NEW REALITIES

The 2009 edition of *Marketplace Realities and Risk Management Solutions*, our long-standing series on the insurance marketplace in every major line and industry sector, is one of the biggest we have produced, and fittingly so. On October 1, 2008, Willis North America and HRH joined forces, doubling our size and forming a new leader in risk management in North America: Willis HRH. This collection represents our first major joint publication effort. It also reflects a vast array of talent in every aspect of risk management, spread over 210 offices in the United States and Canada. We are bigger, we are better and we are more able than ever to provide insight, guidance and support to our clients. This publication is one way we do that.

The timing of this publication is in several ways extraordinary, coming on the heels of our recent combination, which itself happened in the middle of the financial industry storm that inspired the subtitle of this publication. Several times we pushed back our publication date, to allow our authors to catch their breath and keep up with unfolding events. We finally could wait no longer, and decided to publish this inaugural issue of the 2009 series in two parts. In addition, we intend, as we have done in recent years, to publish updates to the 2009 edition throughout the year.

Prognostication is a tricky business. If, in hindsight, your predictions are correct, then your word is gold. If not, then the value placed on your opinion tends to resemble the financial markets of the past few weeks. Putting out a forecast in the middle of unprecedented turmoil seems in some ways foolhardy, but risk management decisions cannot wait for events to take their course. They must be made when they must be made, as carefully, thoughtfully and prudently as possible. To that end, we go to press with our best estimation of what lies ahead. We hope you find the insights contained here useful.

Don Bailey
Chairman & CEO
Willis HRH
The inaugural issue of the 2009 *Marketplace Realities & Risk Management Solutions: A Different Kind of Cat* will be published in two parts. This document includes Part One.

**PART ONE**

- Preface
- Introduction/Overview
- Property
- U.S. Reinsurance
- Employee Benefits
- Environmental
- Personal Insurance
- Terrorism
- Industry Segments:
  - Aviation
  - Construction
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**PART TWO**

- Casualty
- Workers’ Compensation
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- Employment Practices Liability
- Fiduciary
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- Bermuda Markets
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- Industry Segments:
  - Life Sciences
  - Utilities

Each article is internally numbered to facilitate its use in stand-alone fashion.

We also invite readers to visit the Publications page of [www.willis.com](http://www.willis.com), where you will find many other articles and studies of immediate and enduring value to risk managers, financial executives and corporate governance stewards of every stripe.

*Marketplace Realities* is updated on a quarterly basis throughout the year.
A DIFFERENT KIND OF CAT

A whole different kind of hurricane blew through the insurance industry this past September. The subprime/credit default swaps/credit crisis made landfall where only a sage few predicted it could: right in the middle of the financial system of the U.S., and, thanks to an interconnected 21st Century global economy, the financial system of the world. The largest insurance company stood on the brink of collapse. We held our collective breath.

A couple of weeks before, Hurricane Ike ripped through Texas, leaving devastation and tragedy in its wake. This was, terribly enough, more familiar to us. Hurricanes happen, and we have a rough idea of when and where they are likely to strike. We try to prepare, either as individuals in the path of the storm, or as professionals whose entire industry is based on the idea that risks can be transferred and mitigated.

Ike was a disastrous event. When all the losses are calculated, it will likely rank as the third costliest storm ever behind Katrina in 2005 and Andrew in 1992. And yet, the word from most industry commentators is that the insurance marketplace will be able to absorb the shock. Two years of a soft market have made many people wonder aloud what will make the market turn, and a major cat event, many say, certainly could be the thing to do it. Ike – maybe not alone but in a context of other losses and financial turmoil – may well be that event. It will certainly contribute, especially in markets more directly impacted.

At the same time, few question that the industry surpluses of 2006 and 2007 laid a strong and resilient foundation. Another way to put it: the system is working.

The same, perhaps, will prove true of the financial storm still blowing through the world’s economies. Insurers by and large stayed away from the riskiest investments. Yes, tightening credit ripples through the economy, and carriers are not immune. But a sense of resiliency remains. Even in the eye of the storm, AIG’s insuring units are reported to be as strong as ever.

Taken together, the two big storms will have a lasting and deep impact on the conduct of business for most of us in the year ahead. However, as the cleanup work continues in both cases, and we examine what losses must be paid and what lessons can be learned, we in the insurance industry can begin to exhale.
For a more detailed examination of overall market conditions, we offer below the Willis Market Security Report of October 20.

**IMPACT OF THE CREDIT CRISIS ON GENERAL INSURANCE COMPANIES**

On October 7, 2008, International Monetary Fund increased its estimate of global losses from the financial meltdown to $1.4 trillion, driven by asset write downs, credit losses, downgrades of structured finance pools, bond insurers and banks. Although some of the less traditional activities of insurance groups have been impacted, so far the general insurance sector appears to have proved relatively insulated from the hardest impacts of the credit crunch, with relatively few rating actions affecting insurer financial strength. However, as we move toward the Q3 earnings reporting season this sector will be under increasing scrutiny with a number of losses being preannounced already.

Although some of the less traditional activities of insurance groups have been impacted, the evidence to date suggests that general insurance operations have incurred relatively low exposure to the direct impacts of this credit crunch.

Unlike banks, general insurance companies did not play a key role in each link of the chain of transactions that originated mortgage loans and subsequently bought, warehoused and distributed the derivatives to investors throughout the financial sector. General insurance companies did not become as leveraged as many other institutions to positions in those securities, nor did their business models involve being “risk traders” in these credit products. Their investment portfolios typically contain smaller proportions of subprime-exposed collateralized debt obligation’s and lower tranches of mortgage-backed securitizations compared to banks, while their underwriting portfolios typically avoided offering credit protection for assets impacted by the credit crunch. Furthermore, unlike investment banking, it is not generally within the business model of an insurer to rely on ultrashort-term funding. When the short-term funding markets ceased to function normally, the immediate exposure had costly and rapid implications.

Ironically many of the insurers’ strategic ventures that have been impacted by the credit crunch were those that could only be entertained because of their strongly rated businesses. They include banking, mortgage lending, mortgage insurance, financial guarantee and capital markets activities, including the underwriting of credit derivatives. None of these activities are traditionally characteristic of the general insurance sector, but some insurance groups have ventured into these lines through subsidiaries or affiliates. Thus the headline issues that have afflicted a small number of nevertheless prominent insurance groups tend to relate to issues more often associated with banks and financial superstores than general insurance. It is important to note that within such groups, the insurance operations will not necessarily be burdened by the results of these non-traditional activities where they are tied to other legal entities of the group.

The extent to which general insurance operations are being indirectly impacted by the turmoil is likely to become clearer over the coming reporting periods.

**INVESTMENT ACTIVITIES AND RESULTS**

The majority of major insurance companies have reported falling investment income in recent quarters due to deteriorating investment returns. All general insurance companies hold significant portfolios of fixed interest
securities, including government, agency and (largely high investment grade) corporate debt. During Q3, the continued credit market dislocation has caused fixed income corporate spreads – particularly financial sector corporate debt – to widen markedly. These changes result in adjustments – usually accounted as temporary – that will continue to impact insurance company balance sheets as provision is made for unrealized investment valuation changes. Whether or not these are reported as a loss within the income statement depends on accounting basis, but the effect is to reduce shareholder funds. Further declines are also anticipated for those insurers with sizable equity portfolios, where significant volatility and declines in valuation will result in insurance companies making provisions for these portfolios too. Regulatory regimes and rating agency models tend to be more punitive against insurance companies holding equity portfolios. General insurance companies are typically less leveraged to equities than other financial institutions. Other sectors of the insurance industry, specifically the Life sector, are expected to experience greater volatility in this respect.

UNDERWRITING ACTIVITIES

General insurance companies rarely undertake insurance of structured finance assets such as collateralized debt obligations or mortgage-backed securities; these tend to be the realm of the monoline specialist bond insurers. The direct impact on insurers’ underwriting portfolios has been mainly within E&O and D&O lines where liability claims may be made. Again, those insurance companies holding significant portfolios of D&O and E&O business have tended to be stronger, more highly rated companies. Claims related to subprime-related litigation will take time to evolve; the aggregate estimates of insured market loss in this regard vary significantly, ranging from around $6 billion to $20 billion. To date, insurance companies have absorbed D&O and E&O losses within their overall reserved loss ratios or have modestly increased their ongoing forecast ratios. For other lines of business, there is some argument that, historically, market dislocation has resulted in an increased focus on pricing discipline and therefore the current environment may result in moderation of the soft market phase of the insurance cycle.

FINANCIAL FLEXIBILITY

Even though general insurance companies have avoided the spectacular charges seen by banks, investor sentiment has moved adversely against the whole financial sector over the past year and, within recent weeks, insurers have not been immune to this. General insurance companies are trading at lower multiples than they have for many years, spreads on their corporate debt are higher and their ability to raise capital or borrow is more restricted than would have previously been the case. Arguably, in many cases, insurance companies went into the crisis better capitalized as a result of retained earnings and higher rating agency requirements than had been the case before. However, with the continued market dislocation and higher catastrophe and large losses reported in Q3, a number of general insurers have undertaken actions to maintain capital levels, for example, reducing dividends or ceasing share buyback activities. With anticipation of reductions in both book value and market capitalization of general insurance companies in the coming reporting seasons and debt markets continuing to be cautious, the ability of general insurers to raise additional capital, should it be required, will be reduced.
OUTLOOK

A number of pre-announcements of earnings statements have forewarned that Q3 results will be impacted by asset write downs, corporate defaults and increasing bond spreads. In determining the extent of the impact of the credit crisis on the sector in the longer term there are, however, still several uncertainties:

- The impact of current and future government intervention on the financial markets
- How the insurance industry would respond to and recapitalize from a mega catastrophe or series of major losses
- The extent to which the housing sector continues to deteriorate
- Whether other areas within the financial sector still have exposures that spill over into the insurance sector
- The extent to which economic changes impact the claims environment

The effect on specific insurers is difficult to assess. In analyzing any particular general insurance company there are a number of factors that must be considered. These include the risk appetite of the general insurance company both from an underwriting and investment perspective. The impact of an insurance company having to rapidly liquidate its investment portfolio and the resulting realization of losses should also be taken into consideration. The valuation method utilized for certain assets will also have impact. Mark-to-model valuations are likely to be less reliable than mark-to-market methods as they rely upon assumptions in the models, which could assume a degree of liquidity that is achievable.

RATING AGENCY ASSESSMENT

Rating agencies continue to have significant importance in assessing the financial strength of insurance companies. The recent turmoil highlights the importance of them combining an understanding of the financial strength of individual operating entities, group structures and their interaction with and dependence upon global financial markets.

To date, major rating actions within the general insurance sector have been few and far between, with the notable exceptions of AIG, Fortis and XL, which remain within the strong rating categories. The rating agencies are largely maintaining their stable outlooks on the general insurance sector as a whole but note that further market disruptions could generate downgrades.

CONCLUSION

The general insurance sector as a whole appears to have remained relatively isolated from the direct impact of the credit crisis so far. While there have been some, notable exceptions, these have been companies that have stretched the boundaries of traditional insurance, taking them to more of a financial superstore structure. There will inevitably be some wider impact on the investment portfolios and investment returns of general insurance companies that will become evident throughout the coming reporting seasons. With the anticipated moderation in the soft phase of the insurance cycle, the relatively stable rating outlook for the general insurance sector currently appears reasonably justified, but will inevitably be subject to review as financial market turbulence and attendant market sentiment plays out over the coming months.

Disclaimer: The information contained herein is not prepared for and should not be construed as providing investment advice or services. It is not a comprehensive study and should not be relied upon nor treated as such. This document speaks only as of its date.
APPLYING THE BRAKES AT AN UNPRECEDENTED CROSSROAD

At the end of 2006 we began to wonder if predictions of a soft Property market would become a self-fulfilling prophesy in 2007. In the fall of 2008, we are some 18 months into one of the softest Property markets any of us can remember. That we continue in a soft market is a fact, but we cannot help but wonder once again if we might be at another crossroads in the market cycle.

In previous discussions of the softening Property market, we have usually tempered our message with the caveat that it has not been in a precipitous free fall. This is due to various braking mechanisms put in place after the record hurricane season of 2005, such as stricter capital requirements imposed by rating agencies and more robust catastrophic modeling systems.

Very likely, the typical insurance buyer with moderate exposures and a good loss history has seen healthy, if not massive, reductions in one of its last two renewals (2007 and 2008). It is much less likely that they have seen massive reductions two years in a row. The market is ultra-competitive, but not to the point of being irresponsible from a fiscal and underwriting standpoint. Why is that?

Another braking mechanism at work today is a by-product of neither regulation nor technology, but of human nature. In the attacks on 9/11 and the combined hurricane losses suffered in Katrina/Rita/Wilma, the Property insurance community suffered through two once-in-a-lifetime scenarios within the span of roughly four years. Insurance company management felt compelled to look at underwriting processes with an eye toward another worst-case scenario. Perhaps even more importantly, insurers seemed ready at last to act on the oft-spoken but rarely followed advice: maintain as much discipline as possible in the underwriting process regardless of the current insurance cycle – and do not ignore the state of the overall national and global economy.

As a result, the underwriting and financial sides of major insurance companies seem to be more in sync in this softening market – in essence, the left hand (underwriting) knows what the right hand (financial management) is doing. This gets us to our potential crossroads.
MOUNTING LOSSES

Underwriting conditions are worsening inherently with the continued softening of the market. Property rates/premiums continue to erode. The words used to describe recent rate decreases range from “healthy” to “massive” for clients with moderate exposures and good loss histories. Even the modest end of the range involves double-digit reductions. While rates decrease, policy terms and conditions continue to broaden. All of these trends are of course fueled by intense competition among insurers for market share.

Underwriting results are beginning to suffer discernibly for the first time in this soft market – newfound discipline notwithstanding.

