Marketplace Realities
& Risk Management Solutions

Strategies for a Market in Transition

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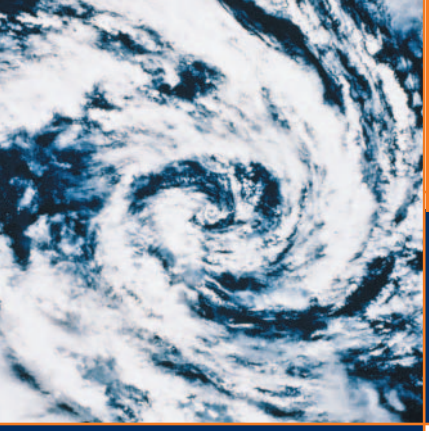

Marketplace Realities 2006
& Risk Management Solutions

Strategies for a Market in Transition

Willis

November 2005

With this edition of *Marketplace Realities*, Willis inaugurates electronic publication of our long-standing series. Approximately every three months, we will provide updated articles – commentary on contemporary issues and marketplace conditions, and white papers treating specific market segments and specialty practices.

Much of the material contained herein was the subject of our webcast held on November 17, 2005 – "Strategies for a Market in Transition". A replay of that webcast is available through our web site www.willis.com until January 17, 2006.

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- Construction
- Directors & Officers Liability
- Financial Institutions
- Healthcare Benefits
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- Reinsurance
- Surety

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Marketplace Realities 2006

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Marketplace Overview

November 2005

Property losses sustained to date in the 2005 Atlantic Hurricane Season are at center stage in marketplace forecasts made by insurers and industry observers for 2006. Forecasters assert that insurers will have to increase pricing due to:

- Capital consumed by hurricanes Katrina / Rita / Wilma (KRW) and other events
- Widespread concern that frequency, severity and volatility of Wind and Flood losses have entered a growth cycle
- The consequent disillusionment with current catastrophe risk models on the part of insurers and reinsurers

Such event-driven expectations need to be assessed in the context of the overall financial state of the marketplace before and after the advent of KRW. At mid-year 2005, the US Property & Casualty (P&C) insurance industry was financially and operationally strong – on its way to its best performance in decades, with a combined ratio of 92.7 percent. In October, Lloyd's announced that they were "on course for a full year profit despite significant impact of hurricanes Katrina and Rita." In October and November, significant amounts of fresh capital were raised by established carriers and by a large new class of Bermuda start-up companies.

What does this mean for insurance buyers? In any marketplace, and certainly for one in the process of sorting itself out, developing a strategy for managing, retaining and transferring risk is paramount. Integral to that is understanding the value and the mechanics of positive differentiation.

Our Marketplace Overview examines:

- The 2005 Atlantic Hurricane Season
- Marketplace Prognostications
- The US P&C Insurance Industry – and Global Capital
- The Road Ahead
- Marketplace Dynamics – and Positive Differentiation
- White Papers for a Multifaceted Marketplace

The 2005 Atlantic Hurricane Season

The lives and livelihoods of hundreds of thousands were devastated by Hurricane Katrina and the storms that followed – a human and economic disaster whose consequences are still unfolding. We have heard citations of benchmarks and milestones that convey a sobering understanding of the forces that have roiled the marketplace:

- The 24 named hurricanes and tropical storms in 2005 set a new record – surpassing the record set in 1933.
- The Big Three in 2005 – Katrina, Rita and Wilma – produced insured losses estimated as high as $60 billion, $7 billion and $12 billion respectively. (The industry's sheer inability to nail down these numbers is a notable feature of the story.)
- Katrina alone eclipsed the 2004 hurricane season – with Charley, Frances, Ivan and Jeanne battering Florida – a record-breaking season itself.
- The above-named windstorms were 7 of the 10 most expensive hurricanes in US history – and they occurred in the 14-month period from August 2004 through October 2005.

Was it any wonder that many questioned the habit and predictive legitimacy of referring to such monster storms as one-in-a-hundred-years events?

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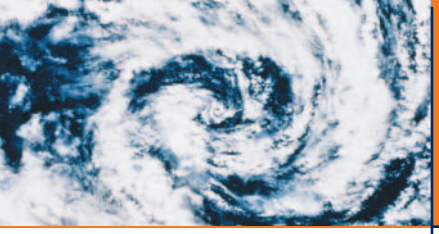

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Marketplace Prognostications

Insurers and reinsurers, whose capacity and capital are on the line, have called for Property rates and premiums to increase. Some observers have postulated that we might expect to see a classic ripple pattern:

- First for Property – commercial and personal – subject to natural catastrophe (Nat Cat) perils of Windstorm, Flood and Earthquake
- Then to some extent for all Property
- And then lapping over into other semi-related and non-related lines of insurance

These ripple effect scenarios are accompanied by plausible rationales:

- The need to replace lost capital
- Requirements by rating agencies for more capital to support current ratings
- Increased cost of reinsurance
- Increase in perceived volatility
- Loss-cost inflation – for materials required to rebuild

Although they are all objectively and intuitively reasonable, we still find ourselves asking:

- Are we truly seeing an end to the period of decreasing commercial insurance risk rates and premiums?
- Are capacity shortages and price increases inevitable, and, if so, to what extent and where?

The US P&C Insurance Industry – and Global Capital

We ask these questions because the financial health and performance of the US P&C industry before Katrina were, in a word, excellent:

- At mid-year, return-on-equity was 15.3 percent … almost half again the ROE of 2004.
- Insurers were on track for their second underwriting profit in 26 years, with a first half combined ratio of 92.7 percent.
- At mid-year, policyholders surplus stood at $412.5 billion – 45 percent greater than at the low point in 2002.

In a position of such strength, existing industry insurers – and a host of new Bermuda-based start-ups – have had no difficulty in raising fresh capital to replenish a good measure of that which was lost.

The Road Ahead

Even in the aftermath of the hurricane losses, the marketplace as a whole appears to be well capitalized and responsive.

Yet from all appearances, we may have entered a new age of windstorm frequency and ferocity. If not quite yet a consensus, there is definitely a sense among underwriters and reinsurers that current models for assessing frequency and severity of Nat Cat perils are no longer reliable. More is at stake than where to find coverage and how much it will cost. Fundamental decisions of where to live, where to do business and where to create capital assets are on the line. The role of the federal government as insurer of last resort is again being reexamined, and there are mixed signals.

