	$25M	$25M	$25M

Note: carriers are able to provide further capacity on a facultative basis.

Response Consultants

Carriers partner with incident response consultants, often on an exclusive basis. The choice of response consultant is a critical factor in determining whether a policy addresses a company's specific exposure. There are material differences in the philosophy, expertise and geographic reach of security firms offering response services. The choice can have a direct impact on whether or not an incident is successfully resolved and can also influence subsequent litigation potential. The costs to carriers in making these firms available to their insureds can vary with response firm, but these costs are typically passed on to the insured through premiums.

Kidnaps for Ransom Worldwide 1998–2002



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When evaluating response consultant capabilities, a number of factors should be considered:

– The number of cases handled
– Country-specific expertise

Special Contingency Risks (continued)

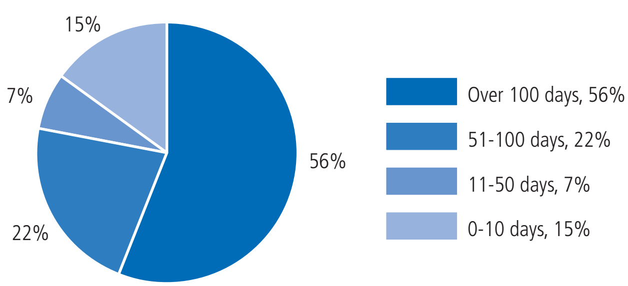
– The number of responders and their employment relationship (i.e. salaried employee, retained consultant or subcontractor)
– Wrongful death litigation history
– Operating procedure

The following table outlines the current carrier / response firm relationships in the market.

Carrier	Hiscox	AIG	St. Paul	Chubb	PIA
Response Consultant	Control Risks Group	Thomas A. Clayton Consultants	Pinkerton/BRI	Ackerman Group	Corporate Risk International
Relationship	Exclusive	Exclusive	Non-Exclusive	Non-Exclusive	Exclusive

Those responders that have signed exclusive relationships with a specific carrier contractually cannot deploy their staff for a company covered by a different carrier – regardless of whether or not this is stated in the insured's policy.

Kidnaps of Foreign Nationals 1998–2002



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Danger Zones

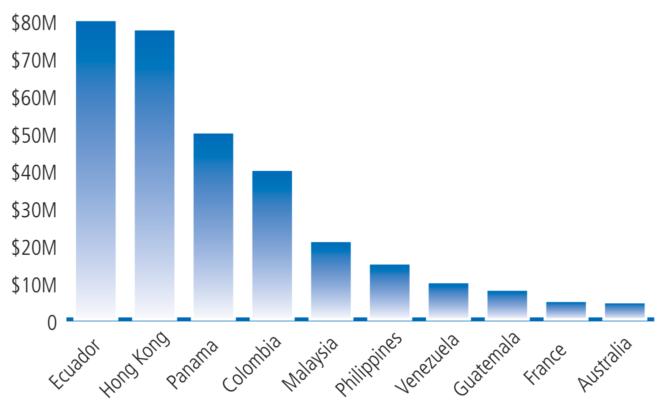
While areas of potential danger have expanded significantly due to the war on terrorism, the steady growth both in frequency and severity of kidnap for ransom as an economic crime is an increasing concern in many parts of the globe. This is not only a problem in countries traditionally associated with this crime, but is becoming an issue in regions previously considered safe. Argentina, for example, was considered one of the safest countries in Latin America prior to the collapse of the economy in 2000. Police statistics now indicate a 500 percent increase in kidnap-related cases since 2001.

Despite the attention garnered by the war on terrorism, the region of highest concern for kidnap and ransom exposure remains Latin America. In general, one can expect higher premiums associated with operations and / or travel to the following countries:

– Colombia
– Mexico
– Brazil
– Philippines
– Venezuela
– Nigeria
– Ecuador
– Former Soviet Union
– Indonesia
– Iraq

Despite the attention garnered by the war on terrorism, the region of highest concern for kidnap and ransom exposures remains Latin America.

Largest Known Ransom Demands in US$ 1998–2002



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Headlines and Highlights

– Markets are showing increased interest in this sector, adding new products and capacity.
– The marketplace trend is toward cross-selling Accident and Special Risk coverages with Property & Casualty programs and for bundling related programs.
– Post-9/11 pricing has leveled off, but underwriting for enhancements remains extensive and at times costly.
– Clients seeking Travel protections should be prepared to deliver detailed travel itinerary plans.

The Specialty Benefits (Accident & Special Risk) sector insures accidents of various kinds and risks associated with travel. Coverages include:

– Corporate Business Travel Accident
– Global Travel / Personal Accident
– Group Personal Accident
– Non-Contributory Accidental Death & Dismemberment (AD&D)
– War Risk
– Special Events
– Occupational Accident
– Youth Group
– Sport Accident
– Travel Assistance
– Industrial Aid Plans for Corporate Aircraft (Crew / Seat Accident)
– CRAF Mission Insurance Common Carrier
– Credit Card Insurance
– Critical Illness

Cross-Selling and Bundling

As market volatility following 9/11 finally subsided in 2003, we saw a distinct division in the marketplace. Some markets withdrew from the Accident and Special Risk lines of business, while others perceived an opportunity to grow their market share. On the whole, 2003 brought growth in this sector – new capacity and new products – and we expect this to continue in 2004.

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Some carriers have raised the profile of Accident and Special Risk products by cross-selling them with Property and Casualty lines. Within the Accident sector as well, carriers are trying to bundle products. Though willing to write Corporate Travel Accident on a stand-alone basis, carriers are trying to package these products with other Accident products, e.g. supplemental & optional AD&D. This trend may come into conflict with the traditional division of responsibilities within large companies, where Corporate Travel Accident is sometimes handled by the risk management team and AD&D programs are maintained by the benefits department.

For AD&D coverage, pricing follows volume. The greater the volume of AD&D placed with a particular carrier, the greater volume discount may be obtained. Placing all such programs with a single Accident & Health carrier may bring savings upwards of 30 percent.

The placement of all programs with a single carrier has several benefits beyond price:

– Consistency in policy provisions, terms and conditions to prevent potential gaps in coverage
– Simplified claims reporting and adjusting
– Simplified administration
– Simplified production of Summary Plan Descriptions (ERISA requirement)

Market Conditions

In 2003, rates on traditional basic Accident business leveled off. Ancillary benefits and provisions, however, are still being looked at very carefully. It is in these enhancements that we see the most significant differences between markets. Enhancements include:

– War Risk
– On-Premises Terrorism
– Bomb Scare
– Felonious Assault

Specialty Benefits (continued)

Some markets continue to provide limited maximum benefits and / or decreased per-accident aggregates. More markets, however, have removed such limitations, although they continue to assess additional premiums.

The events of 9/11 affected no line of insurance more than War Risk. The era of blanket War Risk coverage ended that day and may never return. Carriers now consider disparities in regions of the world in assessing their own risk retentions. While losses due to accidents as the result of declared or undeclared acts of war are a standard exclusion under Corporate Travel Accident programs, terrorism is not excluded. In today's global environment, however, the line between an act of terrorism and an act of declared or undeclared war is so vague that a definitive enunciation is impossible. Each claim is decided on its merits at the time of loss.

Two types of War Risk extensions are available. In one, specific war-risk areas are excluded. In the other, coverage is worldwide, but the insured must provide detailed reports on travel planned. Additional premiums are assessed when travel plans send covered parties into designated war-risk areas. In all cases, coverage in the US and the insured person's country of residence are always excluded. (Some carriers also exclude Canada.)

Market Developments

The primary Accident & Health carriers include: Chubb, ACE, AIG, Zurich and Cigna.

Chubb has recently created a national Accident & Health practice to increase its visibility in the marketplace. With dedicated underwriting centers in New York, Chicago and Toronto, Chubb is clearly displaying a growing appetite.

ACE USA Accident & Health is new to the market and has become a strong competitor, having developed programs, benefits and enhancements for all lines of Accident business. The company is aggressively seeking to expand market share.

AIG has long been a leading Accident & Health carrier. Through the aftermath of 9/11, AIG remained active in this sector, and is now trying to expand its business with the creation of new products and initiatives to cross-market with its Property & Casualty lines.