Let’s look at how we got here. Insured catastrophic losses in 2007 were relatively mild and, as expected, the industry posted underwriting profits just about across the board. But early indicators of deteriorating results were already appearing. While the U.S. P&C industry posted an underwriting profit in 2007, net income declined from 2006 results and net premiums written declined for the first time in more than 60 years.¹

Troubling trends continued through the first half of 2008.

Catastrophic losses were not relatively mild in the first half of 2008. In a July posting from A.M. Best², first half catastrophe estimates reached $8.9 billion due to heavy tornado, flood and wildfire activity. Estimated incurred catastrophic losses for the first half of 2008 will exceed the total catastrophic losses for all of calendar year 2007. These catastrophic losses, combined with noncatastrophic losses for the year, have generated predictable financial results in the P&C industry.

U.S. P&C income was down in the first half. Net income after taxes fell to $15.9 billion, according to A.M. Best³. Annualized after-tax return on equity, which takes into account worsening underwriting results and investment returns, fell to 9.5% for the year ending June 30, 2008. This compares to 14.2% for the same period ending June 30, 2007.

FIRST-NAME BASIS

All this before Q3 – hurricane season. For several years forecasters have been predicting a higher-than-average number of named windstorms for the Atlantic Hurricane season. This year they were right. Arthur, Bertha, Cristobal, Dolly, Edouard, Fay, Julio, Gustav, Hanna, Ike, Josephine and Kyle have all made their presence known so far in 2008.

The national media will tell us that the U.S. got lucky with Hurricane Gustav. Only in the context of Hurricane Katrina would estimates of $7 billion in insured losses be considered lucky. Information is still being collected on Ike. The massive power outages resulting from this hurricane have rendered damage assessment slow and difficult. Insured damages from Ike could end up in the range of $20 billion to $25 billion.

The confluence of a softening Property market and a steady rise in catastrophic losses is producing underwriting results that may begin to significantly erode the excess capital currently prevalent in the marketplace.

Now for the right hand in our analogy, the financial side of major insurance and insurance-related companies. Traditional property perils such as flood, windstorm and fire are not the only factors contributing to rising combined loss ratios. Losses in the mortgage and financial guarantee marketplaces have contributed as well. The subprime banking crisis and ensuing credit crunch have touched the insurance industry broadly and impacted a handful of major players in our marketplace rather significantly.
WITNESSING THE IMPOSSIBLE

AIG is universally recognized as a leader in the global insurance marketplace, with key positions in most product lines. AIG also has complex and substantial positions in many aspects of the global economy that go far beyond the realm of insurance. AIG's adverse positions in the global financial markets led the company to a liquidity crisis that had them teetering on the verge of bankruptcy the week of September 15, 2008. An $85 billion two-year bailout loan from the U.S. government will give AIG time to strengthen its liquidity position.

As many have noted, the insurance operations of AIG are considered solid and are preparing to weather the storm. Lexington has negotiated a cut-through agreement with Berkshire Hathaway that would be available for certain eligible clients and would be triggered in the event of Lexington's liquidation. The intended purpose of this cut-through is to allow AIG access to AAA-rated paper in the event that loan covenants for certain clients require ratings higher than currently published by particular rating agencies.

The crisis affecting AIG certainly grabbed the world's attention, but it is only a cog – a fair-sized cog but a cog nonetheless – in the overall crisis the U.S. economy is facing. At the time of this writing, other iconic U.S./global corporate institutions have already dissolved into bankruptcy, and the U.S. government has put together a bailout of our economic system as a whole. Trepidation over the U.S. economy, stock market performance, energy costs, real estate pricing, etc. further focus insurer attention on weakening investment returns.

Extreme conditions often breed extreme responses. But we circle back to the braking mechanisms that have emerged in the last few years.

It is safe to assume that the perception and reality of weakened investment returns will expose poor underwriting results to insurer management. We believe that what they find will be different from what they found after 9/11 and the 2005 hurricanes. Insurers had lent a blind eye to poor underwriting results in the 1990s due to fantastic investment returns in the financial markets. We think lessons were learned.

There is no doubt, however, that the commercial Property market is truly at a crossroads.

POSSIBLE SCENARIOS

We do not want to over-sensationalize the AIG crisis, but we do think a significant amount hinges on how AIG/Lexington chooses to proceed from this crisis in terms of its Property underwriting philosophies. The company, particularly Lexington, currently holds aggressive and critical positions on a sizeable percentage of major Property placements throughout the world. Lexington is one of the AIG insurance entities that operates at a healthy surplus and with still-healthy ratings.

Will AIG continue to underwrite aggressively to maintain market share, stave off competition from the balance of the market and continue to prove to clients that business as usual continues on the underwriting side? Or will they opt to take a more conservative stance to ensure that underwriting results are as healthy as possible as the parent attempts to emerge from the terms of its loan pact with the government? Finally, how will the balance of the Property insurance market shift its philosophies and tactics to take advantage of a marketplace that might well be in flux?
The answer to these questions will tell us a great deal about what market we are facing heading into 2009. If it is business as usual, we believe that the market will continue to be soft but will start to flatten out. We can envision this particularly on large Excess placements, where prices are currently at extremely low levels. If Lexington changes its aggressive philosophy on primary business (and we are not in any way implying they will), this will open the market to increased competition. Usually competition drives prices down, but the retreat of an aggressive leading player could push prices up. In this scenario, we expect the latter.

Considering all of the factors at work, do we believe the soft market is coming to a close? Even a few weeks ago, we would have said no, despite all of the evidence presented above. Do we believe that the market is going to harden overnight? No, we do not. What we are saying is there are enough indicators, without taking into account the AIG scenarios, to suggest we have reached the bottom of the soft market cycle and market tightening is imminent. This is a time for buyers to keep refining soft market strategies. If navigated with caution, a crossroad is an opportunity, not a road block.

We continue to advocate taking premium reductions to the extent they are rationally available but then concentrating on making programs more efficient, identifying critical policy terms and conditions that have value to each organization, and exploring deductible options that suit risk management appetites and general business strategies.

**CONTACT**

Pete Conway  
Willis HRH Property Practice  
212 907 6310  
pete.conway@willis.com

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2. *Best Wire Services,* July 8, 2008, A.M. Best  
U.S. REINSURANCE

ECONOMIC WINDS OF CHANGE

Through August 2008, the reinsurance market was operating in classically soft conditions. The low interest rate environment and weakening economy placed continued downward pressure on top line premium growth, fostering further competition.

September brought us the landfall of Hurricane Ike, the deepening credit crisis, and the U.S. government intervention to shore up AIG and the financial sector. Will the combination of these events be sufficient to bring about a turn in the reinsurance market in 2009?

Compared to others in the financial services world, reinsurers can mostly count themselves among the fortunate these days. So far, they have not been deeply affected by the credit crisis. Yes, insurers and reinsurers are facing significant claims from Hurricane Ike, but the season’s earlier storms, Dolly, Fay, Gustav and Hanna, are likely to be substantially held by ceding companies within reinsurance retentions. Overall catastrophe losses currently remain well within the reinsurance market’s capabilities. Should there be a catastrophic event that significantly depletes the market’s capital reserves, the credit and liquidity crisis would hit home, as raising new capital would be much more challenging than it has been in recent years. If no such event occurs, the tightening of the financial markets could make reinsurance look like a more attractive form of capital.

Another factor that could reverse the soft climate is an increase in demand. Some insurers are looking to increase their reinsurance programs in order to be able to offer greater capacity, particularly with regard to Fortune 1000 and large national accounts. Many insurers in this space also expect a return to subscription policies for primary limits, utilizing more than one carrier, as original clients seek to diversify in pursuit of a broader panel of insurance security. In addition, we expect demand for Florida-exposed Property reinsurance to increase, given the recently identified potential shortfall in post-event bonding capacity available to the Florida Hurricane Catastrophe Fund (FHCF).

Given this increased demand, reinsurers will be looking to deploy their capital to best advantage and support those cedants who can demonstrate that they are well positioned to benefit from market dislocation. It is conceivable that the combination of increased reinsurance capacity demand, a shift to better quality (and more diversified) reinsurance security and reinsurers paying larger-than-expected losses from Hurricane Ike could have a market turning effect. However, any general market movement will likely be led by the reinsurance market as we proceed into 2009.
There is evidence that inflation is on the rise, which, based upon the pronouncements from several large reinsurers, may affect assumptions with regard to loss reserve and pricing adequacy and, in turn, lead to a market hardening. These inflationary factors can have a disproportionately leveraged effect on ceded excess-of-loss reinsurance, leading to a tightening reinsurance market before a general insurance market turn.

The currently unstable investment environment will increase reinsurers' focus on attaining pure underwriting profits. Additionally, in view of recent primary pricing trends, it seems likely that reinsurers will not be able to rely on reserve redundancies to boost calendar year results, as they have over the past few years. While both the investment environment and reserve levels will clearly influence the direction of reinsurance pricing trends, low investment returns over the preceding few years have already renewed a focus on underwriting profit. Some argue that capital and reserve levels may serve as a better barometer of immediate market movement.

If the market is in fact ready to turn, how sharp might it be? According to the Insurance Information Institute (III), U.S. P&C surplus has increased by 80% since the last hard market in 2002. In absolute terms, the industry surplus stood at $518 billion as of year end 2007. In relative terms, the growth of surplus has far outstripped the industry's assumption of risk, as measured by premium writings; III has observed that as of year end 2007, the industry premium-to-surplus ratio was near a record low of 0.84. Although reserve levels have been generally decreasing of late, the industry seems to be in a stronger position than it was prior to the last hard market. Thus, the current market does not face the immediate pressures that it did in 2001, and barring further balance sheet deterioration, a stabilization of pricing seems more likely than an outright hardening.

As for the competition between reinsurers in the marketplace, buyer scrutiny of reinsurers' financials can be anticipated, with the advantage going to collateralized markets and well capitalized, highly rated participants who have transparency and clarity in their portfolios. As we have said, cedants may look to diversify their exposure to any one reinsurer as they reexamine their plans in these uncertain times.

**PROPERTY**

The first half of the year saw higher-than-average tornado and hail losses in the Midwest. In the first six months there were 25 catastrophe losses declared by ISO's Property Claim Services totaling $9.4 billion, exceeding the total for either 2006 or 2007. While most of these losses will be kept within cedants' retentions, multiple storms will produce losses to aggregate catastrophe reinsurance programs designed to protect against a series of smaller catastrophes. The chart below shows insured U.S. natural catastrophe losses since 1988.

![Insured Losses and Number of Events](source: ISO's Property Claim Services Unit; Insurance Information Institute.)
An active tornado/hail season was followed by an active hurricane season, with the number of Atlantic hurricanes spawned as of this writing already matching the long-term average for the full season.

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<th>Tropical Storms</th>
<th>Total Hurricanes</th>
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<td>7</td>
<td>4</td>
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<td>1995-2007 season average</td>
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<td>7 - 11</td>
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Initial estimates for Hurricane Ike indicate that it will likely be the third most costly U.S. natural catastrophe loss, behind Hurricanes Katrina in 2005 and Andrew in 1992. Consensus is building that the Ike loss could be greater than $15 billion, including a $3 billion to $3.5 billion contribution from offshore losses. The Texas Windstorm Insurance Association (TWIA) has already assessed members $430 million, representing at least a $2.1 billion loss to TWIA with much of the balance being provided by their $1.5 billion reinsurance program. It is noteworthy that the current loss estimates from the modeling companies and PCS, high as they are, seem low relative to the current loss estimates being provided by public companies.

In addition to catastrophe activity, there has been a significant increase in both frequency and severity of large, single risk Property losses affecting the reinsurance market in 2008. Hurricane Ike and the frequency of other catastrophic and risk losses alone would be unlikely to move U.S. Property reinsurance pricing upwards but, when the impact of these losses are combined with balance sheet deterioration from poor investment returns, the signs are clear: pricing for U.S. peak zone reinsurance will likely harden in 2009.

In addition to facing catastrophe losses and poor investment returns, the market is dealing with the effect of the credit crisis on the funding of state-mandated pools and insurers of last resort. Recently, the FHCF advised that owing to the financial crisis, their likely post-event bonding capacity had fallen substantially, from the region of $16 billion to as little as $3 billion. This substantial funding shortfall means that the reinsurance provided by the FHCF to Florida homeowners writers through the TICL layer may not be available in the event of loss. Since the FHCF provides the majority of reinsurance for many of the dedicated Florida homeowners carriers, this could be very serious should there be another hurricane this year. Rating agencies are watching this situation closely and are likely to discount the credit that can be taken in their models for FHCF-provided reinsurance. In addition to FHCF’s bonding requirements, the insurer of last resort, Florida Citizens Property Insurance, would also be seeking post-event bonding. There is no doubt that this development will mean a substantial increase in demand for private Florida catastrophe reinsurance in 2009 and it remains to be seen whether supply will be sufficient to meet this demand. While it currently seems unlikely that the Florida legislature will act to redesign the FHCF before next year’s hurricane season, it does seem clear that these developments will put upward pressure on Florida-exposed private reinsurance pricing.

With the cost of capital increasing, the demand for reinsurance growing, the problems facing the FHCF and reinsurers seeking to produce higher underwriting returns to offset reductions in investment income, we expect U.S. Property catastrophe pricing to increase in 2009.
**CASUALTY**

The Casualty reinsurance market has been generally softening for some years now and this trend continues with regard to standard lines of business and regional carriers. However, there have been signs of firming conditions for larger national account exposures and some E&S classes that have experienced large rate decreases on the original business.

Competitive market conditions have been supported, in part, by continuing reserve releases from prior years that have kept earnings high despite a tough investment environment. There are signs that these prior-year reserve releases may be beginning to slow, as evidenced by many companies reporting half-year earnings below last year’s levels. Ultimately, this should put the focus on achieving positive accident-year underwriting results, which will eventually lead to upward pricing pressure.

