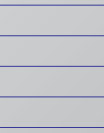


# Energy Market Review

July 2003



Willis

<b>Contents</b>		Page
1	Foreword	1
2	Introduction	4
2	Market Overview	5
3	Market Updates	
	– Onshore	12
	– Upstream	17
	– Power generation utilities	21
	– International liability	22
	– US casualty	25
	– Terrorism	28
6	Lloyd's	30
7	Bermuda Market	32
8	Interview with Andrea Viera, OCIL	34
9	Fronting - a burning issue	36
10	People & Places	44
11	Summary	46

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## Foreword

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### Where do we go from here ?

Some things never change - like the human desire to grasp the meaning of the present and gaze into the future. Where we are, where we're going and how we get there are constant concerns, regardless of the tide of events.

Today's marketplace headlines confirm that which most readers have already experienced or perceived:

- The Property market has stabilized.
- The Casualty market *should* stabilize in next 9 to 12 months.
- D&O underwriters are still "catching up" and many insureds will continue to face stormy weather.

A few armchair pundits and soothsayers are ready to proclaim the onset of competitive market conditions, which in turn - with modest help from financial markets and global economic conditions - might herald the beginning of another ultimately destructive cycle of cash flow underwriting. There are important differences, however, between the marketplace recoveries of the late 1980s and mid-1990s and the recovery phase in which we are living today.

### Then and now: fundamental differences

Over the course of the last two years, the DNA of insurance carriers has been altered profoundly. The nature of underwriting itself has changed forever - at least for the next 1 to 3 years, anyway. The à la carte menu of carrier activities includes:

- In-depth due diligence in the underwriting process, needing to understand their clients' businesses, exposures and interdependency risks.
- Focus on the aggregation risk of earthquake, flood, windstorm and terrorism, and on challenging new-age perils such as MTBE, mold, computer virus and others.
- Sophisticated evaluation of the expected value of clients' retentions, toward the goal of proper pricing of risk.

## Foreword continued

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The real DNA change, though, has been driven by Boards of Directors striving to rebuild share prices and balance sheets. The new class of CEOs and senior staff are seasoned professional financial executives. They have replaced old line insurance managers, and their charge from the Board is to focus on shareholder value. That quest for quantum increases in bottom line results may further erode an already weather-beaten industry concern: client service.

Lloyd's of London is now substantially part of the same club - companies owned publicly, answerable to shareholders. Corporate capital is that venerable institution's new strand of DNA, propelling Edward Lloyd's 17th Century coffeehouse business into the 21st Century.

In the financial and insurance capitals of the world – for primary carriers, reinsurers and capital providers alike – senior managers are focusing on the fundamentals:

- Eliminate cash flow underwriting. Higher interest rates will not be allowed to undermine underwriting discipline.
- Assure reserve adequacy. Take the hit now, if need be, rather than later.
- Increase net retentions as appropriate. Retaining more risk can be more cost efficient and reduce counterparty risk.
- Assure accounting transparency and rectitude. It's a different world out there.
- Revisit investment practices. More conservative investing seems to be the order of the day, as many European insurers have learned.
- Enhance management information systems. Better, faster data translates into quicker responses to negative trends affecting profitability.

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## Energy insurance

The energy insurance business has been very profitable for carriers over 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 DNA changes should have long-lasting effects on risk assessment and pure risk pricing. Further, as implied above, 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.



## Introduction

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In this edition of the Energy Market Review we include as usual an overview of the market and update of each individual sector, including sections on Lloyd's and Bermuda, and make our predictions as to the likely course the market will take over the next six months or so.

For this issue we also have two special features. The first is an interview with Oil Casualty Insurance, Ltd., the sister company of the mutual insurers OIL and sEnergy which we have spotlighted in previous issues. Given the current difficulties in the casualty market we are sure you will agree that this interview is timely.

The second is an article about an issue that is becoming of increasing concern to clients and reinsurers alike. Fronting has much increased in cost over the last year and there is a general lack of availability, so we discuss some interesting alternative approaches and possible solutions.

## Market Overview

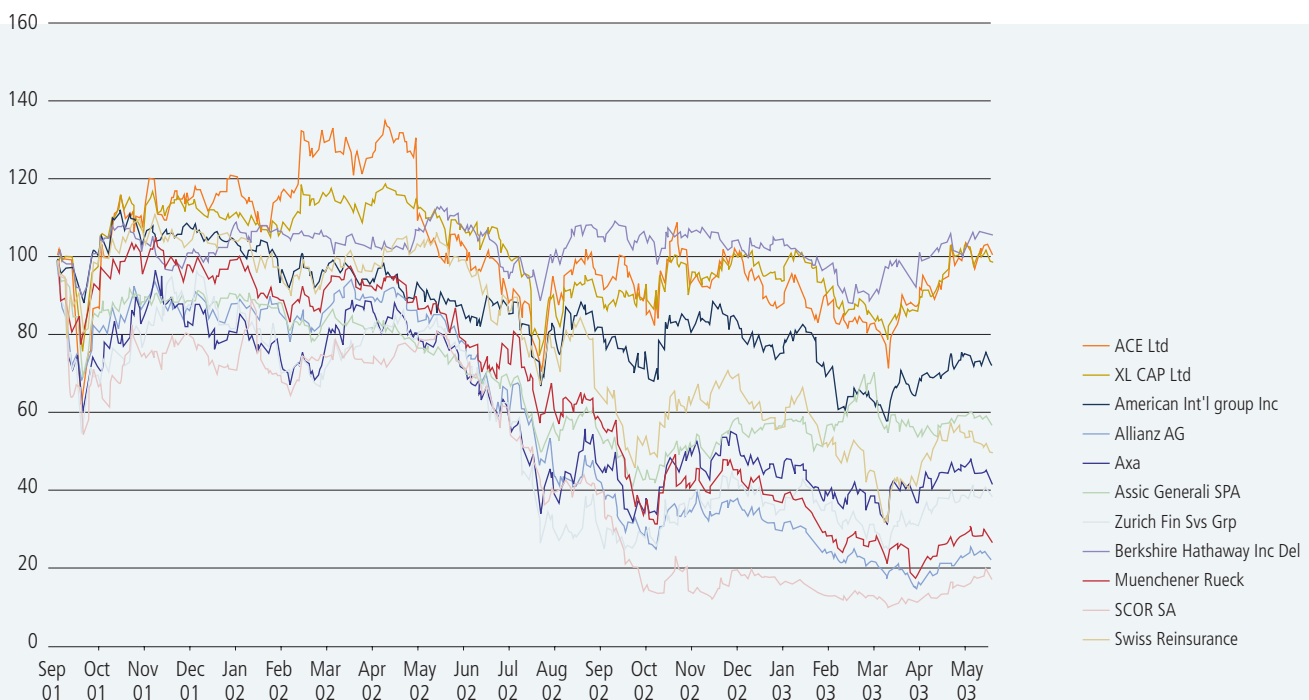
### The Game Moves On

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.

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 last issue of this Review we defined the market as being

comprised of "legacy" and "non-legacy" insurers, and went on to describe the advantage that the latter was gaining over the long-established players, burdened as they are with the sins of the past. In this market overview we continue to chart the progress of these two "boats", and look at the prospects for the market as a whole.

### Rebased Share Price Movement Since September 2001



Source: Willis research

### **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?

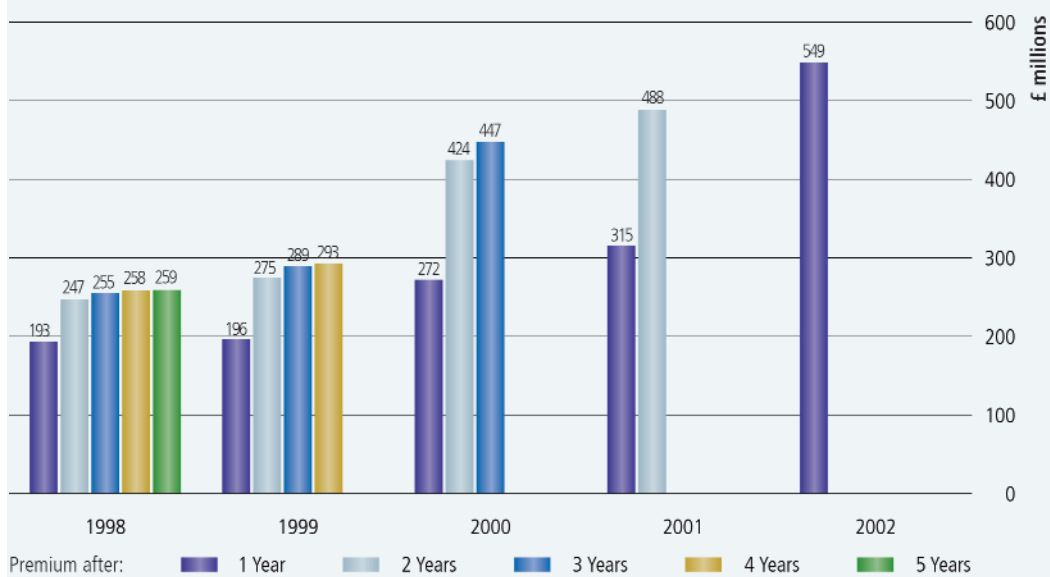
### **The energy market**

As recently as a month ago we would have said as a general comment 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 spectre 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?

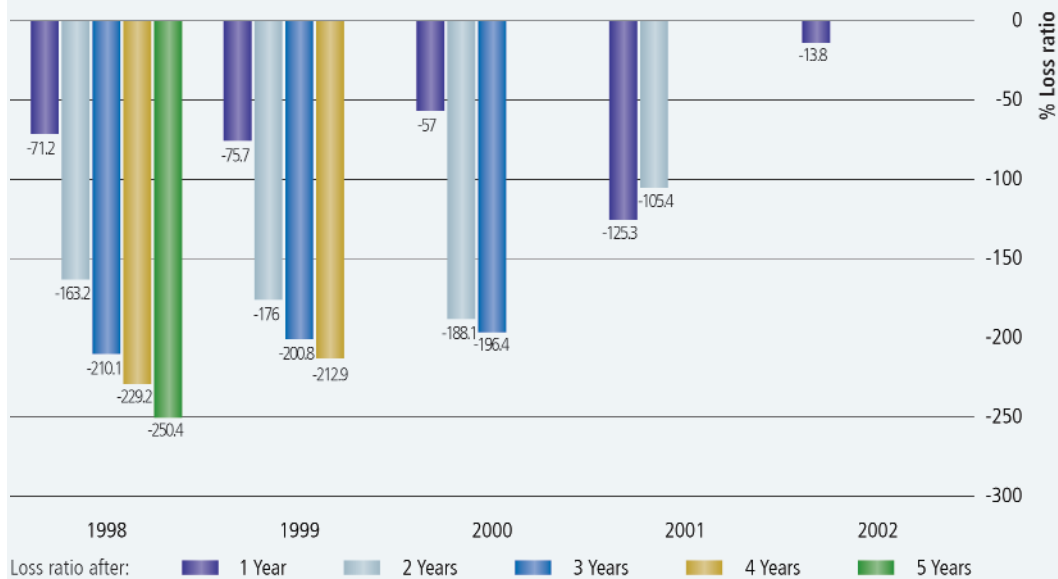
While 2002 produced a particularly good pure underwriting result this was perhaps exaggerated by an exceptionally low incidence of loss, both in terms of frequency (where increased deductibles have clearly had an effect) and severity.

