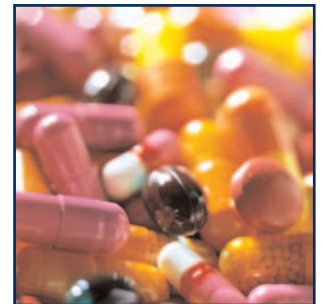


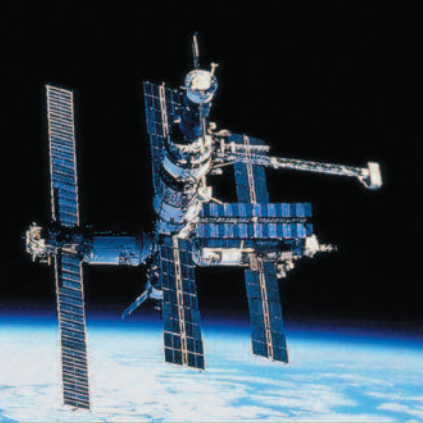
# Marketplace Realities & Risk Management Solutions

# 2007

Adaptation, Innovation  
and the Insurance Marketplace  
November 2006 Edition



Willis



## Adaptation, Innovation and the Insurance Marketplace

# Willis

November 2006

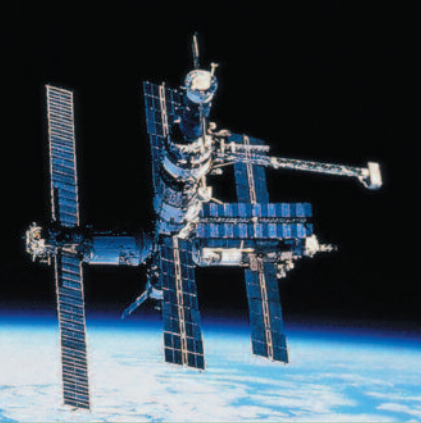
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- International
- Captives
- Construction
- Surety
- Financial Institutions
- Environmental
- Healthcare Benefits
- Healthcare Professional Liability
- Utilities

#### Editorial Staff:

Gordon Prager  
Jonathan Fried  
Agnes Valentin



# Marketplace Realities & Risk Management Solutions 2007

## Adaptation, Innovation and the Insurance Marketplace

# Willis

November 2006

### Foreword

The ability and agility to adapt and to innovate have been hallmarks of social and economic survival, advancement and wealth creation throughout history. They are ever more important today at every level of enterprise, in countries and cultures around the world. On this page, we focus on the fields of risk management and insurance.

In his keynote address to the International Risk Management Institute (IRMI) annual conference on October 10, Willis Chairman and CEO Joe Plumeri encouraged our industry to meet the challenges of our times with the spirit of discovery and innovation:

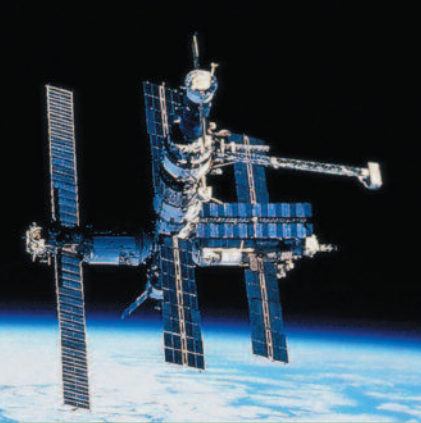
The world is changing. Are we offering solutions that are keeping up with the change? We can't simply shoehorn today's more complicated risk and insurance needs into yesterday's traditional solutions. Be imaginative, be creative, be an adventurer.

In its broadest sense, the term *insurance industry* encompasses all parties who work to manage risk – individuals in their everyday lives, organizations and businesses, government and its associated agencies and institutions, and the extended family of companies and entities who provide risk management and insurance products and services. That extended family includes insurers, reinsurers, sureties, the capital markets, insurance brokers and consultants, third party administrators, captives, safety groups, special purpose vehicles, modeling firms and many other risk-related businesses.

That so many people in so many walks of life are dedicated to studying and mastering the mechanics and nuances of risk comes as no surprise, because it truly is all about protecting lives, enhancing the quality of life, building productive livelihoods and creating lasting value. Ancient civilizations knew it. Sumerians, Babylonians and Phoenicians developed measurement tools, sophisticated and progressively more user-friendly alphabets, the concept of interest and the pooling of risks. Their ingenuity provided a commercial, legal and financial foundation that facilitated trade and helped secure and expand their civilizations. They innovated.

To do so in the 21st Century, in our incredibly dynamic and challenging global environment, we absolutely must understand the complex relationships between risk and reward and the multidimensional nature of causality. We must take the measure, again and again, of the quantum and quality of risk – frequency, severity and volatility. We need to do these things in order to make the most informed choices, as they are the gateways to best results.

The logic, simplicity and pragmatic value of risk management fundamentals are time-honored and timeless: Avoid. Accept. Mitigate. Transfer. We at Willis serve our clients in evaluating and effecting all of them. The risk transfer component requires expertise in brokerage – the art and science of intermediation – to place risk in the marketplace. In the IRMI address cited above, Joe Plumeri



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observed, "It's our jobs as brokers to marry your risk with someone else's capital. Mitigate it, take it off your balance sheet and put it on someone else's capital base."

Insurers, financial markets, mutuals, captives and others who put their assets on the line in accepting risk transfer have concurrent and parallel sets of objectives – elements that are essential for assuring their own long-term viability. They strive to establish equitable rate structures, to build safeguards against catastrophic depletion of assets, and to respond appropriately and nimbly to changing circumstances.

As we have seen time and time again, clients and capital providers have exhibited great resiliency and determination in the face of adversity. About one generation ago, the relatively sudden hard market of the mid-1980s led to significant changes in the risk management landscape: large retentions; expanded roles for risk control and claims management; the birth of specialized underwriting facilities; diversification of offshore capacity offerings; expansion in the breadth and number of captive insurers; and elevation of the profile and role of risk management within the modern corporation.

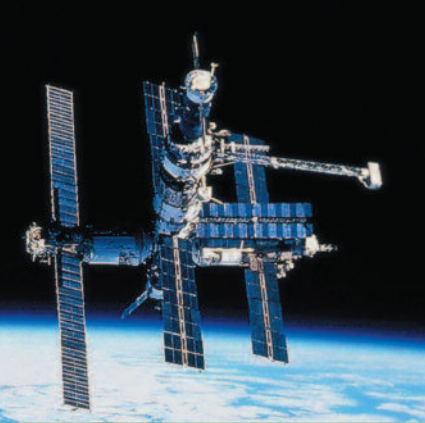
Today's generation has experienced the devastation of 9/11. The 2004 and 2005 Atlantic Hurricane Seasons served as natural catastrophe wake-up calls. We abide in a new millennium that has already demonstrated the pernicious staying power of terrorism, corporate malfeasance, cyber risk and environmental peril. Through it all, the people and industries of risk management and insurance have persevered, adapted and innovated. New models, new products, fresh capital and fresh thinking have come to the fore, and an invigorating can-do spirit fuels our imagination and drive.

Let no one write the epitaph of the incredibly resilient insurance marketplace.

\* \* \*

In this edition of *Marketplace Realities 2007*, we provide a collection of incisive overviews that examine marketplace segments, near-term expectations and advice for our clients. These studies are an expression of our unflinching dedication to the creative process. They represent our commitment to help our clients become better informed, to explore alternative approaches in managing and funding for risk, and to provide exceptional value. In doing so, we are delighted to serve you.

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## Adaptation, Innovation and the Insurance Marketplace

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### Market Overview

In the run-up to the 2006 Atlantic Hurricane Season, those who had assets, operations and other interests at risk were busy taking the measure of their exposure to direct and consequential loss. They revisited disaster and business continuity planning. They undertook scenario building and long-term business planning exercises with the sweep and clarity of vision that often comes with an epiphany – such as that provided by the brutal winds of Katrina.

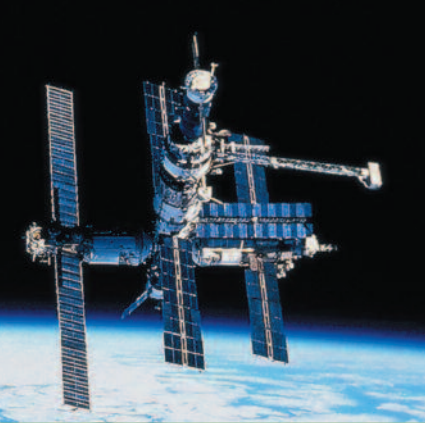
Modeling firms, insurers, reinsurers, rating agencies, regulators, climatologists – everyone studying the record-breaking 2004 and 2005 seasons – had good reason to expect more of the same.

On May 22, the National Oceanic & Atmospheric Administration (NOAA) predicted 13 to 16 named storms, with 8 to 10 becoming hurricanes, of which 4 to 6 could become major hurricanes of Category 3 strength or higher. On August 8, NOAA reduced the numbers, but only slightly, still calling for the tenth above-normal season in the last 12 years. Yet here we are today, on November 1, one month before the official end of the Atlantic Hurricane Season, and we have had only nine named storms, none of them devastating. Last year, we ran the gamut of first names from Arlene to Wilma and then went on to use six letters of the Greek alphabet – for a total of 27 designated tropical storms and hurricanes.

In an article published on October 19 under the banner “Insurers Bask in Sun and Profits As Hurricane Season Nears End,” *The Wall Street Journal*, with metaphorical exuberance, proclaimed: “Every cloud may have a silver lining, but for insurers the lack of clouds could be golden.” And then came the numbers. Property insurers’ third-quarter earnings were expected to soar. Allstate’s alone “could help lift blue-chip earnings more broadly.” Two weeks before, insurance industry analysts had reported that at the mid-year mark, the US Property / Casualty industry combined ratio had improved to 92.0 and policyholder surplus had grown by 2.7 percent to \$450.5 billion.

All good news for now, with this *caveat*: singular events and short-term phenomena, as epochal and disruptive as they can be, do not necessarily make for trends or harbingers of more of the same – and neither does the apparent lack of them. Capital providers and insurance buyers know these maxims quite well. So, although many market segments feature ample capacity and carrier offerings, we believe that the discipline earned at great expense in recent years will not be jettisoned or weakened by a relaxation of risk management and underwriting practices.

We also observe, as we have before on this page, that the insurance marketplace is not a homogeneous whole. It is remarkably diversified and segmented, and while we can speak of aggregate capacity and a single combined ratio for the US Property / Casualty industry, the nature of each market segment and micro market is distinct.



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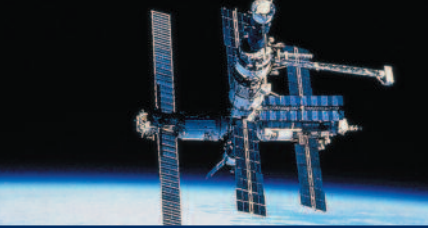
# Willis

November 2006

In this report, we therefore examine the unique characteristics and behavior of 15 market segments, specialty practices and industries. We observe that Nat Cat pricing and capacity conditions have not been immediately ameliorated by the relatively mild hurricane season. We explore challenges and opportunities for construction, financial institution, healthcare and utility industry clientele. We illuminate strategies and best practices that apply across a broad spectrum of client needs and objectives. We strive to provide you with the information and tools you require to manage risk across your organization.

Our purpose herein is to inform and advise. Our ultimate goal, as ever, is your success.

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# Marketplace Realities 2007

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## Property

November 2006

2005 Reviewed  
(Very Briefly,  
We Promise)

2006 in a Nutshell  
– or – How Nutty  
Is this Market?

*The following article is written in the first person, reflecting the author's vast career experience and refreshingly direct style of expression.*

In all, 2005 Atlantic storms generated US insured losses of \$80+ billion. "Insured losses" includes liabilities borne by the National Flood Insurance Program, as well as various state-supported insurers of last resort, all of which are running at deficits wholly or partially landing in the laps of taxpayers, not reinsurers. So let's say the number we are playing with is \$60+ billion, of which more than 50 percent is attributable to Hurricane Katrina. Truly significant, although it has not skipped anyone's attention that many insurers and reinsurers still had positive results for 2005, particularly those with multiline portfolios.

A word on current insured loss estimates. There are still some reinsurers who are registering deterioration in their loss experience due to adverse developments in 2005 storm claims. And we are well aware of some high-profile and high-dollar-value litigation being waged. It is not possible for us to gauge if reserves are being set aside for the amounts at risk. This may well be a continuing saga.

A cautionary note for people outside catastrophe-prone areas. You may want to proceed out of idle curiosity – or not. Your world is not one described in great length below. If you are well protected (though not necessarily Highly Protected) and have good loss experience, many markets vigorously competed for your business in 2006 and will continue to do so in 2007. For others, read on.

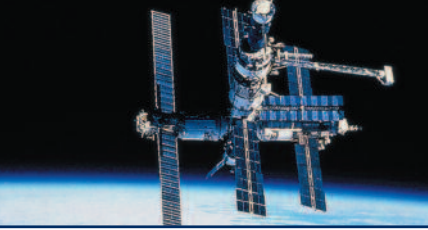
Taking a leaf out of Queen Elizabeth's book, we can safely say that for many policyholders 2006 was an *annus horribilis* of a previously unknown sort. What started out poorly in the first quarter of 2006 quickly degenerated into a total market meltdown in terms of pricing and capacity for many coastal wind exposures. And for some, the term "coastal" was expanded to reach northern latitudes not generally considered at risk before.

By July, it was impossible for many to get more than \$50 million to \$100 million in wind limits at any price. Particularly hard hit were public entities and those in construction, healthcare, hospitality, real estate and retail. It's not hard to figure out why when insurers who were regularly putting out \$100 million or more of capacity came back with maximum lines of \$5 million for coastal wind. When this occurs five times over, you have to replace at least \$475 million in wind capacity – and that was not happening.

For those with West Coast assets and operations, the second quarter saw the beginning of a sharp downturn in availability and upturn in pricing of their earthquake insurance. Why now, when there hasn't been a significant California earthquake since Northridge in 1994? As the president of a leading insurer said, "Earthquakes know no season." Meaning, I suppose, they can't be seasonally adjusted. My answer: "OK, but they can be modeled, can't they, and you've been doing this all along. So what's changed?"

Read below for the real skinny.

The logo for Willis, featuring the word "Willis" in a bold, blue, serif font.



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### Storm Sages (not Surges) – *Bah Humbug*

As we enter the home stretch of the hurricane season, 2006 has placed itself in stark contrast to 2004 and 2005. Despite early and loud prognostications to the contrary by storm sages, Atlantic hurricane activity has been mild, perhaps abnormally so if there is anyone among us who is wo/man enough to define “normal.” The National Hurricane Center on September 30, 2006 declared the fifth hurricane of the season (the ninth tropical storm), Isaac. By the same date last year, we were already past Rita (the 18th tropical storm) and heading squarely toward Wilma (the 23rd).

Of course, with the storm season now well past its halfway point, we see these same sages retreating from their earlier predictions, citing the appearance of a weak El Niño and unusual sandstorm activity over western Africa as factors inhibiting the formation and growth of Atlantic storms this year. So much (so far) for the tongue-twisting Atlantic Multidecadal Oscillation factor – the one that foresaw a 30 percent or higher increase in storm frequency during the next five years.

### The (Not Always Accepted) Theory of Insurance

What is this thing called the “theory of insurance?” The premiums of the many pay for the losses of the few. Nice premise, but it does not always work out that way. When reinsurers at the beginning of 2006 tried to spread the pain around the globe, they were met with a resounding “No way!” Why should Europe pay for losses in the Americas? Why should regional companies (and their regulators) in the US expect (allow) their policyholders (and constituents) to pony up for losses sustained outside their regions? One hopes the parties remember this refrain when European floods, windstorms and heat waves take their own toll or when tornadoes and other severe weather events buffet areas in the US far from either its Atlantic or Pacific coasts.

The above is not an apology for the unrelenting, and to some seemingly unsupportable, development in our coastal areas, nor is it excusing the inexplicable failure of governments to enforce stronger building codes in areas clearly at risk. More intelligent land-use and construction standards must be adopted by governments when their citizens prove incapable of policing themselves, or these governments and their citizens end up paying for their own losses – out of pocket and through the burden of taxation.

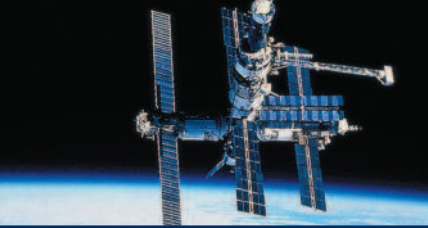
What happens when the theory of insurance breaks down in practice? Without the ability to spread required premiums across a broad base, insurers and reinsurers are left with two options. They can spread the capital costs across only those policyholders presenting the catastrophe portfolio, with each policyholder assuming a significantly greater portion of the burden – if the buyer can or will. Or they can simply reduce that portfolio altogether.

### A Reversal of Fortunes?

In a reversal of the principle that supports the theory of insurance, it turns out that the losses of the many (insurers) end up borne by a relative few (reinsurers). When the 2005 gross written premium for the top 10 reinsurers in the world (approximately \$110 billion) accounts for more than 30 percent of the total written (and presumably an equal share of global risks) how secure is the system really?

Some large corporations and insurers are already questioning whether they are really transferring risk when they buy insurance or reinsurance or merely substituting one risk for another – counterparty risk for event risk.





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### Updated Models – Improved Accuracy or Just Worse Results?

A cynic might take the view that updating models post-catastrophe is as much about revenue generation as it is about providing greater accuracy of probable loss. Leaving that view aside, it is evident that seldom do modeled probable maximum loss estimates go down when an update is introduced.

As an example, using research on 2004 and 2005 hurricanes, RMS' new *RiskLink 6.0* may add as much as 60 to 150 percent to the modeled results for commercial property losses at the 100-year return rate, and that is without consideration of loss amplification. Our recent *Property Bulletin* explores loss amplification further, including how this factor affects modeled losses for California Earthquake.