It's an unsettled picture, but taken together, we simply do not have a classic set of conditions driving market hardening. Today's conditions are neither as dire nor as widespread as those facing the industry four years ago. Simply put, those factors had never existed before in this business

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The Road Ahead (cont.)

We can easily agree that there is one rather large pocket of uncertainty for the insurance industry – and therefore for insurance buyers – and that pocket is underwriting risk in the Atlantic Basin. How does that translate into Nat Cat capacity and pricing? We can readily predict capacity rationing, attempts to aggregate limits, and an increase in the cost of risk for Nat Cat Perils – because they are all happening right now.

It is the extent of such corrective and precautionary measures that remains to be seen, as is the effect that this segment of the marketplace may have on general market conditions. That naturally leads to the collateral question: will marketplace developments necessarily affect all buyers proportionately?

The answer is no – and not for the obvious reason that all risks are not alike, but rather for the more subtle reason that many risks are perceived to be alike – when in fact, they are not. Shaping the perception of risk is a key determinant of how the marketplace will affect individual buyers.

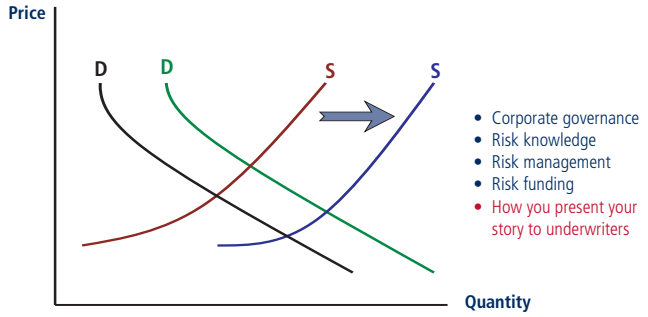
Marketplace Dynamics and Positive Differentiation

The marketplace is in dynamic transition. The parameters, relationships, criteria and choices are all in flux:

- Between risk retained and risk transferred
- Between insurers and reinsurers
- Between preferred risk, commodity risk and problematic or uninsurable risk
- Between private capital and the public coffer

The supply and demand curves – for individual buyers of insurance, for specific market segments, and altogether – are shifting, and all parties want to know where they will be. The excellent news is that every insured has a lot to do with the answer. In the white papers that follow, positive differentiation is a recurring theme. Building and conveying positive differentiation for one's own risk profile has always been a value-laden Golden Rule, and it has never been more important than in today's marketplace. Contained in our November 17 webcast "Strategies for a Market in Transition", the supply-and-demand graph shown below demonstrates the potential motivational and economic power of differentiation.

Positive Differentiation – Motivating the Market



You determine your own demand curve – and you can influence the shape and position of marketplace supply curves

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Marketplace Dynamics and Positive Differentiation (cont.)

One aspect is the obvious one – that you control your own demand curve. Of course, companies may be obligated, contractually or otherwise, to purchase certain kinds and volumes of insurance, but overall, it's your demand curve.

The interesting – in fact, compelling – observation is that you can influence the shape and position of marketplace supply curves. You can move these supply curves – and the further from the origin, the better. How? By virtue of the extent of your knowledge of the nature and behavior of your own risk, by how you manage that risk, by how you fund for it, and – equally important – by how you interface with the marketplace and present your story to the underwriting community.

White Papers for a Multifaceted Marketplace

As we know, the marketplace is the sum of many moving parts. For your review in this first quarterly edition of Marketplace Realities 2006, we present white papers crafted by Willis Associates in the following fields of expertise:

- Casualty – Paul Smith
- Construction – Karen Reutter
- Directors & Officers Liability – Ann Longmore and Jenina Schiller
- Financial Institutions – John Bayeux
- Healthcare Benefits – John Fortin
- Property – Suzanne Douglass
- Reinsurance – Rod Thaler
- Surety – Mike Anderson and Jim Maloney

In the weeks and months ahead, we will be building on this first round of Marketplace Realities 2006 articles with contributions from other Willis Practices and business segments. We invite your comments and suggestions.

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We gratefully acknowledge the following sources for data points and quotations cited in this presentation: Insurance Information Institute; Business Insurance; The Wall Street Journal.

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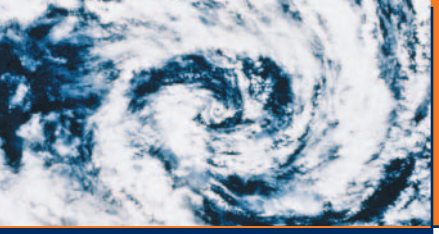

Marketplace Realities 2006

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Casualty

November 2005

Insurer incumbency is at an all-time high as carriers strive assiduously to retain business. In order to attract new business, carriers are carefully targeting specific accounts, classes of business or niche product offerings to meet their objectives. This is not, however, a simple, classic buyer's market. Carriers are underwriting carefully, and integrity of terms, conditions and attachment points are not being sacrificed.

Further, the Casualty marketplace may well be impacted by recent events that so far have been primarily contained within the Property lines. Some insurers will seek rate increases in Casualty in order to meet the cash flow demand of the significant Property losses associated with Katrina, Rita, Wilma and other loss-generating events.

Marketplace Conditions

Global capacity, while nominally abundant at approximately $1.6 billion, is neither homogeneous nor uniformly available. Insurers have individual preferences regarding industry classes, account size, attachment points, potential volatility and other underwriting criteria. The nature and cost of capacity will also depend on whether an insured's program requires participation by insurers who incurred significant Property losses arising out of the 2005 Atlantic Hurricane Season. Large and complex accounts may expect to find carriers pushing for increased premiums in core lines of business, including Casualty. Terms and conditions in the marketplace are not expected to change much from those that have become familiar over the last several years. Commonplace points of underwriting focus include:

- Close management of employee aggregation as it relates to Workers' Compensation
- Insuring financial risk in placements other than General Liability (Errors & Omissions or Professional Liability exclusions)
- Establishing appropriate attachment points regarding Primary and Umbrella/Excess placements
- Development of appropriate retentions to contain expected losses
- Establishing realistic policy terms and conditions based on known exposures (no more throw-ins or "window dressing")

Primary Casualty

For many accounts, Casualty lines remain competitive, with terms and conditions expected to remain relatively unchanged. Underwriter concerns include:

- Employee concentration in large metropolitan areas
- Employees traveling abroad – particularly in and around US military installations or defense bases
- Adequacy of collateral requirements for current and prior policy terms

Umbrella/Excess Casualty

Of particular importance is development of the appropriate attachment point between Primary and Umbrella or Excess. Due to skyrocketing liability verdicts, insurers no longer consider $1 million as the standard. When they do quote at such a level, it is often at a significant premium. Insureds should consider alternatives at renewal, as primary insurers can readily provide liability limits to $2 million and sometimes as high as $5 million.

