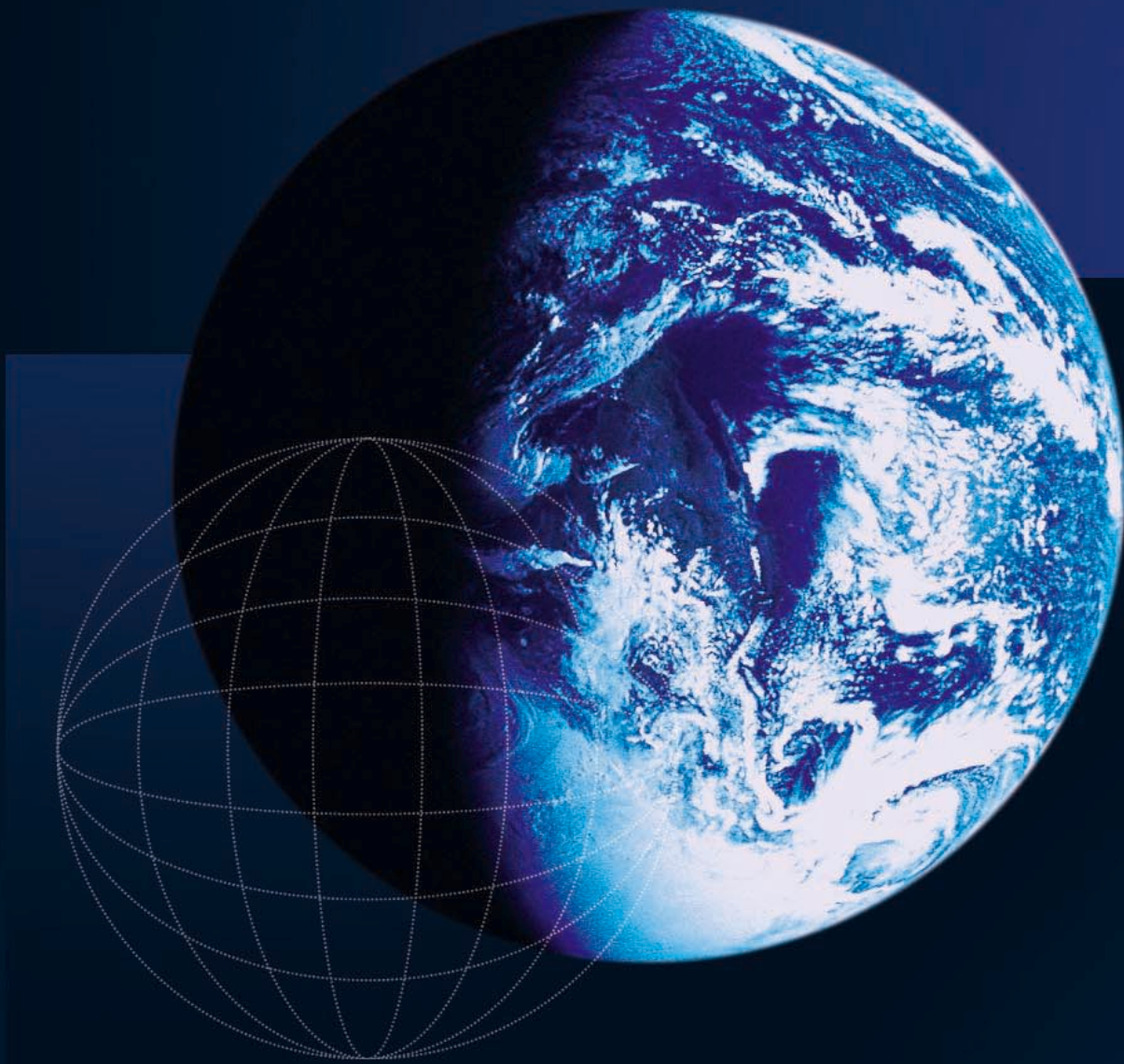


Marketplace Realities and Risk Management Solutions



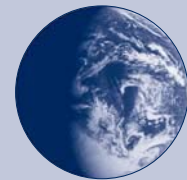
Global Perspectives 2003

Willis

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Marketplace Realities and Risk Management Solutions

Global Perspectives 2003

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"A Hard-Won Prize"

The shared experience of the past year has been remarkable. Insurers and insureds took stock of assets, exposures, loss expectancies, interdependencies, risk control, claims management, the economic and legal environments, and a host of other factors large and small as never before.