The exception to modeled loss increases is RMS' reassessment of New Madrid earthquake losses, which could be reduced between 20 to 60 percent at the 250-year return rate, again without consideration of loss amplification. Of course, since we haven't had a major earthquake in that area for well over a century, one might have good reason to question this outcome, positive though it is for those with exposures there.

### Impact of the Rating Agencies

For the past two years, rating agencies have been updating and revising their capital requirements for catastrophe exposure. As a result, in certain cases more capital is needed to support a given level of underwriting capacity.

The experience of the extraordinary, back-to-back 2004 and 2005 Atlantic Hurricane Seasons acted as catalyst for the updates, demonstrating to the rating agencies a greater threat than previously perceived. Reinforcing the rating agencies' perception was the evident weakness in the outputs from catastrophe models generated by many companies and, in some cases, the inappropriate reliance on such modeling. The ramped-up loss estimates from the catastrophe models are therefore inputs into the ramped-up capital models of the rating agencies, compounding the impact on supply and demand – and therefore price.

A mild 2006 Atlantic Hurricane Season – in progress as we go to press – may or may not influence the rating agencies' thinking in this area, as there are many factors that influence their analytical approach and their role in the insurance / reinsurance sector. (We invite our readers to download the Willis publication "A Vision of the Future? – June 2006" from the Publications page of [www.willis.com](http://www.willis.com). In that publication, we examine a number of related topics: insurers as policyholders, reinsurers, rating agencies and the regulatory environment.)

### Enough Already – What About 2007?

Because this is a forward-looking report, we need to address the question on everyone's mind: Will minimal hurricane losses this year mean a return of capacity and moderated pricing? And if so, when?

### What Do Reinsurers Say? Rendezvous in Monte Carlo – The First Step in the Annual Mating Game

Reinsurers are apparently poised to hit up their January treaty cedents one more time, to level the playing field with those whose geese got royally cooked on mid-year treaty renewals. It remains to be seen whether these cedents will be as docile and apologetic as they might have been in 2006 negotiations, especially absent 2006 losses. Many have had to turn away new policyholders or alienate existing ones. With the exception of a few reinsurers who are still increasing reserves for last year's losses, the others



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have rebounded quickly and are posting healthy premium income and retained earnings for the first half of 2006. Granted, in many cases this health is attributable to more than Property lines of coverage, and the benefits of such diversification were plainly seen in the disparity of 2005 results between monoline and multiline insurers and reinsurers.

## What Do Policyholders Say? “I’m Mad as Heck and Won’t Take It Anymore!”

Insurers and reinsurers tend to ignore the fact that more sophisticated policyholders may get used to having less protection over the long term, may find another way to finance their risks or may become more prone to being opportunistic, buying coverage at its cheapest point and eschewing it at its highest, contributing to the inexorable market cycles.

Further, insurers and reinsurers also help to perpetuate these cycles by chasing business at declining rates in other areas, whether in other lines of business or other areas of the globe. We are seeing this now both in Casualty lines and in placements for properties outside the US.

With funds available from capital markets dwarfing those of insurers and reinsurers, the question becomes whether tapping these funds is most effectively done through cat bonds and sidecars issued by insurers and reinsurers, or whether individual corporations or consortia of corporations can somehow take advantage of this wealth with fewer frictional expenses and for longer periods of time. Clearly, the ability to model catastrophe risks is key to underwriting cat bonds and sidecars, and arguably the smaller the portfolio of risks the less the credibility given to the models. But where there is a will, there is a way.

## What Does Willis Say?

Insurers and reinsurers, and capital markets to the extent they commit funding to event risks, are influenced and constrained now, more than ever, by rating agencies, and rating agencies rely on “storm sages” and models. We do not see this changing significantly in the short term. But without material 2006 losses, there presumably will be fewer newly ramped-up cat models, and therefore less inclination for rating agencies to strengthen their stress tests. That in turn may enable the additional earnings retained by insurers and reinsurers to be used to write more catastrophe business. And as pricing and terms and conditions loosen in other lines of business, more capital may be dedicated to underwriting Property catastrophe risk.

In a word, we don’t see the market getting worse, and we believe it will get better, with slightly more capacity at slightly better pricing – the first being more prevalent than the second, at least in the first quarter of 2007.

## TRIA – Again??

For those of you who forget that it is almost that time again, terrorism insurance will once more take a headline position in 2007. Despite early efforts by policyholders, insurers and reinsurers to convince Congress and the administration of the continuing need to extend federal terrorism risk insurance protection beyond its scheduled December 31, 2007 expiration, no progress has been made to date and there is no indication the Terrorism Risk Insurance Act (TRIA) is on the front burner, at least as far as the Senate is concerned. In fact, the September 30 release of the findings of the President’s Working Group, mandated by TRIA’s extension, is less than supportive of the Act’s continuation. So we will go into the new year facing the same imposition of conditional exclusions we did at the end of 2005. It’s *déjà vu* all over again.



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We also expect to see pockets of reduced capacity for embedded terrorism (that included in a Property placement), as well as an uptick in premiums as insurers' retentions rise to 20 percent of direct earned premium and their coinsurance above that rises from 10 to 15 percent and the certified event trigger rises to \$100 million.

## 2007 and Beyond: The Challenge of Words vs. Intent

Of what value is the mechanism of insurance when it doesn't fulfill its promise to pay? There will always be disputes following events of the magnitude and complexity of Katrina, in particular, and we'd like to think that the majority of this litigation is caused by good faith efforts on the part of both policyholders and their insurers to prove that their respective positions are right. But we are dismayed at some of the reasoning we have witnessed.

Which leads to a second question. What is this thing called "contract certainty?" It is not merely the agreement to verbiage prior to binding. It also affords the opportunity to achieve an unequivocal understanding of the intent of that verbiage by both parties to the insurance contract. Arriving at this is no easy task in our business. While there may be reasonable standardization in homeowners insurance, there is considerably less on the commercial insurance front. Achieving standardization of definitions of common terms such as "occurrence," "wind," "flood" and "earthquake" has been resisted, and such standardization cannot be imposed. How transparent really are the intentions of underwriters when definitions differ even on such fundamental terms?

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## Casualty

November 2006

Insurers are looking at some of their best financial returns in decades. Some carriers even expect returns on invested capital (surplus) to be on par with Fortune 500 companies, which is uncommon for the insurance sector. The projected combined ratio for the Property / Casualty industry for the first six months of 2006 is 92 percent. Introduced during 2006 were enhanced catastrophe models and new rating agency requirements which have, to some degree, reshaped carriers' attitudes toward capital and surplus allocations. Although named storms have caused minimal damage so far in the 2006 Atlantic Hurricane Season, carriers continue to ration their Nat Cat Property capacity in hurricane-prone areas. They are, however, demonstrative in their desire to grow their Casualty books.

Accordingly, pricing in the Casualty market remains relatively soft. Still, we do not see any signs of pricing softening to levels of the late 1990s. Almost as a correction to the broadening of coverages that occurred during the past decade, carriers continue to strengthen their underwriting process to create a "purity" of coverages. An example would be removing Professional Liability from General Liability coverage. This coverage discipline can be seen in both the primary Casualty and excess Casualty areas.

## Primary Casualty

Accounts with good loss records and strong financials are being sought by underwriters. In addition to more aggressive pricing for these risks, the market is again offering multiyear programs and more innovative collateral programs. Based on market pricing and the current interest rate environment, carriers are buying less facultative reinsurance today. Unlike the retail insurance market, the facultative market is not experiencing a soft market, though even with these conditions, carriers are still buying facultative reinsurance for tougher risks. Larger, more complex accounts with volatility may still experience pricing increases in the flat to 10 percent range. The main underwriting concerns continue to be:

- Employee concentration in large metropolitan areas
- Collateralization of expected losses within loss-sensitive programs
- Maintaining suitable terms and conditions pertinent to exposures
- Adverse judicial developments

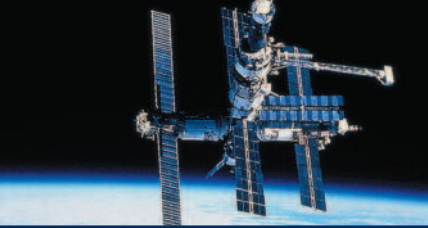
## Umbrella Excess Casualty

The market for large Casualty account umbrella and excess business has continued to soften in 2006. It is not unusual for a risk to benefit from rate reductions in the range of 15 to 25 percent for excess programs. Capacity is plentiful for the right risks in the umbrella market, but there are still no more than a handful of lead umbrella markets. The attachment point for tough exposures, including large fleets, is being bumped up to higher attachments, and risk-specific buffer layer programs have proven to be an effective solution.

## Legal and Regulatory Environment

As we reported in April, tort costs are still a major factor influencing industry performance, notwithstanding the 2005 Class Action Fairness Act, which has so far had little impact on underwriting results. Also, in its present form, the proposed trust fund to handle asbestos claims provides little comfort to insurance carriers, and the likelihood of this fund significantly limiting the ongoing adverse development of incurred claims is remote.





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Another concern relates to an adverse ruling against three paint manufacturers declaring them liable for the expense of cleaning up lead paint contamination. Although the ruling was made on narrowly drawn conclusions, the effect on other litigation could be significant, as several states are considering their own suits. This is being compared by some analysts to the asbestos crisis of the 1970s.

Workers' Compensation reform continues to be a moving target and varies dramatically from state to state. As mentioned earlier, the industry's main concern is concentration of employees and exposure to large losses from terrorism, earthquake or other perils.

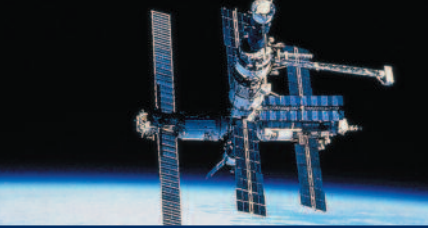
## Strategies For Tomorrow

Most indicators suggest that the Casualty market will remain relatively stable throughout the balance of policy year 2006. There are, however, several factors that could influence the future direction of the marketplace. Based on projected industry combined ratios for 2006, the projected returns on capital / surplus and the current interest rate environment – the temptation to continue to lower prices to win new business is tempered by the heightened rating agency scrutiny. What will carriers do with excess capital? Will it spawn M&A activity? Will they write new coverages, or simply take more risk? As a counterpoint, the possibility of another year of record-breaking catastrophic losses is keeping carriers relatively conservative in their approach to underwriting.

Buyers should expect next year's pricing terms to be somewhat consistent with this year's, but if they have grown very attached to some of the very broad GL coverages we have seen historically, they may want to consider an integrated program to blend coverages. As carriers are constantly adjusting their preferred attachment points, it makes sense for insureds to understand the various structures available in the market and how utilizing these can lower their cost of risk. Structures include the use of buffer layers, increased retentions, integrated insurance products and alternative risk transfer mechanisms.

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## Bermuda

November 2006

## News from the Rock

The much publicized new sources of capital that poured into Bermuda in the past year have given the world new insurance and reinsurance companies, improved existing balance sheets, sidecars<sup>1</sup> and enabled relocation of off-island operations to Bermuda. In the aftermath of the devastating 2005 Atlantic Hurricane Season, with the three now infamous storms Katrina, Rita and Wilma, over \$20 billion was injected into the island.

After 9/11, as supply and demand curves shifted, 10 major new insurance and reinsurance companies were formed, providing needed capacity for large companies. The Class of 2005 / 2006 also numbers 10, but they are predominantly reinsurance companies. While their North America Nat Cat loss experience to date has been favorable, the year is not over yet, with pundits and prognosticators suggesting that the hurricane season is getting longer.

Only two companies have entered the world of direct insurance in a meaningful way. Ariel and Lancashire have created a significant presence in their first year of business, not surprisingly focusing primarily on the need for Property capacity. The street is also alive with discussions of at least one or two more significant start-ups in the works for the end of 2006 / beginning of 2007.

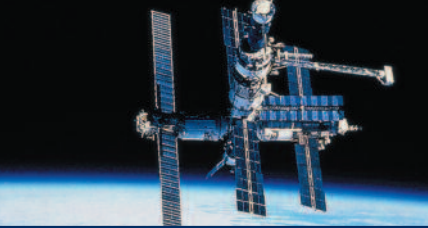
## Why Bermuda?

Why does all this investment capital flow into a small volcanic island in the middle of the Atlantic? Answer: Bermuda offers the ability to quickly and efficiently establish a company, and it possesses a hospitable regulatory and tax climate. This continues to make Bermuda the venue of choice for investors who want to rapidly recognize opportunity created by global market dislocations. Capital from Hiscox, Amlin and other high-profile Lloyd's and London companies has moved from the UK to seek portfolio diversification and take advantage of the Bermuda business model. These relatively recent arrivals have complemented the roster of companies created in the mid-1980s (and before) – companies such as the now well established Global XL and ACE. For some time now, Bermuda has been at the forefront of the global insurance and reinsurance marketplace.

Will the Bermuda marketplace stand the test of time? This year, XL and ACE turned 20, while AWAC went public. Quanta and PXRE have encountered difficulties. In the main, the Class of 2001 looks strong and the market is more robust with the recent arrivals. However, complacency must not develop. Bermuda needs to continue to do what it has done – innovate and evolve, differentiating itself through its product offerings, addressing niche needs as coverage and capacity issues arise, and providing ever more diversified and robust insurance-related services.

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<sup>1</sup> A sidecar is a separately capitalized reinsurance vehicle that operates alongside a parent company, accepting risk as a predetermined quota share of the parent company's book of business. Instead of a financial strength rating, the sidecar offers collateral as security to the parent company.



# Marketplace Realities 2007

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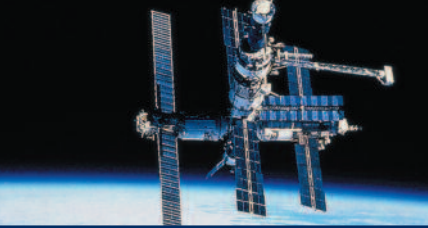
## The Year Ahead

In 2005, \$58 billion of losses were paid by the global Property / Casualty insurance industry, and yet profits were posted. In Bermuda, as in the US and Europe, the markets are expected to experience some softening for the short term. For the rest of 2006 and 2007, established insurance carriers in Bermuda will seek to diversify their product offerings, to attempt to resist the falling market and to continue to weed out unprofitable business. Several Bermuda carriers, such as ACE, XL, AWAC, Starr Excess, Arch and others, now have global operations and can take advantage of geographic diversification, thereby providing balance for their respective portfolios of risk. This clearly provides a greater degree of stability to the Bermuda marketplace.

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## Executive Risks

November 2006

## The Evolving Liability Environment

With 10 mega claim settlements in the first six months of this year totaling roughly \$3.5 billion, both the frequency and severity of such settlements were ahead of 2005's record pace. (Mega claims are those Directors & Officers (D&O) claims where the cash portion of a settlement or court award exceeds \$100 million.) In 2005, there were 17 mega settlements, which followed 13 in 2004. In a counter trend, the frequency of new security class action filings dropped during the first half of this year, along with the size of the related stock-drops. Although the two trends tend to somewhat offset each other, the positive trending for D&O claim portfolios has not reversed cash outflows for D&O carriers.

Corporate directors and their insurers received some good news in the courts. In a closely watched case, the Delaware Supreme Court ruled five-to-zero to uphold the lower Chancery Court's decision in the almost decade-long suit against the directors on Walt Disney's compensation committee. Following that, Milberg Weiss, a well-known law firm that represents securities plaintiffs, and two of its partners were indicted by a grand jury alleging that the law firm paid clients millions of dollars to serve as plaintiffs in up to 150 class action and derivative lawsuits. While the impact of this indictment appears limited (other than to force a change in legal representation in a number of ongoing D&O cases), corporate executives who felt victimized by this law firm are no doubt relieved.

## Recent Headlines

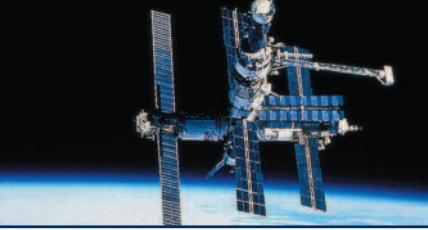
More than 100 companies have disclosed that they are the subject of regulatory, criminal or internal probes into whether or not they improperly inflated executives' pay when dating their stock options. Experts believe the number of companies on this list is likely to grow. These cases may well produce a relatively high frequency of claims and yet result in a fairly low severity, perhaps along the lines of the IPO laddering claims which ultimately resulted in 300+ cases paying an average of \$4 million. With new rules on disclosure of executive compensation currently under consideration, watch for some immediate spillover into probes of corporate auditors. It seems safe to say that the focus on executive compensation is likely to remain strong for all concerned.

The first six months of this year also saw the government's successful criminal prosecution of Enron's most senior executives. With much of the Enron-related litigation concluding, global attention shifted to the extradition from the UK of the "NatWest 3." Three bankers are alleged to have participated in questionable asset sales in which they and some Enron executives personally benefited. Political controversy surrounds this case regarding what some are labeling over-zealous prosecution. With global coordination in D&O enforcement and litigation, extradition may well be something that executives face going forward.

As of mid-July, the Sarbanes-Oxley Act (SOX) became applicable to foreign firms that file with the SEC or are listed on US stock exchanges. This will test their ability to address the complexities of SOX's §404 and its requirement that the company, its CEO, CFO and outside auditors attest to the robustness of the company's financial reporting. Considering that many of these firms may still be dealing with last year's assumption of new international accounting standards, this may be a challenging period for the numbers people – and those responsible for the numbers – at these companies.