Another focal point is the policy form. Historically, drop-down provisions were fairly consistent. Today, the differences between Umbrella forms can be considerable. Coverage triggers, drop-down provisions and other policy terms and conditions must be carefully analyzed and compared.

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Legal & Regulatory Environment

Tort reform action on a national level is likely to remain on hold due to other matters that are deemed more pressing. On the state level, activity continues, especially in the area of Workers' Compensation. Varying experiments in reform move ahead with mixed results, guaranteeing only a complex moving target, especially for those with workers in more than one state.

Client Issues

- Insurer financial strength and claims-paying ability are ever important, particularly given the evolving impact of recent catastrophic Property losses
- Medical cost inflation will have a direct impact on insurance rates
- TRIA – there is still time before the law expires, and the marketplace will react once the question of renewal is resolved
- Worker's Compensation aggregation risk is a bright red flag for insurers

Strategies for Tomorrow

Prioritization of program objectives and differentiation of one's risk profile are paramount. While insurers are eagerly pursuing new business, they will not forfeit underwriting integrity for short-term gain, and they are being selective. They will look to create new long-term relationships predicated on a detailed understanding of exposure, loss history and future plans. Key action items for insureds should include thorough, timely submissions, face-to-face meetings with incumbent and prospective insurers, and detailed discussions regarding risk management and corporate goals and objectives.

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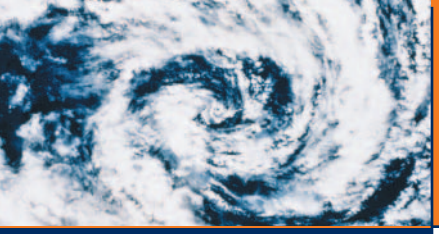

Marketplace Realities 2006

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Construction

November 2005

The Property & Casualty (P&C) marketplace for US construction risks remains fairly stable – in terms of premium costs. Casualty rates for General Liability and Excess Liability are flat or down, depending on risk profile and geographic area. Property rates, of course, are expected to rise given the recent catastrophic windstorm losses, with increases being higher in areas of greatest exposure. As always, retentions and program structures significantly impact rates and the ability of contractors to remain competitive.

In terms of coverage, however, the situation is far from status quo.

Marketplace Conditions

The key issues in the P&C marketplace are not necessarily related to rates, but rather to coverages. In fact, the single most pressing issue facing contractors today is a drastic reduction in General and Excess Liability coverage for Construction risks. There are several reasons for this pull-back by insurers.

- Negative loss development trends on long-tail construction defect losses.
- Actual and anticipated defense costs associated with lawsuits brought by homeowners' associations and/or condo associations, particularly as housing and urban redevelopment projects continue throughout the US.
- Court interpretations that recognize some coverage for losses brought on by poor workmanship. Depending on jurisdiction, courts may deem that there is coverage for certain construction defect losses. We will see this debated in lawsuits stemming from the construction damage brought on by Katrina in New Orleans.
- Unacceptable exposure to contractual risk transfer supported by broad additional insured wording on General Liability policies.

This reduction in coverage is now the topic of national, regional and local seminars among contractors, their financial managers and risk managers. The trend is expected to continue. Key endorsements to watch out for today and in 2006 include:

- Condominium and/or habitational exclusions both on primary and excess liability policies. This is perhaps the number one coverage issue today for contractors, as it impacts all trades, from graders to street and road subcontractors, heating and ventilation subs, dry-wallers, framers, roofers, door and window installers, etc.
- Restricted additional insured endorsements reducing the completed operations period of coverage and/or not allowing for transfer of risk for sole negligence.
- Broadening the workmanship exclusion by eliminating the subcontractor exception. This is significant for general contractors and developers.
- Continued exclusions for the more common risks of mold and EIFS; new exclusions for risks associated with welding fumes and treated lumber, etc.
- Reduced capacity or appetite for professional risks.

Rates may have stabilized, but coverage for some very basic Construction risks is being reduced.

Legal & Regulatory Environment

Legal and regulatory activity related to Construction risks remains lively. First, 37 states have either enacted or are in the process of enacting "right-to-cure" or "right-to-repair" legislation. This is an

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Legal & Regulatory Environment (cont.)

attempt to reduce construction claim litigation by providing a process that allows the consumer/buyer to seek legal recourse only after first allowing the contractor time to correct a construction-related problem. One of the goals is attracting and keeping insurers in certain states, but whether this effort will succeed remains to be seen. For example, California enacted SB800, a right-to-report law, on January 1, 2003, but insurers remain cautious about Construction risks in that state due to a strong plaintiffs' bar related to construction defect litigation. There will need to be long-term, positive results for insurers to consider right-to-cure laws actuarially effective.

Another notable legal trend is the fact that more states are not recognizing "business risk" as accidental and therefore not allowing construction losses to trigger General Liability (GL) policies. A recent case along this line was *L-J, Inc. vs. Bituminous Fire & Marine Ins. Co., 2004 WL 1775571* (S.C. April 21, 2004). This case was ultimately decided by the South Carolina Supreme court, which overturned two lower court decisions. The Supreme Court determined that construction defect loss is not accidental, and therefore is not considered an "occurrence" within a GL agreement and does not trigger coverage. This is troubling to contractors because the Court overlooked case history that found that unintentional and accidental third-party property damage is covered, even though the construction work is intentional and losses are not accidents. Contractors should keep this issue on their radar screen.

Client Issues

In addition to coverage reduction and legal issues discussed above, Construction insurance buyers should watch out for:

- Continued readjustments and reorganizations among Construction underwriters. While some key underwriters keep their messages clear and steady, others continue to analyze and develop their risk appetites and products, and still others are restating their message entirely.
- Increased use of alternative program structures including captives; fronted and gap policies; retentions and alternative structures regarding sharing of defense costs; and controlled insurance programs.

Strategies for Tomorrow

Construction companies are going to need to take care and time with the design and marketing of their P&C programs. Matching their coverage needs with the appetites and offerings of the market will require a different kind of effort than they have required in the past. Buyers should review coverage offerings comprehensively and consider alternative structures. They need to plan for the prospect that insurers may seek to reduce coverage either for the named insured or for their subcontractors. They may well need to amend contract language and/or implement other, non-insurance risk management tools.