Zurich North America continues to be a leading provider of AD&D programs. Zurich tries to provide solutions beyond the scope of its contracts through a platform of services including packaging of Travel Assistance services.

The events of 9/11 affected no line of insurance more than War Risk. The era of blanket War Risk coverage ended that day and may never return.

Cigna continues to be a strong Accident & Health market. It has secured solid and competitive reinsurance agreements, permitting flexibility in its underwriting.

Headlines and Highlights

– Insurance issues have become central in financial negotiations between athletes and their teams.
– The Sports Disability marketplace has been hit by large losses, thinning the field of willing participants.
– For Contractual Bonus insurance, plummeting capacity is bringing about a paradigm shift.
– Event Cancellation coverage is becoming more popular, and capacity has remain consistent in the post-9/11 period.

When a team manager signs a superstar, who is the first person called? Not the team owner, not the press, but the team's insurance broker. So goes a witticism circulating in sports and risk management circles, illustrating the unusual state of play in the business of sports. Far from being an afterthought or a luxury, insurance today has a direct impact on the sports and entertainment industries. The length of player contracts and the size of promotional deals are not only dependent on but are often driven by the availability of insurance coverage. The reason is simple: as the financial stakes climb for the business stakeholders, so does the necessity of finding protection from the obvious risks of an inherently uncertain industry.

The Markets at a Glance

As sports salaries spiral ever higher, so the do the risks associated with them, and so do the losses the carriers bear. Basketball star Jayson Williams' disability cost insurers close to $65 million, while baseball star Albert Belle's going on permanent disability cost upwards of $35 million. The National Basketball Association has a captive that covers the top players in the league; significant recent losses made last year's renewal of that program year quite a challenge. As a result, the overall market remains hard, with the possibility of further contraction occurring in the next three to twelve months. Another superstar-sized loss could send more insurers out of play, hardening conditions further.

The entertainment marketplace – specifically the Event Coverage sector – continues to struggle to get on its feet following the event cancellation losses that came in the wake of 9/11. In this past year, insurers were hit with SARS-generated losses around the world. SARS exclusions, and broader-based communicable disease exclusions, have become relatively standard on many of the London-based Event Cancellation policies. Buyers of this coverage, and their risk management consultants, must now manage placements much more cautiously.

While the Sports and Entertainment marketplace remains volatile, the Promotion marketplace (Prize Indemnity, Over-Redemption coverages) has been relatively calm over the past 12 months, recovering from the drop-off in capacity and increased pricing that occurred following 9/11.

The Disability Marketplace

A few years ago, five-year policies with combined capacity of up to $100 million on any one athlete were available in both the US and European marketplaces. Today, reasonably priced capacity has been effectively reduced by close to 60 percent and policy terms have shortened to a maximum of three years. This turn of events has made headlines on the sports pages, especially in Major League Baseball, as teams will not extend contracts beyond three years – even if sought by superstars. The reasoning behind the rigidity on the timescale stems from recent analysis by many of the key markets showing that disproportional losses occur in the fourth and fifth years of five-year contracts. Without the ability to reunderwrite the risks – or to conduct additional medical assessments on the covered athletes – carriers were finding themselves far too exposed.

What this means for player agents and team risk managers is these issues must be addressed in the actual contract negotiating process. If the owners are bound by the limits of the insurance marketplace, so will be the players. It is possible for such a perspective to work to the advantage of both sides of the bargaining table. For example, a five-year contract (currently unavailable) might be workable if it were

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structured so that most of the contractual value, and the risk, sat within the first three years of the deal.

The Contractual Bonus Marketplace

Companies that sponsor athletes for marketing purposes try to ensure that compensation is based on performance rather than guarantee, so that if the star of today fades tomorrow, the sponsor is not stuck with a high-priced contract. This means expansion in the use of incentives, or contract bonuses, which in turn means the sponsors will want protection against the risks inherent in incentive clauses. Contract Bonus insurance is now a key driver in determining the length and breadth of sponsorship deals.

While the demand for coverage is growing, the supply of capacity has fallen by 70 to 80 percent – more so than in any other area in the Sports insurance market. Policy structures have been altered dramatically as well. Multi-year Contractual Bonus insurance policies, once common for certain types of coverage, are now virtually non-existent.

This impact is also felt at the bargaining table, where risk managers are being pushed to modify expectations. In pre-hard market days, Contract Bonus coverage was seen as a means of saving money. Sponsors could buy coverage that paid most of the incentive payment; if an athlete delivered as expected and won a tournament or a prize, the carrier would pay and the sponsor would come out ahead. In the current market, carriers are raising deductibles to the full amount of the incentive. Why would a sponsor continue the coverage? For exceptional cases – when the athlete surpasses expectations. The goal moves from saving money to protecting budgets.

The Contract Bonus marketplace has become more global over the past few years. A few years ago, the London markets dominated, and despite common perception that this remains the case, London is now a much smaller player in this area. The available broad-based capacity in London has fallen to roughly $500,000 to $1 million. The key players in this area are now in the US and Europe, where, depending upon the risk, $2 to $7 million in available capacity can be found.

In addition to protecting contract guarantees and incentives, companies are now looking to insure other aspects of their association with athletes. Brought to the fore by the legal troubles facing a major basketball star, many sponsors are looking to protect their interests against allegations of inappropriate or illegal behavior on the part of an athlete. When the status or perception of an athlete changes, sponsors may need to hold back commercials or advertisements that have already been produced. They may have to rethink the production and distribution of a signature product line.

A focal point in such cases is contract termination rights. The threshold for termination is often a felony conviction, but sponsors may seek to lower that standard in some fashion. Another option is some version of Moral Turpitude coverage. This is a very specialized product but it offers sponsors a mechanism to protect their interests in an endorsement contract should a star incur damage to his or her reputation.

Event Cancellation Insurance

Over the past few years, several incidents have reinforced the need for Event Cancellation coverages. The attacks on September 11, 2001 impacted a multitude of events on a worldwide scale. The SARS outbreak moved the Women's World Cup from China to the United States. Event managers of all kinds are now looking much more closely at this coverage. It is our estimation that premium costs will remain steady over the next year, but insurers will look to control the risks much more closely through broader exclusions and narrower conditions.

Although London remains the key provider in this area of coverage, we are seeing growing interest on the part of insurers on the European continent and in the US.

The limits for Event Cancellation have actually grown over the past few years and buyers are not encountering difficulty. Insurers are, however, requiring higher deductibles to avoid first-loss coverages that have proven costly in the past few years.

Headlines and Highlights

– We expect demand for Credit insurance in the US will increase in step with resumed economic growth.
– A large part of this demand will be driven by banks and companies that will use Credit insurance as a tool to enhance asset-based financings.
– Credit insurers' underwriting standards will remain strict in 2004 and pricing will remain steady.
– Insurers will seek policyholders that are willing to share risk, typically in the form of a reasonable first-loss deductible.

Overview

Companies accomplish several goals when they purchase credit insurance.

– **Risk Transfer:** Sellers transfer the risk of buyer default.
– **Financing:** Companies that borrow against their receivables are able to get better terms from banks if the receivables are credit insured.
– **Credit & Collection Services**: The major credit insurers offer a large package of services including online credit limit vetting and monitoring services as well as collection services.

There are two basic types of Credit insurance underwriting approaches:

Ground-Up – When using this approach, the insurer reviews most of the policyholder's buyer credit limits. The policyholder has a fairly low level of authority to make credit decisions. Because the insurer is reviewing most of the buyer limits, these policies usually have low annual aggregate deductibles. The insurer uses its own global credit database to make its credit decisions but it may rely on the policyholder to provide information in certain cases. The main insurers who provide ground-up coverage in the US are all European-based companies: Euler Hermes ACI, Atradius (formerly Gerling NCM), and Coface North America. These insurers account for 85 percent of the global Credit insurance market.