There is no question that the 2002 result is both an excellent one and timely 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.

### Lloyd's Onshore and Offshore Physical Damage and Control of Well: Combined Premium Development



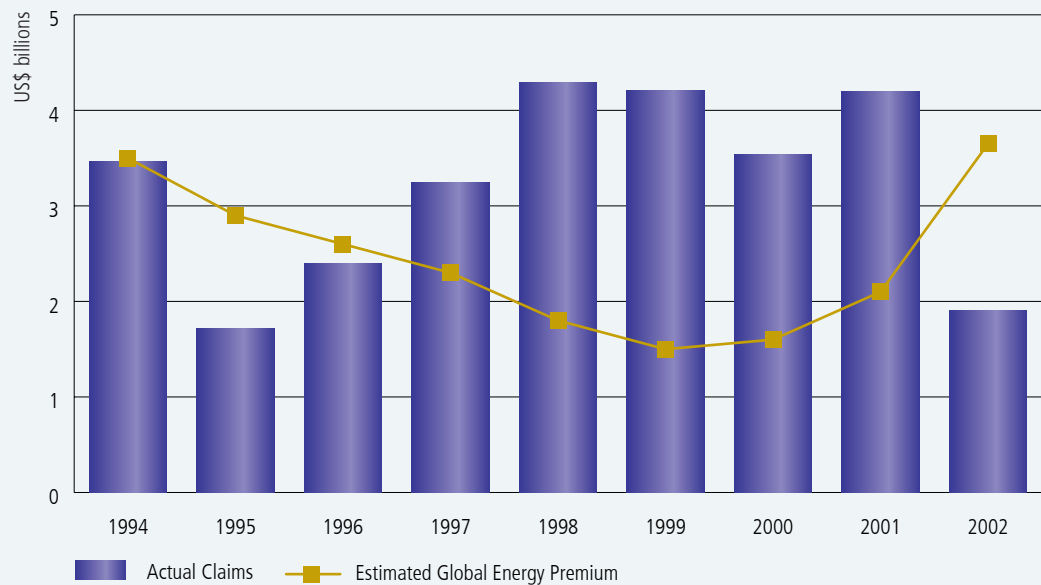
### Lloyd's Onshore and Offshore Physical Damage and Control of Well: Combined Loss Ratio Development



Source: Lloyd's

## Market Overview continued

### Energy Losses 1994 to 2002 + Estimated Global Energy Premium



(Source of actual claims data: Willis Energy Loss Database - figures as at 07 May 2003)

### Energy losses in excess of US\$50m since January 2002

Date	Loss details	Country	Total (US\$)
01/02/2002	Fire & explosion at gas gathering centre & boosting station	Kuwait	150,000,000
02/03/2002	Blowout & fire on swamp barge	Indonesia	51,000,000
15/04/2002	Fire in refinery	Japan	75,000,000
21/04/2002	Collapse of power canal	USA	74,000,000
25/08/2002	Damage to platform jacket piles	Norway	96,000,000
03/10/2002	Hurricane Lili damage to structures	USA	76,000,000
21/11/2002	Fire at chemical factory (resin)	Czech Republic	79,000,000
25/11/2002	Fire in refinery caused by short circuit due to floods	Morocco	130,000,000
06/01/2003	Explosion & fire at oilsands mine	Canada	233,000,000
08/01/2003	Fire following mechanical failure of turbine generator	South Africa	88,000,000

### Hurricane Lili

On October 3, 2002 Hurricane Lili caused widespread damage to structures in the Gulf of Mexico. Whilst initial reports estimated total gross losses at US\$350 million, today we calculate that this amount has risen to around US\$450 million. However, whilst numerous insureds suffered some loss, much of the individual damage was relatively minor, with only seven losses in excess of US\$25 million, and the largest being no more than US\$76 million.

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:

## Standard & Poor's Ratings Comparisons

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+
<b>Reinsurers</b>		
Berkshire Hathaway	AAA	AAA
GE Frankona Re	AAA	AA-
Munich Re	AAA	AA-
Scor	A+	BBB+
Swiss Re	AAA	AA+

Source : Standard & Poor's

## Market Overview *continued*

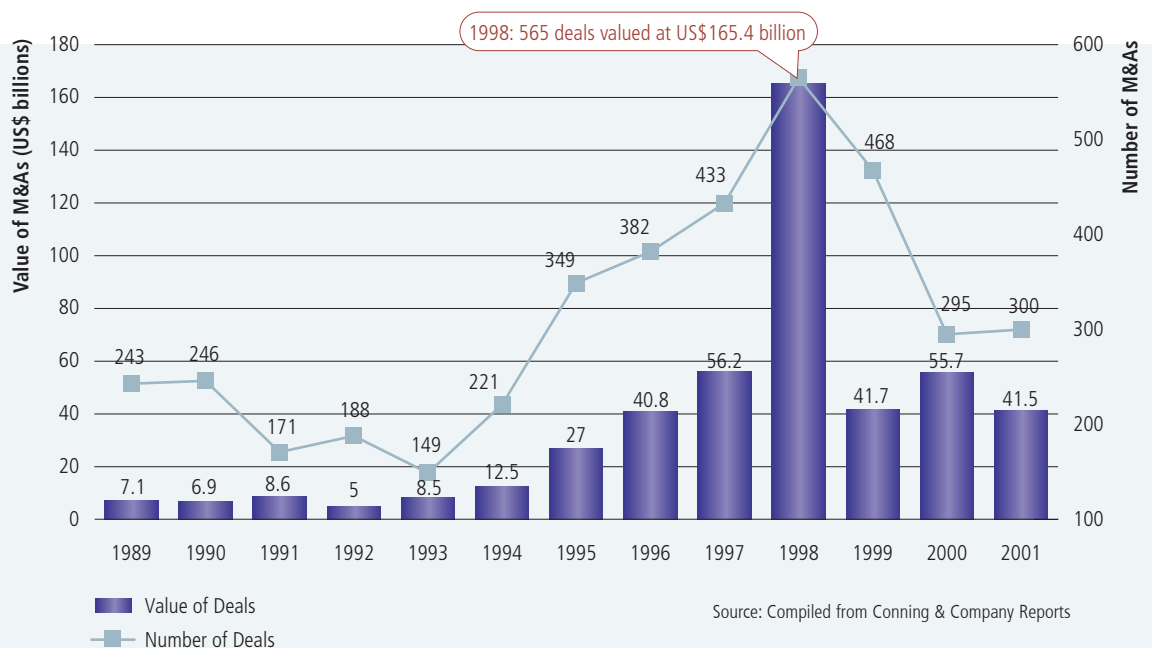
Today there are no more than three insurance and reinsurance groups (AIG, Berkshire Hathaway and CCR) rated AAA by Standard & Poor's, and it is likely that we shall see no early increase in that number. Indeed, it is probable that we shall never witness a return to the significantly higher ratings of 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 favour any imminent restructuring. In the last few years mergers and acquisitions (M&A) activity has dropped off sharply:

### Insurance Companies: Mergers and Acquisitions





However, Standard & Poor's 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.

So who's winning the boat race? At the moment the non-legacy crew clearly have 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.

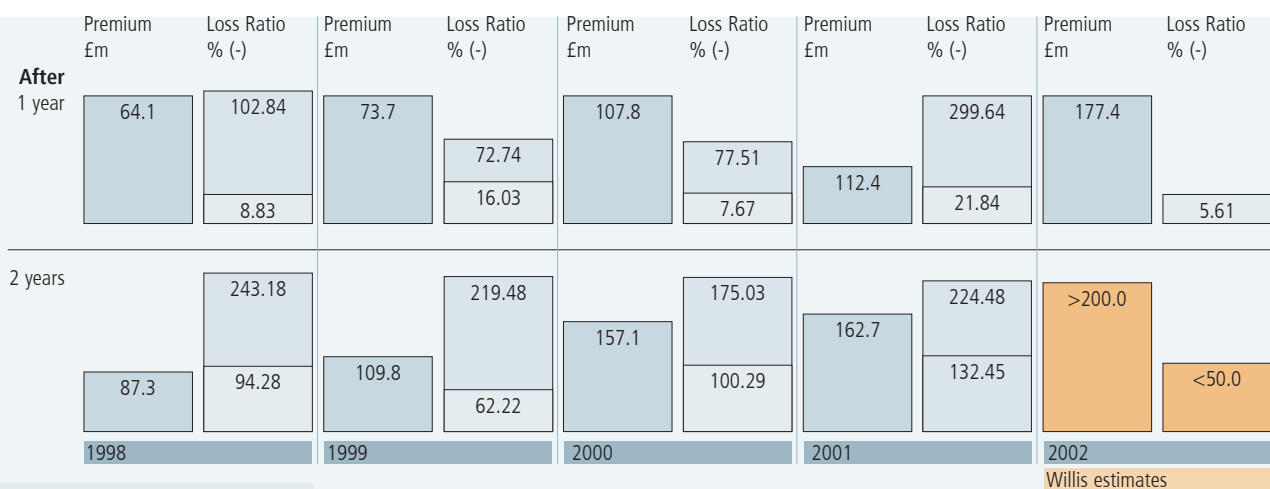
## Market Updates Onshore Property

After all the horrors of the extended soft market, 2002 saw the fortunes of energy underwriters in the onshore sector turn through 180 degrees. Premium income continued to grow apace and this, coupled with a marked lack of reported losses, produced the best underwriting result for years.

Not only were there fewer catastrophes, but the frequency of loss was much diminished. The significance of the latter should not be underestimated, as frequency of insured losses is directly related to the level of minimum deductible that underwriters apply. For the last 18 months or more the market has been seeking to impose greatly increased deductibles for physical damage, and, most importantly, longer waiting periods for business interruption. If the lower frequency seen in 2002 constitutes the beginning of a trend then it follows that

insurers have at last, in their eyes at least, got deductibles right, and the premium that is charged can be reserved for the catastrophe risk which is what they always maintain that they are in business to insure. The setting of adequate deductibles is therefore one of the most important keys to long-term profitable underwriting in the onshore sector. If the market can now be comfortable in this regard, then the question becomes: What should the premium rates be for the long-term?

### Onshore Energy Physical Damage - premium and loss ratio development



**Key**

Premium €m	Loss Ratio % (-)
GBP millions	total incurred
	Paid

Note: While these figures relate solely to Lloyd's we believe the ratios to be widely representative of the onshore market as a whole.

