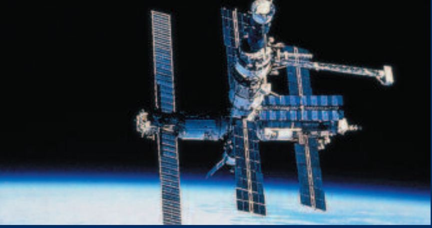


Marketplace Realities 2007

& Risk Management Solutions

Property

November 2006

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

2005 Reviewed *(Very Briefly, We Promise)*

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.

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

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.

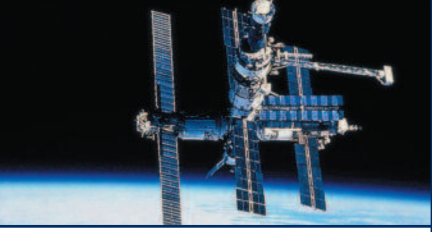
Taking a leaf out of Queen Elizabeth's book, we can safely say that for many policyholders 2006 was an *annus horribilis* of a previously unknown sort. What started out poorly in the first quarter of 2006 quickly degenerated into a total market meltdown in terms of pricing and capacity for many coastal 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.

Willis



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.

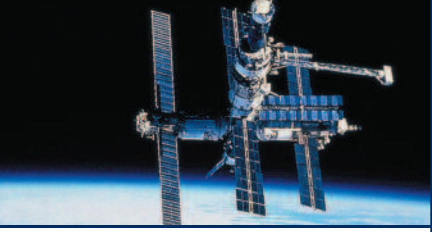
The above is not an apologia for the unrelenting, and to some seemingly unsupportable, development in our coastal areas, nor is it excusing the inexplicable failure of governments to enforce stronger building codes in areas clearly at risk. More intelligent land-use and construction standards must be 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.



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.

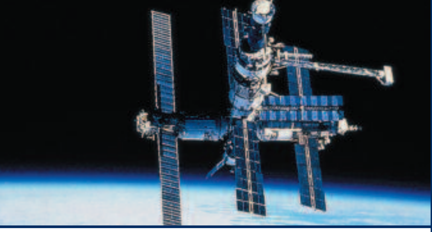
A mild 2006 Atlantic Hurricane Season – in progress as we go to press – may or may not influence the rating agencies' thinking in this area, as there are many factors that influence their analytical approach and their role in the insurance / reinsurance sector. (We invite our readers to download the Willis publication "A Vision of the Future? – June 2006" from the Publications page of www.willis.com. 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 gooses 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



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.

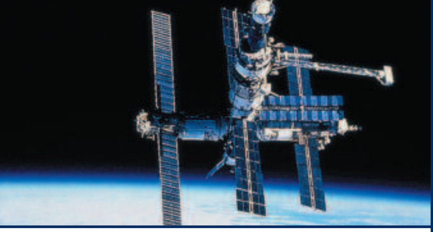
What Does Willis Say?

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.



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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