**WORKERS’ COMPENSATION**

For quite some time, the Workers’ Compensation (WC) reinsurance market has been competitive, with low probability catastrophe layers being subject to considerable competition in price and terms for five years in a row. Capacity for large catastrophe programs is currently plentiful. Prior-year reserve releases have resulted in downward market pressure on pricing; working layer business saw rate decreases of 5-10% in 2008. Working layer pricing has also been affected by the overcapacity in the catastrophe market, which has led some catastrophe reinsurers to begin competing for working layer business. The Willis Re index of overall WC reinsurance cost drivers shows considerable upward pressure from medical inflation and primary pricing being balanced by legislative reform and a generally competitive reinsurance market environment.

In 2009 we anticipate that WC reinsurance pricing will stabilize, as insurers try to protect their diminished capital with additional reinsurance purchases and reinsurers seek higher underwriting margins to offset uncertain investment returns.
PROFESSIONAL LINES

Perceiving Professional lines to be profitable, reinsurers have been prepared to support rate decreases in the non-medical E&O market for the last few years. Reinsurance capacity continues to expand in this sector, even as original prices have declined.

Nevertheless, we are currently experiencing an unprecedented era of financial turmoil and commercial distress. Amid this dislocation we have witnessed the complete failure of some institutions and impaired performances from others. Nearly all economists are predicting widespread recession and an economic downturn seems inevitable. In such times Professional Liability reinsurers tend to fear an uptick in claims activity, a worsening of underwriting results and an increased propensity for severity. To compound this, investment income returns have been seriously impaired and the ability to raise new capital is diminished. Such factors should logically lead to a hardening of the Professional Liability market. The pace at which the market hardens will likely be determined by the speed at which the reinsurers’ fears become realized.

With regard to Medical Professional coverage, reinsurers have been less inclined than the primary health care markets to embrace a softening in rates. This caution is fostered by excess-of-loss reinsurers’ severity concerns and the fact that primary carriers’ dramatic reduction in loss frequency, which has driven primary rates softening, has not brought comparable benefit to reinsurers. In other words, a decline in frequency has not been matched by a reduction in severity. Moreover, health care reinsurers are carefully watching primary underwriting discipline and monitoring the temptation for primary markets to push for across-the-board market share increases.

The exception to the generally competitive Professional lines reinsurance marketplace has been Directors & Officers (D&O) coverage for large, publicly traded companies. Against a backdrop of a fifth year of D&O rate deterioration, reinsurer concerns about the overall economy and a significant increase in claims frequency directly related to the subprime/credit crisis is causing further constriction of reinsurance capacity and in some cases tighter terms and conditions. Reinsurers are especially wary of financial institutions exposures, seeking to avoid large market cap financial companies altogether or imposing aggregate caps on the amount of financial institution exposure they are prepared to accept. The full impact may take time to materialize as the market seeks to gauge the potential impact of legal actions filed in response to the recent financial market crisis. However, early indications clearly demonstrate that the plaintiffs’ bar will be busy. Adding to upward pricing pressure, ongoing D&O reserve releases may not be as readily available to support current accident-year results as they have been in recent years.

CONTACT

Paddy Jago
Chief Executive Officer
Willis Re Inc.
212 915 8383
paddy.jago@willis.com

GETTING INVOLVED

The cost of providing health care benefits continues to outpace the general inflation rate. How should employers respond? This article examines the current state of U.S. health care costs. From legislative and market-driven issues to new cost-control strategies, such as consumerism and wellness incentives, we present readers with a comprehensive look at health care trends, highlighting proven strategies that employers sponsoring group and retiree health programs may wish to consider.

HEALTH CARE TRENDS

According to the Kaiser Family Foundation, last year the average annual total insurance premium in employer plans was $4,704 for single coverage and $12,680 for family coverage.

Public awareness of consumerism appears to be growing, evidenced by the surge in the demand for consumer-support tools ranging from information on provider prices and quality to resources about medical treatment. In response, many more such tools are being developed and made available by insurers and others. As awareness grows, consumers appear to be getting more comfortable taking an active role in maintaining their health and in health care overall.

There has been significant growth in employer-based prevention and wellness strategies to reduce health care costs, lost productivity and absenteeism. Statistical evidence demonstrating tangible returns on investment for these efforts is also becoming more widely available. The 2007 Willis Wellness Survey reports sizeable return on investment savings. The survey also analyzes management’s support of wellness programs and the value of these programs beyond cost savings.
Employers are beginning to gravitate to consumer-based strategies, where employees take on more responsibility for costs, lifestyle choices and treatment decisions. Some consumerism critics decry consumer-directed health plans (CDHP) as a reflexive cost shift. Consumerism proponents argue that when properly structured, a CDHP is more accurately characterized as a means of encouraging consumer responsibility and scrutiny of personal health care expenses. Some employers have expressed high expectations for immediate financial relief, but the move to the consumer-directed approach will, in all likelihood, be most effective over the long haul. The movement toward consumerism is consistent with a general trend away from employer paternalism, also seen in retirement benefits, with the now widely accepted turn from defined benefit pension plans to 401(k) plans.

Note: Small Firms are defined as firms with 3 to 199 workers. Large Firms are defined as firms with 200 or more workers. Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 2008.

Note: Due to a change in methods, the cumulative changes in the average family premium are somewhat different from those reported in previous versions of the Kaiser/HRET Survey of Employer-Sponsored Health Benefits. See the Survey Design and Methods Section for more information, available at http://www.kff.org/insurance/7790/index.cfm.

Insurance plans are employing more care management techniques, such as prior authorizations for specific services (magnetic resonance imaging, specialty pharmaceuticals and many surgical procedures).

The plight of the uninsured and underinsured is gaining prominence in political discourse.

**LEGISLATIVE DEVELOPMENTS**

Although health care concerns may for the moment be eclipsed by economic news, they continue to shape the national legislative agenda and are a major topic in the U.S. presidential race. Many key employee benefits issues – Medicare, executive compensation, paid family leave, mental health parity¹ – remain popular topics in Congress and in statehouses, as does the highest profile issue of all: providing health coverage for the uninsured. Although the number of uninsured citizens has been a political hot button for many years, interest spiked in 2008. This may be due, in part, to controversial and well publicized state health reform activity.

As health care reform initiatives at the federal level have generally stalled, a growing number of state legislatures are leading the charge to tackle problems with the current health care system. A number of state proposals include mandates on employers to provide Internal Revenue Code Section 125 programs (also referred to as cafeteria plans) for all workers. These plans allow employees to find their own insurance coverage but pay for it on a pre-tax basis as part of an overall strategy to make benefit coverage more affordable. (The cafeteria plan mandate was a key component of Massachusetts health care reform.)²

On Election Day, for example, voters in Arizona and Montana will get the opportunity to vote on health care reform measures. In Arizona, the Freedom of Choice in Health Care initiative would prohibit state lawmakers from passing legislation that would require citizens to join a government-run health care system. Proponents of the measure say the proposal is intended to tell the Arizona legislature that the fundamental element of any future health care system reform must be predicated on the idea of protecting individual rights to make personal health care coverage decisions. Legal experts note that if approved, the new law would prevent Arizona from establishing individual health coverage mandates, such as those in Massachusetts that require nearly all residents to get health insurance (or face corresponding penalties). The Arizona measure would prevent state lawmakers from imposing a penalty or fine for health care decisions.

Montana voters face the question of whether to add more uninsured children to the Montana State Children’s Health Insurance Program (SCHIP) and the Montana Medicaid Program. Although many other states have already enacted such requirements, Montana lawmakers resorted to creating a ballot measure for this purpose when their repeated efforts to legislate the expansion stalled.

In addition to state legislative activity, several national proposals have been set forth by the 2008 presidential candidates, various coalition groups and federal legislators. Many proposals echo earlier initiatives, ranging from tweaks to the current health care coverage system to a complete overhaul. Generally, the proposals aim to provide insurance of some kind to all U.S. residents, bringing all the currently uninsured into the system. Most proposals seek to lower the barriers to participating and to spread the risk more broadly among all covered individuals.
BATTLE FOR THE WHITE HOUSE

The proposals of the presidential candidates focus heavily on the use of tax incentives. Under the current system, the Internal Revenue Code (IRC) offers an exclusion that shields workers from having to pay tax on the value of employer-provided health coverage. Employers that choose to provide health benefits receive a full deduction for their contributions. Self-employed individuals are able to deduct 100% of the cost of their health insurance. Workers with no employer-provided coverage are able to take itemized deductions for qualifying medical expenses that exceed 7.5% of adjusted gross income.

The following descriptions are intended to summarize key aspects of each candidate’s positions rather than offer an exhaustive and comprehensive review.

Senator John McCain (R-AZ)

Senator McCain’s proposal centers on a dramatic shift toward the taxation of employer-provided health care. McCain would seek to modify the IRC to eliminate employer-sponsored health insurance’s current favored status. Under the McCain plan, the tax exclusion available to workers receiving employer-provided health insurance would be eliminated or reduced. He would replace the exclusion with tax credits (roughly $2,500 per taxpayer or $5,000 per family) for the purchase of qualifying health insurance. The proposed tax credit would apply whether the insurance was obtained from an employer or as an individual. In addition, the deduction for employer-provided benefits would be retained. The proposal would also provide for expanded Health Savings Accounts (HSAs).

Senator McCain would allow individuals to purchase insurance across state lines to create a more competitive insurance market. He also favors state-based guaranteed access plans for uninsurable individuals, as well as legislation that would promote the expansion of wellness and disease prevention programs.

Senator Barack Obama (D-IL)

By contrast, Senator Obama’s proposal would preserve the exclusion for employer-provided medical coverage. Obama’s proposal also emphasizes efforts to provide coverage directly for many of those who are currently uninsured. Under his proposal, lower-income individuals who do not qualify for SCHIP or Medicaid, and are not otherwise covered by employer-paid plans, would receive income-related federal subsidies. With certain exceptions, Senator Obama’s proposal would require employers who do not provide “meaningful” coverage or a “meaningful” contribution to the cost of health insurance for their employees to contribute a percentage of their payroll toward the costs of a national plan (often called a pay-or-play plan). (The term “meaningful,” as used in the Obama proposal, has yet to be defined.) Certain small employers would be able to purchase group health coverage for their workers through a new public plan with federal subsidies in the form of small business tax credits.

Senator Obama has taken a position in favor of promoting coverage by instituting individual health coverage mandates under federal law for children up to age 25 and the expansion of Medicaid and SCHIP programs. The mandates would compel universal coverage for children under a strategy that is supposed to also encourage health plan access and affordability. The Obama proposal stops short of an across-the-board coverage mandate that some say would be needed to adequately spread insurance risk, and genuinely address the problem of the uninsured.

UNIVERSAL COVERAGE PROPOSAL

At the start of the current Congressional session, Senator Ron Wyden (D-OR) introduced The Healthy Americans Act (S. 334). His proposal would create a centrally financed health care system with universal health care coverage (except for those covered by Medicare or the military) delivered through private health plans.

The Healthy Americans Act would establish a dedicated public entity to certify private sector plans, coordinate enrollment and distribute premium subsidies. The bill would eliminate the current tax exclusion for employer-subsidized accident and health coverage and provide a federal tax subsidy for the purchase of qualifying medical coverage. It would implement a new standard above-the-line deduction to assist individuals in purchasing private, non-employer-based coverage. The plan would also require that employers make “Employer Shared Responsibility Payments” to the federal government to help finance state-facilitated private health care (essentially an application of the pay-or-play concept).
BUILDING ON THE EMPLOYER-BASED SYSTEM
A number of recent health care coverage proposals hinge on requirements that would tax employers not providing health insurance or contributing to coverage costs. Former presidential candidate John Edwards (D-NC) campaigned on a proposal that would have applied a 6% tax on employers that did not provide a minimum health care benefit. Such pay-or-play schemes have also been featured in several state proposals. Massachusetts’ law includes that requirement as did Maryland’s so-called Wal-Mart law (because only Wal-Mart would have been affected). City (San Francisco) and county (Suffolk on New York’s Long Island) proposals have also included such provisions.

So far, the federal courts have generally determined (when the laws are actually challenged) that such state and local laws are preempted by ERISA. Although the Massachusetts law has not yet been challenged, federal courts have already overturned Maryland’s and Suffolk County’s laws.

MEANWHILE, OUT ON THE LEFT COAST…
The San Francisco Health Care Security Ordinance (HCSO) is a health coverage mandate that went into effect on January 9, 2008, despite legal challenge. A federal district court initially ruled that ERISA preempted the San Francisco HCSO. An appeal enabled the city to go forward with its scheme pending a decision, and about 10 months later the Ninth Circuit Court of Appeals formally overturned the lower court’s decision and ruled in favor of the city’s authority to enact its mandate. The ERISA preemption conflict, which now seems to exist between the Fourth Circuit (which overturned Maryland’s Wal-Mart law) and the Ninth Circuit, may set the stage for a U.S. Supreme Court decision on the scope of preemption. Unfortunately, even if the Supreme Court agrees to hear the San Francisco HCSO dispute, it could be years before a final outcome is decided.

ERISA preemption remains an important barrier to the states, keeping them from enacting legislation that could potentially force employers to comply with 50 different state laws (not to mention the thousands of county and municipal laws that could be enacted).

UNCERTAIN PROGNOSIS
Health care reform and coverage for the uninsured have been debated for many years – even before Senator Hillary Clinton’s (D-NY) failed attempt during President Bill Clinton’s first term. The current presidential candidates have touted their positions on the campaign trail, but each has generally refrained from offering specifics. It is also clear that without bipartisan support, broad changes at the federal level are unlikely. Although there has been a significant increase in state legislative activity, the outcome there remains uncertain as well.