Source: Lloyd's/Willis estimates

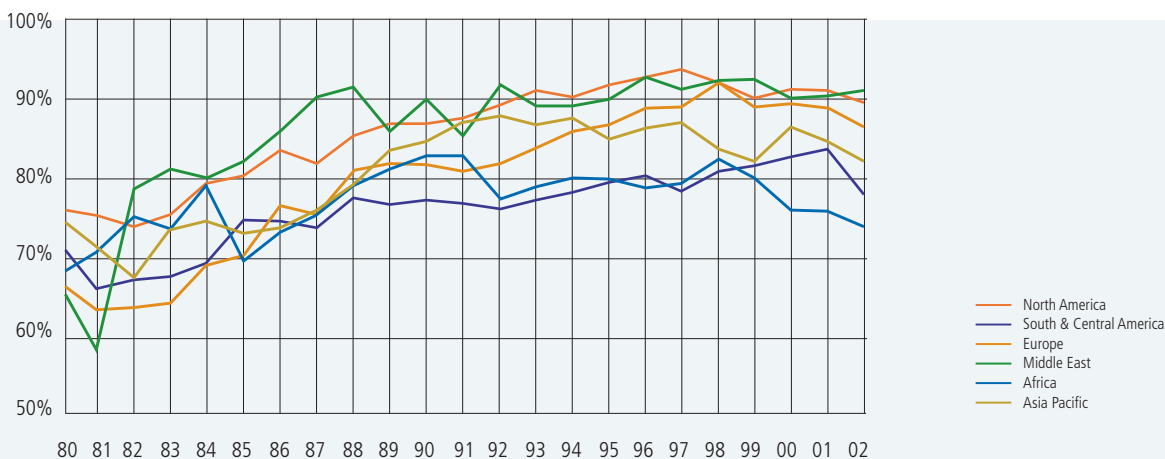


The last years of the soft market cycle saw an unprecedented frequency of severe, or catastrophic, losses, particularly in the oil-refining sector. Such a frequency of severity, if repeated, would plunge the market into loss, with higher deductibles in general having only a minor alleviating effect. So, before we can answer the question about long-term premium, we need to ask ourselves whether such frequency of catastrophe can be predicted.

energy sector is not bad, and certainly much better than that for the wider property market. But from a refining standpoint perhaps there are some pointers, which, if not arrived at strictly scientifically, may give a lead as to which way premium should now be heading. The following charts show a possible link between refinery utilization, oil refining margins, and severe losses in that industry sector:

With regard to natural catastrophe the answer is clearly no. However, natural catastrophe, whilst a significant risk, is well understood; capacity is strictly rationed, and the insured loss record for the onshore

### Oil refinery utilization

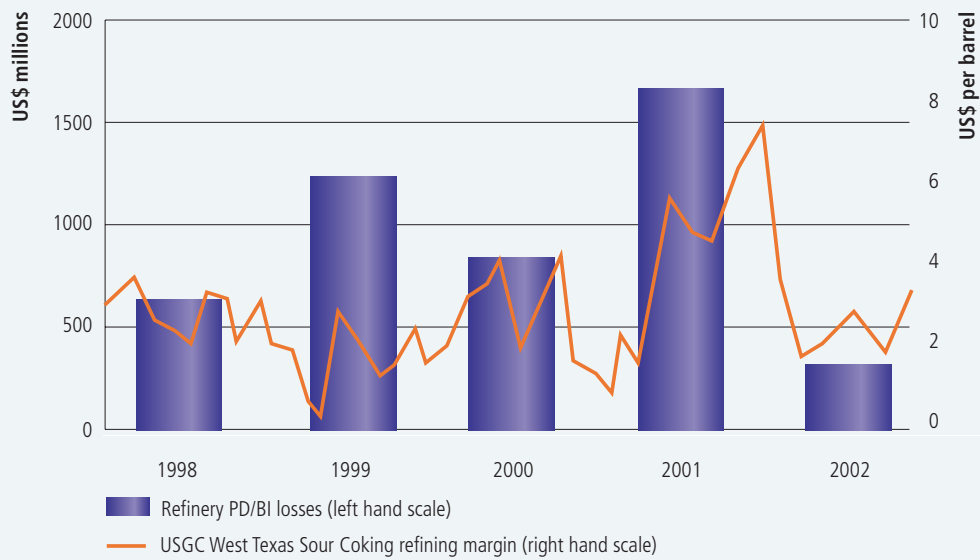


Refinery capacity utilization for most regions peaked in the second half of the 1990s. Slower oil demand growth has meant falling utilization for most regions since then.

Source: BP statistical review of world energy 2003

## Market Updates Onshore Property continued

### Refinery Losses and Refining Margins 1998-2002



Source: Willis Energy Loss Database/BP statistical review of world energy 2003

With margins well down from their recent peak and refinery capacity utilization tailing off we can predict that, if we believe that a link between losses and margins per the above chart exists, we are unlikely to see an early return to the frequency of severe losses of the recent past. So there is an argument that rates are now adequate to cover the catastrophe risk over the long term, and that, indeed, there is room for downwards adjustment in cases where over-corrections have occurred.



## Capacity

There has been a further increase in capacity since our last Review in December 2002. We estimate usable (or economically viable) global onshore capacity for US refining and petrochemical risks to be up by about US\$300 million, making a total of around US\$1.4 billion. Usable capacity for international risks has increased even more, and now stands in excess of US\$2 billion. These are exclusive of OIL and sEnergy which add another US\$250 million physical damage and US\$200 million business interruption respectively.

However, this increase in overall capacity does not paint an accurate picture, in that underwriters are increasingly prepared to write their full line, and this is something that they were hesitant to do until recently. Therefore, there has effectively been a far greater increase in global capacity than the figures suggest.

## Cost

With capacity increasing, insurers are fighting for market share (albeit in a low-key way so far) and this has created the classic conditions for a softening market. Underwriters have once again started actively chasing after the business, and 2003 can so far be described as the year in which they rediscovered how to use the telephone.

Rate reductions are becoming the norm, with 10-20% typical for a good risk with a clean loss record. Reductions can be higher: at the beginning of the year they

were rare or non-existent, and it was difficult to make a convincing case for them to the market. But since then there has been a marked acceleration in the rate of reduction being obtained. If this acceleration continues, then there is likely to be a very rapid softening of the market before the end of the year (always assuming there are no major losses).

Natural catastrophe capacity continues to be in short supply, and is rated accordingly, though there has been some recent easing of concerns across all areas, particularly with respect to windstorm.

## Coverage

There is some easing in coverage restrictions, with certain sub-limits being increased, particularly where these have been shown to be too low for the individual risk in question. The market acknowledges that there has been over-correction in some cases, and will once again listen to an argument so long as it is well reasoned. Differentiation of risk is extremely important in this regard.

Increased capacity has led directly to an improvement in service levels. The market is once again following established leaders. This makes it easier for clients to deal with the market and, without the tail wagging the dog, it is becoming easier to gain consensus on wordings. This means that the time it takes to produce policies is improving.

## Market Updates Onshore Property *continued*

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### **Outlook**

Whatever science we try to apply, premium is always going to be market driven, and markets are in turn driven by confidence, or lack of it. Today, there is less tension in the market, and, indeed, relief for the underwriters themselves that 2002 has shown that onshore energy can be a viable insurance line. They are however concerned over their ability to meet highly ambitious premium targets and, as they increasingly fight for market share, we are beginning to witness a distinct softening in conditions. Indeed, one can detect a feeling amongst underwriters that they had better write the business today because tomorrow may be too late, and this has led to what might be described as a feeding frenzy. Not only are rates generally falling, and coverage enhancements beginning to appear, but, ominously for future profitability, the first signs of reductions in deductibles are being seen. We predict that waiting periods for business interruption will move down on average from 60 to 45 days during the course of the next six months.

Is this just a logical and timely correction to the "ratcheting" process of the last two years? This may be so for now, but experience shows that what starts as a trickle can rapidly become an avalanche. That said, confidence is anything but firmly based, and just one major loss, or increase in frequency, could see it evaporate altogether. In that case there is likely to be an instantaneous return to the hardest of hard market conditions.

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## Market Updates Upstream Energy

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The upstream or so-called "offshore" market is possibly in its most confused state for many years. For a brief period post September 11, 2001 all competition ceased, and during 2002 underwriters largely obtained the terms and premium that they wanted (and sometimes more). When they came to write their business plans for 2003 the majority of the underwriters (and, of course, their financial backers) expected a continuum. Clearly, they thought, 2003 would be one of the easier years to budget for and perform to. Wrong!

Why? The underlying external economic factors that influence the upstream sector would appear to be relatively stable. The oil price has been fairly stable, the US dollar has slid (but not significantly), investment conditions have improved slightly, interest rates are down slightly. The internal factors are similarly unremarkable. No significant loss frequency, or severity, has been reported, and capacity is fairly stable. So why is there confusion, and what is the underlying cause?

The period covering this review can probably be split into two for the purpose of this analysis. Between September 11, 2002 and December 31, 2002, the market maintained its own discipline and there was a continued reluctance to compete. Brokers argued that their renewals had witnessed excessive rises in the previous year (i.e. post-WTC), and sought reductions. Underwriters were afraid to be seen to offer reductions even though some may privately have agreed with the brokers' arguments. The source of their fear was partly their management and/or capital backers, and partly reinsurers' perception at a time when their own reinsurances were being renewed.

We have talked about underwriters, brokers and reinsurers above but one person in the chain hasn't yet been mentioned: The client!

During the crucial period leading up to January 1, 2003 clients were preparing for their renewals, and, following the shock increase of 2002, were busy looking for ways to save money. Some clients increased retentions, some bought less limit, some stopped buying business interruption, some joined OIL, and so on. In soccer parlance, the client took his ball away.

So now we fast-forward to the period post January 1, 2003. Underwriters were largely already down on budget as the premium and insured risk pool was diminishing. With their reinsurances in place (often at lower cost) their immediate concerns regarding reinsurers' perceptions disappeared. Their management and/or financial backers were the remaining barrier to re-engaging in competition, and this is where the market fragmented in its approach.

## Market Updates **Upstream Energy** continued

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Some underwriters maintained their stance of no reductions, and stoically declined business in the belief that it would not get placed. Others recognised that this was a high-price environment and chose to build market share at rates that were just off their peak - in other words, they gave reductions.

This scenario fuelled the cycle. The clients continued to reduce the pot by not buying, and price reductions shrank it further. By way of illustration, a recent single renewal was some US\$15 million or so down in premium owing to discontinued purchase of business interruption.

All of this brings us to today's confused state. Some underwriters are way behind budget. Worse still, they have seen some of their better risks disappear because, being placed with price reductions, they were unable to continue due to management pricing dictates which left them holding some of the poorer risks that renewed at the same or higher terms. Some underwriters have amended their budget and diverted capital to other areas. Finally, in an ironic twist, the more flexible underwriters are probably on or above budget and holding a bigger and better balanced portfolio than they did 12 months ago.

Having spent more time than usual trying to analyse what has happened we will give a brief overview of the effect and the outlook.

### **Capacity**

At the time of the last review in December we were awaiting the results of the January 1 reinsurances to gauge market capacity. Our estimate of exercisable capacity remains at just over US\$2 billion exclusive of OIL and sEnergy. Capacity is price elastic however, and more can always be found at a price. Clearly US\$2 billion continues to dwarf the mean or median risk, and therefore competition is a certain corollary in the absence of withdrawals from the class or a truly momentous event such as WTC, or, indeed, a further downgrading of security.

### **Cost**

A few accounts received reductions in the period leading up to January 1, 2003. Post January 1, 2003 the offshore market has more or less tracked, but slightly lagged behind, the onshore market. Renewals of programmes with terms set in 2002 have witnessed a wide range of reductions. There are still a few price rises, but these are generally confined to accounts coming out of long-term deals and risks with losses.

### **Coverage**

Subsequent to the last Energy Market Review there has been little movement in coverage afforded, although the focus on terrorism has softened slightly.

It is worth reiterating that the imposition of more restrictive conditions and increased deductibles has had the effect of "cleaning up" many accounts by removing attritional



losses and thereby making them profitable. We believe that this has acted as an accelerant in the market cycle as new entrants and aggressive players are seeing attractive "writes" where they are operating with a clean sheet and can underwrite with little reliance on reinsurance.