Excess-of-Loss – Some policyholders with sophisticated credit departments prefer to have significant levels of authority to approve credit limits. Certain insurers will therefore write Excess-of-Loss policies with fairly high discretionary authority, which allows the policyholder to approve most buyer credit limits based on its own internal credit procedures. The trade-off is that the insurer will require a sizeable annual aggregate deductible (normally 50 to 75 percent of the discretionary credit authority level). Under this approach, the insurer will only review the top 10 to 15 credit exposures. Most of these Excess-of-Loss insurers do not have extensive credit databases, so they rely on the policyholder to provide the necessary credit and financial information on the top buyers. Insurers in this category include AIG, ACE, the Export-Import Bank of the US (a US government program), Exporters Insurance Company, FCIA Management Company and Chubb.

Global Credit insurance premiums are estimated to be approximately $5 billion. The largest regional market is Western Europe, which accounts for approximately 80 percent of global premium, followed by the US with about 10 percent.

Reinsurance

Credit insurers rely heavily on reinsurance, with average cession of well over 50 percent. Beginning in late 2001, reinsurers began to pull risk capital away from Credit insurance and allocated it to Property, Aviation, D&O, and other lines that commanded significantly higher returns. Some reinsurers exited this class altogether. As a result, Excess-of-Loss prices increased 100 to 200 percent on the lowest layers. Faced with pricing increases of that magnitude, most buyers chose to increase significantly their first-loss retentions.

For upcoming treaty renewals, there are no new significant entrants to the market. Overall reinsurance capacity remains tight, but premium rates are expected to remain steady.

Moving Out of Recession

During the last several years, insurers participating in the US market have incurred significant domestic credit losses

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Trade Credit Risks (continued)

resulting from US bankruptcies in several sectors, including retail, food, airlines and telecom. These domestic losses were exacerbated by export Credit insurance losses resulting from economic collapses in Argentina and Venezuela.

After increasing by 15 to 20 percent in 2002, rates remained steady in 2003. Instead of significantly increasing rates, insurers reacted to recent losses and diminished reinsurance support by tightening underwriting standards. They continue to avoid adverse risk concentrations with respect to buyers, countries and struggling industries. Some insurers are also requiring policyholders to retain an increased portion of risk in the form of higher aggregate deductibles and / or higher per-credit retention.

Since Credit insurance is for the most part a discretionary product in the US, demand for the product tends to ease during periods of economic recession – even though the risk of default and non-payment increases in just such times. During the latter half of 2003, insurers started to see a modest increase in applications for both domestic and export Credit insurance cover. Insurers believe this is due to two main factors. First, companies may now have more cash to pay for this discretionary product as corporate profits have improved. Second, companies are much more aware of political risk and commercial credit risk, having just witnessed several high-profile bankruptcies and the aforementioned problems in Argentina and Venezuela.

Strategies in a Challenging Marketplace

To overcome some of the challenges presented by today's marketplace, a potential buyer of Credit insurance should consider the following.

- **Insurers are avoiding concentrations of risk.** US Credit insurers have traditionally avoided cooperation with their competitors, but cooperation is increasing due to higher first-loss retentions and lower per-buyer risk limits forced upon them by the hard reinsurance market. It is now possible to convince Credit insurers to co-insure to build sufficient capacity for larger buyer credit limits in difficult industries and / or countries.
- **Insurers are taking a more conservative approach to buyer Credit underwriting and are requiring policyholders to retain more risk.** Companies that have more sophisticated credit departments may obtain higher discretionary credit authority from insurers. This allows policyholders to underwrite and insure more credit limits within their portfolio based on their own credit procedures and without the Credit insurer's approval. While this higher authority normally comes with a higher aggregate deductible, many clients find this trade-off to be preferable.

> ...insurers reacted to recent losses and diminished reinsurance support by tightening underwriting standards.

Insurers favor finance-driven policies. Many companies are now using Credit insurance to enhance "accounts receivable sale" programs (sometimes called accounts receivable securitization). Under this type of program, the company sells the majority of its accounts receivable portfolio to a financial institution (the financier) on a non-recourse basis and at a discount. The company continues to act as the collection agent for the purchaser so the company's clients are not aware of the sale. This allows the company to instantly convert its receivables into cash at a very favorable cost. However, without Credit insurance under the receivable sale program, there are certain restrictions.

- The financier will only fund against 80 percent of the total receivable pool to ensure over-collateralization.
- The financier restricts individual customer concentrations to 1.5 percent of the total receivable pool.
- The financier will not include receivables due from emerging markets.

A Credit insurance policy issued by a highly rated carrier allows the financier to increase the overall advance percentage of the receivable pool to as much as 90 percent, modify individual customer concentration limits (above the typical 1.5 percent restriction), and include most receivables due from buyers in emerging markets. This results in a much larger net pool of assets that the financier can fund against. The benefit for the policyholder comes in the form of greater return on assets because more receivables are removed from their balance sheet. More favorable pricing from the financier usually offsets the cost of the Credit insurance program.

Headlines and Highlights

- The growth of captives and captive utilization will continue apace in 2004.
- The highest growth will be seen at US companies and in insurance market sectors that show few signs of softening.
- Direct writing captive operations will continue to generate interest, especially with the expansion of the EU in 2004.
- Established domiciles will continue to grow but a number of new entrants (particularly South Carolina) are approaching critical mass through aggressive promotion.

The World of Captives

Captive Participation

Captive insurance companies may be the longest-running providers of alternative risk financing. They have been employed strategically for decades to increase control of risk and facilitate risk financing, and they are used tactically to deal with marketplace cycles and to help minimize total cost of risk. Although a softening marketplace for certain lines of insurance may present short-term arbitrage opportunities, corporate-level retention and financing strategies typically do not vary. Captives can be useful tools in attaining strategic organizational goals.

Increasing costs for excess limits and aggregate coverage have impelled captive owners to expand the lines they write and take on more risk. Across nearly all domiciles in the US, year-over-year written premium has grown by approximately 20 to 25 percent.

Corporate Governance

Captives have served as excellent platforms for integration of risk management strategy and specific initiatives. As the repository of key management information, captives have facilitated assessment of the effectiveness of enterprise-wide risk management programs.

The demands of Basel II on financial institutions to effectively measure and manage operational risk are expected to drive further acceptance of captives as appropriate risk-bearing vehicles.

The Sarbanes-Oxley Act of 2002 has only slightly affected captive governance, especially in the areas of separating actuarial service from the CPA audit firm. Given the high level of regulatory reporting and examination, annual outside audit, and independent actuarial loss reserve certification, many captive owners have not had to change how they do business. A few captive owners are considering change, such as direct reporting to the audit committee.

Captive Formation

All captive domiciles experienced significant expansion in 2003 and are expected to continue growing at or close to the same pace in 2004. (The 2003 growth citations in the following list are year-end projections.)

- Bermuda: Licensed 70 new captives in 2003 and should continue to grow at the same pace in 2004. Formations are driven primarily by Workers' Compensation, D&O, Financial Institutions and Healthcare operators.
- Grand Cayman: Continues to be the fastest growing domicile, with 75 licenses, most notably in the highly stressed Healthcare sector.
- Vermont: The largest US domicile added approximately 80 new captives in 2003. New formations include large numbers of risk retention groups and pure captives across all classes of business.
- South Carolina: Has been experiencing significant growth as this energetic new domicile vies for the number two US slot held by Hawaii. Growth reflects a hospitable, business-oriented regulatory environment.
- Hawaii: Formation of 25 new captives in 2003 easily eclipsed the prior year's growth. Expansion continues to be driven by California-based companies, with a large proportion of Workers' Compensation and Contractor risk captives.
- Europe and Asia: Growth has been modest as new formations have been offset in some domiciles by license

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surrenders, many due to corporate reorganizations. In the EU, the tough Management Liability marketplace has driven expanded captive utilization. Expansion of the EU in 2004, with 10 countries scheduled to join, will make a direct-writing captive in either Gibraltar or Ireland increasingly attractive.

– United States: Individual states continue to pass legislation creating captive domiciles. By 2009, we expect that at least 40 states will have captive laws.

Risk Retention Groups

Driven by the most stressed classes of business, group and association captives grew rapidly in 2003, with a fourfold increase over prior year growth. Physicians' Professional Liability insurance costs, for example, spiraled upward throughout 2003, with no end in sight.