In the marketplaces where risk is bought and sold, companies of all stripes made close inspections of their own financial strengths and exposures and those of their counterparties, suppliers and customers.

Financial needs, goals and constraints were integral to the decision-making process that determines how and how much risk is held, shared and sold. For many companies, issues of capital allocation, cash flow, risk tolerance, volatility and balance sheet protection arising out of "ordinary" hazard risk commanded boardroom attention for the first time in many years.

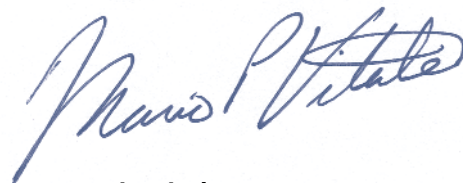
Collectively, during a year of tantalizing false starts and frustrating inertia, we waited with great anticipation as the US government warmed up to the role of becoming insurer for acts of terrorism. Finally, on November 26, President Bush signed into law the Terrorism Risk Insurance Act of 2002. Even as you read these words, the implications and mechanics of the law and the commercial response to it continue to be assessed, defined and developed.

Regardless of the ultimate impact of TRIA, the topography of the commercial insurance marketplace has been dramatically reshaped. Companies have been forced or impelled, by either capacity shortage or pricing regimens, to take on breathtaking increases in the quantum and scope of risk. Like Daniel Dafoe's Robinson Crusoe, thrust into dreadful circumstances, insurance buyers have called upon their ingenuity and resourcefulness and their partners in risk management to make the best of it.

We have been inspired before to devise robust new strategies, procedures and practices. Companies that endured the upheaval of the insurance marketplace of the mid-1980s made structural changes in the way they managed and funded for risk. Some did it out of necessity and some through creativity, resolve and vision. The long soft market that followed may have contributed to disinvestment in risk control, but the architecture stayed reasonably in place: seven-figure retentions, captives, unbundled services and alternative risk financing.

The legacy of the past two years—those things we have learned to do and those we have learned to do better—will also be persistent and valuable. We see it in nature: what begins as a defense mechanism becomes an embedded strength.

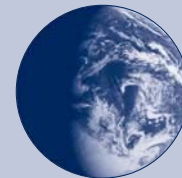
The people of Willis are proud to be your Client Advocate. Together, we have soldiered through trying times. The road ahead is one of challenge and opportunity, as it always is. To know that you are well equipped, that you have weathered a storm that has not altogether settled down, that you are ready to deal with dangerous curves and sudden obstacles—such confidence is a hard-won prize, and we will continue to do our utmost to nurture it and to serve your needs with distinction.



Mario Vitale

Chairman

Willis Risk Solutions



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Marketplace Overview

Though today's challenging commercial insurance marketplace bears little resemblance to that of the halcyon 1990s, it is still a marketplace that cannot be neatly categorized by a single word or phrase. *Hard* and *hardening* are insufficiently descriptive of market conditions of the past two years, the budgetary and fiscal upheaval visited upon all manner of companies, and the sheer unpredictability of what the next day or week might bring in the way of adverse market news.

What we have is not a classic hard market. There *are* lines of insurance for which one's need for capacity can readily be met. There *are* insurance program elements that have not been subject to eye-popping increases. And there *has* been an almost overnight infusion of capital seeking opportunity in the immediate aftermath of the market's loss of surplus.

The events and conditions that precipitated change in the marketplace are not the ones that gave rise to that of the mid-1980s. Their impact has varied, with some factors applying across-the-board and with other factors being specific to industry segments and insurance carriers:

- World Trade Center attacks
- Failure of Enron and other corporate debacles
- European windstorms
- Resurgence of asbestos litigation
- Long-term under-reserving
- Reductions in reinsurance capacity
- Sharp declines in equity markets and investment returns

In this article, we examine:

- **The Numbers**—financial benchmarks of US Property-Casualty insurance industry experience and performance.
- **Terrorism Insurance**—the immediate and potential impact of the Terrorism Risk Insurance Act of 2002 ["TRIA"].
- **Marketplace Attributes**—what this marketplace is really all about.
- **Eye on the Future**—expectations regarding the marketplace and risk financing.