Then there is the question of money. No universal health care solution is free. Given the federal government’s recent commitment to infuse financial markets with cash, money to support health care reform may not be immediately available. Finally, some health care experts are concerned that with all the attention centered on health coverage access, presidential candidates and legislators may miss another fundamental issue – the cost of health care itself. Although millions do not have health insurance, a majority of voters do, and numerous surveys reveal that voters with health insurance are most concerned about curbing skyrocketing medical costs.

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CONTACT
Dennis Fiszer
Vice President & Senior Employee Benefits Attorney
314 854 0260
dennis.fiszer@willis.com
The recently enacted bailout bill contained a new version of Mental Health Parity that will go into effect in late 2009.

ERISA preemption guarantees that only the federal government can enact laws that affect employer-sponsored benefit plans, with the important exception of state insurance laws and regulations. States can regulate employers indirectly when an organization buys a group insurance policy that already contains state-required provisions. Self-funded plans do not purchase insurance and thereby generally escape state mandates. Although ERISA's preemption provision would over-ride any non-insurance related mandates (such as the cafeteria plan mandate noted above), employers often find it easier to comply with a state law than challenge it.

Some say that McCain's proposals seek to do away with the employer-based system entirely. A member of Willis' Legal & Research Group recently attended a meeting with a staff member of the Senate Finance Committee who indicated that was not true. The staff member expressed the expectation of the McCain campaign that, despite the new tax treatment of employer-provided benefits, the net result for taxpayers would produce a better outcome for those on employer-based plans and therefore employers would generally choose to continue offering health care benefits.
THE TURN IN THE ROAD?

The question facing most lines of insurance these days is simple enough: when will the market turn? In Environmental insurance, the answer is complicated by the variability in the market conditions for the individual Environmental products. In general, however, the softening trend appears to have reached its peak and the market is beginning to firm. The main reason: the rate decreases of the last few years were unsustainable – a situation exacerbated by the current condition of the general economy.

At such turning points, buyers are often motivated to consider locking in current terms and conditions on attractive multi-year deals. At the same time, however, the financial stability of potential insurers should be an important consideration, especially on longer-term placements.

MARKET CONDITIONS

A potential turn in the road notwithstanding, the specialist Environmental market remains vibrant and continues to grow at a steady pace both in North America and globally. Insurers continue to accentuate profitable underwriting with increasing emphasis on short-term, renewable programs and less reliance on one-off, long-term, project-specific placements.

The recent turmoil in world financial markets has significantly impacted some of the most important insurers in the Environmental marketplace. The major rating agencies have downgraded the financial strength ratings for certain key Environmental insurers including AIG, the largest specialist Environmental insurer by premium volume. At the same time, many observers, including state insurance commissioners, have pointed out that AIG’s insurance subsidiaries are financially sound. Inevitably, the fall-out from these recent events, particularly the associated credit squeeze, will have an impact that extends beyond the cadre of insurers with major subprime exposures.

While the financial strength ratings for the core insurance operating entities of the main Environmental insurance companies have remained above our minimum rating guidelines, the recent episode has reemphasized the critical importance of including appropriate financial viability assessments into the insurer selection process – especially for
long-term policies. Choosing a market should not be just a price and coverage decision.

Aggregate capacity in the industry remains relatively stable; however, the per-policy aggregate limit of the major carriers is generally less than it was five to 10 years ago. Many of the leading carriers can provide $25 million to $50 million in limits for a single placement. In situations where more is required, some carriers can even increase this limit further, possibly on a ‘net-of-reinsurance’ basis. Further, we are seeing more layered programs involving more than one insurer to build capacity. Depending on the length of policy period, the nature of the risk and complexity of the coverage, program limits as high as $250 million are achievable, and potentially even higher with the direct involvement of reinsurers.

The market has remained relatively firm on long-term policies and more challenging product lines. In particular, the Cost Cap product line has seen unfavorable loss experience (loss ratios of up to 150-200% for some carriers in certain policy years), which has led to more detailed engineering requirements and more stringent underwriting and approval protocols. In contrast, we are seeing strong competition for the more attractive, renewable lines of business – with rates in some areas down 15-25%. However, increases in the frequency and severity of losses on site-specific pollution policies have tempered rate reductions. Recent experience suggests that this market segment is now beginning to firm up and tightening credit conditions are expected to accelerate this process.

On terms and conditions, insurers are being aggressive in some of the more competitive product areas. For mold exposures, insurers are now offering coverage without sublimits for Business Interruption/Property Damage and cleanup costs, and further, they are offering coverage for other conditions caused by microbial pathogens – such as Legionnaires’ disease and illness related to Cryptosporidium.

Some of the established carriers are experiencing adverse loss development based on the broader coverage offered over the last several years, particularly in areas such as first-party business interruption, fines and penalties and on-site cleanup. We are also seeing a trend toward more restrictive terms and conditions for certain products (such as Cost Cap) as well as a retreat from certain sectors. For example, some Environmental insurers have been pulling away from providing Professional Liability programs for environmental engineering firms with a significant component of traditional design engineering, especially those with geotechnical exposures.

Coverage and pricing for long-tail pollution exposures, whether on an occurrence Contractors Pollution policy or a claims-made site-specific policy, need to be examined in the context of insurer security factors, as claims leading to long-term cleanup projects or toxic tort class-action lawsuits may take several years to conclude.

NEW DEVELOPMENTS

Carriers are developing new products to address emerging risk exposures and new opportunities. Some of the innovations include:

- **Green products** – a range of new products aimed at environmentally friendly construction initiatives, such as the U.S. Green Building Council LEED program. Some of these new programs offer premium discounts for certified buildings. Some insurers are considering green Contractor's Pollution Liability policies for contractors who work on green buildings or can demonstrate practices that go above and beyond regulatory requirements and focus on sustainability.
Parent company protection – a growing appetite for high-retention, blanket programs structured to cover all operations, facilities and liabilities facing a parent company – including a new AIG program targeting financial institutions.

Climate change – the development of insurance solutions to address some of the new risks resulting from climate change. Steps can be taken now to examine the exposure and the potential coverage – or exclusions – in the context of current General Liability, Directors & Officers (D&O) and Environmental policies.

Many Environmental insurers are developing small business solutions that enable them to offer cost-effective pollution programs to smaller operators. These programs typically incorporate lower rates, reduced minimum premiums and the efficient delivery of such offerings through online or semi-automated systems.

Environmental insurers have been combining distinct products into bundled or package programs for some time and experiencing solid growth – for example, AIG’s successful EAGLE program and XL’s Pollution and Professional package programs for environmental service companies. Two established environmental insurers have recently added combined Casualty and Environmental policies to their product offerings. Liberty International Underwriters (LIU) offers a combined General Liability-Contractor’s Pollution Liability and Professional policy for contractors (LIU Environmental Advantage). Zurich Environmental has also launched their Z-Link Commercial General Liability and Pollution Liability policy, which includes pollution coverage for premises-related risks, including chemical blending, manufacturers, warehousing and waste-processing facilities.

ACE continues to offer the Site Sure endorsement on their Excess Casualty policy, typically for larger accounts. This endorsement is efficiently underwritten and attractively priced to offer coverage similar to a Pollution Legal Liability policy for prospective exposures.

The leading Environmental insurers are increasingly able to offer coverage for more locations outside of the U.S., including locally admitted Environmental policies in certain locales. We have witnessed a significant increase in interest and placement of global Environmental insurance programs.

The anticipated profitability of the Environmental product line continues to attract new market entrants, most recently Great American Insurance Company (GAIC). Great American offers a full array of environmental insurance products for Premises, Contractors and Professional Pollution coverage. They also offer niche policies for Indoor Air Quality and Mold Liability and Closure/Post-Closure Financial Assurance.

CONTACT

Mike Balmer
Willis Environmental Practice Leader
617 351 7530
michael.balmer@willis.com
PERSONAL LINES

AT LEAST ONE MARKETPLACE IS SOMEWHAT CALM

While personal lines rates are not as susceptible to dramatic yearly changes as commercial lines rates, maintaining up-to-date information on the personal lines insurance market is critical for buyers. Knowledgeable buyers make more intelligent decisions. Conditions are generally favorable for buyers, but marketplace offerings can vary significantly. Industry changes regarding insurer stability and available capacity in certain states will have an impact.

PROPERTY

Over the past year, the personal lines Property market has been relatively stable in most parts of the U.S. In general, insurers have provided more capacity and demonstrated more flexible underwriting across the country, except in the following locations:

- Coastal catastrophe zones such as the Southeast and states bordering the Gulf of Mexico
- Other coastal regions including Long Island, New York and Cape Cod, Massachusetts
- Earthquake-prone areas such as California and the Pacific Northwest

Catastrophes tend to impact underwriting appetite more than they impact rates, particularly in the areas mentioned above. That's because most carriers increase rates gradually or depend on increasing property values to realize low-digit premium increases.

POINTERS FOR 2009

HURRICANE

Wind-exposed, coastal states will be affected negatively by a poor hurricane season. Combined loss estimates for Hurricanes Gustav and Ike are already in the double-digit billions of dollars while personal lines carriers are still trying to make up for losses from Hurricane Katrina. At $43 billion in losses, Katrina remains the most costly hurricane in recorded history.

EARTHQUAKE

California, Washington and other states near major fault lines, such as the New Madrid, may have difficulty getting coverage if there is recent earthquake activity. In California, however, companies are required to offer Earthquake coverage when a Dwelling or personal Property policy is placed. Still, many companies will limit the amount of Earthquake coverage they provide.
CAPACITY
Capacity changes from year to year. The more time that passes after an earthquake or hurricane, the more available capacity there will be.

CARRIERS
Companies leave and enter markets. Since 2005 (post Katrina), new underwriters have entered the market and more carriers are interested in the high net worth market. AIG is a major force in this market sector and the disruptions at AIG should be closely monitored.

NEW PLAYERS
ACE Private Risk could be a factor in the next few years because it has just entered the high net worth market.

AUTOMOBILE
Automobile claims have been down for quite a few years and, as carriers’ loss experiences have improved, most have expanded their Auto insurance capacity. Although Auto coverage is heavily regulated by consumer-driven insurance departments, the sector is not static. Companies have invested in new technology that can more accurately rate drivers using varying underwriting factors. Carriers also are using more variables and rating tiers to more accurately determine premiums and reward good drivers and penalize poor drivers. This approach generally helps consumers and many drivers are seeing reductions in their Auto insurance premiums as this technology is put in place.

POINTERS FOR 2009

VIOLATIONS
Buyers should be truthful about accidents and violations at the beginning of the application process. Companies can find out in an instant whether an application is accurate through motor vehicle and claims history reports.

CREDIT SCORES
Credit scores are still a factor in determining Auto insurance rates.

PREMIUMS
The repair cost of the car, not just the value, is a major factor in determining Physical Damage coverage premiums.

DISCOUNTS
Multicar and multicoverage discounts are available from most companies. Ask carriers if there is any benefit in placing both Property and Auto insurance with them or if they offer discounts when insuring more than one vehicle.

LIABILITY
Liability coverage continues to be one of the best buys in personal insurance. Most companies charge less than $1,000 per year for $5 million of coverage and some charge less than $500, depending on the exposures to be covered. In this market, buyers can purchase up to $50 million of coverage where appropriate and, in special cases, $100 million.

OPPORTUNITY AMIDST HEAVY REGULATION
Personal Lines insurance is heavily regulated on a state-by-state basis. In most states, rates must be approved by insurance departments, so significant rate increases take a while to take effect – even in states such as Florida and California, where catastrophic losses have significantly cut into insurers’ policyholder surpluses. Even in a heavily regulated business, however, rates can vary significantly from company to company.
Carriers can and do charge a wide range of premiums based on their loss histories, underwriting guidelines and risk appetites. Buyers should select an agent or broker who has access to a variety of companies to ensure that individual needs can be met. In addition, a good agent or broker should:

- Be knowledgeable about the changing personal lines marketplace
- Be able to guide clients through market changes
- Make clients aware of new players and products

Most important, a good agent or broker always conducts a risk and premium analysis for each client to ensure that the individual is with the right company and has the right coverage at the most cost effective price.

**CONTACT**

**Sandra Bravo**
National Practice Leader
Willis HRH Personal Insurance
212 915 8019
sandra.bravo@willis.com
TERRORISM

RESPONSES TO AN ONGOING THREAT

While the global effort to eradicate terror may have disrupted Al Qaeda’s central organizational capabilities, those who seek to further their aims through terrorism continue to adapt to the increased political, economic and military pressure exerted against them. Using global electronic communications networks that allow rapid dissemination of ideas and training information, terrorist organizations have recently adopted a transnational, localized approach where radical, loosely affiliated organizations are capable of initiating and executing seemingly isolated terror strikes anywhere in the world.

Over the past few years this sustained threat, as well as favorable loss ratios, has led to exponential growth in the stand-alone terrorism market. As rates have dropped off from the post 9/11 peak, the rush to write this line of business has abated. While there are some new markets with terrorism stamps in 2008, global capacity has momentarily leveled off at around $1.5 billion for nonaggregate risks. Because of the nature of the peril and the tendency of markets to be wary of those most interested in the coverage (following the principle of adverse selection), the private Terrorism insurance market remains constrained by capacity limitations in critical areas (namely Tier 1 cities around the globe). Elsewhere, the market is soft.

The trend of nonstate actors taking on conventional aspects of sovereignty and nation-states sponsoring paramilitary organizations has increasingly blurred the traditional lines drawn between war and terrorism. In response, the stand-alone terrorism market has moved toward offering broader forms in those parts of the world where the potential for ambiguity exists. This, along with growing interest in providing versions of Nuclear/Biological/Chemical/Radiological (NBCR) products, is part of the overall market response to not only ever more complex threats, but also the realities of a still softening market.