# Willis





# Marketplace Realities 2007

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### Directors & Officers Liability

#### Limits and Capacity

Total global D&O capacity remains stable in spite of some carrier turnover. Among the departures were a long-term, specialty insurer and an excess carrier. The loss of their capital was mitigated by the increased appetite for D&O risk in both the US and international markets. As a result, global D&O capacity is greater than ever – well in excess of \$1.8 billion before considering the additional limits that may be available on an A-Side basis (for non-indemnifiable claims).

With one major carrier rejoining the marketplace for primary placements on larger, public-company D&O risks and with continued competition for privately held and not-for-profit organization risks, there may actually be more suitors for the primary (initial base) layer of coverage – setting the tone for the rest of the program. A word of caution: there still remains a marked difference between *stated capacity available* and the actual *deployment of limits*. Carriers are increasingly signaling their desire to deploy significant limits on preferred A-side D&O programs as opposed to the more traditional, more expansive A+B+C coverage for public companies.

#### Pricing

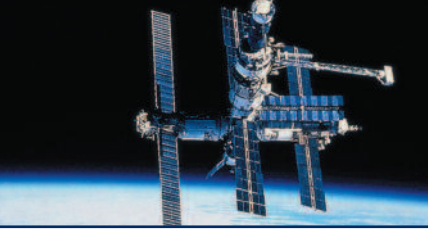
Upward premium adjustments are anticipated for companies facing claims activity and/or financial challenges, but market indicators on new and renewal business suggest that premiums are competitive for worry-free accounts. With risk differentiation and market timing in mind, we believe that premiums for companies with large market capitalizations are generally remaining flat or decreasing by five to 10 percent. Where there are risk adjustments, premiums are increasing by at least ten percent and possibly much more. As always, risk differentiation is critical.

Due to the abundance of available capacity, and as more carriers target mid- to small-market cap companies and private firms, premiums in these classes will continue to reflect greater reductions, potentially in the range of 10 to 15 percent.

#### Terms & Conditions

For all companies, the focus on hot button issues will continue for the remainder of the year and well into 2007:

- **Non-rescindable coverage**, originally available solely for A-Side coverage, which may now be extended to include the rest of the D&O contract with non-rescindable B and C insuring agreements on some accounts (still a challenge for Fortune 500 companies)
- **Thresholds for the personal conduct exclusions:** illegal profiting, intentional illegal conduct – which may dovetail with the firm's indemnification provisions
- **Narrowing the imputation of knowledge provision** and the definition of *Application*
- **Tailoring global programs** to fully balance the need for local policies
- **Modified claims reporting notices** to eliminate the over-assertion of late-notice claims denials
- Potential coverage clarification with newly introduced **D&O extradition endorsements**



# Marketplace Realities 2007

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## Employment Practices Liability

### The EPL Litigation Environment

For Employment Practices Liability (EPL), the signature events thus far in 2006 relate to severity. At least two class action settlements are being finalized in the \$50-to-\$100 million+ range and several single-plaintiff actions exceeded expected settlement figures (and their policies' retentions / deductibles). (Note: neither of these class actions is Wal-Mart, for which national class action status still remains to be determined.)

We expect that larger, multinational companies will now experience greater underwriting scrutiny as carriers review their limits management and seek to adjust retentions.

### Limits and Capacity

In 2005, a major offshore market pulled its maximum capacity back from \$100 million; for large companies in late 2006, there may well be further restrictions of limits. The good news is that while there are few carriers willing and able to lead EPL programs for global Fortune 1000 companies, there is typically abundant capacity in the excess marketplace to fill out a program even at fairly low attachment points. Furthermore, unlike D&O and Fiduciary Liability, the Bermuda markets are pursuing this class and size of business.

Given the robust cast of carriers seeking to write private, small to medium-sized companies, the capacity in the domestic and international markets for these companies is not only competitive but abundant. Please note that EPL for private and not-for-profit organizations is typically written on a combined basis with D&O, so these companies can continue to expect a warm welcome in the marketplace.

### Pricing

Two contrasting trends dominate the EPL marketplace today. For the privately held, small to medium-sized company sector, we find an abundance of capacity, with a long list of qualified markets and competitive premium levels. Clients fitting these risk categories will have plentiful choices, and tailoring the terms to the risk may be their greatest challenge.

For large, publicly traded firms with significant employee counts and international operations, we find that the selection of primary carriers is limited and that discounted pricing is more a phenomenon of the past. Still, claims-free companies, demonstrating sound employment policies, can expect premium levels to remain flat or decrease by up to 10 percent.

### EPL Terms & Conditions

Many of the basic coverage issues identified in a D&O contract have potential EPL implications. As severability remains a focus on D&O, we are often requesting non-rescindable coverage on EPL renewals.

Other anticipated coverage trends are the clarification of retentions for non-indemnifiable loss, refined notice of claims triggers and client-specific bordereau reporting, along with possible expense coverage for mentoring and sensitivity programs (still strictly a Bermuda market enhancement at this time).

Though not an industry staple yet, a very select number of carriers are now offering Fair Labor Standards Act (FLSA) coverage on a sub-limited basis to clients that meet their risk qualifications. Even if the sublimit applies to defense costs only, it may be a valuable extension for companies in the private and/or small to medium-sized category.



# Marketplace Realities & Risk Management Solutions 2007

Some carriers are also offering something akin to a lawsuits-only EPL contract, accomplished by deleting coverage for Equal Employment Opportunity Commission (EEOC) complaints from the definition of claim. This option has pros and cons for insureds and should be selected only after a careful review of a company's corporate philosophy and reporting requirements. It is not a solution for all and could be a serious impediment to coverage for some.

## Fiduciary Liability

### Tagalong and Cash Balance Cases

In Fiduciary litigation, the spotlight is on Employment Retirement Income Safety Act (ERISA) tagalong and cash balance cases.

"ERISA tagalong" is the popular title given to cases brought under ERISA, usually in tandem with a D&O stock-drop securities case, and typically on behalf of 401(k) participants who held the employers' securities in their pension accounts. Unlike the often well tilled fields of securities litigation, there isn't a truly fertile base of ERISA procedural cases to act as precedent in the tagalong cases. This is beginning to yield trial and appellate level decisions that appear, to at least one side in the controversy, to be ripe for (further) appeal. In the short run, the result is twofold: first, there may be little certainty or reliance that either party can place in the initial outcome of their case; second, the plaintiffs' bar is beginning to correct what some perceive as defects or vagueness in their earlier pleadings. In the mid-term, Fiduciary carriers are paying for the defense of the initial suit and the subsequent appeal out of the diminishing limits of coverage. Remember: unlike the results of much cash balance litigation, the Fiduciary Liability carrier may also be liable for a resulting settlement or court award in these cases.

We recently saw the reversal of a lower court win for the plaintiffs in IBM's cash balance litigation, and we are now poised for its potential appeal to the US Supreme Court. Without a doubt, this decision gave heart to other corporate defendants. However, it is unlikely that their insurers felt a similar degree of satisfaction. While defense expenses come out of the available limit of coverage, most Fiduciary Liability policies are written on a duty-to-defend basis. This means that the insurers may be obligated to continue to pay out coverage for the defense of claims even if they may ultimately have no obligation to pay for a resulting court award or settlement. This is largely true in the area of cash balance litigation where the plaintiffs are seeking to reverse benefits decisions (benefits due under a plan are generally not covered under a Fiduciary Liability policy). This means that the immediate impact of the victory for the insureds and the successful appeal by the insurers may be an increase in litigation expenses for the carriers. Regardless of the outcome of the IBM appeal, we expect to see this case go to the US Supreme Court.

The Pension Protection Act of 2006 (PPA), which was signed into law August 17, may have more impact on corporate benefits plans than any event since ERISA itself was passed in 1974. We note three specifics addressed by the PPA. First, the act clarifies that cash balance plans are not a *per se* violation of ERISA's discrimination rules. Second, it sets out new funding standards for defined benefit plans while providing some industry-related funding relief (for example: the airline and auto industries). Third (and perhaps most significant), the PPA focuses on the ground rules for defined contribution plans in the areas of enrollment, advice and investment.

When the PPA is considered in light of the new pension disclosure rules announced by the Financial Accounting Board, it may well be that the earliest results of the Act will be to accelerate the merger, termination and/or freezing of traditional (defined benefit) pension plans. While none of these



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# 2007

transactions in themselves directly result in ERISA fiduciary claims, carriers tell us that they are closely associated with increased claims activity.

### Limits and Capacity

The Fiduciary marketplace is unusual in that rising demand (and rising prices, as discussed below) is not necessarily prompting increased supply. One reason is that underwriters don't believe that they fully understand Fiduciary exposures, especially regarding ERISA liabilities. Even as rates continue upward on many larger, global risks, some carriers appear reluctant to enter the marketplace or to offer capacity on lower layers in a Fiduciary program.

Another factor is the limits management programs of many carriers, who limit themselves to an aggregate amount of coverage they are willing to offer on larger risks. If their available \$25 - \$35 million has already been utilized on D&O, then this market may simply not be available to us on the ERISA Fiduciary program. Efficient coordination of the available markets among the Executive Risks lines of coverage (especially D&O, Fiduciary Liability, and Employment Practices to a more limited extent) is therefore critical for larger placements.

### Pricing

As suggested above, pricing on larger accounts, especially those with significant mergers and acquisitions activity and/or large helpings of employer securities in their retirement plans, continues to rise. While still measurable and more economical than D&O (on a price per million basis), these accounts can expect continued rate increases in the 10 to 15 percent range.

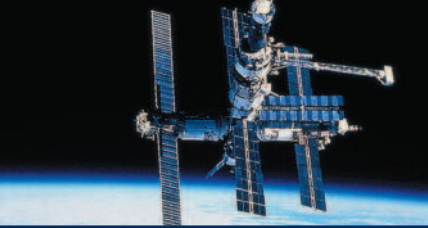
Global companies may face higher increases, as more stringent financial reporting standards may have required them in 2005 to disclose total international pension assets and exposures for the first time. As pension assets are the basis for pricing Fiduciary Liability, utilization of a global pension calculation rather than merely US assets, may result in further upward pressure on pricing.

Risk differentiation continues to be key. Improved limits, pricing and terms are still available where the company has:

- No history of ERISA litigation
- No employer securities in any of its pension plans, including 401(k) plans
- No intention of converting any of its plans into cash balance plans
- No significant M&A activity
- No frozen or severely underfunded benefit plans
- No plans to (drastically) reduce retiree benefits

### ERISA Fiduciary Terms & Conditions

The terms and conditions that come up for discussion with underwriters generally fall into one of two categories. The first includes those that have migrated from other Executive Risks lines of coverage (most notably D&O). These include a priority of payments provision, non-rescindable coverage, and others. The second consists of those terms and conditions necessary to tailor the coverage to a particular risk and includes items such as the basis for the insuring agreement and claims notification requirements.



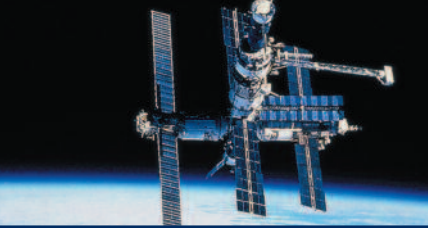
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A notable addition to Fiduciary terms and conditions is an extension offered by at least one major carrier for plans that have undertaken a fiduciary compliance audit. At its most basic, a simple audit can result in the free coverage extension (and help prepare a company for an enforcement audit). A more thorough, operational audit can yield more meaningful coverage enhancements in exchange for additional premiums. This trend may prove to be of considerable benefit to plans and their fiduciaries.

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## Cyber Risk November 2006

### Data Privacy Liability Driving the Need

In 2006, we have witnessed the further coming together of risk management and IT security. There is a growing acceptance that even the most secure network infrastructures can be breached by external hackers, disgruntled employees or service providers with authorized access. Once breached, a computer network or even a single laptop can yield personally identifiable information on customers, clients, patients or subscribers – data that can be put to ill use and lead to financial liabilities.

Security breaches are not new. The common response has been to keep quiet about them in an effort to avoid worry, panic and bad publicity. For the most part, that's no longer an option. Security breach notification laws were passed by more than 30 state legislatures in 2005 and 2006, requiring notification to consumers if their personal information may have been involved in a cyber security breach. These notifications have led to multiparty and class action litigation and to multimillion dollar losses for Cyber Risk underwriters.

The risk and associated litigation have spawned a broadening of Privacy Liability coverage and increased market competition. Key coverage enhancements include:

- Full Privacy Liability coverage for the breach of personally identifiable information beyond network systems to include laptops, non-electronic data (dumpster diving) and release or unauthorized use of data by a service provider
- Defense costs for regulatory actions
- Costs to meet regulatory compliance following notification of non-compliance
- Credit reporting services following a data breach
- Costs to notify consumers following a data breach
- Mental anguish and emotional distress damages following the breach of data

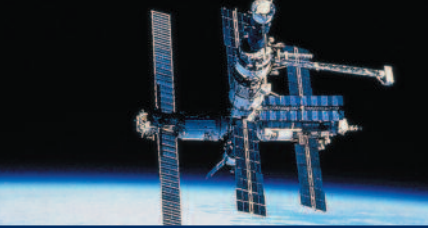
## Marketplace Developments

**CNA** announced introduction of a new policy (and a four-page application) in November 2006 that will broaden privacy coverage (online and offline, plus coverage of theft of media). The new form will also add coverage for:

- Security breach notification expense
- Credit reporting services
- Costs for regulatory defense at full limit\*
- Costs to comply with regulatory statutes upon notice of non-compliance (i.e., implementation of security updates, policies, etc.)

\*Subject to the policy deductible





# Marketplace Realities 2007

## & Risk Management Solutions

**Darwin**, one of the newest Cyber Risk insurers, entered the market with the view that even though network security and privacy risk continues to increase, 80 percent of corporate America does not have Cyber Risk coverage. They introduced a liability product that, with certain enhancements, is one of the broadest Network Security and Privacy Liability forms in the market. Key features include coverage for:

- Regulatory expense
- Notification expense
- Enterprise data privacy
- Cyber extortion
- Crisis management
- Mental anguish

**Arch** is expected to introduce a new WebNet policy before year-end. Built into this new form will be several coverages that they are now offering by endorsement, as well as new coverage. Coverage will include:

- Broadened public relations expense coverage to include notification expense
- Regulatory defense
- Broadened definition of "covered computer system" to include assets residing on stolen laptops
- Employee privacy suits by or on behalf of employees whose personal information was misappropriated from a covered computer system
- Enterprise data privacy (electronic and non-electronic)

Arch will continue to offer broad first-party coverage under this policy including business income, data restoration expense, public relations, investigative costs and cyber extortion.

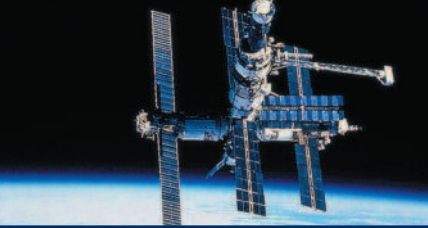
In early 2006, **Beazley** introduced a new product that broadened their privacy liability coverage and added first-party Cyber coverage. Their underwriters are now focused on growing their market share.

**AIG** continues to lead underwriters in the number of Cyber Risk insurance policies written. They have seen an enormous jump in Cyber business since the addition of their Privacy module in 2005. Losses are infrequent, but when they occur, the losses are often severe.

**ACE** added a Privacy Liability insuring agreement and public relations expense coverage to their DigiTech form in late 2005. ACE also introduced DNA, a product that provides first-party coverage for network business interruption and data corruption on a stand-alone basis, or as a tie-in-limit with their DigiTech policy. They are vigorously marketing each policy.

**Chubb** has added endorsements to their financial institution products, CyberSecurity and CyberLiability. Chubb is also willing to provide a sublimit of up to \$1 million to cover the expense associated with security breach notification costs.

**St. Paul** will be more aggressive in marketing their Cyber Risk Liability form for tech companies. It will no longer be necessary to place Errors & Omissions or commercial General Liability with St. Paul in order to access their Cyber Risk Liability coverage.



# Marketplace Realities 2007

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## Other Coverage Issues

Markets have been responding to Cyber Risk issues other than privacy:

- **Internet Media Liability** – products cover trademark losses, which are on the rise
- **Network Business Interruption** – expanding over the past two years to cover entire networks, not just the internet
- **Administrative Errors** – negligent acts that lead to the release of confidential information or distribute malicious code against a third-party network
- **Denial-of-Service Attacks**

A trend developing among professional services firms (especially publishers, broadcasters, technology service providers and law firms) is the blending of Cyber Risk Liability coverage into Errors & Omissions policies. As more firms use their network to provide services electronically, such as distributing content, providing internet services or billing online, their Professional and Cyber risks overlap. Programs are evolving accordingly.

To date, the demand for Privacy Liability coverage has outstripped the demand for first-party Cyber coverage. Many insurance buyers are realizing that a hacking event may not only create liability, but also disrupt critical operations involving supply chain, logistics, account receivables or other financial transactions. A disruption of several hours or days can cause significant loss of income and future business. Markets, as mentioned above, are recognizing the developing demand for first-party Cyber coverage. An informal survey of the markets has determined that no more than 20 percent of Cyber Risk insurance policies issued include first-party coverage.

## Into the Regulatory Breach

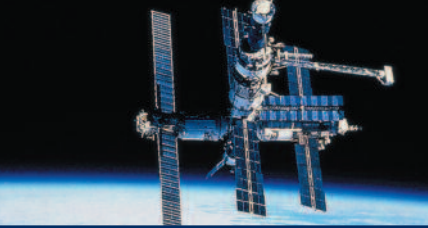
In 2003, California enacted the first security breach notification law requiring a corporation that suffers a breach to report the incident to all California consumers who may have had their personally identifiable information accessed illegally and could be victims of identity theft or fraud. Following several data breaches in early 2005 and the slow responses from some of the breached corporations, more than 30 states have passed legislation patterned on the California model.

The US House of Representatives passed security breach notification legislation, sending it on to the Senate in March 2006. If it becomes law, the legislation is expected to preempt the state laws. The Senate has not acted on this bill.