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Directors & Officers (D&O)

November 2005

After a short period of relative calm, the Directors & Officers (D&O) market is in transition again. No one should be surprised. Executives on trial account for a large segment of news media coverage. The ongoing impact of Sarbanes-Oxley (SOX), particularly its Section 404 requirement that companies assess their internal compliance controls, has led to a record number of financial restatements, which in turn feed D&O activity. Looking ahead, we see further delays in requiring compliance by small public companies, and we wonder if this will merely defer additional revelations of financial miscalculation and subsequent explorations of liability.

The environment for directors and officers may seem a bit perilous, but some of the trials and appeals of the past year have also been edifying. Outside directors received clear guidance on how their decisions might be judged by the lower Delaware Court. The US Supreme Court affirmed that loss causation is a necessary requirement for damages in securities litigation. The spotlight on corporate leadership, however, remains bright and hot.

Marketplace Conditions

With global D&O capacity plentiful (approximately $2 billion) and showing signs of stability across all industry sectors, the number one marketplace question is not the availability of limits, but rather the cost and usage of these limits. While risk differentiation remains an important part of the underwriting process, a broader, strategic rethinking of limits, rates and risk is common. This holds true for markets bound by treaty mandates and rising reinsurance costs, as well as those with larger net retentions.

Coverage issues that are dominating underwriting agendas include: non-rescindability, severability of warranties, entity coverage, the treatment of whistleblower claims, privacy exclusions, changing pollution wording, and provisions tailored to meet local country exposures.

D&O programs with excellent claims histories and strong financial positions experienced premium reductions over the past year; this may be at an end. Rates for excess layers, which over the past year have experienced some percentage adjustments in correlation to the underlying layers, are likewise stabilizing. Underwriters are in fact setting walk-away points – and may invoke them if premium targets are not met. Additionally, with market capitalization continuing to dictate the limits, rates and retentions of underwriters' public company portfolios, the question of "what is the burn layer" – the most vulnerable exposure base for underwriters – differs for every risk.

The demand for dedicated A-Side policies continued in 2005 following the well publicized WorldCom and Enron settlements involving the personal contributions of their directors. Both the domestic and international markets are active. We expect this demand to continue in 2006, turning focus on dedicated towers and difference-in-condition (DIC) policies.

Legal & Regulatory Environment

The influence of SOX on the D&O legal environment is clear. It can be seen in the increase in criminal actions and, perhaps most importantly, what happens along the way. The resulting plea bargains, whistleblowers and star witnesses, have all served, in some degree, to reform the world of D&O liability and insurance.

Financial restatements lead not only to claims against directors and officers, they also raise questions about the purpose and

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Legal & Regulatory Environment (cont.)

applicability of D&O coverage. For example, will coverage apply in cases where the financials provided to the insurance carriers as part of the D&O underwriting process prove to be more fiction than fact?

Similarly, criminal actions and the specter that the corporation itself may be criminally indicted are reshaping defense strategies and discussions of corporate indemnification. The regulators' interpretation of "cooperation" is being redefined. Plea bargains and guilty pleas may implicate the personal conduct exclusions (regarding illegal profiting and intentional fraud) found in virtually every D&O policy.

On the regulatory side, we have not yet seen any change in tone due to the change in senior leadership at the Securities & Exchange Commission (SEC) – other than the much appreciated delay in implementation of Section 404's provisions for smaller public companies. In another question of corporate concern – that compliance be softened for foreign companies traded on US exchanges – there has been no action and, at this time, none appears likely.

Client Issues

One of the biggest questions for 2006 is whether we will see more personal settlements like those in which the outside directors at WorldCom and Enron contributed their own monies to satisfy D&O claims. While there is no doubt that both of these situations involved highly unusual circumstances, some of the luminaries of the plaintiffs' bar have warned that there are more to come. Similarly, some major D&O insurance carriers have suggested that in negotiations in some mega settlements (in excess of $100 million) plaintiffs have been pushing for individual contributions far in excess of the insurance proceeds.

Perhaps in response to this threat, as well as in recognition of the potential severity of D&O litigation today, many companies and their executives have purchased additional limits of D&O coverage. The question here is not just how much to buy, but for whom and for what types of claims. Should all past, present and future directors and officers (and employees?) be covered? Or just directors? Perhaps just outside directors? Should they be covered for all claims or just non-indemnifiable claims?

Another issue that is garnering attention is the challenge of designing and implementing a D&O strategy for a global company. Will the policies address local tax requirements? Will unique local risks be captured by the global insurance program? These are not simple questions; they require strategic responses.

Strategies for Tomorrow

Despite pessimistic predictions, directors and officers continue to lead their organizations, and employers continue to protect them, in most cases, with insurance coverage. The stakes are certainly higher, and the effort required to properly set up that protection has increased accordingly. Exposures are evolving, and the insurance marketplace responds to the demand. Carriers, while not a particularly sanguine group these days, will find that recent developments will increase their ability to differentiate risks. Similarly, their clients, the corporate executives, will continue to learn that not all D&O policies are alike and that separating the best from the rest can be worth their time and attention.

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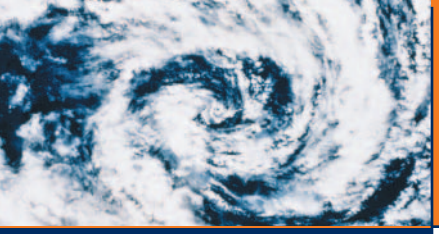

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Financial Institutions

November 2005

Financial institutions face a growing number of challenging exposures – in addition to the familiar basket of standard risks that includes employee fidelity, securities losses, environmental exposures (assumed via commercial lending and real estate operations) and vicarious liability stemming from asset leasing. Our focus here is on certain developing risks that have been "ripped from the headlines":

- The spate of named windstorms in 2004 and 2005, the prospect of more, and the potential for earthquakes in many parts of the US present a mortgage default risk that must be modeled to determine whether and how much additional capital needs to be set aside.
- Exposures may be exacerbated by the evolving operational risk capital requirements deriving from Basel II and the newer Basel IA.
- Banks are increasingly exposed to financial and reputational loss arising from their reliance on vulnerable online technology in the gathering, management and use of customer data.
- The Delphi and Parmalat cases demonstrate that investment banking liability problems have not abated in the wake of the Enron and WorldCom settlements.