### Offshore Construction

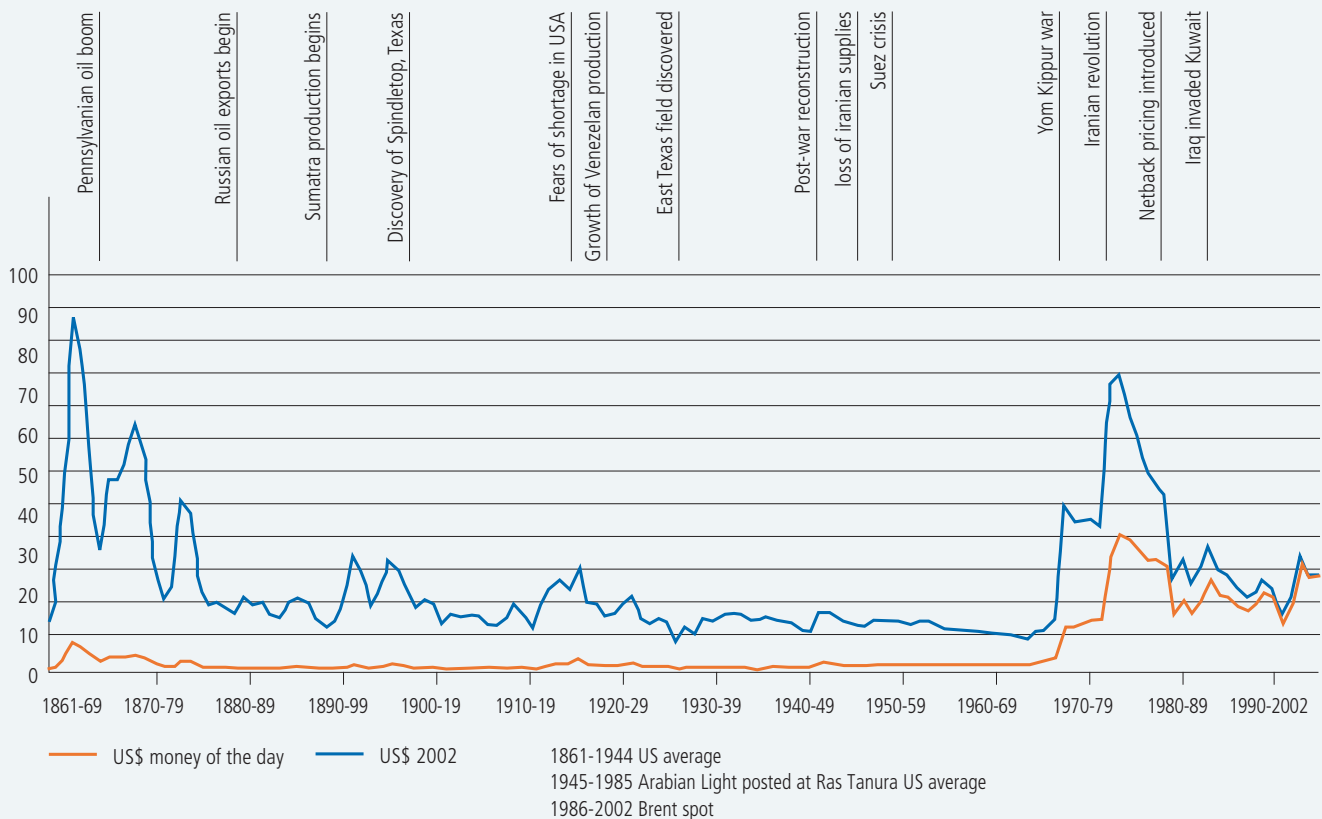
Yet again we find reason to segregate and make specific comment on this class. The rating levels and retentions, coupled with the "Welcar" market wording, have remained

fairly constant and predictable over the past 12 months. Indeed, with no major losses reported under Welcar contracts to date, several underwriters have re-entered the class on a selective basis, and budgeted for more income from the construction book in 2003.

The effect of this is that on small to medium sized projects, with the correct leadership, 100% completion has become far more easily achievable (at the quoted terms) this year than last.

## Crude Oil Prices Since 1861

US\$ per barrel



Source: BP statistical review of world energy 2003

## Market Updates **Upstream Energy** continued

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However, having reached a point where Wellington more or less had a monopoly on leadership, the market has now been thrown into a state of flux as Wellington have recently withdrawn from the class. Again, the market expected a continuum. The expectation is that Wellington will selectively look at new projects but only for those insureds who have renewed their operational programmes with Wellington at the "right terms".

This has allowed other underwriters to step up to the leadership role whilst Wellington considers their position, creating viable alternatives. It does, however, bring up the issue of ability to complete the placement of any project that requires a 100% insured programme. In such instances pressure could again be brought to bear on rates and retentions.

### **Outlook**

We have described the current state of the market as "confused". What happens in the final six months of 2003, and what that leads to will depend largely on the strength of management and/or the financial backing of the individual markets.

As we described earlier some underwriters are behind budget and stuck with a deteriorating risk profile. They can "go for it" in the second half, or accept the fact

that capital is under-utilised. Some will go for it anyway. Others not subject to these strictures will no doubt watch the market and make their call based upon what they see.

We anticipate a further softening of the market, but on a selective basis. Smaller capacity risks with good loss records are likely to witness greater reductions. We also expect to continue to see the odd out-of-the-norm reductions for some US-based exploration and production accounts. Here a controversial microclimate of competition has developed between a few Houston-based domestic carriers and London. The larger risks that require most or all of the above groups of underwriters will not fare quite as well, but can still expect to see improvements.

A couple of questions may be answered in the coming months. Is this a technical correction to a market that went up too high or is the market on the edge of the abyss? Will the market remember the client? The object of insurance after all is to replace an unknown cost with a known one. The market is failing miserably at that.

Only time will tell but in the meantime as the saying goes "when confusion reigns everyone gets wet".

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## Market Updates Power Generation Utilities

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The utilities sector shares many characteristics with the onshore property and casualty markets, and to a great extent the prevailing conditions are similar. This section therefore provides a brief summary of the main points that differentiate utilities within the wider energy market.

### Property

The new capacity that has come into the market over the last two years has had the effect of softening the market. Underwriters are looking to increase market share and as such are reviewing their book and identifying areas they think may have been over-corrected in terms of pricing and deductibles during the recent hard market. Utility property programs were one of the first areas in which underwriters started making price corrections, and as such they now feel justified in competing for the business. Premium reductions of at least 20% have been achieved on programs deemed over-priced, and reductions in deductibles of as much as 33% have been obtained. However, it should be stressed that these decreases are in respect of risks involving proven technology only, with underwriters still trying to hold firm on any risk that is perceived to be new technology.

The US Domestic market continues to expand, with Allianz being the latest market to actively seek utility business. The other main markets for utility property business are ACE, AEGIS, Arch, Axis, Liberty International, Scor, XL, and Zurich.

These insurers also have a healthy appetite for quota share business and this has had the effect of pushing the London market into an excess position on many programs.

On the international side, AIG retains a dominant position but ACE and XL are clearly trying to position themselves as alternative leads, whilst the more traditional players are still very much present.

### Casualty

The market continues to harden with rate increases in the 20% to 40% range not uncommon. Pricing is being driven to a large extent by reinsurers in an effort to rebalance their books. Even the industry mutuals such as AEGIS and EIM are looking to increase rates, and, more importantly, to cut back limits, particularly where there is an aggregation of limits through related insureds.

## Market Updates International Liability

The liability market remains firmly locked in a hard market cycle. The current tough trading conditions which developed 2 years ago and accelerated after the events of September 11, 2001, have continued through the first 6 months of 2003 and look set to persist in the near future.

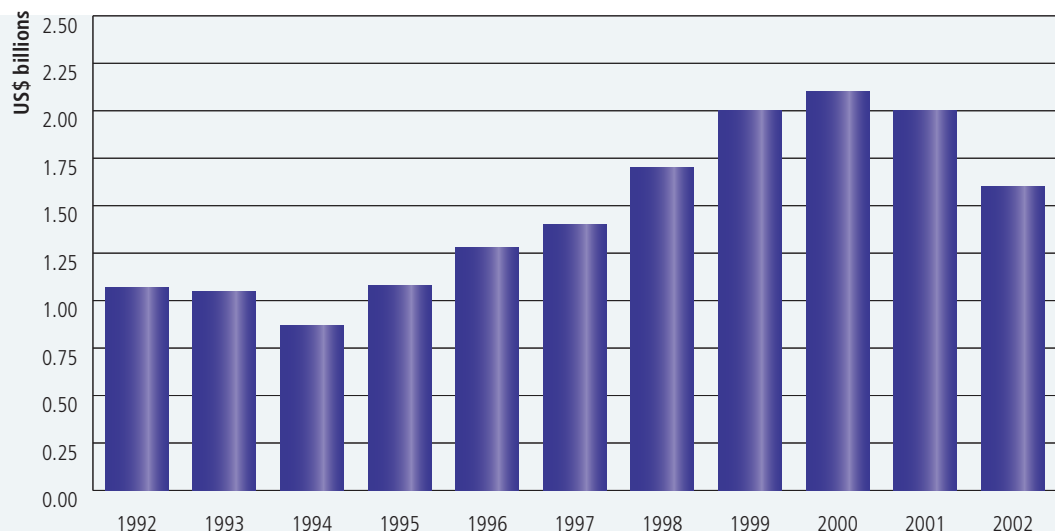
Insurers experienced an extremely challenging year-end treaty renewal season in December 2002 with reinsurers applying continued price increases and restrictions in coverage. These conditions have been fed through to clients by direct insurers. Underwriters renewing their treaties in July have encountered similar pressure.

Interestingly, global capacity (though reduced from its peak of US\$2.1 billion in 2000) remains at a healthy level, as illustrated in the graph below. Losses following market withdrawals by some carriers have been partially compensated by more recent entrants such as AWAC, Arch, Endurance and Max Re. These new markets, however, are looking to capitalise on, rather than compete against, existing prices.

It should also be noted that following mergers and acquisitions, total capacity is now concentrated in the hands of a smaller number of markets. At the primary level in particular the number of available players has declined significantly over the past three years, leading to reduced competition and a shrinkage in the size of the average primary limit.

The hard market conditions are not therefore driven by a capacity shortage, but more by the recognition that previous premium levels were unsustainably low in the face of growing claims and shrinking investment returns. This, combined with the long-tail nature of this class, the growing trend towards litigation worldwide, and a concentration of capacity amongst a smaller

### Global Liability Capacity





number of players, has meant that, despite two years of hard market conditions, we do not anticipate any imminent softening of the market.

### **Pricing**

The average rate increase charged by liability insurers for energy and petrochemical business in 2002 was 30% to 40%, which, when compounded by a similar percentage rise in 2001, makes for a significant increase in rates over the last two years.

In the first six months of 2003 rates have continued to rise, albeit at a marginally lower level of increase compared with last year. Average global rate increases are currently in the region of 25% to 30%, and are expected to continue at this level throughout the year. It should be noted however that for risks whose existing premiums are considered by the market

to be insufficient, or which have been subject to significant losses or increases in turnover, premium increases have been markedly higher.

One particular feature of the current market which should be of concern to the insurance buyer is the increasing requirement of insurers to refer large accounts to their lead reinsurers for price vetting. Some of these major reinsurers have excess of loss pricing guidelines which they are strongly encouraging their insurers to use. Application of reinsurers' rates can cause premiums to increase dramatically, although some insurers, rather than applying these guidelines rigidly, choose to put a more liberal interpretation on them. Correct profiling of risks and leveraging of alternative markets are important in mitigating this pressure.