Recognizing the importance of recovery financing in the face of an event, as well as the critical role asset protection plays in encouraging investment, government-sponsored programs have increasingly...
stepped in to fill the gaps in capacity. In the U.S., the Congress passed the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA), which extended the federal backstop from December 31, 2007 to December 31, 2014. Signed into law December 26, 2007 by President Bush, TRIPRA may not have been as comprehensive as the bill originally proposed by the House, but it was still widely regarded as a clear improvement over the expiring program. In addition to granting the extension, the bill eliminated the previous distinction between foreign and domestic acts of terrorism. Features of the original program that were retained included the continuation of the “make available” provision for insurance for acts of terrorism as defined under the act and the insurer deductible of 20% of direct earned premium for the insured terrorism loss. The current level of federal compensation and insurer co-pay, at 85% and 15% respectively, also remains unchanged.

**TRIPRA AND CAPTIVES**

With the stability afforded by TRIPRA's long-term extension, captive formation to access the indemnities provided under the act have taken a major upswing in 2008. Under the terms of the act, U.S.-domiciled captives writing Property and Casualty coverage on a direct basis are recognized under TRIPRA and are obligated to offer Terrorism coverage in compliance with the act's reporting provisions.

While certified Terrorism Property coverage has been the most common TRIPRA application for captives, many companies are exploring additional ways to apply the act. The recently raised profile of Terrorism Liability has increased the number of captive business plans that provide for writing Liability cover, as Liability exposures should be covered by TRIPRA provisions in the same way as the more familiar Property policies. In addition, Department of the Treasury guidelines indicate that TRIPRA will respond to certified losses resulting from nuclear, biological and chemical perils (even though offers of coverage for these are not mandatory), which are excluded in almost all commercial Terrorism policies. Corporations accessing TRIPRA through their captive subsidiaries can broaden their Property and Casualty programs to cover NBCR (with the TRIPRA backstop) and Liability, as well as utilize customized forms tailored to their particular exposures.

Because the typical aggregate earned premium for a captive insurer is minimal compared to that of commercial insurers, the deductible amount is often quite low and can, alternatively, be insured in the private insurance market. Captives are not required to pay funds to their policyholders in advance of receiving reimbursement from the federal government, alleviating potential cash flow restraints. Programs are also available to ensure the timely payment of anticipated TRIPRA payments in the event that there is a delay by the U.S. government in certifying a claim. For the portion of losses they are required to cover (set at 15% in the latest extension), captives may elect to purchase commercial reinsurance. Often, these reinsurance agreements are arranged so that they not only cover the 15% coinsurance, but also the primary $100 million annual aggregate loss threshold as well as the 20% of prior annual earned premium deductible. In the event that there are no losses during the policy year, the captive owner may then recoup the premiums charged by the captive, less any administrative or reinsurance costs.

**THE SAFETY ACT**

In addition to the options available under the expanded TRIPRA, interest is reviving in a separate federal program initially launched in 2002. The SAFETY Act of 2002 (Support Anti-terrorism by Fostering Effective Technologies) provides revolutionary Liability protections for those companies engaged in a variety of anti-terrorism endeavors. Originally conceived as an incubator for the technological innovations that
would help protect against terrorism, the act has matured into a vehicle for establishing the effectiveness of a particular product or service and receiving government protections for its continued deployment or provision. A number of companies providing an array of services (from protecting chemical processing sites to biometric identification verification) have applied for and received the act’s liability protection. Two levels of protection are available: Designation and Certification. Designation provides a number of benefits (sole federal jurisdiction, caps on legal liability, limited or barred classes of awards) not only to the manufacturer of the recognized technology, but also to every downstream seller, distributor or user. The more stringent Certification provides all of the benefits of Designation but also allows each of the entities involved access to the protection afforded government contractors in the event of a lawsuit. As the landmark decision in the first World Trade Center bombing revealed, failing to take the right measures can lead to extensive liability exposures – exposures that the appropriate combination of risk management and programs like the SAFETY Act can help mitigate.

OUTLOOK

Barring any major losses during the next year, the market is set to continue softening in areas that are loss free without capacity constraints. Regions of the world with open conflict or insurgencies, as well as those that continue to simmer, will be closely watched by underwriters. Tier 1 cities will most likely remain at the mercy of limited available capacity, with few new entrants to ease the pricing pressure being felt by buyers. The seven-year extension of TRIPRA in the U.S. does hold out the promise of a stabilized domestic market, as well as more predictability in the coverage offerings provided by Property carriers, but will most likely have a limited pricing impact beyond what we have seen.

The unpredictability of the peril of terrorism on a global basis hinders any general attempt at correlation with the cyclical movements of the Property /Casualty markets. Global geopolitical events will continue to affect market coverage stability and costs. Meanwhile, the marketplace matures, with increasingly accurate tools to manage risk accumulation, determine proximity to potential terrorism targets and provide more accurate deterministic (scenario-based) and probabilistic modeling. We expect to see more refined and accurate models develop in the year to come, which could potentially have a positive impact on capacity availability and pricing as they allow underwriters to more accurately price individual risks.

CONTACT

Wendy A. Peters
SVP, Willis HRH Terrorism Practice Group
610 254 7288
wendy.peters@willis.com
The global airline industry continues to face a perfect storm of slowing growth in passenger traffic plus comparatively high fuel prices. Together, these conditions could lead the industry to lose $5.2 billion worldwide in 2008 and $4.1 billion in 2009, according to the International Air Transport Association (IATA).¹ In fact, spiking fuel prices and sluggish demand have already driven more than 30 carriers to suspend or terminate operations this year, and the IATA currently is monitoring the financial condition of at least another 10 carriers.

The airline industry is facing unprecedented challenges and as they proliferate, these challenges will impact the economics of the manufacturing and associated service industries. Already, mergers and insolvencies are increasingly commonplace. The global credit crunch is not helping. Major airframe manufacturers are facing additional challenges in delivering the new larger, more fuel efficient aircraft the airlines desperately want to fly, while at the same time dealing with cancellations and deferrals for the aircraft already in production.

The news is not all doom and gloom, however. The economies of certain areas of the world, such as the Middle East and Asia, continue to grow, albeit at slower than predicted levels. The importance of the aviation industry to the global economy and its long-term role in future growth is not in question. The makeup of the industry that is going to underpin this growth is shifting, however, and, in the short term, is far from clear.

At the smaller end of the scale, the business jet industry continues to boom, with some projections forecasting a threefold increase in the number of these aircraft in the next 15 years. The versatility and increasing affordability of this mode of travel is undoubtedly going to play a large part in shaping the air transport industry of the future.

THE CHALLENGE OF VOLATILITY

What will the turbulence mean for the current soft market for Aviation sector risks? Those companies that survive the rash of closings and mergers may find their insurers asking them to pay more
for their insurance in an attempt to at least maintain a viable global premium volume. Airline insurance and airline industry fortunes have always operated on a counter-cyclical basis, and the boom and bust nature of both industries delivers all stakeholders a most volatile ride. Talk of long-term policies to lock in the current low rates has returned to the market, with few insurers willing to establish a projected rate or premium increase benchmark too early. With capacity standing by, any upturn without real market withdrawals will likely be short-lived. There will be opportunities for coverage improvements and increased limits as the negotiations become tougher, but there will also be hard work ahead, as buyers looking for the best marketing results must achieve differentiation. The market remains just that – a market, and the rules of supply and demand continue to apply.

**AVIATION INSURANCE**

The Aviation insurance marketplace continues to evolve quickly in a bid to continue to meet the needs of an evolving customer base. Some of the capacity that has flowed into the market reflects efforts by the world’s largest insurers to diversify their portfolios into niche markets, such as the relatively predictable (low frequency, catastrophic severity) Aviation market. The commitment and costs associated with establishing Aviation underwriting teams, along with an increasingly technical and disciplined approach to underwriting, may encourage these markets to stick to their tasks longer than they might have in the past.

Passenger and fleet growth projections, which have swelled manufacturer order books and provided the potential for insurance premium uplift, have carried the airline industry and insurers on a wave of confidence in continued good times. Change has been swift and significant, however, creating a competitive environment. The pressure to at least maintain the premium volume against a backdrop of high capacity and increasing claims is now coming to bear.

In response, many carriers seek diversity, and the sectors of the General Aviation market provide ample opportunity. These sectors are not without their own challenges. The very light jet (V LJ) sector is an area of significant growth but is still in the early stages of its development. The helicopter industry is developing higher value, more technically advanced aircraft, which, unlike modern airline equipment, is often asked to test its performance limits. This increased risk has unfortunately been demonstrated in some market losses.

In the current climate, geographic differences and subsequent market specialization are going to become increasingly pronounced. With a history of innovation in meeting the challenges of technological advances, increased capacity and legal developments, the market is well positioned to continue to meet buyers’ changing needs.

**AIRLINES**

Many believe the Airline insurance market has reached the bottom of the soft part of the insurance cycle. In fact, insurers have been sending this message for the past couple of years. The combination of the following conditions, however, suggests that 2009 will be the year when the market actually changes.

- Comparatively low premium volumes
- Increasing losses
- A significant slowdown in exposure growth
- Increasing management attention to this high-profile sector

The Airline insurance market has remained poised for change for a while, but with ample capacity at the ready, even if not deployed, the challenge for insurers has been to generate any upward momentum.
As the market prepares for the all-important final quarter of 2008, there is no doubt that the balance of power has shifted from airline buyers to insurers. One sign is the diminishing – and in some cases vanishing – differential between lead and following layers. Exposure growth no longer comes as standard at renewal, and many buyers may in fact see a contraction of coverage. The comparatively excellent safety record of the industry is starting to show some cracks as loss levels continue to increase.

Given current conditions, combined with increased losses and renewal activity heavily loaded into the final quarter of the year, underwriters may finally be able to change the market direction with a meaningful rise in premium income.

**AEROSPACE LIABILITY**

The Aerospace Liability market has travelled a different path from the Airline market for some time and this seems likely to continue. During 2008, renewals have generally received rate reductions, which have resulted in premium reductions for the majority of buyers. The maintenance repair and overhaul (MRO) sector is the exception. Following a string of recent losses, MRO insurers have responded firmly and, in certain instances, have applied significant rate increases.

Insurers have continued to review each renewal program thoroughly and apply actuarially modelled criteria to determine rate and participation levels. Despite substantial capacity in the market, the level of coverage available and the capacity deployed can vary significantly from sector to sector.

Projected exposure in all sectors has risen throughout 2008. So far, the impact of record fuel prices and the credit squeeze are negligible. However, it is anticipated that in Q4 renewals, some sectors will project some exposure reductions, reflecting the downturn in airline traffic. Those sectors include:

- Airport operators
- Air traffic control/air navigation providers
- Fuel providers
- MRO and airport services

**CONTACTS**

**Steve Doyle**  
Executive Director  
Willis Aerospace  
+44 20 3124 7208  
steve.doyle@willis.com

**Garrett Hanrahan**  
CEO, North America  
Willis Global Aviation  
+1 972 715 6390  
garrett.hanrahan@willis.com

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CONSTRUCTION

THE HAMMER BEGINS TO FALL

As foreseen in our earlier market updates, 2008 is proving to be a difficult year for several construction industry segments. Worrisome credit markets continue to impact a number of projects, with many being delayed or cancelled outright. While the credit crunch is centered in the residential market, many segments are being affected, including gaming, office, retail and hospitality.

In addition, uncertainty about continued government funding of infrastructure, as evidenced by the recent Highway Trust Fund emergency appropriation, is causing concern among contractors and the state agencies that manage these projects. Growth is being seen in infrastructure, energy, power and healthcare, as predicted, but the extent and longevity of that growth are questionable. Privatization discussions continue but political forces combined with current credit market environments make such projects very uncertain.

In the insurance marketplace, the dramatic events of September and October, including the challenges facing AIG and others, have created uncertainty and significant concern. While at this writing the final chapter on AIG has not been written, clearly many construction clients will be developing alternatives. The impact on rate and capacity at this point is not significant but combined with other factors, the financial crisis could create conditions for rate increases in 2009.

In the near term, the competitive rate environment continues for most product lines, although there is some evidence of change. Most renewals have been through a full annual cycle of the soft market and follow-on rate reductions are less than those of the previous year. Two key factors will ultimately determine whether this market will be extended or shortened: the hurricane season, which hits underwriting results, and investment performance, which hits carriers’ overall results. The ultimate losses for Hurricane Ike are still unknown, but they are significant and follow notable cat losses earlier in the year. As for investment portfolios, the headlines tell the tale. Carriers will likely examine rate structures in the near future in order to drive more revenue.

One more influence on the market will be reinsurance results, which have deteriorated in the past two quarters.
With the reduction of written premium and profits, continued stress on the balance sheets, hurricane losses and reinsurance performance, we expect a change in market behavior in the first quarter of 2009.

**GENERAL LIABILITY**

Through 2008, carriers have shown a willingness to discuss coverage enhancements with contractors as a way to differentiate themselves in the marketplace. Enhancements have included flexibility on areas such as broadened property damage wording to address construction defects, additional insured endorsements, EFIS and limited residential exposure.

Carriers are underwriting residential projects carefully due to liability concerns. Distinct markets have evolved to provide tailored solutions for residential project exposures. At the same time, main line carriers now are more comfortable with clients who do a limited amount of this work. Carriers often put a 25% cap on the amount of residential work in their contractors' portfolios. The significant decrease in residential activity has reduced some of the underwriting stress in this segment of the commercial market.

Since spring 2008, progress has been made in coverage for exposures related to business information modeling (BIM). Products have been developed from both a General Liability and Professional Liability standpoint. The Professional Liability section of this report covers BIM in more detail but, clearly, the insurance market is becoming more familiar with the issues this approach creates and is beginning to respond.

We have been receiving recent feedback from construction markets that more scrutiny is expected for the banks utilized by insureds for collateral arrangements. Especially in the context of the current economic crisis, we recommend prompt discussions with your underwriter. Addressing this issue in timely fashion will help eliminate or reduce potential challenges with renewals or project-specific placements.