The Numbers

In 2001, US Property-Casualty ["P/C"] insurers sustained an underwriting loss of approximately \$53 billion. Their combined ratio—losses and expenses combined, with no allowance for investment earnings—hit 115.7. The average throughout the 1990s was 107.7.

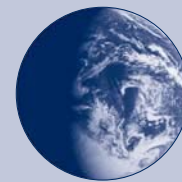
For reinsurers, the year 2001 was abysmal. Their combined ratio was 162.5. The highest it had been in the ten years before was 126.5. Morgan Stanley, in the section of their December 2002 P/C Industry bulletin titled "Reinsurers: Taking it on the Chin", makes this wry observation: "It would be easier to cite classes of North American casualty business that have not contributed to adverse development this year—none."

What's Wrong with the Patient?

Share prices for large insurers have declined for three years in a row. The last time that happened was before World War II. What's behind the woeful performance and the analysts' downgrades? Take your pick. Reserve deficiencies and adverse loss development. The "A" word—Asbestos. Declining investment earnings. Uncollectible reinsurance. These heavyweights can produce chronic earnings anemia. Throughout the decade of the 1990s, the P/C industry's cost of capital ran from the mid- to low teens, and in no year during that period did return-on-equity cover the cost of capital.

Insurance carriers' responses, apart from the soup-to-nuts re-underwriting and re-pricing of their books of business, have been a fresh round of senior management changes. Over two dozen companies at last count have anointed new leadership at or near the top. It's not entirely fair, however, to grouse about the way the P/C industry is run. Let's take a look at two arguably exogenous variables that are actually linked to one another: the US litigation "industry" and the resurgence of asbestos claims.

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Litigation American Style

Over the seven-year span 1994 to 2000, average US jury awards more than tripled for medical malpractice, wrongful death and products liability claims. The pie—the cost of the tort system—is enormous, but successful claimants and other parties receive less than half: 20 percent for economic loss and 22 percent for non-economic loss. The balance goes to attorneys on both sides and the cost of administering the legal process. During the decade of the 1990s, tort costs represented approximately 2 percent of Gross Domestic Product. For the year 2000, GDP was \$9.965 trillion dollars. In that year, tort costs were about 1.8 percent of GDP—\$179 billion. Perhaps we can better appreciate that number if we make a comparison or two. In the year 2001, GDP for the Czech Republic was \$148 billion; for Greece, \$189.7 billion.

The US tort system is big business.

The "A" Word

Incurred asbestos-related losses reached \$31.9 billion in the year 2001. The reserve deficiency—unfunded future liabilities—was estimated to be \$33.1 billion. Over the past three years, the increases in the number of claims have been phenomenal—multiple-hundred-percent increases in industries that have been the traditional source of such claims (e.g., vehicle maintenance, asbestos mining and manufacturing, construction) and industries that are relatively new to the bandwagon—textiles, pulp and paper manufacturing, the food and beverage industry, and others. The growth in the number of claimants is dazzling: in 1982, there were about 21,000; today, roughly 600,000. The estimated future cost of asbestos claims is \$200 billion, of which US insurers might bear 30 percent, or \$60 billion.

The "peril" of Mold may be the flavor of the month, so to speak, but it's still small potatoes compared to the "A" word.

Terrorism Insurance

For the most part, the articles contained in this book do not treat the topic of TRIA. We chose to highlight features and issues here in the Marketplace Overview section, given the multi-line impact of TRIA and the fact that while some features of the Act can be described with confidence, there are many features subject to interpretation. Further, we have observed

that individual insurance carriers' practices in response to the Act are neither consistent nor predictable. What is written today, several weeks prior to the publication of this book, about TRIA or commercial insurance coverage for terrorism, may be stale-dated by the time you read these words.