Mortgage Default Risk

Banks with asset exposures on the Gulf Coast have already reported that they will face a total of $1.3 billion in defaulted mortgages as a result of Hurricanes Katrina and Rita. Banks and other lending institutions have traditionally relied on the principle that their home equity requirements will protect them against loss from mortgage defaults, but there are flaws in that approach. A large earthquake in California (7.0 or greater on the Richter Scale) would likely eliminate a significant amount of the equity due to diminished property values. Furthermore, banks have been reducing their minimum equity requirements – in some cases granting loans at or even above the full appraised value of the property. In both cases, a borrower might suffer little financial loss (other than the damage to their credit rating) by walking away from the loan. Such behavior is already being observed in the Gulf Coast states.

Regulatory Environment

Meanwhile, banks are contending with an uncertain regulatory environment surrounding the capital requirements of Basel II. The Federal Reserve Bank, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Federal Deposit Insurance Corporation have recently arrived at an agreement that would have banks in the US adopt the new capital requirements more gradually than their counterparts in the rest of the world. These regulatory agencies are also working to develop Basel IA, a separate capital plan for smaller banks – one that would establish new risk-based requirements enabling them to continue to compete with the 20 largest banks.

Federal banking regulators anticipate completing the final agreement amongst themselves in late 2005, with the proposed rule subject to public comment in the first quarter of 2006. Regardless of when and how Basel II is implemented, financial institutions can benefit from the capital techniques that Basel II encourages by making more informed and strategic decisions about insurance coverage, limits and deductibles.

Data Security

It is headline news whenever a bank announces that it has lost a volume of critical, sensitive customer data – or that such data has been stolen by someone hacking into their systems or creating a fake "phishing" web site. The financial and reputational impact can be enormous, making information and data security management a top priority for financial institutions. The internet and computer networks are central to the

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Data Security (cont.)

risk management challenge. Computers and web-facing applications are one of the best places for identity thieves to obtain the personal information that they need to ply their trade.

Insurance coverage extensions for identity theft and cyber liability found in traditional policies do not measure up to the exposures. The development of cyber risk liability policies over the past several years now presents a refined, comprehensive solution for many insureds. Cyber risk policies provide indemnity for losses arising from loss or theft of customer information due to security breeches by hackers or acts of malicious employees.

Corporate Malfeasance – Aiding and Abetting

Delphi's bankruptcy filing has already led to a number of suits against some of its bankers. While it is far too early to gauge what the impact will be, we do know that WorldCom and Enron cost US banks many billions of dollars to settle their potential liabilities. Internationally, many global banks are being ensnared by the Parmalat scandal – one that continues to expand and could lead to significant losses in coming years.

The issue at center stage here is whether or not lending institutions aided and abetted the violators of federal securities law. There are three criteria used to assess whether a financial institution aided and abetted:

- A party other than the alleged aider-abettor violated federal securities law.
- The alleged aider-abettor had general awareness of the primary violation or his or her own improper conduct.
- The alleged aider-abettor provided substantial assistance to the primary violator.

In an Enron decision, a judge expanded the "substantial assistance" approach by finding that even if a gatekeeper / financial institution made no misstatements to investors, directly or indirectly, they can still be liable if their conduct is found to be deceptive. From a coverage perspective, these losses generally begin as an E&O or professional liability issue – and often morph into a D&O claim as well. However, such claims may be regarded as the result of intentional acts – and therefore would be subject to a given policy's Intentional Acts Exclusion.

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Healthcare Benefits

November 2005

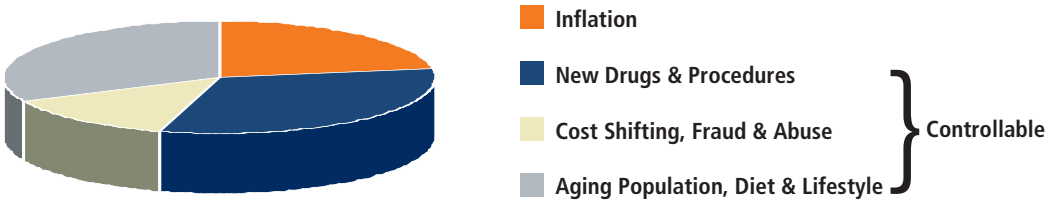
Healthcare costs continue to rise at an alarming rate. Premiums in 2005 increased at a rate of 9.2 percent while most employers are accepting 2006 increases averaging close to eight percent. Premiums would have been even higher – by another two percent – were it not for plan changes that involved higher copayments and coinsurance.

While the 2005 premium increase was lower than the 13.9 percent increase of 2003 and the 11.2 percent figure for 2004, healthcare cost increases continue to be roughly three times higher than both the overall rate of inflation and the average increase in workers' earnings.

Marketplace Conditions

Unfortunately, this trend is expected to continue. We see likely cost increases of 10 percent for 2006 and the foreseeable future. There are a number of factors: inflation, new procedures and prescription drugs, cost shifting from Medicare and Medicaid to the private sector, and an aging, "couch potato" population. Fortunately, there are proven ways to mitigate the impact of many of these factors.

What Will Make Costs Rise 10 Percent 2006?



Many believe the root cause of the upward spiral is the US healthcare delivery system, which insulates consumers from the true cost of care. They contend that the system is broken and enthusiastically endorse consumerism as a tool to fix it. Consumer-driven healthcare plans encourage employees to be better consumers of care through several methods, including higher deductibles and wellness programs.

How are the carriers faring? Marketplace consolidation over that past 15 years has produced higher carrier margins. With less competition, the large carriers' estimated earnings per share increased by over 26 percent at UnitedHealth Group, 21 percent at WellPoint and 30 percent at Aetna between the years 2004 and 2005.

What plan designs are popular? Managed care is in decline, with HMO and POS plans declining from a high of 50 percent market share in 1997 to 37 percent market share in 2004. While consumer-driven plans are still in their infancy, the percent of employers offering a high deductible option is increasing dramatically: five percent in 2003, 10 percent in 2004 and 20 percent in 2005.

Legal & Regulatory Environment

Healthcare has long struggled in a forest of acronyms, from ERISA to HIPAA, COBRA, ADA, ADEA, FMLA and others. Recent additions include HSA and HRA. Health savings accounts (HSA) and health reimbursement accounts (HRA) permit unused fund balances to rollover to the following year. This encourages employees to be better consumers of healthcare.