**GENERAL LIABILITY HIGHLIGHTS**

**RATES**

Reductions are slowing in many cases, with average reductions hovering around 5-10%. As always, rates vary from account to account and loss history has a big impact on final outcomes.

**LIMITS**

While limits of liability in this line are readily available (primary carriers typically can offer $2 million per occurrence), many clients are not feeling pressure to increase General Liability limits to get better Umbrella deals.

**PROJECT-SPECIFIC AND WRAP-UP PROGRAMS**

Project-specific coverage continues to evolve, with carriers aggressively supporting this product. Product benefits include consistent claims approaches, coverage to the term of the appropriate statutes of liability or repose and tailored coverage for the specific project involved. Carriers are very supportive of contractor-sponsored programs because some have seen better loss results from these than from owner-sponsored deals. The enthusiasm for contractor-sponsored programs has resulted in major general contractors reviewing their risk strategies. A number are moving to either project-specific programs or rolling approaches for smaller projects. With the rise in project solutions, carriers continue to be concerned that participating contractors' master General Liability programs may not be appropriately structured to address the contingent liabilities resulting from these projects. The ability to obtain appropriate difference-in-conditions coverage or limits from wrap-ups remains difficult with many carriers, but all contractors that participate in these programs need to be aware of the issue. On a related note, underwriters have developed new coverage that
addresses owners’ and developers’ contingent General Liability risk from projects. This coverage, called Owner’s Interest, is available now from a few carriers.

**WORKERS’ COMPENSATION**

Workers’ Compensation continues to be competitive, although in a few key states we are seeing signs of rate increases. In California, rates will increase late in 2008, which will impact clients over the next 12 months. Workers’ Comp is also being affected by flattening activity in the construction industry and declining payrolls. To date in 2008, the industry has lost over 250,000 jobs, which will reduce exposures in this line through early 2009 and beyond.

**WORKERS’ COMPENSATION HIGHLIGHTS**

**RATES**
Rate reductions continue. We expect the market to remain competitive through at least mid 2009. Results in Workers’ Comp are very strong and predictable; this product remains attractive to carriers and competition remains high.

**RETENTIONS AND DEDUCTIBLES**
Retention levels remain steady for most clients but we have seen carriers offer to attach at lower levels. This is common in a soft market, as carriers trade additional exposure to retain premium dollars. In some cases, clients are pricing different retention levels to see if an arbitrage of trading losses for attractive premiums makes sense.

**COLLATERAL**
Large companies that participate in risk by taking large deductibles typically must give collateral to insurers to cover losses paid on their behalf. The amount of collateral required, especially for plans that cover multiple years, often becomes sizable enough to create balance sheet and credit line issues for contractors. While carriers often are willing to be flexible when negotiating collateral amounts in softer markets, in general, we are not currently seeing carrier flexibility. When discussing collateral with insurers, contractors will benefit from having detailed loss analyses prepared to support what they believe is appropriate collateral. Actuarial approaches often show that these amounts are overstated, giving clients the ammunition needed to negotiate.

**COVERAGE**
While coverage in this line is often straightforward, scrutiny is warranted for Marine exposures, foreign operations (including those covered by the Defense Base Act), leased employees and waivers of subrogation.

**WRAP-UPS**
A new trend in the market is wrap-up project placements that exclude Workers’ Comp. Typically these projects only require placements for General Liability, Builder’s Risk and Excess. While wrap-ups that include Workers’ Compensation are still popular on very large projects (over $350 million in some states), smaller projects are being done routinely without enrolling subcontractors for Worker’s Compensation, which often eases the administration of these projects significantly.

**AUTOMOBILE**
Relatively stable, Automobile insurance triggers fewer coverage disputes than other lines of business. Nevertheless, policies should be crafted carefully, with emphasis on coordinating Equipment coverage with the General Liability coverage, ensuring proper expansions for the transportation of hazardous cargo and obtaining coverage for hired drivers. A recent trend in construction
is contractors outsourcing trucking activities as both a risk management and a cost savings strategy. Whoever is responsible for the vehicles – contractor or subcontractor – will benefit greatly by focusing on best practices. Auto rates will remain competitive as this remains a consistently profitable line for insurers. We expect further declines of 5-10% in 2009.

**EXCESS LIABILITY**

Umbrella and Excess Liability underwriters continue to pursue this line of business aggressively. It is easy for new carriers to enter this market and, not surprisingly, significant capacity has been added by new players. At the same time, current markets are offering significant increases in limits. Umbrella and Excess Liability insurance is truly a global market with capacity flowing through the U.S., Bermuda, London and European markets, easily creating significant competition and broad terms for many clients.

As mentioned above, we are seeing broadening in the Liability market, including contingent Professional Liability, enhanced damage to work wording, and project Excess coverage in the event of being enrolled in wrap-ups. We expect this line to remain quite competitive through mid-2009, if not longer; however, being a line subject to catastrophic exposures, market conditions could change earlier due to major loss activity in other areas of the business.

On another note, many carriers have been putting out significant limits of Liability with ease, while at the same time not reinsuring to the degree they typically would because the reinsurance market has held its ground on pricing. If reinsurers continue to lose business due to their current firm pricing stance, some speculate that they will be forced to offer more competitive terms, which would lengthen the current market.

**EXCESS LIABILITY HIGHLIGHTS**

**PRICING**

Excess Liability will experience similar rate reductions to those in General Liability. This in many cases is the third consecutive year of rate competition, so rate reductions were declining through mid-2008 due to credits previously offered.

**CAPACITY**

Building towers of liability from $200 million to upwards of $500 million is readily achievable in this market. Total capacity available is above $750 million – should it be desired.

**PROFESSIONAL LIABILITY**

Capacity is strong and has been able to address the vast majority of demand to this point. We believe these conditions will continue. In addition, new markets entering the Professional Liability arena during mid-2008 have created an even more competitive environment. Global markets are participating on U.S. risks and offering viable alternatives with aggressive underwriting positions. While we observe upward pressure on retentions, we expect slight rate decreases on clean renewals.

Overall, market conditions for construction-related Professional Liability have been similar to those in other product lines with the exception of a few trends.

- Contractors’ Professional Liability underwriters show little interest in covering the construction management (CM)- at-risk exposures on Contractors’ Professional Liability coverage forms. The underwriters continue to underwrite CM- agency but are more conservative on the CM- at-risk model.

- Owners are showing increased interest in Professional Liability. They are either requiring minimum threshold limits from their general contractors who do not carry...
Professional coverage, increasing existing minimum limit requirements dramatically, and/or pursuing their own contingent Professional Liability policies to treat the exposures. This is an issue for public projects, too.

- Early involvement in large-scale and private/public (PPP/PFI) projects by project financing entities is driving a resurgence in the demand for higher-limit, project-specific Professional Liability placements. Limits recently increased for this segment and have become more competitive because of new markets entertaining these placements. This is a significant change from earlier in 2008.

- Risks associated with BIM technologies continue to get significant attention from both the construction community and underwriters. Insurance solutions are still evolving for this coverage but recent large placements have addressed this potential exposure in broader fashion than we have seen before. We expect the market to offer broader-based solutions over the next year.

- There has been an increase in design/build activity for many of our contractor clients, delivered for the most part through joint ventures with architectural and engineering firms. The structuring of protection for contractors from the acts, errors and omissions of their design firm partners remains problematic. Project-specific professional policies, wherein the contractor is recognized as an indemnified party only, are proving to be reasonably robust mechanisms for addressing these exposures. The cost of this coverage is significant and can result in the insurance creating a non-competitive bid price, unless insurance costs are accurately factored into a project’s financial pro-forma at the outset of the project budget process.

ENVIRONMENTAL LIABILITY

Project owners and construction lenders are increasingly requiring Contractors Pollution Liability (CPL) coverage for their projects for two reasons: 1) the recent targeting of the construction industry as a sector with “high polluting” potential by the U.S. Environmental Protection Agency, and 2) the fact that while construction projects do not generally experience a high frequency of pollution conditions, when they do occur, they can be catastrophic. A CPL requirement is no longer reserved for large projects or jobs on environmentally impaired sites. While CPL has traditionally seen steady, profitable growth and is a preferred line of business for most carriers, the underwriting on these policies is not to be taken lightly.

ENVIRONMENTAL LIABILITY HIGHLIGHTS

- Rates have been decreasing in recent years and, while we see some indications that the soft Environmental market may be nearing its end or at least leveling off, some new capacity is entering the market. Increased competition, of course, usually leads to rate decreases.

- One major carrier recently reissued its CPL form and included many coverages previously negotiated separately.

- While terms and conditions have broadened over the past couple of years, the trend has been toward
increased project-specific information requests, more engineering of job sites, and more intensive underwriting scrutiny.

- Underwriters will provide multiyear, project-specific policies but will continue to push for annually renewable policies.

- For site-specific Pollution Liability exposures:
  - Loss history, including some catastrophic losses, in recent years, has resulted in coverage restrictions and increased underwriting scrutiny.
  - Underwriters continue to reduce policy terms for new conditions. While that coverage had been available for periods up to five years, the recent trend has been closer to three years.
  - At renewal, insureds should expect requests for more location-specific information on their portfolio placements. In some cases, these requests are demands, and coverage is contingent on providing more and better information.

- Along with increasing their number of requests for information, underwriters are more keenly interested in scrutinizing areas of regulatory interest, such as:
  - Vapor intrusion from underground contamination into buildings, which is not only a concern for the building owner, but also for the contractor performing work such as sewer line relocation.
  - Contaminated storm water runoff from construction sites, which has been getting much more regulatory attention at both the federal and state levels.
  - The evolving coverage for mold is improving due to increased understanding of the risk and modified construction and maintenance practices; however, insureds should prepare for coverage restrictions for emerging contaminants, such as perchlorate, E85 (gasoline and ethanol fuel mixture) and PFOA.
  - For remediation projects, cleanup cost overrun policies continue to challenge the market because historically these products have resulted in unacceptably high loss rates for underwriters. With only a few markets for this coverage, we believe there will be more restrictive terms, increased information requests, more engineering (including more site visits) and higher minimum premium thresholds in the year ahead. In fact, up-front engineering or commitment fees are now common and the majority of carriers only offer this product to a pre-selected group of contractors.
  - Professional Liability programs for large environmental service firms have been a source of significant losses for Environmental Liability carriers. Expect a continued pull-back from accounts with a significant component of traditional design engineering (i.e., non-environmental) exposures.

The bottom line in the Environmental Liability market is that insureds should expect challenging renewals with increasing underwriting scrutiny and should take care with the design and marketing of their programs to avoid erosion of valuable coverage. The new markets may not be the only ones asking for detailed information. The incumbents also may request information they never asked for before. Also, for new placements, it will be important to carefully match coverage needs to the current appetites and offerings of the individual markets. As Environmental insurers become more selective, purchasers able to combine innovative program design with high-quality underwriting presentations will fare best.
BUILDERS RISK AND PROPERTY

Perhaps the most troubled construction sector in 2006 and 2007 was Builders Risk. For obvious reasons, insureds in the Southeast faced critical challenges in terms of capacity, deductibles and pricing. The rest of the country has fared much better over the past few years. However, the devastation of Hurricanes Ike and Gustav is expected to affect Builders Risk premiums. While capacity should not be impacted significantly, we can expect an uptick in Builders Risk rates nationally by the first quarter in 2009. Immediate rate increases also can be expected in coastal areas with deductible levels also increasing. The current market still provides opportunities for master Builders Risk programs, which are increasingly popular.

BUILDERS RISK AND PROPERTY HIGHLIGHTS

- Hurricanes Ike and Gustav will impact Builders Risk market pricing immediately and into 2009. Property damage from Hurricane Ike alone is estimated at $20 billion – the second largest property damage loss from a hurricane.

- Outside of coastal areas and California quake country, Builders Risk coverage should continue to be available, though rates are expected to increase in Q4 2008 or Q1 2009.

- On moderate -to- large projects, underwriters are increasingly asking project managers technical underwriting questions and requiring risk control assessments, which means that longer lead times are needed to obtain multi-ple quotes and optimal terms and conditions.

- Contractors’ Equipment pricing is down 5-10% from expiring. Loss experience, retentions and geographies must all be factored in but, for the most part, this line of coverage will enjoy stable or reduced rates.

- Permanent Property rates are generally down, with concerns for aggregation of risk in certain areas of the country.

CONTACT

Paul Becker
Practice Leader
Willis HRH Construction Practice
615 872 3464
paul.becker@willis.com
HEALTH CARE PROFESSIONAL LIABILITY

HEALTHY APPETITES FOR NOW

The Health Care Professional Liability insurance industry has been more competitive in 2007 and 2008 than at any time since the late 1990s. Industry conditions continue to be the best since the mid-1970s and the short-term outlook is positive. Market deceleration continues in 2008 as capacity grows.

Recent entrants, including IronHealth, Allied World U.S., Endurance U.S., Max Managers, Barbican (London) and Canopius (Bermuda), bring more market capacity. Bermudian insurers in particular have expanded their U.S. presence over the past two years. While no major insurers have exited this market in the past 18 months, market consolidation continues, as evidenced by Allied World acquiring Darwin, and The Doctors Company acquiring SCPIE Insurance. AIG’s market share is being challenged due to the highly publicized issues of the parent company. The industry combined ratio is favorable, with many underwriters posting strong results in 2007. Even with sharp decreases in premiums over the past two to three renewal cycles, underwriting results are strong. Loss trends are stable. Frequency is down markedly, while severity continues to moderate.