## Market Updates **International Liability** continued

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### **Coverage**

Apart from price, the other key characteristic of the current hard market is underwriters' increasing focus on policy coverage. Insurers have sought to exclude what they regard as peripheral coverages such as professional indemnity and pure financial loss, and new risks are typically quoted on standard market wordings such as the London PCA94 form, or equivalent.

More specific liability exclusions commonly applied relate to terrorism, electro-magnetic fields (EMF's), methyl tertiary-butyl ether (MTBE), asbestos and toxic mould.

There is also pressure in certain quarters to replace the current sudden and accidental pollution coverage with US-style time element pollution wording, particularly for risks located in South or Central America.

With regard to trigger, whilst losses occurring coverage remains available (at least at the lower levels of a programme), many insurers are now insisting on a claims made or occurrence reported trigger for chemical risks, in view of the potential long-tail exposures.

We have also noted an increasing reluctance by certain excess carriers to provide retroactive coverage on claims made or occurrence reported risks, where they are participating as a new market. Whilst this is being resisted where possible, it emphasises the importance of maintaining continuity and building on relationships with existing markets, whilst carefully structuring and marketing a programme to maximise the leverage available in what is undoubtedly a difficult market.

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## Market Updates US Casualty

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The US market continues to harden for all lines: general liability, workers compensation, umbrella and excess liability. While the acceleration in the rate of price increase is now slowing, we expect to see rates continue their upward path well into 2004. For energy insureds, the market is responding to the law of supply and demand by adopting a "back to basics" approach, with a return to firm underwriting discipline and a tight rein on coverage extensions.

### Primary Casualty

The primary casualty market has very few underwriters willing to offer all three lines of workers compensation, auto liability and general liability, and unfortunately there are no new markets ready to step up. The speedy demise of Kemper now leaves AIG, ACE, and Zurich to cater to the needs of most of the US energy insureds. For workers compensation these carriers are mandating increases of 20-50%, not only in the excess of loss premium but also in the basic costs. Automobile liability increases are running at as much as 40%, and general liability from 25% to over 50%. Further, an insured will be fortunate to get its incumbent carrier to offer a renewal option with deductible levels as expiring. Any loss activity suffered by the insured is likely to dramatically affect the size of increase. While increases can in theory be thwarted by competition, if there is an active loss history in the primary insured layers the entire market seems to have lost its sense of humor, and won't play the game. It is important for insureds to continue to differentiate their risks, not only from their peers, but also from a checkered past, if necessary. Face to face sessions with

underwriters should be scheduled and, in certain cases, meetings with the most senior officers of both the insurer and the client are advised.

Savvy insureds will seize upon the opportunity to split their primary coverages by line, to appeal to markets wanting to carve out, for example, workers compensation or general liability. Whether to create competition or separate a troublesome line, the lack of competition in the current market demands this approach be investigated (or reinvestigated). For the upcoming renewal season, insureds should prepare for dramatically increased retentions and coverage restrictions. Insurers are not in the mood to barter, as their managements' directives insist that these coverages once again become profitable.

### Excess liability

While the market has not moved for the last year, and remains hard, we believe that rates will start to rise again over the next six to 12 months, providing a challenging environment for renewals. Every underwriter

## Market Updates US Casualty *continued*

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we polled pointed to home office directives to move premiums, even for the cleanest renewals, up by 20% as a minimum. As with primary casualty, there is a movement to return to underwriting basics.

Overall, worldwide capacity remains at approximately US\$1.3 billion, perhaps even 10 percent more. Greater than half of this capacity is generated in Bermuda or the European offices of Bermuda insurers.

Viable capacity remains at about 70% of this total. Insureds in the marketplace to buy capacity in excess of US\$650 million are being buffeted by all sorts of market pressures completely outside their normal experience. For instance, larger and stronger excess liability underwriters are now requiring "look up, look down" provisions. Not only do these allow underwriters to review the pricing of the layers immediately below and above them, and to adjust their price upwards if the pricing of these layers is higher than they had initially estimated when quoting their own layers, but it also allows them to restrict coverage. This means that should an insured accept a restriction in coverage imposed by an underwriter, either above or below a particular layer, all underwriters on the program, regardless of which layer they write, have the opportunity to enjoy the same restriction. Seldom will an underwriter who has imposed this "look up, look down" provision agree to expand

coverage, even if his peers agree to an enhancement. The Bermuda marketplace, long a bastion of the stand-alone wording and agreed attachment, has happily embraced this concept.

In previous years we have described a three-tiered approach to accessing the excess liability market which is divided into three tranches, being umbrella/first excess, middle excess, and high/top excess. In the first of these three tranches the demand for umbrella and first excess limits is strong and the supply of capacity is not plentiful. Retentions remain the focal point of renewals. Carriers such as AIG and Zurich hold prominent market share, although interest is being shown by Arch, Munich-American RiskPartners, AWAC, Lloyd's and others. Setting the right attachment point is the key to getting a renewal off to a strong start.

Above the umbrella/first excess placements in the middle excess tranche strong market capacity is available, and we are starting to see signs of an expanding supply. London and European markets are competing with Bermuda for their share of increasing premiums. An issue here is that no one wants to appear to be the first to start cutting prices. Basic market pressures are slowing the rate of increases, but no individual market is prepared to flatten rates.



Those markets that participate in the highest excess layers (ACE, Starr Excess, Swiss Re, XL) have continued to insist on increasing minimum premiums and/or minimum price per million levels. Besides raising the bar for renewals, this practice has had the effect of creating additional upward rating pressure on the underlying layers which have "look up" provisions. Insureds should expect these excess underwriters to mandate a higher percentage of the underlying premiums in calculating the premium for their own layers. Where buyers might previously have expected an excess underwriter to require 50% to 70% of the premium per million of an immediately underlying layer, they should now be prepared for 80% to 90%.

In summary, we believe that the hard market is set to get harder still, with little relief in sight for clients, although we predict some slowing down by the end of this year, or early 2004. Capacity, though, is expanding (at least in the middle excess layers) and this must be a sign of hope for the medium term.

## Market Updates Terrorism

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The war in Iraq, continued political instability in many regions including the Middle East and the possibility of a backlash against American foreign policy continue to create a strong demand for terrorism cover.

The stand-alone terrorism market remains extremely active as new enquiries are joined with the first renewals of policies written in 2002. The continuing need for adequate and affordable protection has also led to increasing government involvement, with the Australian Terrorism Insurance Act being the latest incarnation.

### Property damage and business interruption

The two greatest influences on the current international terrorism market are TRIA coverage in the United States and the increase in underwriting capacity.

The advent of TRIA at the end of 2002 has had the direct impact of providing many clients with a cheaper, more affordable alternative to stand-alone coverage.

While not offering a total solution (see exemptions at the foot of this page), it did offer an alternative to clients, who did not perceive their threat as great, but who were required, often by contract, to have cover in place.

The take-up of TRIA by US companies is generally quoted as low, at approximately 20%. However the existence of this alternative has affected the rating of the stand-alone terrorism market, and the amount of American enquiries has clearly fallen.

Growing international capacity for terrorism cover has created a much more competitive environment. Immediately after the events of September 11, 2001 the total international capacity available

### Examples of losses that would not be covered under TRIA include:

1. Any acts of terrorism perpetrated by any person or groups not acting on behalf of a foreign person or interest, which would include acts of domestic terrorism such as the Oklahoma City Federal Building;
2. If the act is committed as part of the course of a war declared by Congress (except in the case of Worker's Compensation);
3. Property and Casualty insurance losses that do not exceed \$5 million;
4. Interests of American corporations overseas;
5. Biological or chemical terrorism – TRIA does not require underwriters to provide coverage for any risk that would otherwise be excluded under their policy. As most property carriers exclude coverage for non-terrorism biological and chemical perils, they would not be required to cover it for terrorism.



dropped to approximately US\$150 million any one risk. Today market capacity exceeds US\$600 million. This is provided by London, US and Bermuda based markets, and total capacity can be significantly increased if Berkshire Hathaway participates. In addition, cover provided under OIL and sEnergy specifically for energy and construction business contributes to the growing worldwide capacity.

The combination of reduced demand for terrorism coverage from US clients and growing global capacity has led to a reduction in rating not only for US business but also internationally. US business rates have dropped significantly compared to this time last year, and this has had a knock-on effect for international exposures which have seen rates falling steadily for the past quarter.

In many areas rates have stabilised, especially those with a 'traditional' terrorism exposure, and in a few cases rates are still rising. The provision of wrap-around policies both on a "difference in conditions" and "difference in limits" basis has grown in parallel with the growth in government backed solutions. In the UK increases in the rating used by 'Pool Re', especially for business interruption, has created a buoyant alternative market.

### **Third party liability**

In addition to the need for stand-alone terrorism cover for property exposures the demand for stand-alone terrorism liability cover is also growing. Certain liability carriers are excluding terrorism from both

general liability and employers' liability (EL) policies for specific exposures. Terrorism has been excluded from some EL policies (above the UK £5m statutory minimum) often where the insured has significant aggregation of staff. Public liability terrorism cover is also excluded where insurers feel the exposure is too great, for example security companies (baggage handlers at airports, for instance) or managers of sports stadia.

The specialist terrorism market has been quick to respond to this need and has already produced a wording (T3L), as well as offering a 'write-back' solution.

### **Chemical and biological**

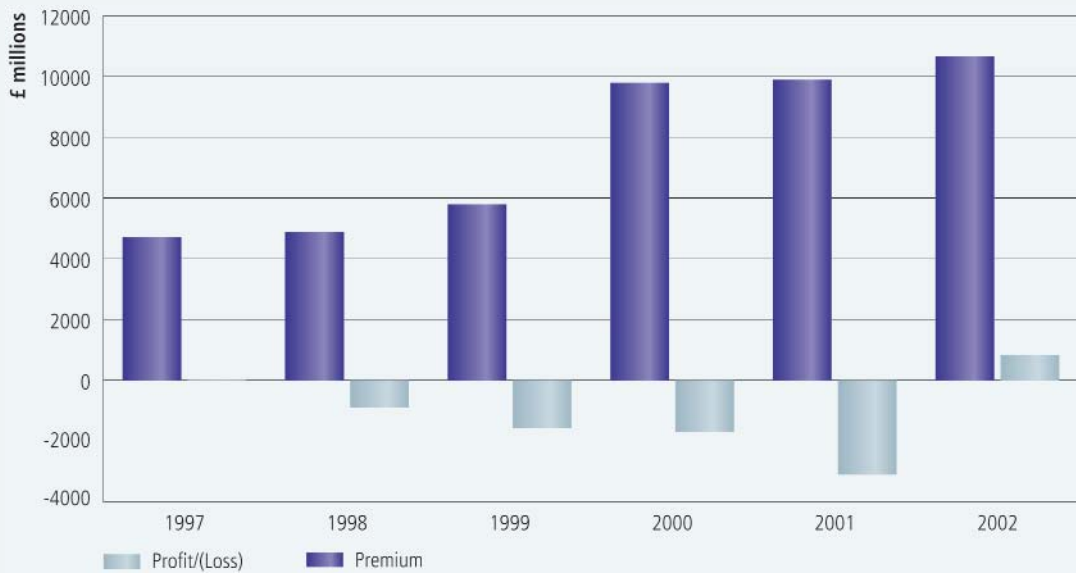
Chemical and biological terrorism cover is still generally unobtainable. Several markets are beginning to look more closely at this element of cover but this is still in its embryonic stages.