For many companies, from financial institutions to retailers to healthcare providers, the new state laws are merely the latest mandates in a growing list of regulatory and industry compliance requirements regarding the handling of personally identifiable information:

- **Health Insurance Portability and Accountability Act (HIPAA)** – for healthcare organizations and any company managing employee benefits
- **Gramm-Leach-Bliley Act** – for financial institutions and any organization processing credit card data, including retailers
- **Sarbanes-Oxley Act (SOX)** – requiring all public companies to have security protections around financial controls





# Marketplace Realities 2007

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All these laws require businesses to protect against unauthorized access or use of data or computer network systems. The government is not alone in these efforts. Energy and power companies, through their critical infrastructure protection efforts, have pushed their industry partners to secure their networks. MasterCard and Visa have required large and mid-sized merchants/retailers to undergo annual network security assessments.

The good news in all of this is not only that businesses are being forced to take steps to protect customer, client, patient and subscriber information – it is also that levels of security and security assessments that are now customary make it easier to purchase Cyber Risk insurance. A strong security program creates the highly protected risk of the electronic age – the eHPR.

The sobering news is that the security breach notification laws create an opportunity for the plaintiffs' bar, as regulatory bodies set standards that organizations may need to prove they have met in a court of law.

## Strategies for Buyers

For organizations new to Cyber coverage or for those who bought an early Cyber product, there is much to review. Starting with privacy protection issues, buyers must understand all features of coverage today, such as full network coverage, coverage for acts committed by employees or service providers, expanded privacy coverage for non-electronic breach of personally identifiable information, expense coverage for security breach consumer notification, lower retentions and waiting periods on first-party coverage. At the same time, coverage is easier to come by. There is increased capacity (\$150 million to \$250 million), sufficient to address catastrophic Cyber Risk. The underwriting process is more accommodating. There are shorter applications, largely thanks to underwriter use of security assessments already conducted by buyers.

This does not mean policies are inexpensive. Underwriters have been hit with multimillion dollar losses arising out of privacy and intellectual property issues, and the new laws are driving more claims. As those losses build and claims are paid, organizations are developing greater appreciation for the scope and value of Cyber insurance. The premiums have, however, flattened out over the past year.

Perhaps the greatest hurdle for companies addressing Cyber Risk is bridging the gap between IT security and risk management / treasury. These two groups need to communicate and act collaboratively. Even with robust network security in place, many large corporations and institutions have suffered highly publicized data breaches and losses. Putting another form of protection – insurance – in place behind robust security policies and procedures should not be viewed by IT as a lack of confidence in their infrastructure, but rather as an important operational risk management tool for addressing this growing risk.

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# Marketplace Realities 2007

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## Special Contingency Risks

November 2006

Over the last five years, the world security environment has deteriorated. The current Worldwide Caution Announcement by the US State Department warns that Al-Qaeda and affiliated organizations continue to plan attacks against US interests in multiple regions, including Europe, Asia, Africa and the Middle East, stating that these attacks can “employ a wide variety of tactics to include assassinations, kidnappings, hijackings and bombings.” At the same time, rapid shifts in regional political and economic climates are dramatically increasing security risk in many developing countries. These facts on the ground are challenging organizations with international operations to find cost-effective approaches to countering terrorism and doing business amidst new threats to their employees and property.

## Kidnap

Latin America remains the focus of economic kidnap for ransom; however, regional spikes in activity have arisen in relatively short periods of time.

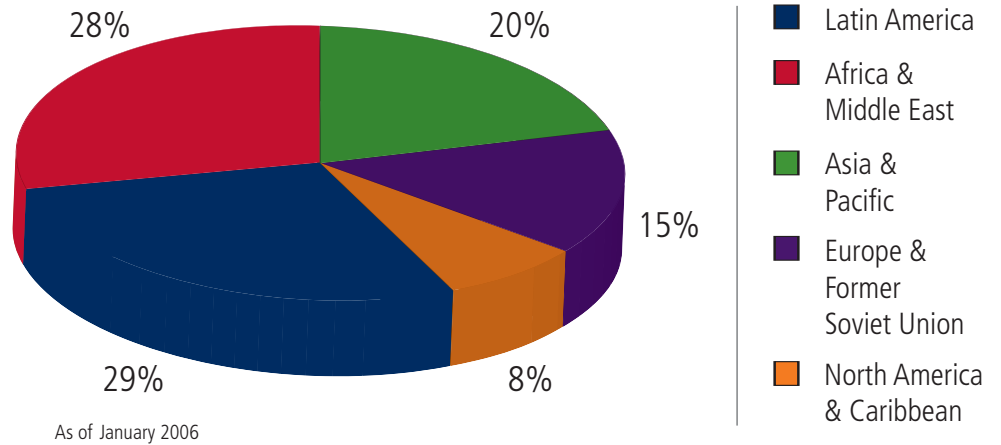
- **Iraq** has emerged as a major hub of both political and economic kidnap and looks to remain in the top-ten list of high-risk countries for the foreseeable future. The US Embassy in Baghdad reported that at least 439 foreign nationals were kidnapped in Iraq between April 2003 and April 2006, with a ransom demand being received in most cases. During this period, 60 non-Iraqi nationals were killed in captivity – 14 percent of the total taken.
- **Afghanistan** is witnessing the reemergence of the Taliban, which has translated into increased kidnap activity. In late January 2006, the US Embassy warned that there was an active kidnapping threat against foreign nationals working in Kabul, with particular emphasis on female expatriates.
- **Israel** is seeing record incidents following the vacuum created by the Israeli army’s withdrawal from the Gaza Strip. This has prompted many foreign nationals to leave these areas and has also raised concerns about non-governmental organizations and journalists operating in the region. The UN recently scaled down its operations in Jerusalem, as it did following the kidnap of two staff in July and August 2005.
- **Nigeria** has suddenly emerged as a major hotspot for kidnap, particularly of foreign nationals. A spate of kidnappings in July and August 2006 targeting oil workers prompted Nigerian President Olusegun Obasanjo to promise publicly that he would deal “firmly” with kidnappers. The militant Movement for the Emancipation of the Niger Delta (MEND), seeking to influence the government’s distribution of oil wealth, has actively targeted foreign nationals to bring attention to their cause and raise money through ransom demands.
- In 2005, **Mexico** surpassed **Colombia** as the number one kidnap hotspot in the world, with the highest estimates approaching 3,000 kidnap-for-ransom cases per year. Most crimes are not reported to the police due to concern that either the authorities are involved in the crime or a high-risk rescue attempt could endanger the victim. Mexico City is considered to be the most dangerous city in Latin America for express kidnapping (carjacking) after Sao Paulo (Brazil).
- **The Caribbean** has also seen a large increase in incidents. Both **Trinidad & Tobago** and **Haiti** have seen a surge in kidnap-for-ransom activity. At the end of 2005, kidnapping peaked at an average of 12 cases per day in Haiti, according to Control Risks Group.

The logo for Willis, consisting of the word "Willis" in a stylized, blue, serif font.

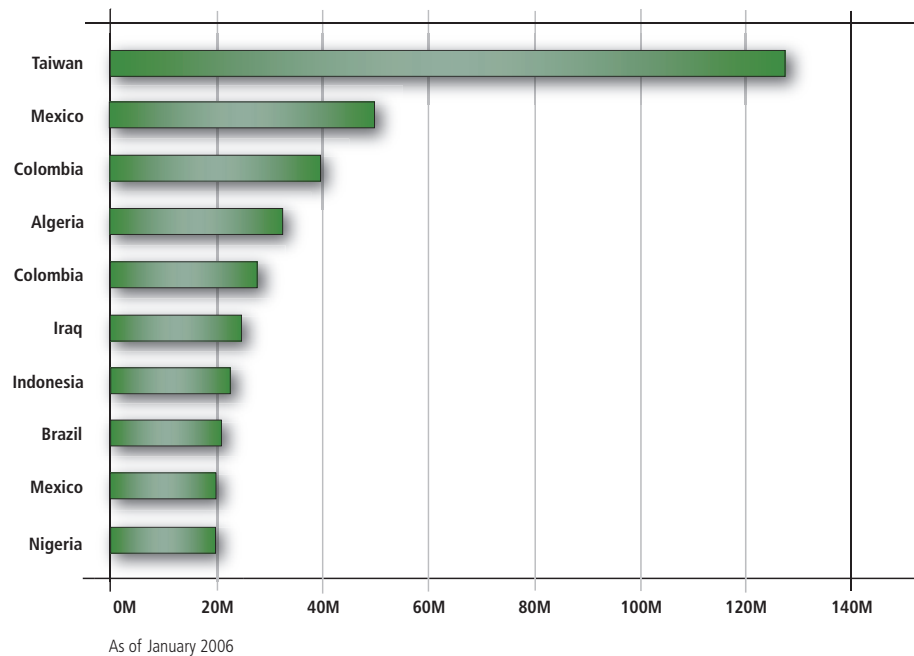


## Kidnaps of Foreign Nationals Worldwide 2001 - 2005

Breakdown by Geographical Region



## Largest Known Ransom Demands in US\$ (2001 - 2005)





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### Evacuation

In July of 2006, Israel began air strikes against Lebanon after Hezbollah guerrillas kidnapped two Israeli soldiers. The air strikes closed down Beirut's international airport and road travel became extremely dangerous due to Israel's targeting of infrastructure throughout the country. Thousands of citizens from around the world scrambled to get out of the country.

Some countries, the US in particular, came under heavy criticism regarding the level of assistance provided to their citizens amidst the chaos. Thousands of expatriates were left stranded and the evacuation efforts were slow. Many attempted to find their own way after receiving little guidance from their governments.

The US State Department advises its citizens that they should not see embassies as "safe havens" in the event of a civil disturbance. They also make clear that "there are no guarantees that an evacuation can be safely executed, and US government evacuations are not free."

What happened in Lebanon demonstrated that the private sector cannot rely on their governments to arrange for the safe evacuation of their citizens. It is therefore imperative that organizations have emergency plans and procedures in place to protect staff overseas. Most companies with expatriate employees will have both corporate procedures and insurance coverage in place should an expatriate employee or business traveler need to be evacuated for medical reasons. However, planning for political or security-related evacuation is much less common.

Evacuation exposure is potentially best addressed under a Special Risk (K&R) policy; however, a number of factors should be evaluated when considering this coverage:

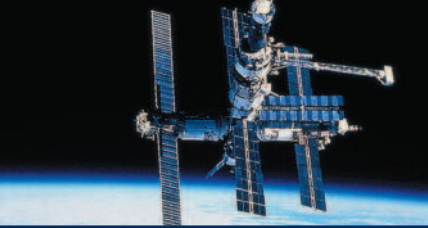
- Is coverage triggered solely by an advisory issued by an evacuee's government or can this be decided in consultation with the incident response consultants associated with the policy?
- Will response consultants deploy to the evacuation area to provide on-the-ground assistance in getting employees to a place of safety?
- Are there sub-limits applicable per person? Are they sufficient for anything other than commercial airline transportation, which may not be available in a crisis?
- Has the underwriter provided a premium credit available for development of an emergency evacuation plan with the assistance of independent security consultants?

### Legal and Regulatory Environment

All employers have a duty to provide a safe work environment and to take reasonable care not to expose employees to unnecessary danger. It is common knowledge that if reasonable precautions are not taken to make sure that employees are kept safe in their workplace, there can be serious legal implications should events lead to injury or death of an employee.

While these issues are widely understood in a domestic setting, few companies link the duty to care for employees' safety to their international business travelers and expatriates when it comes to security. In fact, employees overseas represent a significant liability if reasonable security precautions and crisis response measures are not implemented.

The onus is on organizations to develop policies that will allow them to prove independently that they have met their obligations to business travelers and expatriates when cases are brought to court.



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To make their case, companies should demonstrate that they have carried out and reviewed risk assessments for their staff and operations overseas, made reasonable efforts to train personnel to operate in the environment to which they are being sent, and adequately prepared for security-related contingencies.

There are no clearly accepted guidelines, backed by precedent, on how these obligations should be met. This is due to the fact that there are few examples of security-related duty of care litigation actually reaching court. There are considerable incentives for the companies and individuals involved to settle.

It is also not commonly known that this exposure may be mitigated under a Special Risk (K&R) policy. A comprehensive program can potentially provide value in the following ways:

- Preventative consulting to provide employee training and assist organizations in their development of protocols for managing a security-related crisis
- Coverage for judgment, settlement and defense costs, should an employee or their family bring suit against the insured as a result of an insured event
- Coverage for fees and expenses of highly trained consultants to assist the insured in threat assessment and incident management
- Providing substantial benefits for the victim and their family, thereby promoting goodwill between the parties

## Prevention Strategies

Many companies rely on facility security to protect employees and property. To avoid the potential impact of litigation and loss of a valued employee, an organization should facilitate an employee's ability to avoid dangerous situations, cope with an emergency and get home safely. This requires an approach to planning, organization and training that encompasses more complicated threats than facility security is usually equipped to manage.

The following are some of the basic concepts which should form part of a security risk management program:

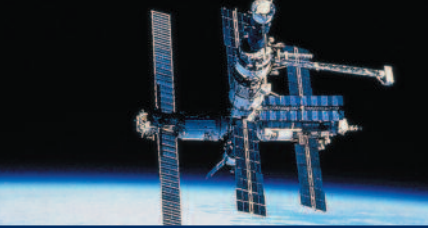
- Security surveys of offices, project sites and facilities in high-risk environments
- Security awareness training for frequent travelers or expatriates in high-risk areas
- Pre-departure dissemination of country risk information for travelers
- Personal safety handbook provided to all business travelers and expatriate employees
- Formal crisis management with clear incident management protocols and lines of communication
- Simulated tabletop exercises to test plans

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## International Markets

### Market Tier

### US Headquartered

### Headquartered Outside US

<b>Tier I</b>	AIG Worldsource FM Global*	ACE Zurich
<b>Tier II</b>	Chubb CNA St. Paul	Allianz* XL Global
<b>Tier III</b>	Liberty Mutual	

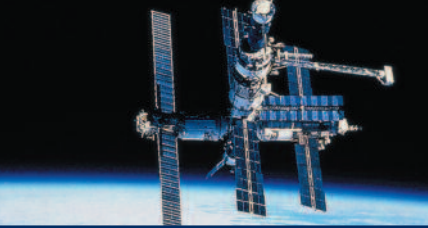
\* Property Only

## Property Fronting Programs

Insurers and capacities have remained steady for Property fronting programs the last two years. While we are seeing a more competitive environment for these programs, we are also seeing less flexibility from carriers in certain areas. Some carriers will not bind programs without reinsurance certificates signed and premium allocations agreed. Also, premium payment warrantees are being enforced and extensions are harder to come by.

### Fronting Carriers as of October 3, 2006

Carrier	Maximum Property Fronting Limits	Security Requirements	Guaranteed Cash Flow (Standard terms)	Front for TRIA	Owned Countries	Affiliated Countries	Total Countries
<b>ACE</b>	\$500M	S&P A-Rated	Paid by the 25th, out the 15th of following month	Will Consider	52	100	152
<b>AIG</b>	\$500M	Committee Approval	25 days, selected countries	Will Consider	89	14	103
<b>Allianz</b>	\$500M	Specified Carriers	None	Will Consider	42	15	57
<b>FM Global</b>	\$2B	Committee Approval	None	Will Consider	19	70	89
<b>XL Global</b>	\$600M	Committee Approval	None	Will Consider	28	52	80
<b>Zurich</b>	\$500M	5% of Surplus/ A-Rated	5 days owned; 30-60 days affiliated	Will Consider	33	109	142



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## Premium Tax Payment Issues

In our last *Marketplace Realities* update we reported that premium allocation and tax payment systems in Europe had matured and were becoming part of common insurance business practice. While this trend continues, a comparable change expected in the North American market continues to take longer than expected.

While premium tax rules existed for many years in the EU, premium taxes were for years often neglected, even on Euro policies. Lloyd's and other London markets consistently mandated the payment of premium taxes on non-admitted placements. Now, however, a growing number of non-Lloyd's markets in Europe are allocating premium taxes on non-admitted placements. This trend is being seen everywhere in the world, not just in the EU. As carriers promote these efforts in Europe, we still believe it is just a matter of time before program carriers in the US adopt the same position.

We also observe that corporate governance activities focused on global compliance have led many companies to examine their records for past years to determine whether there are any outstanding issues in regard to the payment of premium taxes on non-admitted placements.

## Direct-Writing Captives

Direct-writing captives in Europe continue to be popular in today's market.

The most notable event of the past year was the rise of jurisdictions competing with Ireland, the preferred EU domicile for direct-writing captives. This mirrors the competitive situation among US states, where Vermont, long the leader in the field, faces growing competition from a growing number of other states.

Market newcomers generally arrive with a greater appetite for new business and often are more innovative and proactive in the range of products and services they offer. While large US multinationals will still probably pick Ireland as their favorite domicile (due to history, tax treaties, etc.), mid-cap and smaller US companies and large EU multinationals are looking closely at what Malta, Gibraltar, Sweden, the Netherlands and, in certain instances, Luxembourg now have to offer.

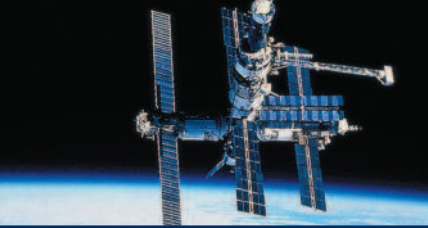
These offerings include the possibility of more flexible capital and solvency requirements, fewer or no enhancements to the rules included in EU directives, protected cell company legislation, tax advantages and lower operating costs. Malta in particular has seen a very busy year with some captives changing domicile to take advantage of what it has to offer. Ireland in turn is taking steps to counter the competition.