What we *can* say with absolute confidence is that Willis has been and will be aggressively proactive in tracking developments, informing clients and helping to shape strategies and programs that take advantage of coverage provided by the new federal facility and by the commercial insurance marketplace. Our practice leaders, terrorism insurance specialists and Client Advocates conduct market research on a daily basis, and we deliver relevant updates to our clients through phone calls, electronic media and published bulletins.

TRIA—Implications and Insurer Response

We need not recite here the detailed structure and scope of TRIA. You have that already from Willis and from other sources. Sullivan & Cromwell, in its December 10 memorandum on the topic, notes:

The Act requires that participating insurers "make available" coverage for "insured losses" in their commercial "property and casualty insurance" policies (as defined by the Act) and that coverage made available may not "differ materially from the terms, amounts and other coverage limitations applicable to losses arising from events other than terrorism."

In very simplistic terms, when TRIA became law on November 26, terrorism exclusions were nullified for in-force policies subject to the Act. Insurers have a 90-day window in which to advise policyholders of the terms and cost of certified terrorism coverage. Policyholders have 30 days after receiving notice to accept or reject coverage. There are stipulated procedures for policies in force that contain terrorism coverage and for new and renewal policies issued after November 26. And for all of the foregoing, there are nuances and *caveats* aplenty.

Marketplace Overview (continued)

Dear Carrier: Whither Goest Thou?

Insurers' responses to TRIA have varied widely. A representative for one European insurer related that company's intention to develop a pricing regimen that would make commercial insurance coverage "attractive"—up to 25 percent of All Risk premium, depending upon the degree of risk as measured by location and class of business. A representative for a large US property insurer spoke of an All Risk surcharge for certified terrorism in the low single digits.

Such apparent disparity invites the question: "Dear Carrier—How do you know how much the risk is really worth?" We cite Morgan Stanley's cautionary note:

Although the progress of government-backstop legislation has been glacial, its implications for insurers could prove sudden and dramatic. The industry is on the hook for greater risk but has limited experience in managing it. From a ratings standpoint, Standard & Poor's will adjust its measure of capital adequacy to take into account the terrorism risk that both insurers and reinsurers will be taking on, and it will call on them to demonstrate a thorough understanding of the new exposure. Without that exposure, insurers might be building frail houses of risk on the uncertain sands of government backing and facile dependence on unreliable pricing models.

We couldn't have said it better.

Marketplace Attributes

By now, most if not all risk managers and insurance buyers have an excellent sense of the commercial insurance marketplace and would be happy to share with you exactly what they think about it. We said earlier that the marketplace cannot be described by a single amorphous word or phrase. The articles contained in this book deal one-on-one with conditions specific to the line of business or specialty area. We look at capacity, pricing, terms and conditions and expected developments. Although there are some themes in common, each market segment is unique.

What are some of the themes in common?

- Minutely detailed underwriting scrutiny is here to stay, regardless of pricing levels or growing profitability. For the foreseeable future, anyway.

- For certain lines, rates and premiums have reached a level at which underwriters are comfortable or eager to take on more risk—to the point that the word "competition" has re-entered the lexicon.
- Individual carriers have unique sensibilities, desires and fear factors. Achieving neatness, uniformity and concurrency in program construction are stretch goals.
- Capacity is more than a number. The nature and quality of capacity are important as well.
- Reinsurance and the health of the reinsurance industry have tremendous if not controlling influence on a primary carrier's behavior.

Legacy, Capacity and New Capital

Standard & Poor's estimates that the global insurance and reinsurance market has suffered a net reduction in capital of \$170 billion over the past few years due to underwriting losses, significant claims activity, and poorly performing investment markets. New capital coming into the market has been a fraction of the capital lost, but it has been invigorating—a psychological shot in the arm. Worldwide, over the past 16 months, new capital in place and pending capital total over \$50 billion. What is there about this infusion that makes it so noteworthy, given that it is but a small wedge of total market capacity?

The answer has to do with the clean slate effect. In the December 2002 update of the Willis Energy Market Review, we addressed the growing gulf between "legacy" and "non-legacy" markets. Legacy markets are those carriers that are saddled with the burdens of the past, and non-legacy markets are the new capital entities that are operating with a clean slate—a balance sheet free of the debilitating wounds of history.