Given the continued trends of aggressive underwriting competition and expanded coverage terms, the worsening economy, and the bottoming out of claim frequency and severity, we believe the marketplace will gradually begin to harden beginning in 2009. Premium reductions of 10-20% and, on occasion, 25-30%, continue to be the norm at renewal across most facility segments, with decreases of at least 5-10% and often more for physicians, especially large physician groups. High excess capacity has become very inexpensive for health care facilities but layers excess of $50 million are beginning to show signs of market hardening. Multiyear programs are available. Some, however, are voicing concern about the industry cycle repeating itself, especially with redundant capital creating pressure on rate adequacy. Underwriting loss ratios may have nowhere to go but up, due more to declining rates than loss frequency and severity, as those measures continue to remain stable. Continued softening into 2009 may not be sustainable.

RENEWAL STRATEGY

In the current marketplace, buyers should have their accounts marketed aggressively at renewal. In the process, they should:

- Challenge carriers to provide the very best coverage at the lowest cost
- Manage the renewal process, so that carrier relationships are valued, and multiple, quality carriers are utilized
Many facility buyers maintain relationships in all three major markets: domestic, London and Bermuda. In a line of coverage as volatile as Health Care Professional Liability, savvy buyers will cultivate alternatives and position themselves for the worst. Each line in the sector, of course, comes with its own marketplace characteristics.

**THE NATIONAL MEDICAL MALPRACTICE ENVIRONMENT**

The national Medical Malpractice environment continues to be the best it has been in the past 30 years. Observers point to several reasons.

- The successful enactment of malpractice reform laws in 30-plus states since 2000, particularly damage caps
- The media focus on the malpractice problem and the link to health care access
- The alignment of quality, patient safety and risk mitigation initiatives, especially in health care facilities

Coordination of these important initiatives has reduced claim frequency and moderated claim severity in all but a few states, such as New York, Pennsylvania and Florida. However, many claims professionals and defense lawyers think claims frequency has bottomed out and the number of malpractice cases filed will slowly begin to grow, even without any other unfavorable factors. They are concerned that an extended economic downturn may cause a gradual increase in frequency and severity rates and erode what appears to be increasingly unfavorable public attitudes toward malpractice litigation. In addition, the trial bar will continue to pursue its strategy of judicial nullification in attempting to overturn malpractice reform laws by challenging their constitutionality. The state of Illinois should be watched closely. The Supreme Court is expected to render a decision on an Illinois case (*LeBron v. Gottlieb Memorial Hospital, et. al.*) centered on this issue at the end of 2008.

Plaintiffs’ attorneys have been forced to be more selective in the types of cases they will accept due to the expense involved in trying cases and the increased chance of dismissal or of juries being sympathetic to the defense. They are seeking potentially high damage cases that will not be adversely affected by state caps on noneconomic damages. The cases with the greatest potential for large damages often involve injured children in obstetrical or pediatric cases.

**PHYSICIANS AND SURGEONS**

Consolidation continues in this segment, with The Doctors Company purchasing SCPIE in 2008. In addition, a new carrier was launched in South Carolina, with the state medical association’s creation of the South Carolina Physician Assurance Company. However, the number of start-up physician insurers, including risk retention groups and captives, has leveled off.

Market conditions are favorable for most participants. The tort climate is good and some physician carriers have enjoyed ratings upgrades from A.M. Best in recent years. PPIC, AP Capital and The Doctors Company have all moved to A-.

Physicians in most states are experiencing rate decreases ranging from low single digits to low double digits, typically 5-10%, and sometimes more. Many physician carriers are providing dividends to their insureds – yet another indication of profitability in this segment.

**HOSPITALS**

Improved underwriting results and new capital over the past five years, especially for Excess business, have made this segment highly competitive – truly a buyer’s market. July 1 renewals saw marked reductions, often in the neighborhood of 10-20% and occasionally more. High Excess layer pricing has softened, especially above $10 million, but may finally be showing signs of hardening in the layers excess of $50 million. Attachment points for Excess coverage are falling primarily in
less litigious states and carriers are jockeying for the lead layers in response to the improving environment and restored profitability.

Allied World US is a recent entrant to the domestic primary market, as are Endurance Specialty and Max Managers. Allied World has announced a merger agreement to acquire Darwin. Domestic Excess writers include AIG, Allied World US, CNA, Zurich, Am Re, Berkley Medical Excess, Arch, OneBeacon, AWAC US, Endurance Specialty US, Munich American and ACE USA.


**LONG-TERM CARE**

Like other segments of Medical Professional Liability, the long-term care segment is very competitive. Availability and affordability are no longer issues for most buyers. Large chains retain a significant layer of risk but can build capacity in London and Bermuda or buy down large retentions using alternative risk structures. There has been a limited reintroduction of occurrence coverage in this segment, offered by THOMCO, IronHealth and CNA, along with certain regional players. AIG and CNA continue to be major players, along with many others, including ACE USA, Darwin, IronHealth, OneBeacon, Old Colony, James River, Bunker Hill, Lighthouse Underwriters and Shand Morahan. London and Bermuda are important markets – London for Primary and Excess/Reinsurance capacity, and Bermuda for the latter only.

**MANAGED CARE**

The managed care segment remains stable but continues to have fewer markets than any other Health Care Professional segment. Yet there is more than ample capacity for most managed care risks and, like other segments, managed care buyers are enjoying the fruits of a competitive market. Pricing is even more competitive in 2008 after IronHealth’s market entry. Buyers can expect decreases ranging from 10-15% and more, while coverage enhancements abound.

New entrants, such as ACE USA and Allied World US in 2007 and IronHealth in 2008, have made the managed care segment much more competitive in the past few years. They join other relatively recent players in this segment, including Darwin, Lexington and OneBeacon. Excess underwriters include the London markets (Beazley, Lexington, Starr Excess, Liberty and Hiscox), Hanover Re, Swiss Re, and Bermuda markets (ACE, Allied World, Endurance, Starr Excess and XL). Domestic Excess underwriters include Darwin, OneBeacon, National Union and Travelers.

**MISCELLANEOUS HEALTH CARE FACILITIES**

Over the past decade, the miscellaneous health care facilities market has consistently had more competition than any other Health Care Professional Liability market segment. Buyers have seen rate decreases at renewal similar to those seen in other facility segments, typically from 10-20%. Virtually the entire range of health care facilities (50-plus types, with new ones created each year) are desirable underwriting risks because they generally have never experienced the dramatic rise in claims severity that began in the late 1990s (although large losses can and do occur). Ambulatory surgery centers are highly desired risks. Med spas, on the other hand, are an underwriting challenge. Many Excess and Surplus Lines carriers write miscellaneous health care facilities, while most of the commercial carriers pursue these classes of business. Medical Protective has entered this segment recently.
CONTACTS

Kevin J. Downs
Executive Vice President
Industry Co-Leader – Healthcare
Willis HRH
312 621 4812
kevin.downs@willis.com

Mary S. Botkin
Managing Director, Industry Co-Leader – Healthcare
Willis HRH
281 584 1646
mary.botkin@willis.com

Paul A. Greve Jr. JD RPLU
Executive Vice President
Willis HRH Healthcare Practice
615 872 3320
paul.greve@willis.com
STAYING AFOAT

Despite currently depressed worldwide economic conditions, the maritime industry remains buoyant. The need for key raw materials from the emerging economies of China and India, which drives demand in the dry bulk sector, is helping outweigh fluctuating costs of oil and climbing costs of shipbuilding and repairs.

CARGO

The Cargo market is soft and continues to soften. However, as we get closer to January 1 reinsurance treaty renewals, underwriters are warning that if reinsurance costs increase, their rates will follow. Broadening terms and conditions, including lower deductibles and rates, are still available in the worldwide marketplace. Stock Thoughtput, which insures goods in transit and those stored at warehouses and other locations, has, in some cases, been extended to provide coverage at retail stores. This soft market, combined with the manuscripted nature of the typical cargo form, lends itself to the crafting of policies that are tailored to each shipper’s needs. Despite falling premiums, Cargo insurance remains profitable for insurers, so competition for the business remains fierce.

In 2008, there have been no losses impacting the entire market, nor any catastrophic losses related to weather that might have reversed the softening trend. Despite no new entrants to the U.S. market, Cargo rates have fallen by as much 50-60% in highly competitive situations, where overseas and domestic markets are competing. Rates also are falling in markets outside of the U.S.: Reductions of 10-15% or more are common in the Asian market, with similar reductions noted in the London and European markets. The Middle East looks poised to receive an influx of capacity in the near future, similar to the increase in capacity currently taking place in Asia, although uncertain financial markets may curtail this activity.

The best way for insureds to take advantage of the current soft market is to use some of their premium savings to prepare for the harder market that will eventually follow by ensuring that their packaging and warehousing standards, including cargo security, become or remain best in class. A commitment to loss prevention will be key to obtaining the most competitive terms and pricing in a hard market.

HULL & MACHINERY/P&I

Brown water Hull & Machinery premium levels remain relatively flat. We expect rates to remain unchanged or decline by no more than 5% in 2009, barring any market-changing catastrophic events.
The recent oil spill in the Mississippi River and two recent large Builders Risk losses indicate that pricing may be near the bottom for those coverages. In fact, it seems likely that accounts with less than pristine loss records will see some rate increases in 2009. Rates tend to be a bit softer for brown water than blue water business, however, because there are many more competitors in the brown water market. The blue water market has few players because traditionally blue water business is not profitable. Since the insured values for most tonnage is significant, claims settlements often exceed earned net premium. Underwriters strive for a balance between retaining business and making a profit.

There are a number of worldwide Hull & Machinery underwriting markets:

- London (Lloyd's and Companies)
- Scandinavia (mainly Norway)
- U.S.
- Far East
- Continental Europe

Each of these markets is competitive on its preferred classes of business. The U.S. market strategy seems to focus on attractive risks, and now the major underwriters are adopting the U.S. strategy. The Scandinavian markets have been highly aggressive and, until recently, quoted very competitively. The London market is the most traditional and flexible. Underwriters are competitive and creative, providing solutions that may not offer rate reductions initially, if unwarranted, but that may ultimately result in a return premium if claims experience is good. If the account is restructured or remarketed, insureds may achieve greater premium savings.

For Protection & Indemnity (P&I) business placed in the Clubs, the range of increases for 2009 most likely will be slightly lower than those for 2008, though this will vary according to Club members’ varying financial positions. The lowest increases are expected to be between 5% and 7.5% and the highest between 15% and 20%. To date, pool losses for 2008 are much lower than the record amounts from 2006 and 2007, with only one pool loss recorded in the first six months of the year. Since most of the Clubs are reporting poor investment returns, they will need to rely heavily on their underwriting results for profits.

**MARINE LIABILITIES (PORTS/TERMINALS AND SHIPYARDS)**

The U.S. Marine Liability market remains fairly stable, with rates renewed as expiring or with reductions in the 5-10% range. The Marine Liability market tends to lag behind other Marine markets in terms of marketplace fluctuations due to the long-tail nature of losses. Marine Liability business, including Real and Personal Property and Equipment and Business Interruption coverages for ports/terminals and shipyards, has historically been profitable for underwriters. Premium levels have declined over the past two years due to increases in capacity and competition in 2007. However, the potential exists for prices to rise in 2009, especially with reinsurers feeling pressure to increase rates due to the prevailing global financial conditions.

**SUPERYACHTS**

Over the past 12 to 18 months, U.S. Yacht insurance rates did not soften as dramatically as expected. Rates have been stable or softened slightly. This trend follows several years of pricing increases.

Despite recent events in the financial market, there is still an abundance of capacity available in the Yacht market, including some new entrants into this arena. Competition among insurers worldwide, all of whom are competing for the same
owners, has been keeping rates down and creating broad coverage opportunities for yacht owners.

Again pointing to the current financial situation, we expect rates to trend upward over the next 12-18 months. This could be accelerated if one or two key insurers exit the Yacht marketplace.

A hardening of the Yacht market will also be caused by the same factors that impact other insurance lines; that is, anything driving higher reinsurance costs or reduced capacity.

Now is still a good time to be a Yacht insurance buyer. Yacht owners should evaluate options in the world marketplace and not limit themselves to U.S. insurers at renewal. While no insurer is reducing rates across the board, insurers are still reacting to competitive pressures on individual accounts.

CONTACT

Jane E. Sharfstein, CPCU, AMIM
Senior Vice President
Global Marine Practice
617 532 9790
jane.sharfstein@willis.com
Insurance buyers budgeting for 2009 can expect a buyer’s market, although the percentage of decline may diminish, and may even plateau. As always, however, the factors that likely will have the greatest impact on anyone’s experience in the marketplace remain individual loss experience, risk quality and exposure to catastrophe. As the market begins to show signs of change that will ultimately bring an end to the current soft market, the task of risk differentiation will become increasingly important as buyers of insurance seek optimal protection at an optimal price.

“All the signs are that I don’t think the soft market is going to last a long long time...but it does not seem to be something that is going to end in a few months,” said Willis Chairman and CEO Joe Plumeri in a recent interview with the Financial Times. Plumeri went on to say that catastrophic losses in the range of $50 billion-$100 billion would “accelerate” market stabilization, but even losses of that magnitude would not transform the market overnight.

Several carriers are reporting significant profit declines through the first half of the year, and this trend is continuing as insurers begin to report their third quarter numbers. Travelers reported a Q2 profit decrease of 25%, attributed to increased claim payments and falling premiums. Chubb said second-quarter profits fell 34% amid “industry-wide price declines and a surge in claims tied to the record number of tornadoes in the period.” The Hartford’s net fell by 13% as “investment troubles mounted and property-casualty insurance earnings and premiums fell.” As for reinsurers, first half results were “dismal,” attributed to falling prices, subprime write-offs and lower investment income.
The net effect of reduced earnings at the carriers will be to stabilize the markets and level off premium reductions. Carriers, of course, have varying exposures, as do insurance buyers. Exposure to investment losses in the wake of the ongoing credit crisis varies widely – the most notable example of course being AIG. Some insurers will be able to absorb the losses with their 2006-07 surpluses more effectively than others. The marketplace will also vary according to line of insurance.