A potential threat on the horizon to all EU-based captives lies with Solvency II. The first draft of this risk-based capital model is likely to come out of the European Commission as early as next year. Captive owners need to understand the long-term implications of Solvency II, which is expected to increase capital requirements and enhance corporate governance in ways similar to Sarbanes-Oxley. Captive owners should be seeking information from their captive managers.

In another change on the regulatory front, the EU introduced regulation of reinsurance companies on a pan-EU basis at the end of 2005. Only Ireland to date has introduced local regulation based on the EU directive. Other countries are expected to follow suit. The directive was to a large extent based on the previous EU insurance directive and will be superseded to a large extent by Solvency II.

*For more information on European captives, see our International Alert, Direct-Writing Captives in Europe – Taking Control and Cutting Costs. This is available on the Publications page of the International section under Services on [www.willis.com](http://www.willis.com).*





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## Country Issues

Multinationals need to be keenly aware of local developments that impact the way business is conducted in countries around the world. We select a few countries where particularly noteworthy activity has occurred recently.

### **Brazil**

Brazil continues to be a challenging country in which to handle multinational programs. Last year, the government changed reinsurance rules to allow limited reinsurance outside of Brazil, but the government also introduced strict security requirements. Brazil also changed reinsurance rules for Directors & Officers (D&O) coverage. To accommodate the long-standing practice of issuing a global D&O policy and relying on the non-admitted carrier to reimburse for claims on a non-admitted basis, Brazilian authorities recently announced that up to 80 percent of local D&O limits can be reinsured to international reinsurers including global programs. Directors and officers in Brazil are subject to strict regulations and may have their assets frozen by local court rulings until their cases are settled. Evidence of a local policy may be used at the local courts to prevent freezing of assets. Non-admitted policies, which are not legal in Brazil, are of little use in such situations.

### **Canada**

Rules governing insurance placements involving international carriers and brokers are being scrutinized by tax authorities. While non-admitted policies are permitted for non-statutory lines, the placement of a Canadian account via a non-admitted carrier / broker, even if a local Canadian company, could be subject to premium tax that can be as high as 50 percent. The rules governing these issues are complicated and buyers should consult with their risk management adviser.

### **China**

The market continues to be very soft following the huge growth in local underwriting capacity in response to earlier double-digit market premium growth. A factor that may change this is government involvement in insurance for major construction projects, such as power stations. Chinese regulators are putting pressure on local underwriters to maintain minimum premium rates in an effort to bring local ratings closer to international levels. If the regulators are successful, China Construction/All Risks rates are expected to double. Similar requirements may be extended to other types of insurance.

Following the passage of new reinsurance regulations in late 2004, pure fronting is no longer permitted in China. We can expect more premium to be retained in China and reinsurance arrangements, captives and coverage through international carriers, which require an operational license in China, may be increasingly difficult to set up.

### **UK**

The recent focus on corporate governance issues has brought to the UK insurance industry new requirements for contract certainty at inception. The UK Financial Services Authority (FSA) has made it clear that it expects the industry to be compliant with these requirements by December 31, 2006. Brokers and insurers who fail to comply with the requirements will face penalties from the FSA.

What does this mean for non-UK multinationals with operations in the UK?

- More detailed information will be required from the insured in order to meet contract certainty requirements at inception and, therefore, the renewal process will need to begin earlier.



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- An insured's UK colleagues can expect to receive their evidence of cover, such as the policy document, within 30 days of completion of placement or renewal.

However, the contract certainty requirements may not apply to:

- The master policy and local UK-placed portion of a global program where the master policy is issued outside of the UK under local relevant jurisdiction. (Contract certainty requirements *do* apply to the locally placed coverages outside the global insurance program and to variations to the local UK-placed portion of a global program, when those variations are negotiated locally in the UK and the risk is retained by the local UK insurer.)
- The non-UK, locally placed portion of a global insurance program where the master policy is issued in the UK and the local policy is issued outside of the UK under local relevant jurisdiction
- Local UK programs placed with a non-UK insurer and where the policy is issued outside of the UK under local relevant jurisdiction

## Venezuela

International programs in Venezuela are complicated by restrictions on currency conversion. Local premiums must be converted to pay reinsurers. However, driven by economic and political concerns, the Venezuelan government has strict restrictions on converting local currency into any other currency. These restrictions, burdensome as they may be to multinationals with exposures in Venezuela, are not expected to change in the near future.

## Strategies for Tomorrow

While international coverage is mostly focused on traditional Property and Casualty programs, multinationals are now asking themselves: how global is our coverage for other risks? Even excess Liability programs issued in the US are becoming an increasing area of concern in terms of their applicability abroad. The good news is that carriers are responding to the growing demand. Several carriers, for example, are publicizing their ability to write global D&O programs with underlyers issued where needed. Coordinating the carrier administration of these programs is presenting initial challenges but over time we expect the carriers to improve their service in this area.

We continue to caution multinational organizations about compliance with local laws governing compulsory and non-admitted insurance. National enforcement bodies are growing less tolerant of violators, and violations can be costly.

Risk managers are encouraged to be sure they are receiving timely information on regulatory changes around the world. The examples cited above are reminders that the world is changing.

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## Captives

November 2006

### “So You’ve Got a Captive ... What Now?”

#### Captive Insurance Companies and the Capital Efficiency Imperative

*The following article is based on a transcript of the Willis Webcast conducted on May 25, 2006, featuring Tom Stokes, Regional Partner, Willis CAPS (Captive, Actuarial and Pooling Solutions). The webcast was conducted as an interview.*

That’s a fundamental question for any capital deployment, but one that many risk managers can’t adequately answer when it comes to their own captives. We live in a world where “return on invested capital” is king. In all enterprises, but especially in public companies, CEOs and treasurers are expected to achieve their target rate of return on invested assets. That rate is typically influenced by Wall Street, which drives share price based in large part on the overall return expected by capital invested in a given industry.

Risk managers have to be ready to explain and, in a manner of speaking, defend the capital deployed in their captives. It is critical to have just the right amount of capital. Not enough, and domicile regulators may require recapitalization. Too much, and senior financial management may assert that a redeployment is in order.

#### Isn’t capital management a built-in feature of captive management?

For the most part, yes. The majority of established captives build capital over time, and most have embedded distribution provisions that should automatically engage when capital accumulates to excess levels. Distribution provisions must be flexible enough so that accumulated capital can be earmarked for increased risk retention when changes in the insurance marketplace conditions reduce capacity or make it more cost efficient to retain more risk – or both. There are a *few* captives out there that have allowed capital to accumulate for long periods of time without scrutiny, and they do need to get their ducks in order.

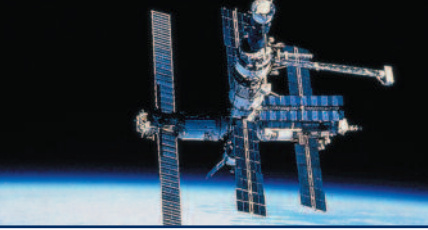
In our discussions leading up to today’s webcast, you mentioned other considerations – beyond those of capital efficiency.

Absolutely. Significant excesses in capital can also affect your status as an insurer with regulators *and* the IRS, especially when investment returns grow disproportionately to underwriting activities.

Well, wholly owned captives are, by definition, both arm’s-length insurers and parent company subsidiaries. So is the message that they are expected to walk a narrow line ... to make money, but not too much money?

Well, essentially, yes. And while there is no general rule, it is best to say that a captive’s financials must evolve as it matures.

1. How do you know if the capital tied up in your captive is being used to its full potential?



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## For example?

For example: Most straightforward calculations of return on capital for a captive will generate a slightly negative or essentially flat rate of return on a present-value basis in the early years, because initial premiums are set equal to the projected losses for risks assumed by the captive. So there is approximate balance – over time – of premiums and paid losses. Then you look at the cost of captive administration, which is at a minimum partially offset by income from investment of the captive's financial assets. As you can imagine, this dynamic is affected to a great degree by interest rates.

Putting interest rates and taxes aside though, most established captives' actual loss experience is lower than initial projections, resulting in what can be significant underwriting profits that drive a healthy rate of return. After all, the main rationale for retaining risk is that the commercial markets set their premiums too high relative to expected loss levels. To the extent that captive pricing approximates commercial insurance marketplace pricing, captive underwriting profits are usually realized.

## Let's call that a bit of Captive Pricing 101. What about capital efficiency?

Okay. Capital efficiency. Sophisticated risk management methodology has evolved to analyze not only the claims-paying ability and risk-retention capacity of your captive, but also to stress-test the parent's consolidated balance sheet to determine if greater or lesser amounts of risk could or should be retained in the captive. All of these factors are then compared to current and projected market conditions to assure that sound decisions are being made.

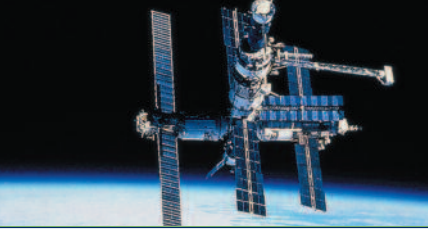
If analysis shows your captive doesn't measure up – that the capital base is being eroded by losses, or that higher returns on capital can be achieved at the parent company level – then you have to determine if fine-tuning or an overhaul of your captive structure is indicated. Remedies include amending the scope of coverage, limits and aggregates, premium levels and any other relevant factors that may affect performance.

## Captive owners have more flexibility for course corrections than do the large commercial insurers, right?

Absolutely. In a manner of speaking, it can even be said that captive owners even have a *competitive advantage* over commercial markets in that they have much greater ability to completely analyze their risks, properly price them and select only the best terms. Commercial insurers have to include perceived uncertainties in their pricing models – uncertainties that reflect exposures driven by their book of business ... exposures that may have nothing to do with an individual insured.

## What else?

Well, it is often a forgotten factor, but a captive's return on capital can also be enhanced by concentrating on its investment policies to help augment returns. Many captive domiciles permit their captives creative ways to capitalize and invest premiums and surplus *back in the core parent business* to further increase rates of return. This is another distinct benefit that captives have over commercially regulated entities, and it should be used to its best advantage. Do keep in mind that there are governors on just how much you can do – governors such as satisfying IRS requirements.



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As you can see, there is no single rule of thumb, so it is necessary to evaluate the total amount of loss that your captive could face within a given confidence level and index capital and surplus to that number. Confidence level is an individual decision for each enterprise. Obviously more conservative business philosophies will dictate higher levels, while aggressive ones will tend toward the opposite.

## 2. What are the drivers behind captive formation today ... and what does that tell you about the potential for diversification of your captive's portfolio of risks?

I don't need to remind any of our listeners that buying insurance is basically a cost / benefit decision.

It has been happening for some time now, but market-altering events like 9/11, the crisis in corporate governance, runaway product liability and malpractice awards, ever increasing Workers' Compensation costs, year after year of record storm damage – and the list goes on ... have permanently altered the cost / benefit equation. Risk managers are faced with significantly (and permanently) higher deductibles and retentions. The days of fully insured, dollar one coverage are the stuff of lore.

Well, that explains progressively higher retentions, but not necessarily diversification.

Remember that captives are agile, adaptive creatures. They were born of necessity, to fill niches that were ignored or underserved or outright deserted by the commercial marketplace. The factors that we have been talking about today affect not only retention thresholds, but also provide for loss funding where adequate coverage is again no longer commercially available. For example, after the TRIA bill was passed, many (US-domiciled) captives (for operations in areas considered vulnerable) availed themselves of backstop coverage provided by the federal government *without utilizing a commercial insurer*. This provided low-cost coverage and capacity at a time when commercial insurers were trying to sort things out.

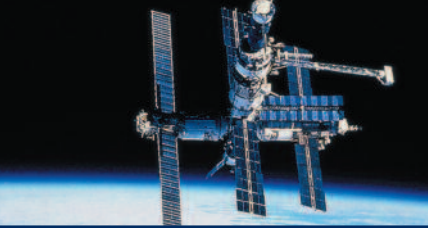
Would qualifying for TRIA coverage be sufficiently valuable – all by itself – to justify a company's forming a captive?

I'll answer that question with an unequivocal "maybe." As we know, TRIA was recently extended through 2007. The new acronym is T-R-I-E-A, which stands for the Terrorism Risk Insurance Extension Act of 2005. It still provides inexpensive coverage, though somewhat diminished because of changes in deductibles and coinsurance percentages.

Natural catastrophe perils are drivers as well. More recently, construction firms, REITS and property holders in storm-prone areas have been forced to reevaluate Nat Cat property coverage in their captives – not heretofore a necessarily desirable coverage because of its potential volatility.

Did captives underwriting Nat Cat risk for parents with Atlantic and Gulf Coast exposures take a beating last year and the year before?

Some did take a beating, but most were adequately capitalized and managed to weather the storm (no pun intended). Just like the commercial insurers, reinsurers and capital providers, captive managers with Nat Cat risk are looking much more closely at the newly retooled catastrophe risk models, and they'll be reevaluating their positions by reducing the captive's overall exposure, aggregating the risk, arranging for reinsurance or calling for more capital to strengthen its insured position.



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What all of these factors tell us about a captive's philosophy regarding risk is that it can never remain static. It is not only external factors that affect the portfolio of risk in your captive. Events such as mergers, acquisitions, divestitures, new business ventures and traditionally uninsured, unfunded risks should continually be examined in shaping the role and scope of the captive. I will go out on a pretty sturdy limb here and say that there will never be a time when risk transfer is so comprehensive, efficient and affordable that captives would become obsolete.

3. Does the value of a captive vary according to the market cycle... less for soft and more for hard?

That's an emphatic NO.

Those with captives know through experience, captives are long-term investments. Results should be evaluated over a significant time horizon. Risk managers who utilize their captives as a vehicle that effectively competes with the commercial insurance marketplace for the risk of its parent company and its affiliates find that it can be of tremendous strategic and financial value at each program renewal. The captive, by taking on strategically targeted layers of insurance, or by assuming a column of coinsurance, can change demand *and* supply dynamics. If, for example, your program calls for limits that approach global capacity, you're typically going to experience adverse terms at the margin – whether in terms of pricing or breadth of coverage or both. If you use your captive to mitigate the need for marketplace capacity, terms can be far more advantageous. In a similar fashion, reinsurance out of the captive – that is, having the captive reinsure its assumed risk – can often be achieved on terms that are superior to those negotiated on a facultative basis by your direct insurers.

All this illustrates that captives must remain flexible in their operation. When markets are soft and risk transfer is cheap, captives should be evaluated as to the amount of risk they insure and adjustments made accordingly. Sophisticated analytical techniques have been developed to model the implications of self-insurance vs. risk transfer decisions. Everything else being equal, if you can get reasonably priced insurance from a quality carrier, buy it! The quintessential demonstration of a captive's flexibility is in its ability to jump into the commercial program renewal process and take on risk in years where markets are hard and prices are high and to reduce participation in years where the markets are more amenable.

Some pundits point to a tapering off of captive formations in 2005 as a demonstration of the proposition that the value of a captive really does fluctuate with the markets. In response, I would point to the fact that the fall-off follows one of the greatest years in history for the establishment of new captives.

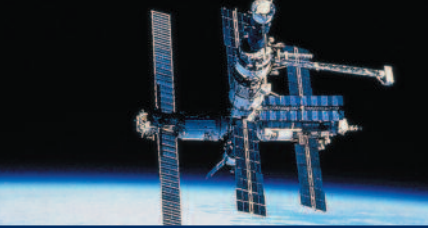
4. Are regulatory actions driving companies to move offshore captives onshore?

Not really. While there is a good deal of interest in (and indeed implementation of) redomiciling captives onshore, the drivers, though, are typically based on garden variety business benefits.

The court of public opinion has made regulators wary of *offshore* capital migration. Non-captive-related events like the recent fracas over the redomestication of Stanley Works' parent offshore points to a definite "ill wind." The IRS pays particular attention to offshore captive vehicles in part because of some of the schemes that seek to permanently avoid US income taxation. While these arrangements are clearly in the minority, it does cast a shadow over all offshore captives.

**Bottom line?**

Bottom line: If your captive is currently domiciled offshore, then unless there is a compelling economic or business reason to relocate, you should stay where you are. Review of US and domicile law changes should be an integral part of the annual evaluation of the operation of the captive.



## Why have so many states entered the arena?

Because captives are considered a clean, desirable, “white collar” industry. And you’re right ... many states have passed legislation or are in the process of evaluating captive statutes. Upwards of 30 have enacted enabling legislation, and others like New Jersey and Connecticut are in the process. This phenomenon creates competition for existing captives – both onshore and off.

Anyway, real business and economic benefits may be available for captives redomiciling onshore to a particular state. For example, New York-domiciled captives have access to additional state-provided medical malpractice coverage not available to foreign (those not domiciled in New York) captives. Also – and this is key – access to TRIEA cover and the ability to insure employee benefits (as approved by the US Department of Labor) *must be placed in a US-domiciled entity or branch*.

And there are cash register reasons as well. In our age of instant communication and the “global reach” of the insurance and reinsurance markets, captives are no longer necessarily tied to domiciles where the insurance markets congregate. Significant savings in costs of travel, legal retainers and so forth can result from a redomestication to a local captive domicile, and other financial benefits may be obtained as well.

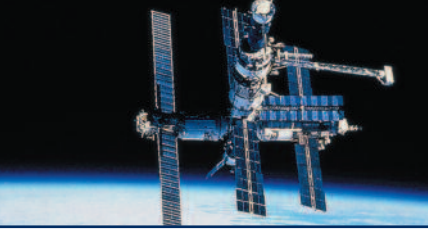
5. You’ve already underscored the point that the role and value of the captive should be validated on a regular basis. The \$64,000 question is ‘If you didn’t have a captive, would you have a reason to form one?’ What’s the best way to go about answering that question?