Quite understandably, many legacy underwriters are keen to tell anyone who will listen that the hard market will continue for a number of years, perhaps well into 2005. There will be no loosening of terms, they say, and indeed there is likely to be some residual hardening throughout the period. Non-legacy underwriters, however, view current rates and terms as being highly attractive. Their chief concern is to gain market share without seriously undercutting prices. They are also concerned



opportunities for profitable underwriting—that onerous terms and pricing may drive customers from the marketplace altogether, into alternative funding arrangements and stand-alone facilities.

If legacy markets are simply unable to escape the financial burdens of the past, to what degree can new capital entities influence the overall levels of market capacity and premium? Until relatively recently it seemed that the supply of new capital would continue to grow at a healthy rate. New start-ups appeared almost every month, and the capacity crisis of the last quarter of 2001 appeared to be waning. But if global equity markets remain in the doldrums or fall further, will enough new capital be available to fill the gap created by the legacy markets' refusal or inability to compete?

At this moment there is enough capacity for most risks—at a price. Programs that have had or are having their second renewal since September 11, 2001 are for the most part experiencing far smaller premium increases. Yes it is far too early to bless such positive change as a trend. Supply and demand curves are shifting, and on the supply side, market capacity is a function of many variables: new capital formation, legacy issues and reserve adequacy, investment earnings, corporate earnings and more.

We begin 2003 with high hopes that the industry has regained its footing, that new capital has made a substantive and energizing contribution, and that rational pricing will begin to ensue. Nevertheless, carrier security issues and rating agency actions continue to command our attention. On December 24, 2002, A.M. Best Co. lowered the financial strength rating of the participants in the Kemper Insurance Companies intercompany pool to B+. Adverse carrier security developments often impel immediate adjustment of program structures and marketing activities. We monitor carrier security issues continuously to help facilitate advance planning and achieve flexibility in the choice of program placement options.

Eye on the Future

For risk managers and senior financial officers, there are lots of futures: later today, the next D&O renewal, the next quarterly earnings forecast, the April 1 and July 1 reinsurance treaty

renewals, and many more dates and thresholds than one really wants to contemplate.

Well before the exigencies created by the marketplace of recent years, companies had taken important steps to integrate management of firm-wide risk. Though the speed and breadth of developments in the insurance marketplace may have swamped initial efforts to cope with change methodically and dispassionately, companies have by and large "caught up". Budgeting for cost of risk is more reliable. The tools for funding and managing the big new crop of retentions have been deployed. Captives have been and are being formed and expanded. New group programs and stand-alone facilities are being developed. Conditions are far from optimal, but people are beginning to feel that they are in control again—that they have come through the worst and have the resources they need to manage.

Meeting the test of each future event and goal requires strategic vision and indefatigable dedication to task. For our many valued clients, Willis will continue to be tireless in the pursuit of excellence.

Attributions

Sources for this article include:

- Presentations by Dr. Robert P. Hartwig, SVP and Chief Economist for the Insurance Information Institute.
- Citations from A.M. Best; Claims Resolution Management Corporation; The Geneva Association; ISO; Jury Verdict Research; Morgan Stanley; The Rand Corporation; Reinsurance Association of America; RIMS (2001 Benchmark Survey); Sullivan & Cromwell; Tillinghast-Towers Perrin; US Bureau of Economic Analysis; US Central Intelligence Agency; Willis (Energy Market Review), and Willis Associates worldwide.

Headlines and Highlights

- Reserve adequacy has been impacted by WTC-related claims, accelerated development of asbestos and environmental claims, and historically underpriced casualty business.
- New capital reinsurers are expanding product lines and territorial scope.
- Advanced analytical technologies and state-of-the-art information management are contributing to the growth and efficiency of the reinsurance marketplace.

The year 2002 was supposed to be a banner year for all reinsurers as they set out to replenish a meaningful amount of the capital lost on September 11, 2001. The frequency and severity of new loss activity in 2002 was not adverse by historical standards, even though some insurers and reinsurers were impacted disproportionately. The adverse forces that did arise in 2002 came from the sins of the past—under-reserving and the development of a new generation of asbestos claims.