Recent events in Saudi Arabia, Colombia and Morocco continue to focus attention on the catastrophic effects of terrorism and the need for insurance protection. The market is currently going through a period of relative stability but, as has already been made all too clear, this situation could change in the course of a day.

## Lloyd's

Lloyd's made a strong return to profitability in 2002, with a declared profit of £834 million (US\$1,376 million) on a pro-forma annually accounted basis, and a profit forecast of £1,484 million (US\$2,448 million) on a three-year accounted basis.

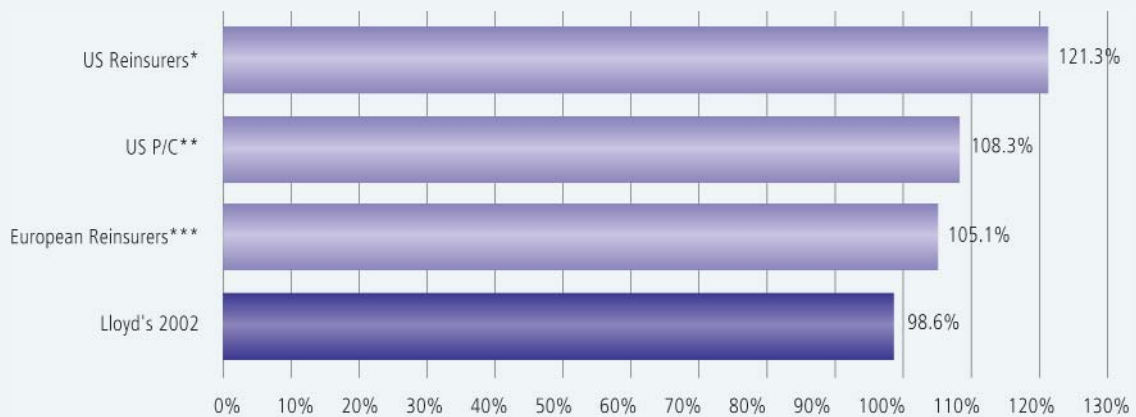
**Lloyd's: Premium and profit/loss**



Source: Lloyd's

Lloyd's performance compares favourably with that of its international competitors as reflected by the market's combined ratio:

**Lloyd's vs Industry 2002 Combined Ratios**



\* Source: RAA

\*\* Business Insurance Q3 2002 figures

\*\*\* Source: CSFB

Source: Lloyd's



With record capacity for 2003 of £14.4 billion (US\$23.75 billion) (before allowance for additional qualifying quota share reinsurance) Lloyd's reckons that it is "strongly positioned", as improved trading conditions continue to be sustained following the significant upturn in the underwriting environment in 2002, and notes that "increased rates have been supplemented by tighter terms and conditions, higher deductibles and tougher underwriting practices".

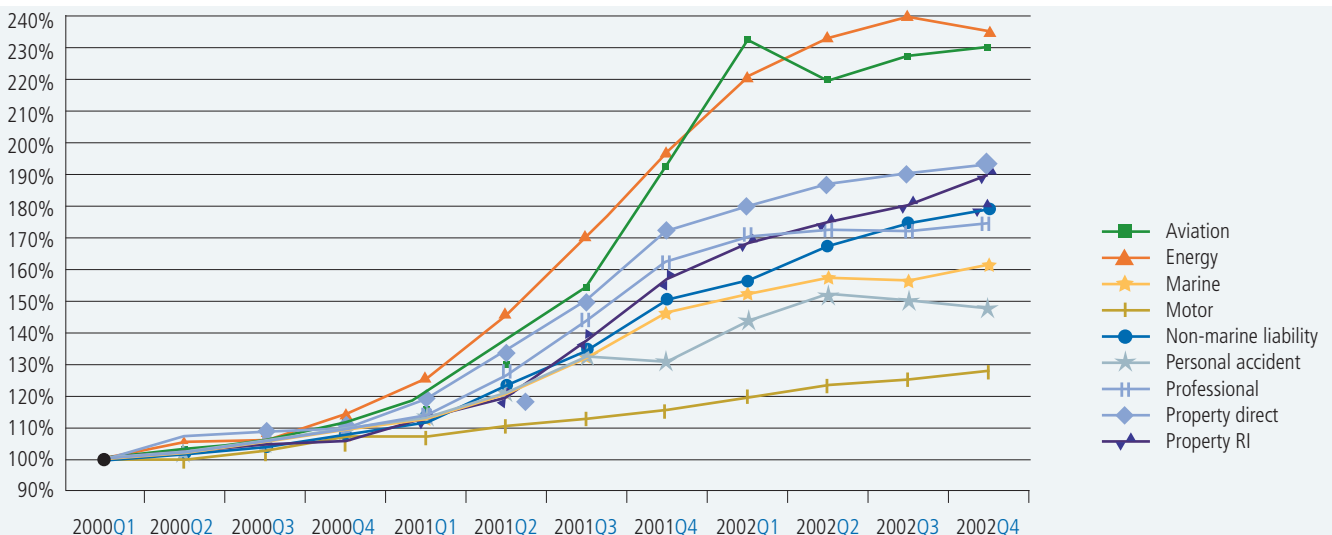
The improvement in trading conditions has occurred across all classes, but none more so than in the energy sector, as the chart below demonstrates.

However, with respect to the energy sector, the last quarter of 2002 shows rates beginning to fall, and, given that this premium rating index does not include renewals at 1/1/2003 (when rate decreases were starting to make a more general

appearance) it will be interesting to see how this chart develops. But, because of the magnitude of premium rate increases over the last two years, there has undoubtedly been significant over-correction in the rating of certain individual cases, and Lloyd's is probably (for the moment, at least) not being over-optimistic in its view that the market is "ideally placed to trade forward robustly". The warning signs, though, are there, and it is unclear if the energy sector in Lloyd's will enjoy the same level of profitability in 2003 as in 2002.

That said, Lloyd's is in a relatively stronger position than many of its competitors: the ring-fencing of asbestosis and other historic liabilities within Equitas is proving a more farsighted bet with each day that passes, and, whilst much criticised in its infancy and certainly not perfect, it is becoming a vehicle that many legacy insurers and reinsurers outside Lloyd's can only view with envy.

### Lloyd's Premium Rating Index



Source: Lloyd's

## Bermuda Market

The Bermuda marketplace continues to grow. The new carriers are now established and, with an excellent year of results behind them, are looking for further opportunities. Energy is one such area. We are seeing markets either expand their capacity in this area or in fact begin to look at this specialism for the first time:

### Bermuda: the rapid growth of new insurance enterprises

	Date of Creation	Premium Income 2002
Arch	May 2001	\$1,487,000,000
Axis	November 2001	\$1,108,000,000
AWAC	November 2001	\$ 922,511,000
Endurance	November 2001	\$ 798,760,000
Montpelier Re	November 2001	\$ 607,688,000

Source: Willis research/Company Reports

Arch is one market which has moved into the energy arena. They have recently hired Ken McPhail from Starr Tech in New York, and he is looking to write a book of business that would include petrochemicals, utilities, pulp and paper and mining. Their line size is US\$30 million, however the sharing of responsibility between Bermuda, London and New York is still to be decided.

Another market that has evolved in the past year is AWAC. On the energy side they have increased their capacity steadily and it now stands at US\$20,000,000. They are not afraid to use this and continue to be a strong player in the energy market.

Everest Re has hired two more underwriters over the last six months and now has a complement of three. This means that they are likely to feature more prominently as they are looking to write in the same area as AWAC - i.e. primary or low excess. Their line size is US\$10,000,000.

Montpelier Re is an excess of loss underwriter and has US\$25,000,000 of capacity to deploy on an excess of loss basis, often at the top of programmes. They naturally complement AWAC and Everest, and it is possible to build a tower of capacity using these three markets.

Endurance have US\$15,000,000 of capacity they can use on energy related risks. They tend to deploy this cautiously, and to date have been more focused on US rather than international business, but their rating is strong and their capacity can be useful.

No discussion of the Bermuda market would be complete without mention of Axis. Axis was one of the first of the "new wave" of insurers established in Bermuda in the aftermath of 9/11. It is now an underwriter of considerable size and importance within the global energy market, though it should be noted that much of the energy underwriting is now conducted in Europe, rather than in Bermuda.

Finally, the two well-established carriers, ACE and XL, have also experienced some changes. ACE's energy book has now moved to Canada under Chamen Aggawal, and so ACE Bermuda is no longer a market for this class of risk. XL have continued to grow, and their line size is now up to US\$150,000,000.

### The Bermuda Top Ten

<b>BY CAPITAL AND SURPLUS</b>		<b>(\$000s)</b>	<b>BY PREMIUMS EARNED</b>		<b>(\$000s)</b>
1	XL Capital Ltd.	6,569,589	1	ACE Limited	6,830,504
2	ACE Limited	6,388,686	2	XL Capital Ltd.	4,899,073
3	PartnerRe Ltd.	2,077,182	3	PartnerRe Ltd.	2,425,736
4	AXIS Capital Holdings Limited	1,961,033	4	RenaissanceRe Holdings Ltd.	760,905
5	Allied World Assurance Holdings, Ltd.	1,682,365	5	Arch Capital Group Ltd. and Subsidiaries	654,976
6	RenaissanceRe Holdings Ltd.	1,642,035	6	Inter-Ocean Reinsurance Co Ltd.	621,087
7	Arch Capital Group Ltd. and Subsidiaries	1,411,244	7	AXIS Capital Holdings Limited	536,850
8	IPC Holdings, Ltd.	1,291,483	8	AEGIS	505,655
9	Montpelier Re Holdings Ltd.	1,252,535	9	Overseas Partners Ltd.	457,317
10	Overseas Partners Ltd.	1,208,065	10	Allied World Assurance Holdings, Ltd.	433,967

<b>BY TOTAL ASSETS</b>		<b>(\$000s)</b>	<b>BY NET INCOME</b>		<b>(\$000s)</b>
1	ACE Limited	43,450,937	1	XL Capital Ltd.	405,571
2	XL Capital Ltd.	35,648,558	2	RenaissanceRe Holdings Ltd.	364,814
3	PartnerRe Ltd.	8,737,974	3	AXIS Capital Holdings Limited	291,059
4	AEGIS	4,216,152	4	PartnerRe Ltd.	190,302
5	RenaissanceRe Holdings Ltd.	3,745,736	5	Montpelier Re Holdings Ltd.	184,734
6	Overseas Partners Ltd.	3,339,366	6	IPC Holdings, Ltd.	185,522
7	Arch Capital Group Ltd. and Subsidiaries	2,991,328	7	Allied World assurance Holdings, Ltd.	127,625
8	AXIS Capital Holdings Limited	2,986,121	8	Olympus Reinsurance Company Ltd.	121,082
9	Max Re Ltd.	2,639,140	9	ACE Limited	76,549
10	Allied World Assurance Holdings, Ltd.	2,547,360	10	Arch Capital Group Ltd. and Subsidiaries	58,982

Source: Bermudian Business / Deloitte & Touche

From the above it is clear that the Bermuda marketplace continues to go from strength to strength. Global expansion has been confirmed as insurers increase their share of non-US international business, and development continues as new markets such as Max Re branch out into casualty and executive risk underwriting. All carriers have strong financial ratings, with some being actually upgraded by A M Best at the time of writing.