Nationally, Medicare Part D is being implemented as a way to provide affordable prescription drugs to retirees. At the state level, there are ongoing changes regarding mandated eligibility and benefits for insured plans. These generally result in more complexity, broader coverage and higher costs.

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Legal & Regulatory Environment (cont.)

What is on the drawing board? Accountable health plans have been proposed as a way to promote economies of scale and risk sharing among smaller employers; legislation allowing such plans does not yet have sufficient support. Congress is also considering a cap on the maximum amount of employer healthcare contribution that is deductible.

Client Issues

Not long ago, the benefits manager routinely handled – without a great deal of discussion with senior management – healthcare and other "fringe" benefits. Now, healthcare costs are discussed regularly in the executive suite. The reason is clear: continuing increases in healthcare costs jeopardize margins. Cost shifting to employees is a partial solution – but employees cannot afford annual 10 percent increases any better than the organization. For all the attention healthcare benefits now receive, answers are hard to come by.

Strategies for Tomorrow

Consumer-driven health plans show promise in helping employers provide quality healthcare in a more affordable way. Through innovative plan design, employers are studying how to engage employees and their families to be better consumers. Early adopters of healthcare consumerism in South Africa and in the US have positive results to report:

- Increased generic substitution
- Reductions in emergency room visits
- Decreased prescription drug costs
- Reductions in the rate of medical costs increases

If healthcare cost increases are in fact controllable to a significant degree, it doesn't happen by simply switching health plans. Organizations must make a commitment to a deeper, more strategic understanding of the factors involved. Organizations need to:

- Define their healthcare strategy, including clear-cut goals, plan design, administration and communication
- Understand claims data and their impact on healthcare, disability, paid time off, productivity and turnover
- Measure the return on investment of such programs as wellness and disease management
- Embrace consumerism as an opportunity to educate employees and engage them in a partnership with employers to address the issues
- Reward employees who become better consumers

What is the potential impact? By lowering cost trends by two to four percent per year, a company with 1,000 employees can save from $6.1 million to $11.7 million in health claims costs in just six years. And employees can be the real winners — with lower premium increases and better health.

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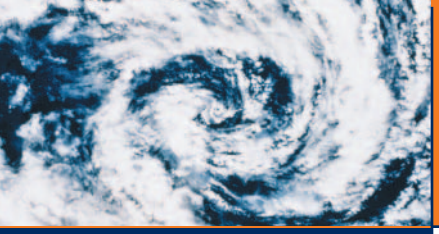

Marketplace Realities 2006

& Risk Management Solutions

Property

November 2005

No one would have imagined that almost three months after Katrina, the city of New Orleans would continue to be, to a large extent, non-functional. Every business sector in that city, for that matter across the country, has been affected by this event. In the city itself, schools and universities, healthcare facilities, real estate and hospitality and infrastructure have sustained significant damage. The levees meant to protect the city remain vulnerable, and by the Army Corps of Engineers' own assessment, they may not be repaired by the start of the 2006 hurricane season.

The delay in restoring New Orleans and other areas affected by the hurricanes presents the potential for upward swings in loss estimates made to date.

Altogether, these conditions make for a volatile mix:

- Demand for building materials has surged throughout the affected areas and beyond – in some cases costs are up over 45 percent.
- With the lack of habitable housing, the labor force is scarce and costs are rising.
- While petroleum prices have stabilized (though at a high level), natural gas prices have soared, causing some companies far from the Gulf Coast to close facilities based on simple economics.
- Contingent losses – those caused by disruptions in supplier and customer operations – are still being calculated.
- Positions announced by certain insurance regulators make claims litigation seem inevitable.

Marketplace Conditions

Program renewals to date in the 4th Quarter have shown the following:

- Some markets were clearly intent on shedding catastrophe exposures and/or not adding to them.
- Fewer rate reductions and coverage enhancements were achieved than in the first three quarters of 2005 – many fewer on 11/1 than on 10/1 – a question of timing post-Wilma.
- More rate increases were imposed at 11/1 – in some cases even on accounts not sustaining hurricane losses – although these were "modest" in the latter case.
- Wind deductibles in highly exposed areas were challenged, but in the main stayed at a range of three to five percent.
- Carriers made some attempts to aggregate Wind peril losses, but to little effect.
- Flood exposures received ever greater scrutiny.
- Some California Earthquake pricing increased, perhaps as a result of carriers' loss of faith in their catastrophe risk models, or perhaps due to the need to defray the costs of treaty insurance reinstatements.

It is interesting to note that a very recent Advisen/RIMS survey indicated pricing increases of up to 20 percent on 10/1 renewals – but such averages cannot be treated as predictive of individual experience in the months ahead.

Perspectives for 2006

Reinsurance Costs – Almost certainly, multi-state and global insurers will attempt to spread the costs of their treaty reinstatement and renewal premiums and seek to satisfy rating agencies and shareholders with replenishment of, or addition to, capital.

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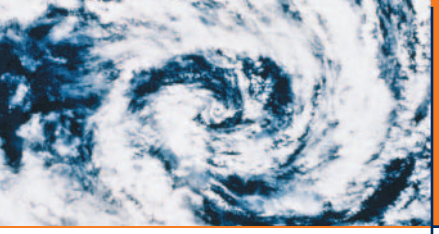

Perspectives for 2006 (cont.)

Nat Cat Capacity – While premiums always command attention, of more concern is the availability of coastal Wind and Flood capacity, at least in early 2006. Will billions of dollars be available where it is needed?

The term "coastal" takes on a new meaning if we consider the following from AIR Worldwide:

- 35 percent of the insurance industry's exposure in the Gulf and the East Coast states is situated in coastal counties.
- Insured property values in coastal counties from Texas to Maine total $7 trillion.

Aggregation Risk – Several attempts have been made before to aggregate Wind, as Flood and Earthquake are aggregated. Will this attempt succeed?

Coverage Extensions – Those most likely, though not exclusively, to be under pressure will be:

- Miscellaneous Unscheduled Locations
- Miscellaneous Personal Property
- Service Interruption
- Contingent Time Element

All of these present considerable, but generally unidentified, exposures for insurers in catastrophe scenarios.

Contract Certainty – Will a march to a multiplicity of insurer forms return? If so, we may face a stiff wind on the road to contract uncertainty.

Client Issues and Strategies

Consider where your company is vulnerable to catastrophic loss – not just Wind, but also Flood, Earthquake, Fire and Terrorism or any other peril that may threaten people, earnings and assets. You know what your risks are.