Other entities that formed risk retention groups (RRGs) include hospitals and healthcare practices, nursing homes, contractors and long-term care, assisted living and trucking facilities.

Regulators are reacting to the seemingly frenzied formation of so many RRGs. Effective June 4, 2003, Vermont now requires RRGs to "possess and thereafter maintain unimpaired paid-in-capital and surplus of $1 million." This doubled the previous amount.

A recent *Risk Retention Reporter* survey reveals that 2003 RRG annual premium is projected to surpass $1.7 billion, "an increase of $460.4 million (36.4%) over 2002 premium, which grew 34.0 percent from 2001…with no end in sight."

Issues and Opportunities

GAAP Accounting Issues

US Financial Accounting Standards (FAS) Interpretation Fin – 46f will create some activity in the protected cell captive arena. Protected cell companies (PCCs) have gotten off to a relatively slow start since enabling legislation was enacted beginning in the late 1990s. PCC structures with relatively skewed cell sizes (very large cell owners versus smaller cell owners) may run up against some of the consolidation issues involved with Fin 46.

Consolidation may be required despite preferred shareholder status, as the FAS interpretation concerns itself with consolidation of variable interest entities, a treatment that is consistent with UK practice.

A working group in Grand Cayman is tackling this issue in conjunction with an AICPA task force focused on the PCC industry. Recommendations and conclusions should be reached in Q1 2004.

Taxation

An increased number of countries are adopting strict Controlled Foreign Corporations (CFC) rules, effectively taxing captive profits as if they were locally tax resident. These actions are not expected to slow the growth of captives (few are formed primarily for tax reasons), but they will slow the accumulation of free reserves and hence capacity in the captive marketplace. Some captive owners may consider relocating their captives to their home territories.

Recent EU case law supports the need for an equitable allocation of premium by territory within captive global programs, with resultant local premium tax registration and filings.

The US Federal income tax environment saw no significant changes affecting captives in 2003. Captive owners continue to expand and plan to take advantage of treatment the IRS accords insurance companies.

In response to international pressures to synchronize tax treatments, a number of captive domiciles are amending their tax structures so that captives do not receive preferential treatment. Some offshore jurisdictions such as Isle of Man and Guernsey are pursuing zero tax strategies, whereas territories within the EU (such as Gibraltar) are establishing low tax regimes. This will give captive owners an even greater choice of domiciles to consider for group tax planning.

Employee Benefits

Employee Benefits reinsured by captives (for qualified US Department of Labor plans) were finally approved for fast-track treatment with the Archer Daniels Midland program in 2003.

> Driven by the most stressed classes of business, group and association captives grew rapidly in 2003, with a fourfold increase over prior year growth.

Multinationals are exploring the use of captives to consolidate regional employee benefits cover into global programs, in an attempt to provide consistency and standardization of cover. We nevertheless believe that benefits plans will be added to captives at a measured and conservative pace.

Regulatory Environment

The emergence of the International Association of Insurance Supervisors (IAIS) as a global insurance regulatory body is expected to drive further standardization of insurance regulation around the world. Captives should have little to fear.

Offshore captive centers have proven to be well-managed centers of finance. The results of recent International Monetary Fund (IMF) reviews of captive domiciles have been released, and they confirm the high standard of regulations in place.

Guernsey introduced a ground-breaking code of corporate governance in connection with its new insurance law in November 2002. The code is being easily integrated with captive management practice, and we expect that these protocols may become adopted as standard requirements throughout the global captive industry in 2004 and beyond.

Alternative Risk Transfer

Headlines and Highlights

– Hard market conditions created opportunities for "reengineering" risk transfer programs to include ART solutions such as integrated finite.
– ART market capacity is looking for risks uncorrelated with traditional insurance – using indices tied to agriculture, weather or securities markets.
– The general decline in credit quality of many carriers, with the financial distress of certain corporations, has led to novations accompanied by loss portfolio transfer transactions.
– Dual trigger structures incorporating the potential bankruptcy of the insured are examples of capital market solutions to D&O exposures and unfunded pension liabilities.

The 2003 marketplace for Alternative Risk Transfer (ART) experienced changes that are likely to pave the way toward more favorable conditions in 2004.

At the beginning of last year, the ART marketplace experienced a reallocation of insurer capital from alternative solutions into traditional insurance products and a decrease in the number of markets actively writing ART programs. This abatement of capital was largely due to the following:

– Increasing returns from the hardening market for traditional products created a natural movement of capital toward greater expected returns.
– Several markets sustained underwriting losses on ART programs, or mark-to-market losses on credit derivatives, that forced management to abandon or significantly reduce alternative risk transfer business.

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ART Markets

Insurers who have exited the ART market include Chubb Financial Solutions, Winterthur SFS, Commercial Risk (SCOR), Gerling, Royal & SunAlliance and Mitsui. Centre Solutions has ceased underwriting credit enhancement products and is more selective in writing alternative risk transfer business for retail accounts.

Although capital allocated to alternative risk financing products declined in the beginning of 2003, several insurers both large and small remained committed to this market segment and are actively writing business. The larger ART insurers include ACE, AIG, Converium, Swiss Re, XL and Zurich.

By the beginning of Q4 2003, insurers began showing renewed interest in underwriting customized risk transfer solutions, and new capital dedicated to ART programs is flowing into the marketplace. Examples are Quanta Holdings, Catlin and Imagine Re:

– Quanta Holdings, a Bermuda-based insurer, was formed with $700 million of capital by the former management team of Chubb Financial Solutions and other professionals. Most of Quanta's business is expected to be in ART products.
– Catlin, the Lloyd's syndicate, has formed a Bermuda-based insurer that is expected to write about one-half of its business as ART.
– Imagine Re, a Barbados-based reinsurance company specializing in finite risk products, received an additional $100 million of capital from its Canadian financial services parent company.

A list of insurers that are active in providing ART products for North American companies includes: ACE Financial Products, AIG Risk Finance, Ambridge Partners, XL, Quanta Holdings, Imagine Re, Catlin, Zurich Corporate Risk Solutions, Swiss Re, Converium, PartnerRe, Element Re and Berkshire Hathaway.

ART Solutions

Examples of the types of ART solutions we expect to see in 2004 are:

Integrated Finite

An integrated finite program is a multi-year risk financing alternative that combines various coverages for the layer of risk transfer that attaches directly above the retained risk layers (e.g. $25 million to $50 million). In recent years, premiums have increased dramatically for this first layer of risk transfer to the point that over multiple years, total premium can over-fund the layer. If expected loss over the multi-year period is significantly less than the layer or the amount of total premiums paid over the period, an integrated finite program may create substantial savings on annual premium expense, given good loss experience.

ABC Corporation: an Example

ABC's first layer of risk transfer provides a $25 million limit for Auto Liability, General Liability, Umbrella, Employment Practices Liability, Excess Workers' Compensation and Property. Premiums total $7,950,000 per annum or $39,750,000 over five years – well in excess of the $25 million layer. In effect, ABC would be overfunding the limit over the course of the five-year period. If expected losses are significantly less than either the $25 million layer limit or the $39.75 million total premium payment, savings could be created through an integrated finite program.

Making certain assumptions regarding loss expectancies, carrier earnings and interest earnings, ART modeling tools demonstrate potential savings to ABC in excess of 50 percent.

Loss Portfolio Transfer

Although interest rates are at or near historic lows, we are seeing an increased level of interest in loss portfolio transfer (LPT) programs. There are three primary drivers that we expect will continue operating in 2004:

- **Adverse Loss Development:** Many companies are experiencing adverse loss development arising out of historical retained losses – a development that can create unexpected charges to earnings. By transferring liabilities associated with expired policy years, a company can avoid or substantially eliminate the impact of future loss development on earnings.
- **Efficient Use of Capital:** All companies seek to increase the efficiency of collateral posted to secure retained losses under deductible and self-insured programs. Many are facing a capacity squeeze on their overall letter of credit needs as banks are growing increasingly rigid about pricing and the amount of capacity they will provide in a given credit line. In some cases, a loss portfolio transfer can be structured whereby the LPT insurer will provide a trust agreement or other form of security to the legacy insurance companies. Existing collateral can then be released, thereby enhancing the value of the cash paid to the LPT insurer as premium.
- **Market Security:** Recent insurer failures and downgradings, and concerns for the claims-paying ability of certain carriers, may encourage companies to consider novating policies from a legacy insurer to a new one. In many cases, a loss portfolio transfer can be used to provide an incentive (i.e., more premium) for the new insurance company to agree to the transaction. Novations that include a loss portfolio transfer of the insured's retained losses create the twin benefits of earnings protection and collateral efficiency.