The new carriers are particularly attractive as they have no legacy issues, which is significant in light of the recent downgrades of so many established carriers around the world. The Bermuda market has tough growth ambitions for 2003, however its low cost base continues to make it a competitive option.

## An interview with Oil Casualty Insurance, Ltd.

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Oil Casualty Insurance, Ltd. (OCIL) was established in 1986 in response to the crisis in the US casualty and directors and officers liability (D&O) markets. Today, those markets are once again hard, though this time it is a global rather than a purely US phenomenon. OCIL offers US\$150 million of umbrella general liability (UGL), and we asked OCIL's head of underwriting, Andrea Viera, to give us an insight into the company and its ambitions.

### **OCIL's sister companies, Oil Insurance Limited and sEnergy, are mutual insurers. How does OCIL differ structurally?**

OCIL is not a mutual, but an industry-owned company of policyholders, all of whom are shareholders. It partly embraces the concept of mutuality, in that all policyholders (shareholders) are treated equally in much the same way as members of a mutual. However, unlike mutual insurers, it acts more like a commercial company, having no set payback formula.

### **Who qualifies for membership?**

An energy company defined as having more than 50% of gross assets or 50% of gross revenues derived from "energy operations".

### **How broad is that definition?**

We have expanded the definition of "energy" from exploration & production, refining & marketing, pipelines and petrochemicals to gas and electric utilities, mining, and other chemical companies (although excluding pharmaceuticals).

### **Why will you not cover pharmaceuticals?**

We believe that pharmaceutical liability exposures are too dissimilar from those of our existing membership, and could act as a destabilising factor.

### **What is your principal goal?**

We aim to establish OCIL as a global energy casualty company for excess liability and D&O, not just an insurer of US risks. To that end we are looking to grow our international book of business while remaining a relevant insurer of US business.



### **How closely are your shareholders linked to OIL?**

There is no requirement for OCIL policyholders to be members of OIL, and only around 50% of our shareholders are also members of OIL. The profiles of our shareholders are often different: for instance, size does not matter in the same way as for our sister company. For OCIL it is the size of the exposure, not the company itself, which is most important.

### **In the current market you must be seeing huge growth?**

No, not huge, because we are looking for steady rather than rapid growth. OCIL is already a major insurance company, having 78 policyholders at June 1, 2003 with US\$1.6 trillion of revenues insured between them. We have neither the need, nor is it our intention, to go purely for market share; rather, OCIL is interested in finding clients that are the "right fit" - long-term, non-opportunistic buyers. Remember, all policyholders are also shareholders in OCIL.

### **In that case, will you offer multi-year policies?**

Although we will not write any long-term policies OCIL is obligated to offer renewal terms, and will not issue notices of cancellation. We therefore do not see any need to offer multi-year policies.

### **OCIL has provided D&O coverage for the last 16 years. Given the recent experience of energy companies, how is OCIL responding?**

OCIL continues to provide D&O for existing policyholders with the same terms and conditions. New purchasers are able to access D&O coverage but must already purchase UGL. Despite the reticence the commercial market may have exhibited towards this class of business, OCIL remains true to its mission to provide coverage to the energy market.



Andrea Viera  
Vice President, OCIL

## Fronting – a burning issue

Once a relatively easy procedure the process of establishing a fronting programme has become an uphill task. Where have all the fronters gone and how do risk managers find a suitable arrangement?

A select group of insurance companies has traditionally provided global fronting services for captives. Carriers that have maintained their fronting operations now find themselves in a new climate, where all parties - the fronting carriers, reinsurers, corporate risk managers and brokers - are anxious about potential liabilities and losses. As the market begins to stabilize, however, we may see some of those carriers come back into the business.

In the last couple of years, risk managers have had to cope with rising costs and a lack of capacity in the traditional insurance market. To control their business insurance costs, many have turned to captive insurers as an alternate strategy.

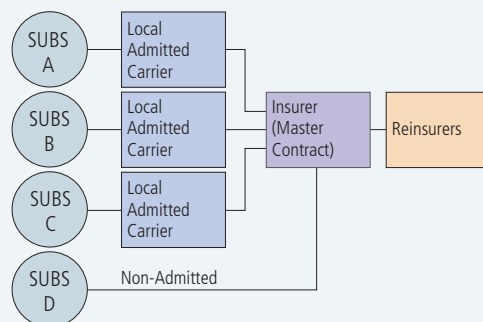
But instead of finding an easy solution, risk managers looking to set up a global fronting programme have encountered new restrictions and higher costs. Fronting costs, in some cases, have tripled in the past few years. The hard market, 9/11 and fallout from corporate governance scandals caused drastic changes in how fronting services are provided. Once a fairly easy procedure, establishing a fronting programme has become a much more challenging task.

### New challenges

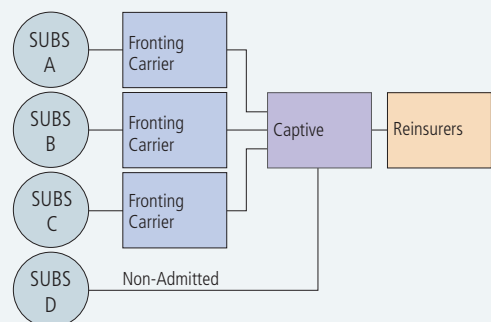
Although today's marketplace presents risk managers with new restrictions and challenges, some fundamental issues remain unchanged. Fronting fees and the fronting carrier's requirements on captive

### International Issues

Basic structure of an international insurance program



Basic structure of an international captive insurance program



Source: Willis



and reinsurance security are important. The fronting carrier should have broad geographical spread and own the local fronts. The ability to cede premiums and losses out of the countries where you operate also is key.

The basic design of a fronting programme is not that complicated. What is usually known as a controlled master insurance programme is the model for how a captive fronted programme operates. These programmes function the same way for both property and casualty risks. In some cases, the captive uses a front to provide legally admitted paper and in other cases the captive provides non-admitted coverage, where legal.

A select group of insurance companies has traditionally provided global fronting services for captives. Later, this article will highlight which carriers are providing these services today and offer possible solutions to help risk managers cope with the new challenges in today's fronting marketplace.

### **Changes and 9/11**

The stage was set in 2000 and early 2001 when the property market started to harden. Prices rose sharply and capacity decreased. Investment income came under pressure as the stock market dropped.

Then came 9/11. Insured losses from that event are estimated at US\$42.5 billion, making it the biggest insured loss in US history. What made this catastrophe even more unusual was the fact that it affected

so many lines of insurance. Hurricane Andrew, for example, was mainly a property catastrophe. The attack on the World Trade Center, however, affected a number of insurance lines, including property, liability, aviation, business interruption and workers' compensation.

Although the insurance industry has a total of about US\$300 billion in policyholder surplus, only about 33 percent of that, or about US\$100 billion is available to pay commercial property claims. Clearly, this had serious repercussions for the insurance industry. Of 39 insurer failures in 2002, twenty-eight were property-casualty insurers.

The industry's financial woes were just part of the story. Corporate America, including the insurance industry, has come under intense regulatory scrutiny as a result of today's well-publicised business ethics scandals. In this environment, insurers have been more reluctant to do fronting deals, which can be complex, time-consuming and potentially risky if the captive or its other reinsurers run into financial trouble.

After 9/11, many carriers simply pulled in their reins and reassessed all their lines of business. Many customers remarketed their core risk transfer programmes and the underwriters were then buried under submissions. Fronting was a secondary business for many carriers and it drained resources away from their core operations. As a result, some carriers have withdrawn from the fronting business while others have drastically reduced the resources

## Fronting – a burning issue *continued*

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dedicated to that business. Demand for fronting services, however, has surged as risk managers responded to the sharp contraction in the traditional insurance market.

### **New climate**

Carriers that have maintained their fronting operations now find themselves in a new climate, where all parties - the fronting carriers, reinsurers and corporate risk managers - are anxious about potential liabilities and losses. This has brought sharply higher fronting fees, diminished capacity, stricter wording of policies and other contracts, and other changes in relationships with reinsurers and risk managers.

In terms of capacity, risk managers could line up US\$3 billion in property limits for fronted programmes without much difficulty before 9/11. Now, they might get US\$1 billion. Fronting carriers are also cutting back on the limits available at the local level in foreign countries. Carriers used to offer local blanket limit policies; now they are restricting the size of limits offered at the local level. For example, in the past, if a multinational company wanted a property limit of US\$500 million for its operations in Germany, the fronting carrier would write the entire limit. Now, a carrier may front only a US\$100 million limit, forcing the company to then buy coverage of US\$400 million in excess of US\$100 million.

Capacity also has been restricted by conditions in the reinsurance marketplace. Reinsurers were hit hard by 9/11 losses and many have been downgraded by rating agencies. Fronting carriers worry about the quality of the security provided by reinsurers and fear reinsurance may become unrecoverable if the reinsurer becomes insolvent.

Carriers also now need more reinsurers to fill a programme. Before, reinsurers had plenty of capacity and few were needed for any one fronting programme. But they have sharply curtailed their capacity, forcing carriers to search for more reinsurers.

The Terrorism Risk Insurance Act, which was passed in late 2002, also has played a role in limiting capacity. The federal programme requires insurers to offer terrorism coverage to all their insureds in return for federal assistance in paying claims. The federal government will help to pay claims after insurers meet a deductible based on their premiums written. Carriers that provide fronting services take on additional premium, which boosts their deductible. Fee-based fronting programmes, however, generally do not adequately compensate carriers for this increased deductible exposure. To keep their TRIA deductible under control, some carriers have been reducing capacity in their fronting operations.



## Changing relationships

The fronting carrier's relationship with the captives also has changed since 9/11. Fronting carriers used to routinely cede most of the risk straight back to the captive. The captive then would arrange for reinsurance. Fronting carriers these days often prefer a net line cession arrangement, where they cede just a small portion of the business back to the captive and cede the remainder to a panel of reinsurers. This gives the fronting carrier more control over the relationship with the reinsurers and greater confidence that it will be able to recover payment from the reinsurer if the captive or reinsurer becomes insolvent.

In addition, carriers have become much stricter about their collateral requirements. When a fronting carrier cedes risk to a captive, it requires the captive to put up some collateral. In the past, that could take the form of a letter of credit, a trust agreement or other financial vehicles. Now, carriers almost always want a letter of credit.

Cancellation provisions also have become an issue. They were more of a veiled threat and rarely exercised before 9/11. Fronting carriers will now exercise cancellation provisions if warranted, especially for nonpayment of premium.

The wording of policies and other agreements is also coming under intense scrutiny these days. Before 9/11, fronting carriers were content to use the standard broker-generated manuscript policies. In this

new climate, however, carriers are nervous about manuscript policies and want more control over the wording of policies. Some carriers now use their own specialized policies instead of the manuscript policies. The policies also now contain more exclusions and more restrictive terms and conditions.

The wording and administration of reinsurance certificates has become a time-consuming problem for fronting carriers. Reinsurance certificates are legal documents outlining how a carrier will be paid by its reinsurers. In the past, reinsurance certificates were fairly standard, and there were few disputes over wording. Reinsurers now often have a raft of objections, and fronting carriers find themselves negotiating with a number of reinsurers to settle disagreements about wording.

Fronting carriers are also encountering new problems in their relationship with reinsurers. Claims control, for instance, has become an issue. It is no longer acceptable for fronting carriers to just keep reinsurers informed about losses. Reinsurers now want a more active role in the process and want these changes reflected in their agreements with the fronting carriers. For fronting carriers with more than one reinsurer, this can pose a serious problem.