- Try to reduce your vulnerabilities. This mean improving physical protection, reducing the concentration of your assets in a single location/territory, establishing redundancy in capacity, or increasing the number of critical suppliers and/or customers. Antithetical to today's "lean and mean" business practices? Perhaps. But this is worth revisiting with your corporate governance committee.
- Test your Business Continuity Plans. And when they work, be able to enunciate them to insurers.
- Consider your employees as your most precious asset. If they are not available, where is your business?
- Reassess values at risk. Take into account demand surge, labor shortages and all the other aspects that could preempt your normal calculations of risk.
- Identify and quantify the risks presented by key suppliers and customers and other income-affecting parties.

In short, risk management comes before risk transfer.

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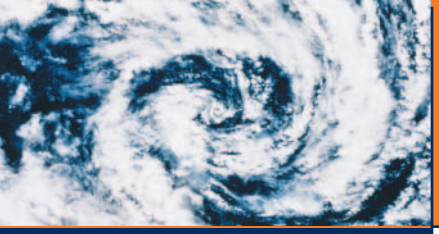

Marketplace Realities 2006

& Risk Management Solutions

Reinsurance

November 2005

The unprecedented hurricane activity of 2005 is bringing dramatic change to the reinsurance industry, change that will affect the way reinsurance is transacted. It will alter the universe of reinsurers and other capacity vehicles, providing interesting alternatives as ceding companies look for more vertical and horizontal protection with enhanced reinsurance security. Unlike natural catastrophes in prior years, Katrina, Rita and Wilma landed successive punches that prompted rating agencies to view reinsurers more critically, differentiating between mono-line Property writers and more diversified multi-line reinsurers. The impetus to require greater capital to support the greater shock-loss volatility inherent in a mono-line Property reinsurer's portfolio will inevitably dampen the supply of catastrophe and per-risk reinsurance capacity – particularly at a time when the demand for catastrophe and per-risk reinsurance is sharply increasing as buyers reassess what their worst case loss scenarios might generate.

Against this backdrop, it is interesting to see how quickly existing reinsurers have accessed the financial markets to "re-load" their capital base. Also, to date, at least seven new start-up reinsurers have been announced. Taken together, over $10 billion of new/increased capital has already come in or been earmarked post-Katrina for the reinsurance business.

Reinsurance Marketplace Conditions

Most of the large global and national commercial Property insurers exhausted their catastrophe reinsurance programs with Katrina, but since many of those reinsurance programs do not renew until mid-year 2006, the expected sharp increases in reinsurance pricing may not be fully manifested until we are well into 2006.

We anticipate that the combined effect of reinsurers reducing their Property exposures and ceding company clients seeking to increase their reinsurance limits will not be offset completely by new reinsurance capacity coming into the business (i.e., new companies and increased capital for existing reinsurers will not completely fill the void).

It is likely that loss-affected reinsurance programs will experience significant increases, although the extent of the increased reinsurance premium outlay may be mitigated by ceding companies taking increased retentions. Also, the implementation of non-concurrent terms (with differing terms applying to new markets that did not incur any losses) could mitigate the increase in ceded premium outlays.

Whereas there may have been $1.5 to $2.0 billion of traditional catastrophe capacity available in 2005 for territorially discrete programs (predominantly personal lines writers), there is likely to be closer to $1.25 billion capacity for such programs in 2006, with less catastrophe capacity available for purely commercial/industrial Property companies' catastrophe programs.

Of perhaps greater concern to reinsurance buyers is the viability of loss recoveries from reinsurers involved in multiple large catastrophe events. As are result we see a pronounced interest in creating integrated solutions to address the need for reinstatement protection, by simultaneously tapping alternative sources of capacity such as hedge funds and capital market vehicles. This capacity would supplement, not replace, traditional reinsurance capacity. The attraction to ceding companies is the ability to diversify their counterparty credit risk so that they would not have all of their eggs in one basket.

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Legal and Regulatory Environment

Rating agencies have already begun to evaluate reinsurers more closely in terms of the makeup of their portfolio, focusing most critically on mono-line Property insurers that have experienced large losses in 2005 (and some in 2004) without the offsetting benefit of other lines of reinsurance (Casualty, Workers' Compensation, etc.) or insurance business. Rating agencies' scrutiny is all the more intense now as they recognize that they cannot rely as heavily upon catastrophe models to accurately gauge the potential impact of large loss events upon a Property reinsurer. Going forward, rating agencies appear to be building in a cushion in terms of capital requirements for a Property reinsurer in order to mitigate concerns over the difficulty in quantifying Property portfolios comprised of large risk and catastrophe exposures. Rather than seek even more additional capital to satisfy rating agencies, we suspect that some Property reinsurers in this situation will trim their overall risk and catastrophe exposures – although it may not be an across-the-board reduction in capacity on all accounts. It should be noted that rating agencies' downgrades have come about regardless of the significant re-capitalization of several reinsurers. This suggests that these reinsurers may be seeking to improve the rating agencies' outlook by providing them with tangible signs that they are controlling their catastrophe exposures (i.e., by reducing their commitments going forward).

Another potential area of scrutiny for regulators and/or rating agencies is the monitoring of letters of credit (LOC) exposure issued by reinsurers. With ceding companies increasingly looking to have reinsurers collateralize their commitments, there is a limit as to how much reinsurers can collateralize, and regulators may be paying much more attention to this issue going forward. With increasing competition from hedge funds and capital market alternatives, the issue of collateralization by traditional reinsurers could take on even more significance.

Client Issues

The issues that clients face in 2006 will vary considerably depending upon the size, geographic scope of exposures, lines of business written and loss situation. For the large global/national insurers writing commercial and personal lines business, key reinsurance issues will be capacity, pricing, risk management, adequacy of limit, catastrophe modeling, market security and contract certainty. For other ceding companies, there may not be the same level of pressure on either capacity or pricing, but adequacy of limit, risk management, catastrophe modeling, market security and contract certainty will still be important issues.

Capacity and Pricing will be a factor for the large global/national companies, particularly on catastrophe and large Property per-risk programs. As reinsurers look to allocate their capacity, minimum rate-on-line standards will again influence program pricing and create the need to restructure layering with new, higher attachment points. For regional insurers, we anticipate that pricing will vary based on experience/exposure, as there is ample capacity available.

Adequacy of Limit – As ceding company clients reassess the adequacy of their vertical catastrophe limit, they will need to more closely examine the increased catastrophe loss severity arising out of coastal pools/ fair plans etc., as the market share of coastal exposure absorbed by these residual market entities will continue to increase significantly. Demand surge for extreme events, approaching 40 percent in some areas, is another factor increasing potential catastrophe loss severity.