Claims Impacting Loss Reserves

In 2002, the ongoing development of WTC claims, the accelerated development of asbestos and environmental claims, and the persistent impact of underpriced casualty business over the past decade highlighted the inadequate level of loss reserves for many reinsurers.

WTC Claims

Given the enormity of the loss of human life, companies were understandably focused on addressing the personal needs of their employees and their families. The sheer lack of experience in preparing and processing such large and complex insurance claims overwhelmed many insureds at a time when they were already dealing with a turbulent post-September 11 insurance marketplace. It was well into the 2002 year before greater clarity was achieved regarding the size and scope of many WTC-related claims.

Insurers and reinsurers, despite their supposedly conservative track record in assessing and reserving large losses, found that they had to increase their loss reserves for late-developing WTC claims.

Accelerated Asbestos Claims

Due to court decisions in the past year in which asbestos plaintiffs prevailed, there has been acceleration in the payout of asbestos claims. In addition, with the geometric increase in the number of asbestos defendants, the number of insurers with policy exposure to asbestos litigation has increased sharply. While Congress is likely to take up the issue of tort reform in 2003, insurers have experienced a quantum leap in reported claims, with the average size of claim also increasing sharply.

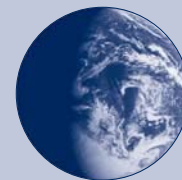
Impact of Underpricing and Coverage Expansion

Though less visible, perhaps the most significant factor in reinsurers' results has been the cumulative weight of inadequate pricing over the past decade. The 100 to 200 percent rate increases achieved over the past two to three years have, in many cases, returned technical rate levels to where they were in 1994. In the intervening years, however, the breadth of coverage was expanded while attachment points were lowered, and the combination was quite effective in generating larger than expected loss ratios. Many industry observers feel that the impact of these factors is yet to be fully registered.

Uneven Results

As the chart below indicates, through September 30, 2002 there was considerable variance in how reinsurers fared in 2002. Of the 30 reinsurers surveyed, 12 had combined ratios below 100 percent, nine had combined ratios between 100 and 110 percent and nine had combined ratios above 110 percent. The variance can be attributed to different risk appetites and length of time in business.

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Combined Ratio: RAA Statutory Nine-Month Results at 30 September 2002

| Number of Reinsurers | Combined Ratio | Net Premiums Earned (\$ thousand) |
|----------------------|----------------|--------------------------------------|
| 12 | <100% | 7,592,303 |
| 9 | <110% | 2,980,448 |
| 9 | >110% | 9,937,695 |

The Asset Side of the Reinsurers' Balance Sheet

While the above statements focus on the liabilities of the insurance and reinsurance industry, the compounding of the declining equity market and corporate bond positions in companies like Enron and WorldCom have added greater pressure on the overall financial position of most reinsurers.

Implications for 2003

The overall implication for 2003 is that reinsurers' inability to replenish a more sizeable amount of capital in 2002 will stiffen their underwriting resolve; they are likely to continue pushing for increases to improve their overall level of underwriting profitability. However, within specific lines of business there will be variability, ranging from maintenance of expiring reinsurance terms on property reinsurance programs (particularly regional programs) to sharp 50 to 100 percent increases on specialty programs.

Capital Update: "Old and New"

Since the time of the WTC attacks, \$24 billion in new capital has been injected into the reinsurance business, approximately \$8 billion of which went into Bermuda. A sample of the new Bermuda reinsurance capital, and how it fared in 2002 through September 30, appears in the following table.

New Bermuda Capital: 2002 Results (through 30 September 2002, unaudited)

| New Reinsurer | Initial Capitalization (\$ billion) | Gross Written Premium (\$ million) | Capital at 30 Sep. 02 (\$ billion) |
|-------------------------------|--|---------------------------------------|---------------------------------------|
| Allied World Assurance | 1.5 | 684 | 1.6 |
| Arch Reinsurance | 1.0 | 965* | 1.4* |
| Axis Specialty | 1.6 | 779 | 1.8 |
| Endurance Specialty Insurance | 1.2 | 624 | 1.2 |
| Montpelier Re | 1.0 | 534 | 0.9 |

*Arch 2002 figures include Bermuda and US insurance and reinsurance operations, as they are reported on a consolidated basis.