Reinsurers are also now more impatient for payment, asking for 30 to 60 days instead of the six to nine months they used to wait for payment.

## Fronting – a burning issue *continued*

### Carrier Comparisons

Carrier	Maximum property Fronting limits	Security Requirements	Guaranteed Cash Flow (Standard terms)	Front for TRIA	Number of owned countries	Number of affiliated countries	Total Countries
ACE	500 Mil	S&P A rated	Paid by 25th out of 15th of following month	Will consider	40	60	100
AIG	500Mil	Committee Approval	25 days Selected Countries	Will consider	89	14	103
Alianz	200Mil	Specified Carriers	None	Willi consider	42	15	57
FM Global	500-1,000Mil	Committee Approval	None	Will consider	18	70	88
Royal	500Mil	250Mil Minimum Surplus	60 days	No	47	94	141
XL Global	500Mil	S&P A rated	None	Will consider	26	44	70
Zurich	300Mil	5% of Carrier Surplus or rated	None	No	36	47	83

Source: Willis

In this environment, it's no wonder that some carriers have withdrawn from the market. The above chart outlines the current carriers. ACE, AIG, XL Global (formerly XL Winterthur) all offer property and liability fronting programmes. Allianz, Royal and FM Global will front property, but not liability programmes. There may be one or two carriers outside the United States providing such services, but it is fair to say these are the industry-recognized carriers. Some international carriers, however, have exited the market. The list of those who have left includes Reliance, Kemper, Gerling, Home and others.

While changes in maximum property limits, security requirements, guaranteed cash flow, TRIA and network ownership have been relatively easy to compare, the issue of cost is more difficult.

### Fronting costs

Insurers are looking at captive fronting cost components more closely than ever before and it is more difficult to compare their pricing methodology. Most carriers today do a much closer assessment of premium taxes, premium reserves, reinsurance export taxes, stamp duties and fire levies and are sure to pass those costs onto the captive.

Profit and administration costs, which fronting carriers charge to the captive, are now broken down in great detail to include cost of capital, management, accounting, credit risk, collections, finance, reinsurance, operations, legal and actuarial services. But not all carriers will disclose how these components are priced.



Equally difficult is the comparison of the use of technology to manage captive administration. Several of the fronting carriers are looking more closely at how to improve their ability to report on captive costs and reinsurance cessions. It is no wonder that this is being done given the significant increases in costs that captives are facing - a 300 percent increase in fronting costs is not unusual.

While information on all the carriers mentioned in this article is current up until April of this year, we suspect that there will be changes in some of these factors as the year progresses. We would not be surprised if one or two of these carriers withdrew from this business in 2003.

Regarding the companies cited in the chart, ACE will provide US\$500 million in property limits, but requires hold harmless indemnity agreements for limits in excess of US\$100 million. This is possible for other carriers as well. AIG has been known to front for limits higher than US\$500 million. While FM Global has limited ownership overseas, they claim that 90 percent of their premiums come from countries where they own their own operations. Royal requires that premium allocations be submitted prior to inception. Zurich does not offer guaranteed cash flow but will move cash in 48 hours in countries moving US\$250,000 in premiums. For the carriers that provide guaranteed cash flow, these terms are standard and quicker terms can be negotiated for a price.

### **Finding a fronter**

When considering different strategies for captive fronting programmes, no stone should be left unturned. Risk managers should consider the following approaches:

- Design a programme structure that considers the realities of today's fronting world, including any applicable tax considerations. Work with a carrier who can best fit your geographical spread and has an appetite for your specific risk. Most carriers are reluctant to front today without participating in the risk transfer.
- Develop and present an agreed fronting form policy. You can work with your broker in developing a policy that suits your needs and has acceptance by key reinsurers.
- Negotiate and deliver acceptable reinsurance certificates. Risk managers can take a more active role and speed the process by working with the reinsurers on their fronting programmes and helping them to reach agreement on acceptable wording on reinsurance certificates.
- Advise the fronting carrier on the list of likely reinsurers. This will assist the fronting carrier in pre-qualifying these reinsurers.

## Fronting – a burning issue continued

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- Complete the premium allocation process as close to inception as possible. Deciding on allocations after the effective date is perhaps the most difficult issue that underwriters have in implementing a programme.

Other optional strategies include:

- **Self insurance.**  
Risk managers will sometimes discover they have coverage gaps in their traditional insurance programmes. These gaps need to be recognized and addressed. They can be funded either through the company's captive or through self-insurance.
- **Non-admitted approaches.**  
Accepting a non-admitted programme with no local fronting policy is an alternative, provided the risk manager understands the legal and financial implications. The chances are good that most multinationals already have non-admitted insurance covering risks abroad.
- **The European Union**  
For multinationals with European operations, it may be advantageous to have a fronting carrier issue a policy in one EU country covering all EU exposures. Under the Freedom of Services directive, some coverages can be written outside the country where the company has the exposure. Auto

and excess liability, however, must be written in the specific country. The issue here is the payment of premium taxes. Also, some countries will require a translated policy.

- **Direct writing captives**  
A direct writing captive based in the European Union can issue a policy that covers all EU exposures. Domiciles to consider are Dublin and Gibraltar. With a direct writing captive, you might be able to avoid a costly fronting arrangement. But the cost to create a direct writing captive is more expensive than a traditional captive. Up to 10 percent of the risk must be retained in the captive and local premium taxes must still be settled. In addition to the EU, Iceland and Norway, this method could be used in countries such as Australia, Hong Kong, New Zealand, Singapore and South Africa.
- **Subscription policies.**  
If TRIA becomes a barrier to fronting in the United States, a subscription policy may provide a better solution. The traditional arrangement calls for one carrier to provide all of the fronting services. But with a subscription policy, several insurers share the risk and there is no one fronting carrier. Each insurer will issue a declarations page for their share of the overall business. In Europe this is a common arrangement known as coinsurance.



- **Loss limit**

To avoid reinsurance security issues, a loss limit approach on fronting could result in an efficient programme. Instead of asking the fronting carrier to issue a US\$500 million policy limit on the master programme, ask the carrier to issue only a US\$50 million policy limit. This reduces the carrier's credit risk and the number of reinsurers it will need for the fronting programme. Risk managers can buy direct excess insurance over that loss limit, if necessary.

- **Simultaneous loss payment.**

Fronting carriers can add a clause in a policy that says they are not obligated to pay a claim until they have been paid by the captive. When the carrier receives payment from the captive, it sends payment on to the insured. Although this practice is acceptable in some countries, others, including some states in the United States, do not allow it.

### **Present and future**

Because fronting carriers need a global network to service this business, the number of carriers will always be somewhat limited. In the last year or two, that market became even smaller. As the market begins to stabilize, however, we may see some of those carriers come back into the business. In the meantime, by using some of these strategies, risk managers can overcome the challenges they now face in setting up a fronting programme and make the best use of their captive insurer.

## People and places

- **Mairead Ni Chochlain** has been appointed head of upstream and downstream underwriting at ACE, reporting to **Roger Giddings**
- **Lesley Harding** has resigned from Arch.
- **Bill O'Malley** is joining Arch as vice-president of energy from ACE Global Markets
- **Olivier Carriere** was appointed head of energy at Axa Re following **Pascal Chebrou's** transfer to treaty reinsurance
- **Paul O'Neill** is leaving XL in London and is relocating to Allianz Singapore
- **Paul Kelley** has joined AIG London from New York and has responsibility for Starr Tech business.
- **Peter Coleman** is leaving Willis to join the Reith syndicate at Lloyd's (Ascot Underwriting). He will be working closely with **Mark Donald** on the property and energy books
- **Gunter Becker** is joining Munich-American RiskPartners from Gerling
- **Maurice Purslow** has transferred from Zurich in Hong Kong to Zurich New York as head of oil, gas and petrochemicals. **David Drinkall** has left Zurich Energy in Zurich
- **Kudret Oztap** has left Scor Re in New York for ACE Global Markets in New York
- **David Hawksby** of AIG has moved from London to New York as head of AIU Energy
- **Bob Gefers** joined Global Special Risks in Houston earlier this year.
- **Ken McPhail** has joined Arch in Bermuda from Starr Tech New York
- **Paul Dawson** has moved from Aegis to Beazley syndicate in Lloyd's
- **Chris Charlton** has left Allianz to join Swiss Re in London
- **Richard Pelangat** at Aegis is now writing offshore energy
- **Will Martin** has joined Catlin from Dandridge at Lloyd's
- **Stuart Holmes** has moved to Hiscox to write the upstream liability account
- **Christian Scott** has joined Houston Casualty
- **Philip Hancock** has resigned from AIG and joined Millennium syndicate to develop the operational power utility book alongside **Stephen Coward**
- **Ian Green** has been appointed Manager, Power Utilities, at AIG



**The following is some brief news of onshore liability developments:**

- AWAC's London Contact office became a fully licensed branch office in April 2003, and the company's liability capacity has increased from US\$ 25m to US\$ 50m.
- **Carla Greaves**, formerly of AWAC, has joined the Arch excess liability team in Bermuda.
- Following **Bob Wallace's** retirement at 1 July 2003, **David Constable** was appointed as the "active underwriter" and the syndicate name has been changed from RJ Wallace to DA Constable syndicate.
- **Jeremy Fage** has been promoted to board level with responsibility for the international liability account and **David Fitzpatrick** has joined the syndicate from Marketform to write international liability business.
- **John Boylan** and **Colin Shaw** both left XL to join Max Re, Dublin in May. John is appointed as Chief Underwriting Officer and Colin as a Senior Vice President.
- Max Re's Capacity is US\$ 25m and they are positioning themselves as low excess players in the liability market.
- **Martin Hawkins** resigned from Gerling and has joined Newline as Underwriting Manager for liability.
- **Bob Pattern** joined XL as Casualty Underwriting Manager, Ireland. Bob was formerly the Senior Vice President and Casualty Manager at Starr Excess.

## Summary

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The frequency and severity of loss in the energy sector from 1998 to 2001 was certainly extraordinary.

However, the lack of loss activity in 2002 seems to have been equally exceptional, with the first six months of 2003 continuing in similar vein.

When rates which are at a ten-year high, and deductible levels that are higher than for maybe twenty years, are coupled with breadth of coverage narrower than anything granted for ten years, it is easy to understand why energy business has become attractive again to underwriters.

The hard market started in earnest in the energy world at the beginning of 2001 and gathered pace throughout that year, with a massive spike occurring post September 11.

What is clear to us is that the excellent results for 2002 and 2003 to date are allowing underwriters to withdraw the "9/11 surcharge", the imposition of which had more to do with a crisis in the general insurance market than specifically with the energy market and its results.

So, yes, prices are softening. But at this stage they are doing no more than reverting to the albeit less steep, but nevertheless upwards, trend that was evident in the first nine months of 2001.

The most encouraging aspect of the market in recent months has been the renewed availability of capacity in the property classes. We are pleased to report that after becoming risk-shy post 9/11, insurers and reinsurers are once again providing much-needed capacity for energy clients.

Willis specialists have recently published other market reviews which might be of interest to you:



Lloyd's Review 2003



Marketplace Realities and Risk Management Solutions



Reinsurance Market Review  
March 2003

Willis also publishes regular technical reports and analysis such as these examples below:



Gas Turbines in the Modern Power Industry



Risk Technology Insights II

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

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