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Client Issues (cont.)

Risk Management, namely the extent to which insurance companies manage their own accumulation of risk and peak catastrophe accumulations, will need to be evident to reinsurers. In turn, reinsurers will use this qualitative and quantitative information to differentiate between insurers they choose to support. There is the potential that reinsurance demand will exceed supply for buyers of significant limits of catastrophe reinsurance. Therefore, price will not be the only differentiator. Reinsurers will increasingly practice risk selection, which simply reinforces the need for insurance companies to manage their exposures more conservatively.

Catastrophe Modeling looms as an issue for ceding company clients, but the problem is not with catastrophe modeling *per se*. Rather, the challenge is due to some reinsurers' and rating agencies' near total preoccupation with catastrophe models to the exclusion of all other forms of catastrophe exposure analysis. Catastrophe models have been embraced as a short cut, a common denominator that could be applied across a given industry, and yet some astute lead catastrophe risk markets never stopped using other catastrophe exposure analysis tools – which may yet come back in vogue.

Market Security – The sizeable percentage of policyholders surplus lost by some reinsurers in Katrina serves as a sober reminder of the need to evaluate reinsurers' security closely. Going forward, buyers of reinsurance, not unlike rating agencies, will need to ask more questions about how their reinsurers manage their catastrophe accumulations. Does the reinsurer purchase any retrocessional protection, and if so, what is the quality of the retrocessionaires? Is there any designated quota share or contingent capital that expands the resources available to support the reinsurer's commitment?

Contract Certainty – Understanding and agreeing upon the contractual basis of reinsurance coverage *ab initio* – from the inception of the contract – is vital. For clients and their brokers this means conducting thorough contract wording reviews 90 to 120 days prior to renewal so that the desired renewal wording can be presented to reinsurers with sufficient lead time.

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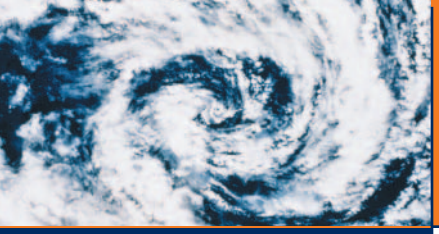

Marketplace Realities 2006
& Risk Management Solutions

Surety

November 2005

The following is an update of the bulletin issued on May 19, 2005, in conjunction with the Willis webcast The Unsettled Surety World.

Losses and consolidation in the primary and reinsurance ranks of the Surety industry have progressively and significantly reduced overall capacity. For example, in 1995 Reliance was the number one ranked Surety in 1995. Today, St. Paul / Travelers tops the list, having absorbed the surety businesses of Seaboard, USF&G, Aetna, Fireman's Fund and Reliance along the way.

Why? From January 2001 through June 2005, the Surety industry has sustained paid and reserved losses exceeding $9.8 billion. Contract Surety losses have been at unprecedented levels. Commercial Surety – constituting about one-quarter of total industry premium and historically a line of business with predictably low losses – has posted loss ratios close to and well in excess of 100 percent in three of the past four years. Many insurers have looked at their overall Surety operations and have come to the conclusion that capital can attract better returns, and with less volatility, elsewhere in other lines.

Implications for Buyers of Surety

- Capacity remains an issue for aggregate programs above $250 million. There are 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. Further, sureties continue to scrutinize the credit risk associated with co-surety partners. Many clients are well-served by putting in place a "Stand-by Surety" relationship (sometimes a co-surety can serve this dual purpose) to protect against unforeseen marketplace issues.
- Single Bond Size Limitations may be imposed by surety(ies) on contractors that do not have a joint venture partner. 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 continue to have an influence on sureties' underwriting approach. This has manifested itself through underwriting discipline (more adherence to traditional underwriting ratios, personal indemnity, quality submissions, flow of information, ease of analysis, etc.); pricing (a stabilizing, but continued market bias toward higher rates); higher retentions (leading to limited appetite for aggregate exposure on any single client's account); and additional security and/or collateral requirements (to cover net risk retained by the surety).
- 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
- Availability of Surety credit may affect a firm's valuation and its shareholders' ability to transfer ownership of the business.

On What Do Sureties Focus?

In addition to the traditional underwriting of a firm's financial performance and business plan, sureties continue to underwrite risk-specific characteristics of individual bond requests from clients.

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On What Do Sureties Focus? (cont.)

Some of these risk factors may result in one-time pricing and security requirements that deviate from the client's standard bonding facility.

- Contract Duration – Duration greater than 24 months may result in changes to pricing and terms
- "Under-engineered" Designs – Not only for potential liability, but schedule risk will also be assessed by the underwriter
- Subcontractor Default Exposure – Sureties underwrite their clients' own risk management practices, including their subcontractor selection criteria
- Warranty / Maintenance Periods – Maintenance or warranties in excess of five years are unlikely to be approved without additional security or collateral
- Performance Efficiency Provisions – May result in 'exclusion' 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
- Materials Escalation Clauses – Sureties will ask how the client has protected itself against unforeseen price increases during the course of the contract
- Bond Forms – Deviations from standard language unlikely to be approved without additional security
- Residential Projects – Sureties focus on the 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

A View Forward

The Surety market will continue to be unsettled, with no indication of any broad market softening for large buyers before the end of 2006. The middle market continues to be well-served by a number of quality sureties and capacity is less of an issue. The credit considerations discussed above remain the same, however.

Further industry consolidation is likely for both sureties and their reinsurers. Financial ratings, driven largely by rating agencies' examinations of loss reserve adequacy, will be a primary factor that can impact a client's surety facility, sometimes literally overnight.

Even in the midst of such unsettled conditions, positive differentiation remains paramount in achieving preferred terms. Well managed firms with a sound credit profile will attract surety underwriting support.

A Client's Surety Best Practices Checklist

Maintaining strong partnering relationships will reduce chances of the unsettled surety world negatively impacting a client's business. Planning and communication are the key elements to dealing with continued uncertainty. Accordingly, we work with our client to secure answers to the following 'Best Practices' checklist and to act on their implications:

- Am I completely familiar with my Surety submission and the on-going work product representing my company?

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A Client's Surety Best Practices Checklist (cont.)

- How does the Surety analyze my company?
  - Review my Surety's financial analysis – 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 'Stand by Surety'?

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