Capital Market ART Solutions

Directors & Officers Liability

The D&O insurance market is one of the most difficult sectors to navigate. Businesses are seeing sharp retention and price increases combined with reduced coverage and capacity. This dramatic hardening has been driven by:

- Heavy increase in claim activity
- Actual and perceived increase in risk due to corporate malfeasance
- D&O claims that are highly correlated with depressed economic activity
- Businesses growing ever more complex

The capital markets solution involves a dual trigger insurance policy issued by an offshore captive or insurance company. The policy is supported or reinsured by the capital markets using funded insurance-linked notes or credit default swaps. The policy is written to cover a multi-year period of up to five years. The use of a bankruptcy trigger allows the capital markets to analyze the risk of the transaction as corporate credit risk and to price it in line with the corporation's bonds or swaps. The structure allows for broad coverage with straightforward terms.

> The capital markets solution involves a dual trigger insurance policy issued by an offshore captive or insurance company. The policy is supported or reinsured by the capital markets using funded insurance-linked notes or credit default swaps.

The capital market is equipped to provide Side A capacity for cases where the business entity cannot indemnify the Ds and Os. Side A provides coverage for those claims levied upon the Ds and Os for their liabilities incurred as a result of their service to the entity. The majority of Side A claims against Ds and Os are indemnified by the business entity. When the business entity is unable to make good on that indemnification, e.g. because of a bankruptcy, the coverage can easily be likened to credit. Furthermore, the types of claims that the business entity cannot indemnify are either excluded from insurance policies or are relatively small in nature. Thus, at some attachment point, traditional Side A D&O insurance is really only providing bankruptcy protection to the Ds and Os.

The key to the product is the back-to-back nature of the insurance policy issued to Ds and Os and the ultimate debt placement to investors. In other words, a paid claim will in all instances trigger a loss of principal to the investors under the note issuance. In addition, there will always be sufficient capital to pay a loss because the proceeds from the debt issuance will equal the policy limits.

Pension and Medical Benefits Funding

Another capital markets solution helps companies solve pension and medical benefit funding shortfalls using various insurance structures. The corporate challenge to unfunded pension liabilities has taken on a high profile. The decline in the equity markets has reduced pension portfolio values while the low level of interest rates has increased the pension liability calculation. The unfunded gap is a corporate problem requiring a five-year solution since that is the timeframe companies are granted to catch up in funding of the liability. The corporation is going to have to fund some of this liability, with the remainder financed through an ART vehicle.
In a typical case, the corporation acquires a policy written by a Bermuda carrier that will respond in the event of bankruptcy. The policy will backstop the obligation of the corporation to fund its pension over the five-year period. The existence of the policy improves the corporation's ability to work with pension regulators and achieve terms that do not unduly stress cash flow. The policy also helps buy time for the pension portfolio to recover from a period of negative returns on equities.

Headlines and Highlights

– Sharp rate increases have shifted from Property to the Casualty lines.
– Unlike its counterpart in the US, the D&O marketplace is facing little respite from premium hikes.
– Capacity for Professional Liability is in critically short supply, encouraging certain groups to seek alternative solutions.

The Canadian Marketplace generally mirrors the US insurance markets, with a few months' delay. Over recent years, commercial insurance buyers north of the border have received a less-then-warm greeting from underwriters. Recent surveys on the commercial marketplace, however, suggest that we may be at a turning point, or at least a point of moderation of the hard market that has dictated the pricing for the last two years. The intensity in rate increases has shifted from Property to the Casualty lines.

Property

After facing successive rounds of paying much more for far less, companies in Q3 2003 found Property increases flattening to some degree. We anticipate 2004 rates will be flat and may even begin to fall, perhaps as much as 10 percent. Better treatment will be received by organizations that can document clean loss records and an absence of CAT exposures. Capacity has returned, with some underwriters offering substantial additional capacity. The Lloyd's and Bermuda markets have stepped in to the market void left by the retreat of domestic markets.

Underwriters continue to assume a conservative stand on policy wordings. Several underwriters continue to insist on company wordings. Others are approaching renewals with an open mind, but all are maintaining close scrutiny on exposures such as Business Interruption and Contingent Business Interruption and on policy limits and deductible levels. Accurate values and full explanation of exposures will remain critical to the underwriting process as carriers impose location limits and write detailed policies based on submitted values.

General Liability and Excess Liability

In 2004, Liability underwriters are expected to adjust pricing as they have for the past two years, with rate increases of 10 percent for primary underwriters and 20 percent in the Excess Liability segment.

Canadian companies with cross-border exposures are considered especially vulnerable by underwriters, and rate increases could range between 30 and 40 percent. As the Canadian economy becomes increasingly connected to that of the US, the entire spectrum of risks, from those of the small middle market to national and international organizations, are facing this pressure.

Umbrella and Excess underwriters are requesting higher underlying limits, varying from $2 million to $5 million, and $10 million if Automobile exposures are high. This drives prices upwards for primary underwriters, creating a "rate relativity" problem, as Umbrella and Excess underwriters continue to demand a percentage of the underlying premium.

Automobile Insurance

The Ontario Automobile marketplace, which is the largest Automobile segment in Canada, suffered a poor loss record in 2003 which in turn drove pricing upward in the rest of the country. Rate increases of about 10 percent are expected in 2004. However, increases may be moderated by recent provincial government rate freezes and promised rate rollbacks.

Fewer underwriters are willing to write an Automobile fleet on a monoline basis, with the result that the remaining few capture the market share at their own terms and conditions.

Directors & Officers Liability

Placement of D&O coverage continues to be a challenge in light of recent scandals, lawsuits, bankruptcies and corporate financial restatements. Contrary to a US marketplace that has seen new capacity in D&O and consequently a possible flattening of rates, Canada in 2004 will still see premium increases, particularly for the publicly traded corporations

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For the Property market, we anticipate 2004 rates will be flat and may even begin to fall, perhaps as much as 10 percent. Better treatment will be received by organizations that can document clean loss records and an absence of CAT exposures.

with US exposures. Increases for publicly traded companies will start around 30 percent and increase further if a company faces financial difficulties. Private companies should see some stabilization (i.e., minimal increases) depending on the industry; technology companies are still being closely monitored.

Retentions will continue to increase and terms and conditions will further tighten. Allocation will be scaled back. EPL extensions and Pollution extensions will be sub-limited further. Additional exclusions will be added, such as those for failure to maintain insurance and intellectual property. Entity coverage for security claims will still be available but at increased premium and reduced coverage.

The Canadian Securities Administrators' responses to the initiatives launched by the US Sarbanes-Oxley Act could have implications for the D&O landscape. It is anticipated that the proposed rules will be adopted by most of the CSA and will become effective in 2004.

Professional Liability

The marketplace for Professional Liability remains extremely tight in terms of capacity and terms. Recent court rulings in the US and scandals involving mutual fund dealers have cast a shadow over the entire underwriting community. Cover for financial, legal and real estate professionals is almost non-existent, except for some select capacity in London and Canadian capacity controlled by US head offices. Prices for group Errors and Omissions programs are still increasing wildly – from 50 to 300 percent. Creativity is the name of the game. Reciprocals and pools are back in vogue as potential solutions.

Energy

Having now achieved the level of deductibles and waiting periods they wanted on certain accounts, Canadian Energy markets are starting to follow the London trend of plateauing rates, with reductions considered on a selective basis. Technical information is still very much a requirement to win underwriters' favorable attention.

Operators Extra Expense, a coverage specific to the Energy sector, sustained huge increases in the hard market. All major Energy brokers have access to facilities, which is helping to stabilize rate structures. Loss ratios have recently improved and now we expect competition between the facilities will translate into a softening of terms during 2004.