Captive formation drivers are highly individualized. Clearly, the reasons can be much more compelling for certain industries today like healthcare and construction, because they are experiencing volatility and uncertainty in capacity, terms and pricing in the commercial insurance marketplace. More generally, however, companies should evaluate the total amount of self-insured retention that they have accumulated in the past seven to 10 years and determine whether the company can withstand significant adverse development within those retentions, particularly if a single event could impact multiple lines of insurance simultaneously. If that “worst case” retention number has grown less financially and/or philosophically tolerable by the year, senior management needs to revisit the risk transfer and funding options. First and foremost, a captive should be evaluated as a funding mechanism for such negative development. If adequate capital is not deployed to specifically fund these occurrences, it may be difficult to explain to shareholders that cash flow had to be diverted in the current period to satisfy unexpected losses when that diversion negatively impacts earnings per share.

Today’s audience consists for the most part of risk managers, and so I fully acknowledge that the foregoing was a form of preaching to the converted, but I’ve learned through experience that it’s far better to expend the time and energy being prepared than to be in a situation of explaining why preventive actions were not taken.

Events and developments in our new millennium have tested the mettle of financial, operational and hazard risk management around the world. In virtually every theater of risk, new and sophisticated tools have been called upon to help identify, analyze, fund and manage risk.

Lastly, I would urge those evaluating captives to talk with other captive owners. You will find that of the more than 5,000 captives throughout the world, the predominant responses from those owners will be positive.



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## 6. For those who, by fate or by fiat (and not by design) find themselves in the position of owning multiple captives, what advice would you offer?

This is not an uncommon situation. As there are in the neighborhood of 5,000 captive entities owned throughout the world, it is inevitable that acquisitions and mergers are going to result in multiple captives. Many companies choose to own and operate multiple captives for a variety of reasons, and they can dovetail nicely. But for those who, in quotes, “wake up one morning” to find that there’s an inherited captive on the horizon or on the doorstep, it’s of course important that a complete analysis be conducted. Here are some of the things that should be done immediately:

- Determine the circumstances surrounding the formation and continuation of each captive. Have the circumstances changed? Are the drivers still present?
- Find out if any of the captives involve third-party risk. If so, take care to evaluate the loss histories and loss development ... to confirm existing reserves. Many long-established captives insured third-party risks that were not fully understood, and sticky legacy issues remain. Any third-party risk issues must be resolved as soon as possible to avoid the potential for future financial statement adjustments that could affect overall business profitability down the line.

Here, again, I’d like to interrupt and say – third-party risk and legacy issues and anything else that may be dwelling in an acquired captive – aren’t these things that have to be evaluated well before a merger or acquisition? That’s got to be part of the due diligence process.

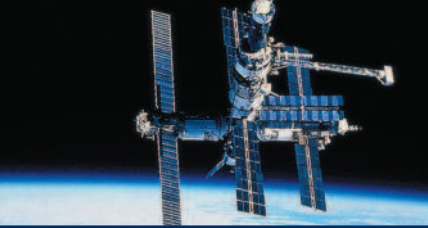
No question about it. That’s why I put “wake up one morning” in quotes. And a chief point of concern is how early and fully risk management is brought into the due diligence process and the data room. It’s amazing how effectively rosy *pro forma* financials can be torpedoed by unexpected adverse developments coming out of something that looks like an asterisk on the radar screen of the overall deal.

So ... back to the checklist.

Ah, but I digress...

- Check the status of each captive. Are any of the entities dormant or in runoff? Which ones might have long-term or difficult-to-resolve legacy issues? If present, it may be best to let these captives continue in runoff. Other options exist such as novation or the transfer of the risk to another insurer or to another captive.
- Evaluate the amount of capital and surplus in each entity against the total exposure. One of the disadvantages of multiple captives is the required duplication of minimum capital and surplus requirements for each entity. It may be more efficient to consolidate some of the captive entities.
- Research the domicile requirements of each captive. Is it still the right domicile considering current requirements?
- Before making any decisions regarding shutting down, redomiciling or even novation for that matter, make sure that the cost, timing and human resource requirements are worth the investment.





# Marketplace Realities 2007

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Even if you have inherited an existing multiple captive scenario, don't just assume that because they have been operating for a long time that everything is going according to a predetermined plan. You need to know if you are sitting on potential problems down the line or have the potential to be a hero by identifying capital that can be freed up for other productive purposes.

To sum up, what would you say is the single most important take-away that captive owners listening today should keep in mind regarding their captives?

Keeping in mind that this is my chosen area, I am always surprised when captives are kept on the sidelines, waiting for some critical event or acute marketplace condition to call them onto the playing field. I agree that this is one of the basic reasons to have a captive – to have that kind of versatility and flexibility, but today your captive needs to be right there, as a strategic and tactical ingredient of every program renewal. Risk managers and captive managers should be seeking and evaluating every possible advantage. There is no better way to make certain that capital deployment is at its most efficient.

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# Marketplace Realities & Risk Management Solutions 2007

## Construction

November 2006

## Property and Casualty

While overall the US construction industry continues to thrive, the balanced growth enjoyed by the industry for the past number of years is becoming a thing of the past. The industry is best divided into three categories: residential (single and multifamily); general commercial building; and civil and public works. The residential segment is struggling, while the other segments remain robust.

The relative health of the residential housing market is very closely linked to overall economic growth in the US. Single family housing starts have cooled dramatically, and multifamily housing is trending negatively as well. Observers point to a slowing economy, with the core inflation rate reaching its highest point in four years. Housing starts are down 7.4 percent, while several major mixed-use and condominium developments have been cancelled or put on hold.

Commercial trends look more positive. Investments in education, commercial, manufacturing and healthcare segments are fueling growth. Resurgence in electric utility construction in particular has bolstered the performance in this sector.

Thanks to the Federal Highway Bill and other government action, public funding for heavy highway and infrastructure projects is strong, fueling growth in the civil and public sector as well.

One factor that is acting as a drag on all industry segments is the ever-increasing cost of construction materials. This has had a major impact on the costs associated with construction projects, and has hindered project starts in many areas. The average increase associated with material costs across all sectors is about 10 percent.

All in all, the outlook is cautiously optimistic, even if we do see a continuation of the declining housing market coupled with the rise of construction material costs. The industry may not be in heavy growth mode, but all indications point to a stable future.

## Marketplace Conditions

Insurance trends for the construction industry generally follow those of the overall Property and Casualty marketplace, with some notable exceptions.

The overall health of the US Property / Casualty Industry is remarkably strong given recent catastrophic events. All indications point to a profitable 2006 underwriting year for the industry as a whole and investment returns are improving for carriers as well.

The main drivers impacting construction risks are General Liability (primary and excess), Workers' Compensation and Builder's Risk.

General Liability rates are trending downward for commercial risks, though buyers in all segments, especially residential contractors, are facing more restrictive terms. Policy language, as well as

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interpretation of stated language, is becoming problematic. Additional insured wording must be closely scrutinized as carriers have begun utilizing manuscript wordings to suit their appetite, often at the expense of protecting interested parties. The definition of "occurrence" is under scrutiny for construction risks under the business risk doctrine, resulting in deteriorating ability to apply "damage to your work" provisions.

From an excess standpoint, we observe a lack of continuity of coverage. Rates are also trending slightly upward, and available capacity for construction risks is constricting. Reiteration of terms and definitions can lead to a disconnect in the event of a high-severity claim. Contractors are experiencing difficulty in obtaining excess cover in the event of inadequate protection under a wrap-up policy.

Workers' Compensation, Automobile Liability and Environmental Liability programs are priced competitively. In Workers' Compensation, state reforms have provided especially significant rate reductions. The movement of larger accounts from residual markets to standard carriers is also a sign of health for this line. We remain cautious about Workers' Compensation, however, due to increasing medical costs as well as the aggregation issues associated with terrorism exposures.

Professional Liability is a difficult placement, with strained capacity and frequent unwillingness on the part of carriers to offer adequate coverage for contractors. The long tail related to construction claims increases the apprehension of Professional Liability underwriters. Protective policies for owners and contractors are commonly being placed on a project basis. (For more on Professional Liability for the construction industry, please see *I-Beam*, the recently launched newsletter series on the topic, available on our web site at <http://www.willis.com/Extras/Publications.aspx>.)

## Volatility in Builder's Risk

The big story for construction risks is the struggle for Builder's Risk capacity. The volatility of this line has had a major impact on contractors. Much uncertainty exists as of this writing as we wait to see the impact of this year's hurricane season – benign so far, but far from over. For coastal placements, rate increases of 100 percent to 500 percent have been reported. The lack of capacity, however, has outpaced increased cost as the issue of prime concern in the minds of buyers. Where coverage is available, it is not only expensive, but terms are strict and retentions are high. Beyond issues related to Wind and Flood, terms for Earthquake cover are also tightening, with reports of 50 percent to 100 percent rate increases *plus* higher retentions. Continued pressure from this line will perhaps inspire owners and contractors to become more cooperative and creative in order to reduce Builder's Risk exposures.

## Strategies for Tomorrow

While rate trends appear favorable relative to Casualty lines, key coverage for Construction risks is not as broad as it has been in recent years. Contract requirements that had been supported by insurance products may be borne by the contractors, and we expect this to continue. Many contractors are looking at alternative risk transfer mechanisms for portions or all of their risk, another trend we anticipate will maintain its momentum. Market volatility has impelled all Construction risk professionals to think of more creative methods of managing the total cost of risk.

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## Surety

November 2006

## Stability and Uncertainty

The US construction industry may be in the early stages of the strongest construction economy in more than 10 years, as measured by available work and the prospects for future work during 2006 and into much of 2007. These conditions coincide with the Surety industry's return to profitability after the catastrophic experiences of 2001-2003. Most major Surety writers enjoyed very good years in 2005, after returning to underwriting profitability in 2004. Surety reinsurers – the capacity engine of the industry – returned to profitability for the first time since 1998.

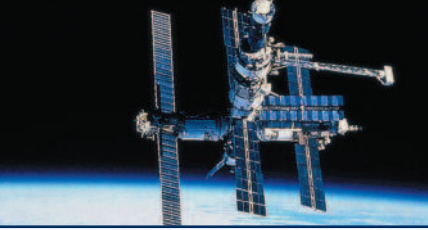
Within the current prosperity trend, there are signs of slowing. On the whole, however, most contractors' current planning revolves around the successful completion of existing backlog and timing work to match resources. One example of the changing and dynamic construction marketplace is the rapid escalation of private finance initiatives (PFIs) in US public works markets, as state governments seek to promote constituents' perception of fiscal responsibility. Projects involving new infrastructure or upgrades to existing facilities, water projects and hospitals have all seen some examples of this procurement process. This method for funding and constructing major infrastructure and facility improvements is spreading from Europe, where the governments have been privatizing rail systems, airports, highways and post offices for years. US locales that have seen public-private partnership (PPP) and PFI activity to date include Florida, Illinois, Indiana, New Mexico and Texas.

A PPP conference in New York in late September received so much advance interest that the venue was changed to accommodate a record number of registrants willing to pay top dollar to find out how PPP/PFI might be implemented in the US marketplace. Contractors pursuing these projects can expect their sureties to inquire about requirements for capacity on billion-dollar projects, the acceptance of lower penalty bonds and the financial implications of financing and constructing a given contract and concession. Contractors should also anticipate higher, project-specific pricing for this work, especially if it includes provisions for extended contract duration. Discussions about the cost / benefit value of surety in the world of PPP/PFI was one of the topics at the New York conference.

There is strong evidence of a renewed interest in US acquisitions by major contracting groups from Europe and Asia, particularly Spain, Japan and China. The availability of work in the US market (especially in contrast to their respective domestic markets) and these groups' experience in PPP/PFI initiatives are driving this interest.

Amid this good news, we must sound a note of caution. The Surety industry is cyclical, and in the past, severe Surety industry losses have often followed very strong construction marketplaces. Sureties have not forgotten the recent past. From January 2001 through September 2005, the Surety industry sustained paid and reserved losses exceeding \$11.9 billion. This period saw Contract Surety losses of unprecedented levels and Commercial Surety loss ratios close to, or in excess of, 100 percent in three of the past five years. The ability of sureties to balance support for contractor clients in a very attractive marketplace for construction services while maintaining the underwriting discipline that has returned the business to profitability will be the determining factor in whether the return to profitability is the beginning of a longer-term trend or merely a brief respite between periods of industry hardship.

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### Implications for Buyers of Surety

While conditions today are more stable than in the recent past and underwriters have an increased interest in new business, the Surety market retains elements of uncertainty. Financial ratings and the potential for further industry consolidation – at the primary carrier or reinsurer level – could, at any time, interrupt the Surety industry's ability to maintain capacity. For clients, continued vigilance and strategic planning around their Surety program is advised, as rating changes and mergers generally come with little or no warning. Recent improvement in Surety industry performance notwithstanding, insurance company management sees in Surety a business that:

- Generates approximately one percent of US P&C industry revenues
- Presents aggregation of liability vs. spread of risk challenges
- Requires highly specialized underwriting
- Demands significant capital support
- Has exhibited increasing loss volatility in recent years
- Holds the potential for any single loss to impact the insurer's quarterly EPS

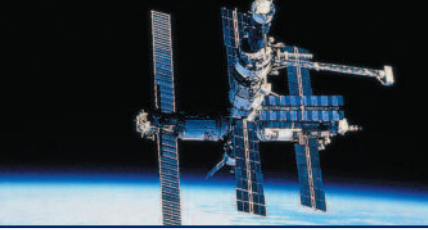
The following comprise the major structural attributes of today's Surety marketplace:

- **Single Surety Capacity** remains an issue for aggregate programs above \$300 million. There remain only four sureties that will write aggregate programs of more than \$500 million without a co-surety partner.
- **Co-Surety Programs** may be arranged to obtain needed capacity for large accounts, but they present certain structural issues. The credit risk associated with co-surety participants remains a point of focus for potential surety partners. Many clients are well served by putting in place a standby surety relationship (sometimes a co-surety can serve this dual purpose) to protect against unforeseen marketplace developments.
- **Single Bond Size Limitations** may be imposed by sureties on contractors involved in sole-venture work. This requirement is driven by a surety's desire for its client to obtain a spread of risk for any large single project, as well as its own desire to maintain single credit aggregate exposures on any single risk within its current credit model.
- **Reinsurance Terms** have eased as capital has been attracted by the Surety industry's return to firm footing, as evidenced by:
  - *Underwriting discipline* – greater adherence to traditional underwriting ratios, adequate indemnity security, quality submissions, flow of information, ease of analysis, etc.
  - *Pricing* – stabilizing and an easing of the previous market bias toward higher rates
  - *Higher retentions* – leading to limited appetite for aggregate exposure on any single client's account
  - *Additional security and/or collateral requirements* – to cover net risk retained by the surety

### On What Do Sureties Focus?

The robust construction economy presents sureties with a different set of parameters to consider as they are asked to support a customer's pursuit of potentially attractive opportunities from repeat customers or new markets. Some of these risk factors may result in one-time pricing and security requirements that deviate from the client's standard bonding facility.

- **Expansion Risk** – The current conditions are presenting clients with expanded opportunities and potentially attractive margins for work. Underwriters will focus on the contractor's prequalification of the owner, its source of financing, and the contractor's experience in the type of work proposed and its familiarity with the market conditions (labor, material availability, etc.) in the project's location.

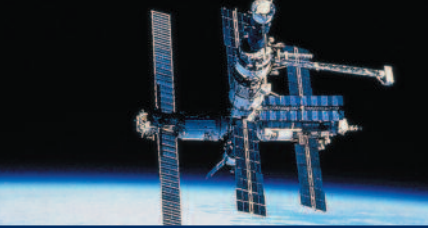


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- **“Under-Engineered” Designs** – Schedule risk will be assessed by the underwriter, at least in part for potential liability.
- **Subcontractor Default Exposure** – Sureties underwrite their clients’ own risk management practices, including their subcontractor selection criteria. Some sureties are now requiring that clients have in place a risk transfer mechanism for subcontractor default risk (be it surety or insurance) that affords coverage to its surety partner on bonded work. With increasing frequency, subcontractors that cannot secure adequate capacity from traditional surety providers are obtaining surety support from unrated and/or non-admitted carriers.
- **Contract Duration / Warranty / Maintenance Periods** – Durations of more than 24 months and maintenance or warranties in excess of five years are unlikely to be approved without additional security or collateral. Performance efficiency provisions may result in exclusionary language for the bond or a stipulation to cover such contract provisions through a separate surety performance obligation.
- **Liquidated Damages Levels** – Unusually high amounts or consequential damages are unlikely to be supported.
- **Consequential Damages Provisions** – Sureties rarely agree to cover such provisions and will inquire about the client’s insurance covers’ capabilities to respond to any claims not supported by the client’s own resources. In the case of both liquidated damages (above) and consequential damages, contractual provisions may inhibit the ability of subcontractors to provide bonding to their general contractor and construction manager clients.
- **Materials Escalation Clauses / Industry Inflation** – Sureties will ask how the client has protected itself against unforeseen price increases during the course of the contract. A more general concern relates to qualified labor and supervisory inflation costs due to the shortage of both in the construction industry.
- **Bond Forms** – Wordings continue to receive close scrutiny. Provisions relating to damages, any curtailing of the contractor’s or surety’s rights under the bond, or obligations that are outside the contract language itself are examples of “show stoppers” that may preclude underwriting support or condition it upon additional security from the client.
- **Residential Projects** – Satisfaction regarding the source and adequacy of financing in place to pay the client for its work and, within the contract documents, on provisions that may expose the surety or the client to homeowner warranty claims are a surety’s primary focus in this rapidly expanding sector. The adequacy of the contractor’s insurance coverages will be a surety underwriting focus.
- **Continuity Planning and Ownership Transfer** – The construction industry is entering into a significant period of generational change. Sureties are looking for continuity planning, both operationally and financially, that allows for a smooth transition in the case of a sale / buyout or the orderly completion of existing work in the event the ultimate plan is for the firm to discontinue operations. The availability of surety credit may affect a firm’s valuation and its shareholders’ ability to transfer ownership of the business.