Another powerful marketplace force is reinsurance prices, and widely divergent views are appearing on what is coming on that front. Munich Re recently said “it believes the current reinsurance market cycle is about to turn and said rates could increase by double-digit percentages.” According to a report from the recent reinsurance industry gathering in Monte Carlo, “with a market awash in capacity, no natural catastrophe to deplete industry coffers with burdensome claims and primary insurers taking higher retentions, reinsurance prices are expected to drop further still.” We believe the likely answer lies in between. We see the market remaining soft, but less so than it has been.

**PROPERTY**

Property markets are competitive. The industry remains challenged, however, by the need to develop catastrophic loss capacity for exposures to substantial windstorm damage. For these risks, the market is firm, though year-over-year pricing in general has seen modest decreases. For California Earthquake coverage, the absence of large seismic events has allowed rates to decline in most cases year over year.

In terrorism coverage, risks in central business areas with above average exposure are finding capacity adequate, thanks largely to the government backstop provided by TRIA and its legislative successors. The perception of underwriters regarding these risks depends on several factors: Is the risk of iconic stature? Are large numbers of people exposed, as in a major sports stadium? Does the potential exist for broad rippling economic impact (e.g., bridge and tunnels)?

For risks without catastrophic exposure of either the natural or man-made varieties, the Property market can be exceptionally soft, and year-over-year premium reductions should still be available. One indication of insurer attitudes is the trend toward multiyear policies.

**CASUALTY**

Capacity for General Liability, Auto and Excess Liability is abundant and rates are dropping significantly, in many cases, year over year. Several carriers are aggressively pursuing these lines of coverage and competition is often fierce for the accounts that control their risks and have favorable loss experience. Excess capacity is available from many carriers and Excess programs can offer substantial capacity using various carriers at very competitive rates.

**WORKERS' COMPENSATION**

Workers’ Compensation constitutes the largest single piece of the insurance industry – over 50% of the Casualty market. California constitutes the largest single piece of the Workers’ Compensation market in the U.S., and reforms in the state have had a major impact, reducing California rates by 65% in the last several years. This trend may be ending, however. The state’s Workers’ Compensation Insurance Rating Bureau has filed for a 16% rate increase “based on increasing medical costs for claims for the years 2006 and 2007,” according to a bureau spokesman. Some insurers have indicated that they believe other states will follow suit to reflect steadily increasing costs of care. Most major carriers write Worker’s Compensation. If results in this line deteriorate, all lines will be affected. Renewed emphasis on claims management is probably in order,
including utilization review, case management, and return-to-work programs.

In addition to rising medical costs, some believe the rising unemployment rate (which reached 6.1% in August, the highest level in five years\(^1\)) will have a major impact, bringing about an increase in both claim frequency and the length of time injured workers remain out. During economic downturns, Workers’ Compensation claim frequency often rises as some workers, afraid of losing their jobs and salaries, may look to Workers’ Compensation as a source of support that for many is higher than the amount paid under unemployment insurance mechanisms.

**ENVIRONMENTAL**

Environmental coverage has been relatively immune from soft market pressures, but, according to a report in *National Underwriter*, “increased competition – on top of declining demand, due to a slowing economy – have combined to prompt significant price drops.” The report goes on to quote Willis Environmental Practice Leader Mike Balmer: “It’s a buyer’s market...in pricing terms we are looking at certain program reductions of 25% to 30% – something not seen in the past.”\(^2\) Market penetration, at about 20%, may expand as a result of increased affordability and the growing importance of environmental considerations in the construction industry (see the comments on green construction below). As expectations for environmentally friendly materials and design grow, so may the impetus to assess and transfer these exposures.

**CYBER RISK**

The demand for coverage for Cyber exposures is also likely to increase. One factor is the announcement in August that the U.S. Justice Department charged 11 with stealing 40 million credit and debit card numbers from nine retailers. U.S. Attorney General Michael Mukasey said, “This is the single largest and most complex identity theft case that has ever been charged in this country.” He said the indictment “highlights our increasing vulnerability to the theft of personal information.” Mukasey said the scheme could ultimately cost citizens billions of dollars, and that some people may not learn they’ve been victims “for months or years.”\(^3\) We have seen an increase in requests for Cyber coverage from organizations that store credit card information. The marketplace appears ready to respond.

**EMPLOYMENT PRACTICES LIABILITY**

The Employment Practices Liability (EPL) market is a contradictory place these days. The market is attracting more entrants and the competition is driving down rates, but at the same time claims are increasing significantly. According to the Equal Employment Opportunity Commission (EEOC) 2007 Report\(^4\), total claims rose 9% in 2007, the largest annual increase since 1993. Retaliation cases rose to record levels. Race-based cases hit their highest levels since 1994. With the economy in decline, observers expect EPL claims related to terminations and downsizing to increase, but markets are not leaving yet. This space bears watching.

**REAL ESTATE MEGA TRENDS**

Hotel and Real Estate insurance buyers must not only navigate the general insurance marketplace, but must be aware of the impact of key industry sector trends on coverage issues. Mega trends include:

- Increasing replacement costs
Green construction
Financial stress and its impact on maintenance
Increasing foreign ownership
Declining real estate sales activity

INCREASING REPLACEMENT COSTS

While the credit crisis is sending the market value of real estate downward, the insurable replacement cost of most buildings is rising. The U.S. Bureau of Labor Statistics reported recently that construction materials costs, including fuel costs, rose 10.4% over the previous year; highway construction materials went up 18.9%. Since 2003, the cost of construction materials has risen 39%, more than double the general inflation rate over that period. Fuel costs are only part of the reason. Steel, copper, drywall and concrete costs have gone up, in part because of the weak dollar and in part because of competing demand from Asia. The impact on insurance is felt in replacement cost valuations. Replacement costs must reflect actual costs for coverage to be complete. Any organization facing a renewal should be sure to carefully review building replacement costs in advance of the renewal submission process.

GREEN CONSTRUCTION

The trend toward sustainability in buildings continues unabated. (See the previous issue of Views.) More insurance companies are amending their offerings to include coverage provisions that respond to the needs of green buildings. Some carriers are offering rate credits for LEED®-certified buildings. (LEED stands for Leadership in Energy and Environmental Design and is the acronym for the rating system of the U.S. Green Buildings Council.) Others are considering offering these credits. Green buildings are generally considered better risks. Green construction, with its emphasis on energy efficiency, grows only more popular with the rising cost of energy – from $3 per square foot to $3.50 per square foot, according to one global real estate company. In tough economic times, landlords have a hard time passing along increased energy costs to tenants, giving even greater incentive to reduce energy costs. As more builders offer green construction services, the cost of going green goes down and the return on investment improves. The insurance benefits of going green can only serve to support the general industry trend.

FINANCIAL STRESS AND ITS IMPACT ON MAINTENANCE

Many companies purchased real estate at historically low cap rates with the expectation that property values would continue to escalate and rental revenue would also increase. As raising rents becomes increasingly difficult in the current economic environment, debt service is becoming problematic for some who purchased at the top of the market in 2007.

As real estate companies look for financing, balance sheet lenders are, in many instances, replacing the commercial mortgage-backed securities (CMBS) market, which has almost disappeared. Balance sheet lenders, who generally do not securitize loans and tend to hold on to loans for a period of time, along with other financing sources, are seeking lower loan-to-value ratios, and more conservative loan covenants, particularly debt service ratio. Some lenders are beginning to once again ask for recourse in the loan agreements.

The credit crunch is also resulting in fewer projects being built, as construction loans are more difficult to obtain at favorable terms. Some projects have stopped midway, as the developers have found themselves unable to secure additional necessary financing. Build-to-suit projects are comparatively easier to finance, especially in contrast to spec projects, where financing is particularly hard to obtain.

Insurance underwriters are becoming aware of the financial stress some real estate companies are under and are beginning to look closely at each insured's financial condition. They
generally want to underwrite companies in sound financial condition to ensure premium paying ability, the ability to maintain properties and the likelihood the company will be in business. Carriers generally look for long-term relationships.

**INCREASING FOREIGN OWNERSHIP**

The decline of the dollar, along with the transfer of wealth to oil-producing nations, has lead to increased real estate investment across national borders. This trend toward cross-border real estate investment makes it important for all parties involved in insurance transactions, carriers and brokers alike, to understand and respond to the unique issues markets present around the globe.

**DECLINING REAL ESTATE SALES ACTIVITY**

Several factors reduce sales of real estate assets. Differing perceptions of market values on the part of buyers and sellers make agreement on terms more difficult, if not impossible. The scarcity of capital for acquisitions that followed the virtual elimination of mortgage-backed securities, plus the imposition of stricter underwriting standards by financial institutions, have made the task of finding funds for acquisitions extremely difficult.

**REAL ESTATE SECTORS**

**RETAIL**

The retail sector of the U.S. economy is struggling. “There is deep-seated pessimism in every corner of the retail landscape this year,” National Real Estate Investor reported recently. Of the 32 million square feet of new retail space that became available in Q1, only 22 million was leased. In Q2, retailers closed stores and curtailed expansion plans to the extent that vacancies at retail properties hit “multiyear highs.”

The chief cause is obvious enough: reduced consumer spending. In addition, those retailers with plans for acquisitions or expansion have been hamstrung by the credit crisis. Vacancies mean financial stress for real estate companies, and financial stress is one of the factors underwriters consider when assessing the quality of a risk, along with loss experience, catastrophe exposures, etc. We have not seen higher premiums directly linked to vacancy rates but would not be surprised to see this trend emerge.

**RESIDENTIAL**

The residential sector has been affected by the decline in housing values, but in ways that may not be intuitively obvious. “Much has been made about the flood of former house owners into apartments, but we are not seeing that,” said Doug Bibby, president of the National Multi Housing Council in a report in GlobeSt.com, a commercial real estate publication. “Instead, the primary effect the housing downturn is having on the apartment sector is a dramatic slowdown in the number of renters leaving to become owners.” Apartment landlords have seen vacancies increase some, largely attributed to the increase in the number of single-family houses and condos entering the rental market if they cannot be profitably sold, according to The Wall Street Journal.

**HOTELS**

The fortunes of the hotel industry historically have followed the trends in the general economy. When business is slow, people travel less for business and pleasure. In the current climate, the
situation has been exacerbated by the increase in air travel costs due to rising fuel prices. True to form, U.S. occupancy rates are down to about 65%, or 5% lower than last year.23 Distant destinations are in considerably worse shape. The industry averaged a 1.2% RevPar (revenue per available room) gain in the second quarter, leaving many wondering how long it will be before this number turns negative.24

Hotels may not be able to control economic cycles, but they can do something about other uncertainties they face. Hotels are increasingly looking at the entire continuum of risk. While they continue their traditional focus on fire, security and life safety issues, they are also looking at ways to reduce Workers’ Compensation claims through proper training and supervision. The goal is twofold: reduce costs, but also keep workers on the job, as finding and retaining the employees required to operate a hotel and deliver the services that guests require seems to grow only more challenging. We also see an increasing focus on food safety, cleanliness throughout the hotel and the risks associated with pandemics and cyber attacks. Hotels are seeking assistance in developing emergency response and business continuity plans. Such plans are seen as a way to provide improved security for guests, reduce recovery time following loss events and protect the ever-important hotel brand.

OFFICE

Office occupancy rates vary by city, but overall, the economic trend is expected to catch up with the office sector of the real estate industry. “Cutbacks in key industries such as information technology, finance and professional services have led to more than a quarter-million layoffs during the first half of 2008, which has emptied an estimated 38 million square feet of office space,” according to a report in *Financial Week*.25 The report quoted Grubb & Ellis, the real estate advising firm, as saying that office vacancy rates could reach all-time highs by the end of 2009. Rental prices are expected to flatten out. Forced sales of assets by owners caught in the credit crunch may lead to a rash of acquisitions by better funded institutional investors. “As office vacancies increase into next year, some owners of real estate assets may experience hardships,” the report said.26

INDUSTRIAL

With retail sales declining, warehouse vacancy is on the rise. The national industrial vacancy rate, according to Grubb & Ellis, rose to 8.0% from 7.7% in Q1 2007, following six consecutive quarters in which the rate hovered around 7.7%.27 However, expanding international trade should buffer the industrial market from the worst effects of the economic downturn, the real estate researchers said.

Vacancy rates were hurt not only by lowered demand for goods and services but by the arrival of newly developed property in the marketplace. While the construction pipeline is narrowing, with a decline in construction starts, the pipeline is set to deliver “some 121 million square feet of space over the next few quarters, a period during which demand for that space will be lackluster, according to Grubb & Ellis, which expects the vacancy rate to end the year between 8.5% and 9.0%, below the prior peak of 10.1% in the first quarter of 2003.”28 The threat of recession that hangs over most sectors of the economy does not appear to be affecting exports or even imports – yet. Thanks largely to the weak dollar, exports were up nearly 21% over the 12 months ending in February. Imports rose 16.4% during the same period. Rising vacancy rates will put downward pressure on rental rates, but trading activity gives a strong boost to warehousing activity, which should have a counter effect.

RIDING THE CYCLES

The insurance and real estate industries are both cyclical. They are also both impacted by inflationary trends, availability of credit and capital, the direction of interest rates, expansions and contractions in GDP, the overall performance of the financial
industry and unemployment rates. They both share concerns about the enormous impact of natural and man-made catastrophes.

Both industries often have periods where credit or insurance capacity is freely available on favorable terms and costs, followed by periods when providers of credit and underwriting capacity will reverse themselves by employing what some call draconian measures. The latter periods bring significantly higher costs and retentions and much more difficulty in finding capital or insurance capacity.

It is important to be mindful of these trends, and establish relationships that will help you successfully navigate good times and bad.

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CONTACT

Brian Ruane
National Practice Leader
Willis HRH Real Estate & Hotels Practice
212 915 7971
brian.ruane@willis.com

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