Headlines and Highlights

– The local P&C market remains fairly soft, but large catastrophe risk programs that involve global reinsurance markets have seen dramatic premium increases.
– Mexico has been hit repeatedly by natural catastrophe losses, and local markets, reinsurers and the federal government have responded in a variety of ways to help provide protection.
– With the Social Security System beginning to fail, the marketplace is offering a variety of opportunities for private providers of Employee Benefit plans.

Property & Casualty

The Mexican marketplace remains somewhat immune from the market forces at work in the global marketplace. The market hardening predicted to follow in the wake of hardening elsewhere – especially the US – has not materialized for locally placed risks. For sizable placements that involve facultative reinsurance markets, however, avoidance of global influences is impossible, and large risks with catastrophic exposures (hurricane and earthquake) experienced dramatic premium increases. Carriers also exercised stricter control of policy conditions, agreeing to very few broadly worded terms.

For 2004, capacity will continue to be scarce for sizable catastrophic risks. Hurricane and flood exposures became the market focal point after a year of many losses. In the aftermath of the destruction wrought by Hurricane Pauline, carriers began developing a new hurricane endorsement. After hurricanes Juliette, Isidore and Kenna, the Mexican market instituted a new hurricane tariff – one that also takes into consideration other meteorological risks and flood.

Uncertainty and confusion regarding coverage responses to weather-related events led the markets to integrate all these coverages into broader products. These cover:

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– Water damage
– Hail
– Hurricane
– Flooding due to overflow or rain
– Storm Surge
– Other risks related to water

Despite the integration of weather risks, the P&C market overall continues to specialize. Most carriers shy away from writing all lines and types of business, looking for niches and specialized client groups.

Use of business technology increases in Mexico, and the insurance industry should soon begin to benefit. Electronic tools will aid in the delivery and implementation of policies, increasing efficiency and ultimately lowering costs.

Reinsurance

The Mexican reinsurance market continues to be stable, with a core group of carriers remaining in place. On large risks, competition among them may reduce prices by 10 to 20 percent. As the Mexican market matures, local carriers are better able to handle the largest risks.

Expected changes in Proportional programs or Excess Loss programs will force insurance companies to cede risk to minimize their own capital exposure, especially for natural catastrophe ("CAT") perils (hurricane, earthquake, volcanic eruption).

Government and Special Risks

As natural disasters have increased in frequency and severity for Mexico, the government has become more aware of the need for catastrophe protection and is pursuing means of transferring such risk. With relatively scarce capacity, this is no easy undertaking. The federal government is now in the process of creating a fund for CAT coverage, designed to complement the CAT coverage purchased by individual Mexican state governments. This policy is designed to encourage the purchase of coverage by the individual states so they can qualify for federal help. As a result of these activities, a large market is opening for CAT coverage, and a handful of Mexico's 31 states have already purchased coverage or are seriously considering doing so.

> As natural disasters have increased in frequency and severity for Mexico, the government has become more aware of the need for catastrophe protection and is pursuing means of transferring such risk.

Employee Benefits

The struggling Mexican economy has spelled trouble for large-scale Employee Benefits coverage. Companies are reluctant or unable to expand or even implement Benefits programs. The government's Social Security program is bankrupt and the services provided are poor and only getting worse every year. At the same time, an expanding and aging population puts pressure on health services and pension schemes. The government cannot fulfill these needs, thus opening a gradually growing market for the private sector.

Employers are looking at various means of reducing their burden. Medical plans with third-party administrators are becoming popular. Minor medical plans are becoming more common. Employee Benefit plans, when they exist, are being paid for by participants in part or even in full. Individual programs, rather than large group plans, will probably be more popular in the future.

Auto

The Automobile market is fairly stable. On the one hand, a rise in claims frequency puts upward pressure on prices. On the other hand, insurers in Mexico tend to use profits from other lines to subsidize the Automobile lines. Mandatory third-party liability coverage has not begun to operate in Mexico, even though it was legally instituted a while ago; it is still unclear if it will be operational anytime soon.

Government Regulation

The Mexican business community is awaiting reform in several areas, including the financial, labor, utilities and energy sectors. Some modest reform is expected in 2004, but far short of the legislative overhaul for which many are hoping. In the Mexican political calendar, the buildup to the 2006 presidential elections will begin this year. This tends to slow down legislative activity, which will decline even further as the election approaches.

Highlights and Headlines

– Withdrawals continued, with longstanding participants having exited the marketplace.
– Premium tax payment and allocation issues should be addressed by anyone doing business in the EU.
– Finding fronting carriers remains a challenge.
– Rate increases brought by hardening markets are easing.

International Programs

The landscape for International program underwriting underwent considerable change in 2003. The years of solid traditional insurers dominating the field are fading away. Those who remember names such as INA, AFIA and Continental – long-gone fixtures of another era – understand how the quickly the changes can happen. In recent years, we have seen similar departures, and more may be on the way.

At the very end of 2002, Kemper was suddenly downgraded, taking it out of the International market for 2003. This was followed by Royal & SunAlliance's announcement that it was closing down its US Global Property operations and offering that book of business to XL Global on an acceptance basis. (This followed Royal & SunAlliance’s withdrawal from International Casualty in 2002.) Atlantic Mutual, although not a big International player, also stopped writing this business in 2003.

Not all of the change has been negative. The November 2003 news about St. Paul's and Travelers merging could have a positive impact in strengthening the joint company's International capabilities. Travelers withdrew from International business 10 years ago and since that time tried to form alliances with other companies. Travelers' major accounts may now be able to expand overseas within the same company.

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Market Snapshot

The international carriers serving multinational clients divide into three tiers according to their appetite for business, global presence and product range.

Tier I – The top carriers include a broad, worldwide network of centrally owned, nationally operating insurers; these companies offer the widest range of products and have the underwriting expertise to accept the most difficult classes of business. Two years ago, this tier was dominated by a greater proportion of non-US owned carriers.

Tier II – These carriers own a moderate geographic spread of locally based companies, and on the whole offer a limited range of products. In general, they show some aversion to difficult classes of business.

Tier III – While operating on an international scale, these companies are supported by a limited geographic spread of nationally operating companies and offer a very limited product range.

International Markets

Tier	US Headquartered	Headquartered outside US
I	AIG Worldsource	ACE
	FM Global*	Zurich
II	Chubb	Allianz*
	CNA	XL Global
	St. Paul	
III	Liberty Mutual**	Fireman's Fund

Recent departures: Royal & SunAlliance, Kemper, Atlantic Mutual
* Property only ** International only with domestic support

While this listing pertains to carriers underwriting International programs in the US, recognition needs to be given to carriers outside of the US who are offering these programs. In Continental Europe, carriers such as Generali, AXA, Gerling and HDI are active. Despite closing its US book of business, Royal & SunAlliance still provides this capability elsewhere. In Scandinavia, IF and Trygg Hansa are the dominant underwriters.

Key Marketplace Trends

– We are seeing some leveling off on pricing for International Casualty and we expect this to continue.
– Several of the Tier II carriers are looking at tougher risks now that they are seeing improved pricing.

- Zurich has shown renewed aggressiveness in writing International Casualty business.
- Carriers are faced with more challenges regarding premium payment requirements. Several jurisdictions, such as Mexico, Puerto Rico and Turkey now require premium payments before or shortly after the inception date of the policy.
- With US government-funded projects in the Middle East, most underwriters are interested in providing Defense Base Act (DBA) coverage for employees. The cost of covering this exposure is high.
- The changes in corporate governance standards and expectations following the passage of the Sarbanes-Oxley Act have caused carriers and risk managers to be more attentive to non-admitted insurance requirements.
- The technological difficulties of coordinating international coverages are easing as carriers upgrade IT systems; the exchange and reporting of information is improving, but there is still further to go in this regard.

Premium Taxes in the European Union

An important international issue that is only now coming to the surface relates to the European Union (EU) Court Kvaerner decision, which was issued several years ago. The Kvaerner case broadened the applicability of premium taxes.