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## A Client's Surety Best Practices Checklist

Positive differentiation remains paramount in achieving preferred terms. Simply put, surety support is available to well managed firms. Treating a surety as a partner will reduce the chances of unexpected events negatively impacting a client's surety facility, but strategic planning and communication are the key elements in dealing with continued uncertainty. Accordingly, we work with our clients to secure answers to the following questions and to act on their implications:

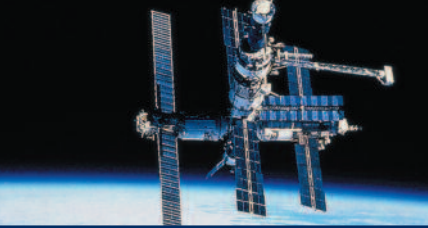
- Am I completely familiar with my Surety submission and the ongoing work product representing my company to the Surety marketplace?
- How does the surety analyze my company?
  - Review my surety's financial analysis and credit modeling – it's their scorecard for extending credit.
  - Communicate what we expect of our surety and clearly understand the surety's expectations of my company.
- What are my surety's underwriting results?
- What level of reinsurance support does my surety rely on to service business? Have there been any changes to my surety's single project and aggregate program capacity?
- What are my surety's financial ratings? Have there been any recent changes to its or its parent company's ratings?
- Have there been recent personnel changes within my surety at the local and/or home office level?
- What is the status of my standby surety?

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# Marketplace Realities & Risk Management Solutions 2007

**Financial  
Institutions**  
November 2006

Much has changed, and much has remained the same, since we last discussed the marketplace realities facing financial institutions. Last year, we wrote about such issues as catastrophic mortgage default; the regulatory environment surrounding the implementation of Basel II; the growing concern over data security and the liabilities that banks face as a result of a data breach; and the exposure an institution faces in failures like Enron and WorldCom. We predicted that these exposures would prove vexing to the financial institutions risk management community.

In fact, each did prove to be a major risk management concern.

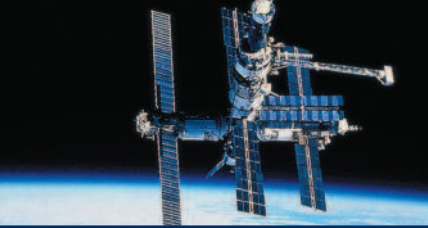
- Hurricane Katrina, and other natural catastrophic losses, did lead to a large spike in mortgage defaults in the Gulf Coast region. Many financial institutions are now evaluating their reserving practices to minimize or eliminate unexpected and unreserved losses resulting from future catastrophic events.
- There is a vigorous debate over whether the implementation of Basel II will put the largest US banks at a disadvantage when competing with foreign multinational banks. Four of the largest institutions have indicated their concern that Basel II, as currently written, will *indeed* put them at a competitive disadvantage with foreign banks and US investment banks. Congress and the major regulators are all evaluating Basel II's impact on US banks. Basel IA remains an alternative to those banks not adopting Basel II's advanced measurement approach, but has its issues as well. This bears continued vigilance in 2007 as the global implementation date draws nearer.
- Financial institutions large and small have suffered data breaches. Many of the largest financial institutions have suffered losses of sensitive client information that have caused them significant financial loss. The insurance industry response to this risk is still developing, but viable risk financing mechanisms are available.
- Lending institutions continue to settle liabilities stemming from their investment banking operations, rather than face continued costly litigation and adverse publicity.

Looking forward to 2007, these issues remain areas of focus. In addition, there are several other areas we will be monitoring on behalf of our clients:

- The availability of terrorism insurance as the Terrorism Risk Insurance Extension Act (TRIEA) expires at the end of the year
- Continuing banking industry consolidation – not only regionally and nationally, but internationally and horizontally as well
- The trend for multistate banks to switch to a federal charter from a state charter
- New capital requirements emerging for construction loans, mirroring those required for mortgage loans
- Hedge funds coming under increasing pressure to conform to some degree of regulatory authority

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# 2007

### Terrorism Insurance

The President's Working Group on Financial Markets, charged with determining the need for a government backstop for the commercial insurance marketplace for terrorism, released its findings in early October. The Working Group discouraged any further extensions of TRIEA. They stated numerous reasons, but all revolved around the existence of a commercial market, the perceived lack of demand for any coverage outside of Workers' Compensation, and the belief that the laws of supply and demand will prevail in the terrorism insurance marketplace.

With the continued uncertainty of the ongoing availability of terrorism coverage beyond 2007, the financial institutions risk management community has taken the initiative to seek new coverage facilities to protect corporations against losses stemming from a terrorist attack involving nuclear, biological, chemical or radioactive (NBCR) weapons. While intended to be available to multiple industries, the financial institutions community has taken a leadership position in driving the dialogue. The potential absence of a viable market for NBCR coverage will impact virtually all business areas, including but not limited to lending, real estate investments, investment banking and private equity transactions. We will continue to support the multifaceted study of potential risk financing and transfer solutions.

### Merger and Acquisitions Activities

There will be considerable conjecture as to which institutions will be acquired and cease to exist, and which are well situated to remain independent in 2007 and beyond. Among the largest banks in North America, a small core is widely expected to survive as ongoing entities. Beyond that group, there is talk of strategic alliances within regions to consolidate positions, or across regions to realize a larger footprint for the sales of financial products and services. An example of the former is the First Union / Wachovia combination; an example of the latter is the Fleet / Bank of America merger. Size will not be an issue, as small community banks and larger regional and super-regional institutions will continue to evaluate merger opportunities.

In the community bank world, a new combination of institutions is announced almost daily. These combinations might be between local community banks looking for operational efficiencies. They might involve a large regional or national bank looking to buy into a state they see as strategically important. They might involve a large Canadian, Asian or European institution looking to increase its presence in North America.

There will also continue to be a number of transactions between institutions looking to enter, or leave, a certain product area (such as mutual funds or other investment advisory activities). The result will be a continuation of the blurring of the lines between banks and securities firms, as well as the trend by which the largest institutions get larger, leaving the great majority of the remaining firms far behind in terms of size and breadth of capabilities.

### State vs. Federal Bank Charters

For banks with an acquisitive history, there is a growing trend of combining their many bank charters either under one state charter or under a federal bank charter. It has become inefficient for banks to have more than one state banking authority to respond to, and there is a trend for multistate banks to merge their charters under a federal charter as a means to simplify their business operations from state to state and to consolidate their banking oversight, generally at the Office of the Controller of the Currency (OCC). The result is a consolidation of bank regulation within the federal government, and a corresponding reduction at the state level. As large banks change to federal charters, their former state banking commissions, usually funded by fees charged to the banks, are left with large budget shortfalls, further impacting their ability to monitor the many smaller banks that remain under their supervision.



# Marketplace Realities

## & Risk Management Solutions

# 2007

## Construction vs. Mortgage Loans

An emerging proposal from the Federal Deposit Insurance Corporation (FDIC), OCC, Office of Thrift Supervision (OTS) and Federal Reserve Board covers the accounting of construction loans that may have a significant and adverse balance sheet impact. Coming out under the FDIC, FI-4-2006, was issued on January 13, 2006. Essentially, the proposed guidelines would assess a larger capital charge against those banks with a high percentage of construction loans. These regulators have become concerned that too great a concentration of these construction real estate loans could have a materially adverse impact on earnings and capital. They are currently seeking comment from the industry. Not surprisingly, the industry reaction is not positive.

The rules would instruct banks to account for their construction loans to contractors who build on spec differently from the way they account for their mortgage loans. While mortgage loans can be valued as a percentage against the property's value, the speculative construction loan would be accounted for at cost of construction. Banks are considering the impact that this change will have on their capital and what they may be able to do to minimize that impact.

The failure in mid-October of a New Jersey home builder may give added urgency to this proposal. We will be closely monitoring this development and its impact on lending institutions.

## Hedge Fund Oversight

In a September 2006 *Alert*, we spoke in detail about the exposures facing hedge funds and their officers. We discussed the specific areas of liability they face and provided a few case studies.

Throughout 2006, there has been a growing movement toward forcing hedge funds under the regulatory oversight of the Securities and Exchange Commission (SEC). In fact, in July, the chairman of the SEC told the Senate that regulation of the hedge fund industry is inadequate. This trend is likely to continue given the recent trading losses suffered by hedge fund Amaranth Advisors. Now that the fund is liquidating, with its investors having lost over half of their investments (roughly \$5 billion), we expect increased pressure from Congress and others toward centralized regulation. In the days after the news of the Amaranth losses, Congress passed a bill calling for the federal government to review hedge funds and their exposures. The study will be conducted by the President's Working Group on Financial Markets, the same group discussed above regarding a terrorism backstop.

Up to now, we have seen a minimal but growing appetite from the hedge fund community for Executive Risks coverage. We predict that recent developments, and the realization of the potential for personal liability facing hedge fund officers and directors, will lead to a close reevaluation of the coverage. We will be following these developments closely and will report back to our clients via further *Willis Alert* bulletins.

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# Marketplace Realities & Risk Management Solutions 2007

## Environmental November 2006

In 2006, we have seen the continued emergence of several trends in the Environmental insurance markets: the establishment of new market drivers, the rise of new risk exposures and changing underwriting appetites.

Overall, the Environmental market has maintained the moderate but steady growth pattern that we have experienced in recent years. This \$2 billion to \$3 billion market, however, is being propelled now by a new set of drivers that include:

- The routine application of Environmental insurance to a wider array of properties (including non-industrial sites) and transactions (both M&A and real estate)
- The burgeoning brownfield and military base redevelopment markets
- New demands for greater financial disclosure of Environmental liabilities
- The trend towards insured, fixed-price cleanup projects

As the market develops, we are seeing a gradual change in underwriting profile, with less emphasis on one-off, long-term, project-specific placements and an increasing proportion of short-term, renewable programs. It is clear that this market has now evolved from that of a specialty niche product line into a mainstream purchase, addressing a wide range of circumstances and needs.

Nevertheless, the relative immaturity of the market is still evident. Loss trends from long-term policies written in the past decade or so continue to come to light. This has prompted a general tightening of terms and conditions and a fundamental reassessment of certain product lines such as Cleanup Cost Cap. Carriers are accentuating profitable underwriting and strongly encouraging shorter-term, renewable policies. They are also addressing new areas of exposure from emerging contaminants to the challenges presented by new regulatory initiatives.

## Marketplace Conditions

Global Environmental capacity remains plentiful (approximately \$400 million) and relatively stable. Once at levels over \$100 million, leading carriers such as AIG are currently comfortable maintaining a capacity for single placements of \$50 million. This is largely a result of weaker demand for higher limit programs and the associated cost of unused reinsurance protection, rather than any fundamental change in risk appetite. Certain other carriers have been able to increase their capacity. For example, ACE increased its capacity for single Pollution Liability placements to \$50 million as it continues to grow its Environmental business segment.

Environmental insurers have been participating more and more in layered programs, which are designed to build capacity above and beyond that which is available from a single insurer. As rising financial disclosure expectations force companies to take a harder look at large existing liabilities, we expect the demand for major programs requiring higher limits may well increase.





# Marketplace Realities & Risk Management Solutions 2007

The most critical market question for Environmental insurance buyers in the current climate is not limits or rates (which have been relatively steady), but rather how to best manage increasingly restrictive terms and conditions. Due to past carrier losses, new scientific advances and new regulatory initiatives, buyers can now expect:

- Pressure to reduce policy periods
- New coverage restrictions for certain key issues, such as mold, certain building materials (with the potential to cause mold) and emerging contaminants such as perchlorate or perfluorochemicals (PFCs)
- More demand for location-specific information on portfolio placements
- Increased underwriting scrutiny of areas of regulatory interest such as vapor intrusion of underground contamination into buildings
- Ongoing difficulties in obtaining attractive options for environmental surety needed for project work or operations of regulated facilities

## Carrier Preferences

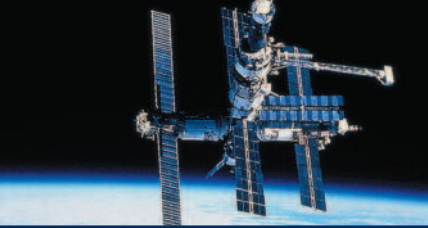
Changing carrier appetites can be seen clearly in three product lines.

- **Cleanup Cost Cap** underwriters have experienced unacceptably high loss rates and they continue to introduce mechanisms to incentivize contractors – such as loss sharing or co-pay provisions. There has been a progressive tightening of policy terms and certain insurers have introduced minimum premium thresholds and up-front engineering or commitment fees. Some insurers will only offer their Cost Cap products to a limited group of preselected contractors. However, having introduced the new controls and restrictions outlined above, most Cost Cap insurers are tentatively expanding their books.
- **Professional Liability** programs, especially for large environmental service firms, have been another source of significant losses for the Environmental carriers. Insurers have been and will continue pulling back from accounts with a significant component of traditional design engineering (i.e., non-environmental) exposure.
- In contrast, construction-related products such as **Contractors Pollution Liability (CPL)** insurance represent a growth area targeted by all the major carriers. Mold and completed-operations exposures are two of the main coverage drivers.

Other notable market developments include the recent entrance by Berkley into the market and the complete exit of Quanta. Berkely Specialty Underwriters will be targeting environmental contractors and consultants as well as property pollution risks. Quanta's Environmental underwriting activities were stopped earlier in the year and were later placed in runoff due, in part, to underwriting losses in other lines of business caused by the 2005 hurricane season.

## Legal and Regulatory Action

The influence of the Sarbanes-Oxley Act (SOX) and the ongoing demand for greater corporate transparency continue to drive the tightening of disclosure rules for Environmental liabilities. Public companies are now in their first year of implementing the requirements of FIN 47 (FASB Interpretation Number 47) which addresses conditional asset retirement obligations. FIN 47 mandates that companies may not wait until they actually retire an asset to acknowledge the associated costs, such as future cleanup obligations. They must recognize the costs on their balance sheet as soon as the numbers can be



# Marketplace Realities & Risk Management Solutions 2007

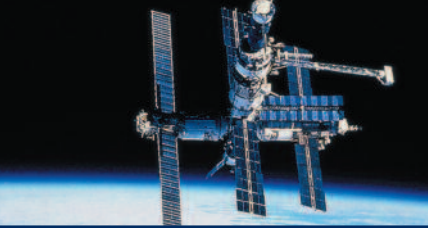
reasonably estimated. The early impact of these rules is mixed, as some firms have disclosed major increases in environmental liabilities while other disclosures have remained relatively unchanged. The longer-term consequences of this rule have yet to become apparent. Also unclear are the preferred approaches firms will take to address newly disclosed liabilities. Although disclosure is required, funding or insuring for potential future liabilities is not. We anticipate firms with likely near-term asset retirements involving significant environmental expenses will be exploring options to cap their total exposures through insurance-backed solutions. Such approaches will not only improve the quality and certainty of their financial disclosure but also create more options for sale or redevelopment.

Global warming is not only receiving a tremendous amount of media attention; its potential to cause large losses through weather events is now one of the main long-range concerns for the insurance industry. At this time, it is difficult to predict the nature and scale of all the various liabilities that climate change could create. Some recent developments suggest possible areas to watch. In September 2006, the state of California sued six leading automobile manufacturers because of their products' contribution to global warming and resulting pollution and erosion problems. The lawsuit cites the creation of a "public nuisance" from carbon dioxide emissions. The insurance industry has started to respond to other global warming-related exposures. Examples are novel insurance programs that guarantee the financial subsidies associated with the earning of carbon emission credits from certain qualifying projects that are designed to reduce carbon emissions.

Several other regulatory issues bear watching:

- Recent regulatory initiatives could mandate additional activities at many contaminated sites, increasing the likelihood that regulators will **reopen previously closed sites**. For example:
  - The Environmental Protection Agency (EPA) is currently reviewing the effectiveness of institutional controls – e.g., legal mechanisms such as deed restrictions that are used to minimize the potential for human exposure.
  - The EPA and several states have issued guidance documents for reevaluating the health risks posed by subsurface vapor intrusion.
- **Natural Resource Damage (NRD)** claims continue to be a looming regulatory concern for both clients and Environmental insurance markets. While the Federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) provides the basis for NRD, administration of NRD falls to individual state trustees. In addition, each state has its own legislation affecting the administration of NRD, and there has been no real coordination of the federal and the state programs. To make matters more confusing, each state pursues NRD claims with varying degrees of aggressiveness. Since the Environmental insurance marketplace closely tracks federal and state regulations, the availability of Environmental insurance for NRD claims is often determined by the location of the property in question. NRD submissions will continue to be evaluated on a case-by-case basis.

A recent development that created significant interest in the insurance community was the announcement in June 2006 that the Department of Justice reopened one of the highest profile NRD settlements in US history – the Exxon Valdez oil spill in Alaska. In accordance with the "re-opener" provisions in the original \$900 million settlement, the Department of Justice and the Alaska Department of Law have presented Exxon with a request for additional funding of approximately \$90 million.



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- **Emerging contaminants** are substances that are currently unregulated, but that may be subject to increased regulatory standards in the near future. A good example is perchlorate, a common contaminant on defense-related facilities that until recently had been lightly regulated.

## Strategies for Tomorrow

As we reported in April, insureds should expect challenging renewals with increasing restrictions on terms and conditions. Careful, strategic program design and marketing will be paramount to avoid erosion of valuable coverage.

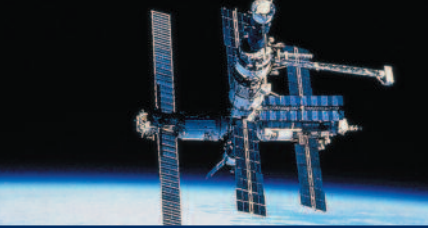
For new placements, it will be important to carefully match coverage needs with the current appetites and offerings of the market. As Environmental insurers become more selective, purchasers that are able to combine innovative program design with high-quality underwriting presentations will derive maximum benefit.