The payment of premium taxes is not new for the EU. Europolicies have long recognized the importance of paying local premium taxes. What the Kvaerner ruling implies is that premium taxes not only have to be paid for Europolicies, but also for any coverage a multinational places that extends to its domiciled operations within the EU, even if the placement is non-admitted. Premium taxes must be paid even where there is no policy issued and no internal allocation of premiums to the overseas subsidiary. Multinationals operating outside of the EU are subject to the EU's premium tax rules for operations domiciled within the EU. A US multinational is obligated to pay taxes on the proportion of premium that covers the EU domiciled operations of its worldwide policies – Umbrella, Directors and Officers, etc.

Lloyd's has recently begun more strict enforcement of overseas tax rules. Lloyd's accounting structure enables it to perform this task wherever Lloyd's is licensed outside of the UK. Lloyd's automatically includes local premium taxes on any cover that is worldwide and not just within the EU. Payment of premium taxes is becoming a requirement for coverage to attach.

Premium taxes have not been instituted in the same way outside the EU, but many markets are reviewing the question. Insureds are urged to monitor the implications of this trend.

Property Fronting Programs

A year ago, the scarcity of fronting capacity for captives and reinsurance panels arose as a major concern. The hard market, reinsurer security issues and the fallout from corporate governance scandals brought drastic changes in how fronting services were provided and in what they cost. A reduction in the number of fronting carriers this past year did not help the situation.

In the beginning of 2003, we identified seven fronting carriers. The updated list below shows a comparable picture in terms of capacity, security and cash flow. The only significant changes from a year ago are the departure of Royal & SunAlliance from the US market and Zurich increasing its property fronting capacity from $300 million to $500 million. It is possible that one or two more fronting carriers will re-evaluate their fronting

Fronting Carriers as of December 2, 2003

Carrier	Max. Property Fronting Limits	Security Requirements	Guaranteed Flow (Standard Terms)	Front for TRIA	No. of Owned Countries	No. of Affiliated Countries	Total Countries
ACE	$500 M	S&P A Rated	Paid by 25th, out 15th of following month	Will consider	46	100	146
AIG	$500 M	Committee approval	25 days selected countries	Will consider	89	14	103
Allianz	$200 M	Specified carriers	None	Will consider	42	15	47
FM Global	$500-1,000 M	Committee approval	None	Will consider	18	70	88
XL Global	$500 M	S&P A rated	None	Will consider	28	53	81
Zurich	$500 M	5% of carrier surplus/A rated	None	No	36	47	83

Note: While this chart highlights Property fronting, Casualty fronting is available from all but FM Global and Allianz

> We continue to recommend that insureds consider a global primary with an insurer that has the ability to issue local policies, and then build a non-admitted excess program.

positions and we will see additional withdrawals in 2004.

Strategies for 2004

We continue to recommend that insureds consider a global primary with an insurer that has the ability to issue local policies, and then build a non-admitted excess program. Another tactic we see growing in popularity is separating domestic and International programs – if the International is large enough to be written by one insurer with the proper capabilities. Regional programs, such as Euro policies, should be considered where applicable.

The selection of underwriters is shrinking, but that does not necessarily simplify the task of deciding on the best carrier to approach. Insureds must assess which underwriter has the ability to best satisfy short- and long-term program objectives. If you think that you eventually want to create a captive, for instance, be sure that the carrier you use today has that capability.

Organizations with significant geographic spread have a particular challenge in describing a complete and accurate risk profile for underwriters. Great care must be taken to articulate catastrophe potentials and what the organization is doing to minimize the risk of loss. Fortunately, 21st century technology should help in the increasingly complex task of preparing underwriting submissions.

As always, get to know your program underwriter and be sure that your global needs can be properly served.

The Bermuda Marketplace

Headlines and Highlights

– Bermuda has more than 1,641 international insurers and reinsurers...
– ...with $164 billion in assets...
– ...and $48 billion in gross annual premiums.

Vitality and Strength

In 2002, during the drought of offerings on the New York Stock Exchange, Bermuda's Montpelier Re Holdings, then a 10-month-old global Specialty Property reinsurer, launched a successful $200 million initial public offering. The company closed its first year of operations with over $607 million written premiums and a return on equity of over 18 percent. For the first nine months of 2003, Montpelier Re reported $706.6 million of written premium, representing a growth of 75 percent for its core Property and Specialty lines compared to the same period in 2002.

AXIS Capital, another company started in the wake of September 11, 2001, reported that at the end of Q3 2003, it had increased shareholder equity in excess of $1 million per day since its formation.

These are but two examples of the strength of the Bermuda insurance market, which has a long history of stepping up when other world markets are struggling. In 1985, Bermuda responded to a hardening market and lack of capacity with the formation of ACE and XL. After Hurricane Andrew devastated the Life, Property and Reinsurance markets in 1993, Bermuda responded again, with the launching of eight highly capitalized catastrophe reinsurers. With three successful IPOs completed in 2001 (by Montpelier Re, AXIS Capital and Endurance Specialty on the New York Stock Exchange), the Bermuda market delivered yet again, underscoring its pivotal role in the growth and expansion of the insurance industry over the last 20 years.

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Arch, Montpelier Re, Endurance Specialty, AXIS Capital, Allied World Assurance, all formed in the year 2001 with total capital of approximately $15 billion, joining the ranks of ACE Group, XL Capital and other well-established insurance and reinsurance companies headquartered in Bermuda. Some skeptics predicted that the capital raised in Bermuda following September 11, 2001 would disappear as quickly as it arrived. More than two years later, the capital remains; the new carriers have experienced extraordinary growth and have predicted measured growth through 2004. There is now more capital in Bermuda than ever before. Once regarded as an alternative marketplace, Bermuda has become the market of choice for many.

Operating Results

In 2003, with the few exceptions noted below, Bermuda carriers reported "outstanding growth", "exceptional growth and earnings", and "excellent growth and consistently low loss ratios". Pricing and terms remain attractive and expected return on capital employed remains quite acceptable. Bermuda market companies have outperformed many of their competitors in North America and Europe, and the market continues to show strong momentum.

The insurance market in general, however, is witnessing rating downgrades and continuing deterioration of prior year reserves, putting pressure on the availability of quality capacity. The Bermuda market has not been immune to these issues. ACE has booked charges for additions to A&E reserves (Asbestos and Environmental), while XL has suffered from a boost in loss reserves for potential claims in Medical Malpractice and Professional Liability policies dating back to the late 1990s. Another carrier facing mixed results, Max Re, undertook to turn itself around by moving away from reliance on its hedge fund-led investment portfolio and reemphasizing traditional insurance and reinsurance. The timing of Max Re's launch as an alternative investment insurance company had not been ideal, and it experienced poor results throughout 2002. With a change in focus, however, the company moved into the black.

Classes of Direct Insurance

In 2003, the new carriers increased limits as they established their niche and developed their reinsurance treaties. Their additional capacity has stabilized the market somewhat, and premiums in certain areas have started to level off. Conditions are not expected to ease everywhere. Executive Risk, Healthcare and to some extent Excess Liability (particularly for difficult classes of business such as Chemicals, Energy and Pharmaceuticals) will continue to see increases in 2004.

Excess Liability

Bermuda-based insurers can offer significant Excess Liability capacity excess of a minimum attachment of $25 million, the historical foundation on which the market built its reputation. The principal form being used is "occurrences first reported" – often referred to as the Bermuda form. The liability market has changed a great deal since the introduction of the Bermuda form in the 1980s, and coverage is far more widely available. The Bermuda market has responded to these changes by making Excess Liability cover available on an occurrence form or on a claims made follow form basis. For many risk classes, $100 million of follow form occurrence cover is readily available. Unique features of the Bermuda form remain – such as the mandatory arbitration clause and the fact that coverage is affirmatively provided for punitive damages.

Healthcare

Buyers of commercial Healthcare insurance are finding more affordability and more access in Bermuda. With rates that continue to rise in traditional markets, and the associated reduction of capacity, Bermuda insurance brokers are receiving an increasing number of submissions. Bermuda has four key carriers with expertise in healthcare; they are all A- rated or better and highly capitalized. The combination of these companies with other high excess providers such as Starr, ACE and Arch results in over $400 million of capacity. While nearly all Bermuda carriers targeting Healthcare prefer to attach excess of $25 million, some have been able to attach as low as $5 million or $10 million for particular risks. Bermuda policy forms continue to provide comprehensive coverage, often with unique features.