FIN 47 makes it clear that, beginning this year, companies must reserve for asset retirement obligations despite uncertainties as to the time or method of settlement. Many companies will be looking for options to help mitigate the impact of FIN 47 on their financial reports. These options might include the accelerated cleanup of a contaminated site, sale of non-performing sites or operations, and/or use of risk transfer arrangements such as Environmental insurance or liability transfer alternatives to bring resolution to cleanup obligations.

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## Employee Benefits

November 2006

### Healthcare Benefits

US companies continue to get pummeled by rising costs for their employees' health benefits. Even with plan changes such as higher deductibles, renewal increases are approximately nine percent per year.

Over the past 10 years, employers have tried various methods to deal with the sharply growing costs of healthcare benefits – self-insuring the risk, changing carriers, adopting managed care and sharing costs with employees. While these measures have produced some savings, employers have been looking for new ideas, as the current trend is simply not financially acceptable. At the same time, employees are frustrated. They see increases in employee contributions and deductibles that are sometimes far greater than pay raises.

What factors contribute to the high medical cost trend? Pure inflation represents only about one-quarter of the total annual increase. Other factors include new drugs, new medical procedures and an aging workforce. The root cause, however, is the third-party payer system where both employees and physicians are insulated from the costs. A typical employee generally has little financial incentive and limited opportunity to become a careful consumer of healthcare.

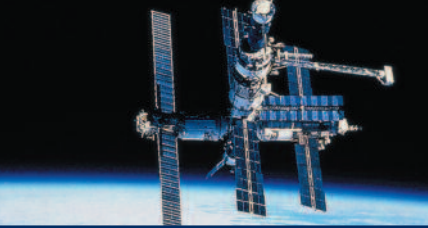
## Consumer-Driven Healthcare and Wellness Programs

The industry in recent years has finally come up with some promising answers, starting with consumer-driven healthcare plans. These plans have been taking shape in the marketplace for some time and may finally be poised for broad acceptance – they certainly deserve broad consideration.

Consumer-driven healthcare addresses employees' healthcare purchasing behavior. These plans use higher deductibles with health savings accounts (HSAs), and health reimbursement arrangements (HRAs) that can be rolled over to subsequent years if the accounts have unused balances. Since employees are far less insulated from cost, they think twice before spending money on healthcare. Early adopters have experienced much flatter trends as a result.

Another growing trend is the use of wellness programs and disease management strategies – loss control, if you will, for the healthcare benefits sector. Employers are considering a broad variety of approaches to promoting health, ranging from basic newsletters to broad, integrated programs that are designed to change behavior. Many employers are taking a hard look at how high-risk individuals can be identified as early as possible and tracked over time. Some employers have used biometric screenings (analysis of blood pressure, body mass index and blood tests) and health risk assessment questionnaires very successfully to save both lives and money. Combining biometric screenings, health coaching and financial incentives, employers have reported strong progress in identifying, measuring and reducing risk. Wellness programs, companies have found, can help lower claims, increase productivity and create a healthier work environment.





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## Regulatory Issues

Federal agencies continue to issue guidance on the building blocks of consumer-driven healthcare: high-deductible health plans, HSAs and HRAs. Additional guidance helps minimize unexpected liabilities and may encourage employers to adopt consumer-driven plans. For example, new regulations clarify when employers are deemed to be making HSA contributions through a cafeteria plan so that the relatively rigid requirement to make comparable contributions to employees' HSAs does not apply.

Creative and aggressive uses of wellness programs and disease management strategies have raised new issues under old laws. These include the prohibitions on non-job-related health inquiries under the Americans with Disabilities Act of 1990, and the privacy and non-discrimination provisions of the Health Insurance Portability and Accountability Act of 1996. Even so, a well designed program can minimize these legal risks while improving employees' health and helping to slow healthcare cost increases.

Employer-sponsored health plans continue to have many regulatory hoops to jump through each year, and no relief is in sight. In fact, recent court cases and regulations suggest that plans are best protected against unexpected liability by establishing detailed written policies and procedures and distributing notices that inform employees about those details. Meanwhile, state legislatures and regulatory agencies are becoming more active in mandating health benefits, and employers struggle to understand and accommodate both federal and state laws.

## Clinical Considerations

With the large number of aging baby boomers, our workforce is experiencing higher medical claims. Age is not the only factor, however. Over the past decade, the population across the country has gained weight and become less active. A number of sources report that lifestyle behaviors (diet, exercise and smoking) adversely impact about 70 percent of all medical claims.

Insurance carriers have responded to the clinical challenges by developing a variety of disease management programs to treat patients who have been diagnosed with chronic conditions such as coronary disease, cancer, diabetes or asthma. They have also developed wellness programs to help us stay healthy. Yet, the success of both disease management and wellness programs is not at all clear. Many employers doubt that they are getting a satisfactory return on their investment in them.

## Strategies for Tomorrow

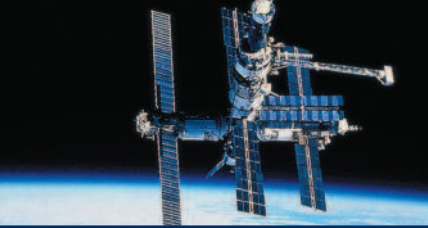
Regardless of whether their health plan is insured or self-insured, employers understand that they and not their carriers pay for their claims experience over the long run. They also recognize that the current healthcare system is broken. The question is: What can be done ... and by whom?

Each employer is different – in goals, industry, location, size and culture. Some employers react to premium increases by simply passing them on to their employees. More and more, we are seeing interest in consumer-driven healthcare and wellness.

The marketplace is in turn responding to these changes. While there has been a consolidation of carriers over time, a number of specialty vendors have emerged. They offer clinical, software, education and other services related to consumer-driven healthcare, wellness and disease management.

In another important trend, human resources and finance people are joining forces to analyze alternatives and performance. They are demanding better clinical and financial information to see what really works:





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- What benchmarks should be used to measure which carrier is delivering the best value?
- Which hospitals and physicians are delivering high-quality, effective healthcare using evidence-based medicine?
- How do you track patient compliance with the physicians' recommended protocols on high-risk members?
- How do you measure ROI of wellness programs?
- How do you structure performance guarantees with metrics that hold carriers and other vendors accountable?

Employers who have embraced data analytics have been rewarded by being able to identify optimal solutions and realize significant savings.

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# Marketplace Realities 2007

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## Healthcare Professional Liability

November 2006

Stability and rate adequacy are the words that best characterize the Healthcare Professional Liability (HPL) insurance market we expect to see in 2006-2007. This optimistic outlook is a result of several factors. While conditions do vary by state and jurisdiction, overall claim severity has moderated, and claim frequency is down markedly. The improvement in severity and frequency is attributable to widespread state enactment of malpractice reform laws and to improved facility commitment to risk management, patient safety and quality initiatives. Flat to high single-digit premium / rate reductions are typically being seen for most segments at renewal. However, slight increases are possible for certain physician and surgeon classifications and for managed care organizations, depending on location and risk profile.

An indication of HPL market stability is AM Best's report of malpractice premium growth in 2005 – just 0.5 percent, to reach a total commercial marketplace premium of approximately \$11.5 billion. Stability is further demonstrated by the virtual absence of pricing volatility in this line of insurance.

Most observers attribute the calming of the malpractice market to the stabilization, and in some cases decreasing trend, in tort awards. A significant recent study on the malpractice problem released in May 2006 by the Manhattan Institute ("Medical Malpractice Awards, Insurance, and Negligence: Which Are Related?") found that "medical malpractice premiums are closely related to medical malpractice tort awards." The study also concluded that "medical malpractice premiums are not explained by insurance industry price gouging" and that other factors such as states' judicial electoral systems have an impact on tort awards. This study mirrors many of the conclusions of the US General Accounting Office (GAO) on the malpractice problem in their report, "Medical Malpractice Insurance: Multiple Factors Have Contributed to Increased Premium Rates," released in June 2003.

While the effort to enact federal tort reform continues haltingly, approximately 30 states have enacted malpractice reform laws or improved existing malpractice legislation since the year 2000. An important part of the trend is the widespread enactment of "I'm sorry" laws that encourage physicians to communicate with patients after unanticipated outcomes without those expressions being subject to use in a subsequent lawsuit. Various medical groups and the hospital industry continue to lobby for the enactment of state malpractice reform laws.

Another major factor in HPL is the improvement in quality of care. Facilities across the US are reporting better outcomes, more effective intervention to reduce ultimate injuries and, as a reward, decreased claims activity. As transparency becomes more ingrained in the healthcare system, and as access to outcome and performance data increases, quality and risk management initiatives can be expected to remain a priority for healthcare executives.

All these factors bode well for longer-term HPL stability. A key unknown, however, is the fate of reform laws in the face of challenges by the trial bar. The trial bar seems to have lost the battle for public opinion on the malpractice problem and thus is attempting a strategy of judicial nullification: utilizing appellate courts to strike down these laws on the basis of their constitutionality. How successful they are will have a broad impact on the future of this often deeply troubled line of insurance.

The logo for Willis, featuring the word "Willis" in a bold, blue, serif font.



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### Physicians and Surgeons

This segment has experienced significant improvement over prior years. Currently, physicians typically experience no more than single-digit increases in most states and many experience slight premium / rate decreases in select states. Premium affordability overall remains an issue, particularly in the primary care specialties of general / family practice, internal medicine and pediatrics. While physician premiums have stabilized, they have done so at historically high levels. In addition, some classifications such as obstetrics / gynecology, neurosurgery, radiology, and emergency medicine continue to be viewed as challenging classifications by underwriters.

There are few remaining national carriers for physicians. However, in many cases the "bedpan mutual" companies that have been more restrictive with writings in recent years are altering their position. Leading markets are MLMIC, Medical Protective, ProAssurance, The Doctors Company (TDC), ISMIE, MAG Mutual, ProMutual, NorCal and FPIC. In recent market consolidations, ProAssurance acquired Physicians Insurance Company of Wisconsin and TDC acquired Northwest Physicians Insurance Company and has announced plans to acquire OHIC Insurance Company in December. In what may well be an industry first as well as further evidence of industry stability, TDC regained its A- rating from AM Best in 2006, improving from a B++.

London and Bermuda markets continue to provide reinsurance or excess cover for physician captives and risk retention groups (RRGs), depending on classification and risk profile. The rate of formation of start-up physician insurers, including RRGs, captives and reciprocals, has declined from that of years past.

### Hospitals

The hospital segment has become one of the most competitive in recent years despite the disappearance of certain major carriers, most recently Employers Reinsurance Corporation (GE sold the renewal rights of this book of excess Medical Professional Liability business to ACE USA in 2005) and Chubb (which sold its renewal rights to OneBeacon in 2005). Improved underwriting results, and the attempt by recent entrants to gain much needed market share, have made this segment much more competitive. Lower attachment points for excess business are being offered in response to the improving environment. However, most hospitals and healthcare organizations are electing to remain at current retention levels due to the control this option provides.

Pricing has softened for both primary and excess coverage, with minimum rates per million for high excess layers markedly reduced from recent years. Domestic markets are attempting to regain market share lost to London and Bermuda and will aggressively compete on favorable risks. Primary domestic HPL underwriters include ACE USA, Arch, Darwin, CNA, Zurich, AIG, Hudson Insurance, OneBeacon, Medical Protective and several "bed-pan" mutual carriers. Domestic excess writers include AIG, CNA, Zurich, Am Re, Berkley Medical Excess, Arch, OneBeacon and ACE USA. London / European markets include Beazley, Catlin, Chaucer, Lexington, Liberty, Starr Excess, Aspen Re, Swiss Re, Hannover Re, Max Re, Faraday, Hiscox, Starr, ACE and Amlin. Bermuda markets are Endurance Specialty Insurance, XL, Allied World (AWAC), Renaissance Re, ACE, Arch and Max Re.



# Marketplace Realities 2007

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## Long-Term Care

The long-term care (LTC) segment demonstrated marked improvement over the last year. Availability is typically not a problem for most buyers, although small to mid-sized insureds may find more difficulty building layers of coverage. The large chains typically retain a significant layer of risk but are able to build capacity in London and Bermuda, or buy down large retentions with alternative risk solutions and structures over relatively low retentions. New entrants and increased competition have greatly assisted this segment with program costs, as have moderating loss trends. Carriers continue to scrutinize risk and claims management programs. Insureds are expected to retain a level of risk, although deductible / retention amounts vary by insured and type of facility (for-profit versus nonprofit, assisted living versus skilled nursing facilities, etc.). Most carriers have their own select targeted classes of business. Carriers / MGA programs include: AIG, CNA, ACE USA, OneBeacon, Colony, James River, Uni-Ter, Bunker Hill, Lighthouse Underwriters and Shand Morahan / Evanston. London and Bermuda are also important markets for LTC business, with participation varying by attachment level and risk profile.

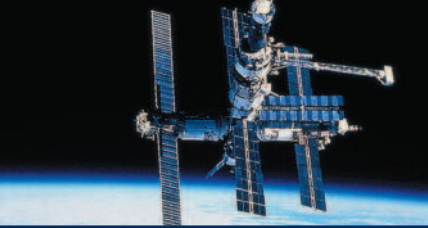
## Managed Care

This segment has stabilized, though there are only three underwriters willing to write primary coverage: Darwin, Lexington and OneBeacon. Chubb withdrew from underwriting Medical Professional Liability, including managed care, in 2005; OneBeacon retains the renewal rights to this business. Single plaintiff claim frequency and severity are down over the last five years, with antitrust and vicarious liability claims becoming more prevalent than the once dominant denial-of-benefits claims. Class action claim frequency has increased, due in part to business dispute litigation from providers, employers, regulatory entities and consumers. Managed care buyers are experiencing flat retentions, with some imposition of sub-retentions and sub-limits for class action litigation and/or antitrust claims. Larger risks may require a higher retention by underwriters. There has also been some extension of regulatory exclusions. There has been some expansion of coverage for release of confidential medical information. Excess underwriters include the London market, Beazley (will consider attaching above \$250K), Starr Excess and Hiscox, and Bermuda markets ACE, AWAC, Endurance, Max Re and XL. Domestic excess underwriters include Darwin, OneBeacon, National Union and Travelers.

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## Utilities

November 2006

### The Technology Factor

*This Marketplace Realities update focuses on the important insurance implications of specific technological developments in the utilities sector.*

The utility sector normally follows the same market cycles as other industry sectors, feeling the burden of a hard market and the relief of a soft market. However, from time to time, utility companies do face issues that impact them exclusively.

Technology has been one such issue in recent years. The story here starts with the early edition simple cycle and combined cycle gas turbines. These machines were seen as the way forward for new power generation, as they were far more efficient and environmentally friendly than most other forms of power generation.

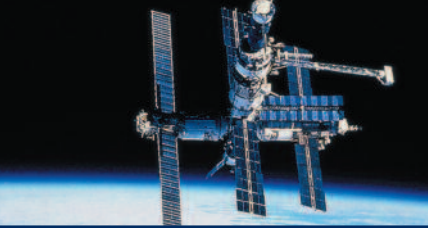
Beginning in the late 1990s, a new generation of these machines experienced mechanical and electrical failures that were attributed to design deficiencies. These failures led to serial losses to the insurance industry, which in turn caused a hardening in the Property market for utilities, particularly in regard to the scope of Business Interruption coverage and deductible thresholds.

As the original equipment manufacturers (OEMs) fixed the design flaws by the early part of 2003, many insurers felt comfortable with the technology issues, and we saw rate relief across the board in the Property sector for gas-fired combustion technology. By mid-2005, however, it became apparent that many of the new machines were experiencing further design failures, particularly in the combustor segment of the gas turbine after significant numbers of fired starts had been undertaken.

The persistence of technology issues has led to insurers taking a much closer look at these machines before offering renewal terms. Most insurers will work with their insureds to address the exposure, but they are digging into the operational and maintenance details. At a minimum, they are looking for full compliance with OEM operational guidelines and compliance with technical information guidelines.

Solutions to the design flaws are being sought. Edison Power Research Institute has undertaken a root cause analysis for the industry, as have manufacturers. It is expected that as the root cause is identified, a full design fix can be implemented. Having been through it all before, the insurance industry will look for sustained operation without any further losses before they will consider the technology proven and revert to more normal acceptance of the risk.

At the moment, insurers seem comfortable with dealing with the design concerns through increased deductibles and by imposing mid-level design and workmanship exclusions – normally referred to as either Defects Exclusion 3 (DE3) or London Engineering Group Defects Clause 2 (LEG2). These policy clauses allow consequential loss following a design or workmanship instigated loss, but exclude the specific design or workmanship defects themselves.



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If the situation were to degrade further, the likely stance of insurers would be to either increase deductibles substantially or, worst case, implement more stringent DE and LEG exclusions. This could include resorting to a DE 1/2 or LEG 1, which would remove the consequential loss coverage currently granted. However, most industry observers are confident that the problem will be identified and rectified and that such stringent actions will not be necessary.

Related technology concerns are affecting integrated gasification combined cycle (IGCC) plants. These are the next generation of coal-based power generation systems. In an IGCC operation, a chemical process creates coal gas that is then used as the feed stock for a combined cycle gas turbine unit that is similar to the problematic machines discussed above. This is considered very clean coal-based technology, as emissions are low and much of the by-products, such as mercury, are captured at the primary stage of the process and removed.

Although coal gasification technology is not new, IGCC plants represent a fairly new technology for the US. Insurers will be focused on the overall process, but will pay special attention to the combined cycle gas turbine units being installed as the generation source in the package. Clearly, if the equipment is deemed to be prototype technology, then extra close attention will be paid to it by insurers.

Similar technology issues are arising with the latest line of wind turbines. Now producing as much as three to four megawatts, these machines have seen significant design changes. Insurers will look closely at these units to ensure they are comfortable with the changes.

It appears that the utility industry will continue to wrestle with these issues, as the need for cleaner, more efficient power generation produces technology-related exposures that may be an unavoidable part of risk management for utility operators.

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