Directors & Officers (D&O) Liability

D&O has been offered in the Bermuda market since the formation of ACE and XL. After the market started to harden in 2001 and new capital found its way to Bermuda, the market transitioned from having three main D&O carriers (ACE, XL and Starr) to nine (the same three plus Arch, AWAC, Endurance, Everest Re, Max Re and AXIS). Even with the new capacity, D&O premiums rose by an average of 50 percent through 2003 as the corporate world adjusted to Sarbanes-Oxley and its implications for corporate governance.

Employment Practices Liability

EPL coverage was first introduced in Bermuda in 1995 when XL launched its newly created coverage in response to the concerns of insureds over the increasing number of large lawsuits being filed by employees against US companies. Several other companies now offer the coverage. EPL policies are designed to protect employers from catastrophic claims resulting from class actions and large individual lawsuits. Punitive damages are covered in all of the policies offered by the Bermuda carriers. The capacity available now exceeds $350 million, including the contributions of several of the new carriers. XL is the leader in the field but Max Re is also now offering primary terms. The typical attachment for the other carriers offering follow form capacity is $25 million.

Errors & Omissions (E&O) Liability

E&O or Professional Indemnity coverage has been available to financial, law, architectural, engineering, accounting, management consulting and insurance brokerage firms since the formation of ACE and XL in 1985. With the addition of new capacity since September 2001, a greater emphasis has been placed on these products, and the depth and experience of underwriters has improved considerably. While Bermuda remains an excess market, attachments as low as $25 million are common, with capacity layered up in excess of $100 million.

Property

Property coverage for petrochemical companies has been available in Bermuda since 1972 when OIL Insurance Limited was formed as a mutual insurer. Property insurance became generally available to all insureds in the early 1990s when XL and then ACE commenced writing the coverage. With the entry of new participants post-9/11, there are now far more Property markets, with many of them able to tailor coverage to meet unique or specialized situations. The appetite of each carrier varies vis-à-vis primary, quota share, first excess or high excess of loss.

The Bermuda Marketplace (continued)

By the Numbers

The chart below outlines the maximum capacity offered by Bermuda carriers over various lines of business. Attachment points and policy forms will vary depending on the risk class.

Company	Property	Liability	Healthcare HPL	D&O	E&O	EPL
Ace Bermuda	$50M	$200M ($100M Single Occurrence)		$25M A/B Plus $25M SIde A $50M Coda	$15M	$50M
AWAC	$10M $20M (Energy)	$50M	$25M	$25M	$25M	$25M
Arch Bermuda	$50M	$50M		$25M	$25M	$25M
Axis Specialty	$125M			$25M	$25M	$25M
Chubb Atlantic		$25M				
Endurance Specialty	$40M	$50M	$25M	$25M	$25M	$25M
Everest Re	$10M			$10M		$10M
Glencoe Insurance	$10M					
Max Re		$25M	$25M	$25M Side A or $15M ABC	$15M	$25M
Montplelier Re	$50M ($25M ENERGY)					
OIL (Energy Only)	$250M PD ONLY					
Senergy (Energy Only)	$200M BI					
OCIL (Energy Only)		$150M		$50M		
Starr Excess		$100M		$75M	$75M	$75M
XL Bermuda	$250M	$100M	$100M	$50M IDOL, $25M A/B, Plus $25M A only	$50M	$100M
Zurich Global Energy		$50M				

The Willis Re* Lloyd's Review*, published June 2003
and available at www.willis.com, provides readers with a thorough report on the Lloyd's marketplace – results, forecasts, capacity, management, regulatory issues and security.

This article includes introductory comments from the Lloyd's Review *and also cites portions of a speech ("The Changing World of Business Risk") given by Lord Levene, Chairman of Lloyd's, on October 24, 2003 in New York. Lord Levene's address included commentary on the state of Lloyd's, the financial impact of 9/11 and the ongoing efforts to preserve and enhance the Lloyd's brand.*

From the Willis Re *Lloyd's Review*

The year 2002 was a momentous period for Lloyd's. It was a year in which Lloyd's demonstrated its resilience in meeting the challenges presented by the losses of September 11, 2001 – the market's largest-ever loss. It was a year in which Lloyd's demonstrated its capacity for capital regeneration, and a year in which the market returned to profitability.

Further, in September 2002, Lloyd's members voted in favor of the reform proposals developed by the Chairman's Strategy Group (CSG), thus giving Lloyd's its mandate to create a modern, transparent, profitable marketplace and the opportunity to enhance the Lloyd's brand for the 21st century.

Having remained stable at approximately £10 billion for a number of years, the capacity of the Lloyd's market has increased significantly for the third consecutive year. Lloyd's opening capacity for 2003 was £14.4 billion, a rise of 18 percent on 2002. This represents the Lloyd's market's highest-ever capacity. The diversity of the Lloyd's capital base continues; with the international insurance industry and UK-listed Lloyd's vehicles continuing to provide strong support for the market.

Lloyd's reported a return to profitability with the publication of the market's results for 2002 on a *pro forma* annual basis. The 2002 result, with a combined ratio of 98.6 percent, compares favorably with Lloyd's peers and is a reflection of the favorable underwriting environment.

However, the significant loss for the 2000 year of account, together with the forecast loss for the 2001 year, are reflections of the poor underwriting conditions that existed in those and prior years, as well as losses arising from September 11, 2001. These results, taken together, will present Lloyd's with legacy issues to manage and resolve in order to minimize the impact on central resources and the Lloyd's brand.

Lloyd's is in the middle of a change process: It has been through a period of self-analysis as demonstrated by the CSG proposals: Lloyd's management has started to implement the changes necessary to move to a franchise system for the market, which has the primary goal to improve profitability and returns to capital providers. While the market is again profitable, the challenge for Lloyd's will be to instill a culture of profitable underwriting and proactively manage the franchise to avoid a repeat of the losses of a relatively small number of businesses, which caused significant damage to central resources and the Lloyd's brand. How Lloyd's manages the next downturn in the market will be seen as the real test for the effectiveness of the franchise system.

From Lord Levene's Speech to RIMS

"Ours is a brand built on trust – trust that Lloyd's, the insurer and reinsurer, will pay when things go wrong."

"I say 'when things go wrong'. That suggests our role is simply to pick up the pieces, to rebuild, to recreate. We do that, of course. But we do more: we enable people to experiment, to innovate, to create. Insurance is the oil in the engine of the economy, allowing entrepreneurs to take risks, helping businesses to grow."

On 9/11 and Globality

"...The test we faced was not just emotional. It was financial. And in the case of Lloyd's, it was immense. We incurred the largest loss of any insurer for the attacks on the WTC. Doom-mongers predicted that we would never be able to meet our claims. But we proved them wrong. We have now paid $4.2 billion in direct and reinsurance claims."

"The role that insurers played following 9/11 shows the global nature of our business. Of the 10 insurers facing the highest gross losses from the 9/11 attacks, one is Bermudian, two

Lloyd’s of London (continued)

How Lloyd's manages the next downturn in the market will be seen as the real test for the effectiveness of the franchise system.

Japanese, two American and five European, of which one is Lloyd's. We may be British, but the insurance we offer runs like a thread through the world's economies. More than 90 percent of the Dow Jones companies have policies with Lloyd's. So do the top 10 global banks, the top 10 global pharmaceutical companies, the top seven global airlines and eight of the top 10 motor vehicle manufacturers."

On Market Discipline...

"...New risks have appeared after years of underpricing and under-reserving. We now want to break free of the turbulence of the soft and hard markets, so that insurers and buyers alike can better plan ahead."

"Going forward, the insurance industry also needs to act with greater discipline, levelling out the peaks and the troughs of the market: So let me be honest: pricing must remain firm."

...and the US Tort System

"New York is no stranger to extreme weather. Sadly, it is also not a stranger to terrorism. And nor is it immune to the third issue that our industry is grappling with: the cost of the tort system. This subject is a speech in itself, so forgive me for gliding over the surface. My case is simple. The United States has to reform its tort system, as it is eroding the spirit of enterprise, innovation and risk-taking that lies at the heart of the American culture."

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