In reviewing the past year, it is clear that these new companies have:

- Diversified quickly into insurance, setting up specific insurance capabilities with technical underwriting teams.
- Exercised restraint in their pricing and underwriting requirements on reinsurance business, generally not undercutting existing leads.
- Positioned themselves to take a lead role in the future by significantly adding to their underwriting staff and their technical cat modeling and financial modeling capabilities.

Expectations for Different Behavior in 2003?

The coming year will present interesting challenges (hence opportunities) for the class of new reinsurers. Casualty reinsurance terms may increase significantly, and the increased focus on the quality of reinsurance security will inevitably prompt some reinsurance buyers to solicit lead pricing indications from these new reinsurers whose capital is adequate enough and for the most part unencumbered. In addition, the seemingly distracted state of some of the larger direct-writing reinsurers creates an excellent opportunity for these new reinsurers, along with other established reinsurers who are technically capable of underwriting difficult types of business decisively (and positively) within reasonable time frames.

The sharply increased staffing levels of these new reinsurers will enable them to take on the more labor-intensive role of leading business. Whereas most of the newly formed reinsurers focused more intently on excess of loss reinsurance, primarily catastrophe excess of loss, we see them stepping up their focus

Reinsurance (continued)

on working business, on both Property and Casualty lines. They have developed the underwriting resources to more closely underwrite risk-exposed business, and some may do this from vantage points in the US.

Consolidations and Mergers

The historical experience of reinsurers falling behind the pack only to be absorbed by another reinsurer may be less likely to repeat itself in the future. Acquiring reinsurers are much more critical in their assessment of a target reinsurer's financial health. Being inundated with a myriad of new business opportunities, and being able to selectively hire new underwriters, there is less motivation to acquire long-standing reinsurance companies with multiple decades of exposure to asbestos and environmental claims.

If significant reinsurance mergers or acquisitions are to occur in 2003, it will require very substantial commitments on loss reserves by the selling company, if part of a large financial entity (e.g., GE), to make it worthwhile for the acquiring reinsurer. Consolidation over the past 20 years has reduced the number of reinsurers from 112 to 30, while surplus has grown from \$3.5 to \$39.7 billion.

Terrorism

While there is much ongoing discussion and review of the Terrorism Risk Insurance Act of 2002 (TRIA), initial comments from a private sector reinsurance perspective included the following points:

- Reinsurers paid a high percentage of the September 11 losses but are not subject to protection under the Federal "backstop".
- Publicly traded reinsurers are acutely sensitive to the potential volatility associated with terrorist acts.
- Capital within the reinsurance industry represents a small fraction of US insurance industry capital.

Reaction in Reinsurance Treaty Renewals

Against this backdrop, one might expect reinsurers to be reluctant to relax terrorism exclusions in reinsurance treaties. The emerging consensus approach at year-end was to exclude Acts of Terrorism that are covered under TRIA, thereby effecting coverage for Non-Certified Acts of Terrorism, which would encompass so-called "Domestic Terrorism" or acts of terrorism occurring outside the United States (other than acts involving a US carrier or US mission, which are covered under TRIA). Not surprisingly, in situations where a ceding company's exposures are more narrowly contained in a regional area, away from the major US urban centers, some reinsurers are still willing to provide terrorism coverage for Certified and Non-Certified acts.

Spike in Demand for Stand-Alone Terrorism Reinsurance

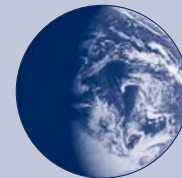
For insurers with meaningful 2003 deductibles under TRIA there has been increased demand for stand-alone Terrorism Reinsurance, recognizing that in the next two years, their deductibles will grow.

Technology

Modeling

Catastrophe modeling has become an even more integral part of the reinsurance negotiation and placement process, yielding far greater transparency regarding accumulations of exposures to a wide range of perils; from the traditional natural catastrophe perils to the newly-encompassed peril of Terrorism. Catastrophe modeling in the wake of September 11 focuses on multiple lines of exposure being impacted by a single event.

Leading catastrophe model vendors have developed probabilistic capabilities to assess terrorism risk. These models are not without great uncertainty, however, as determining the probability of a certain type of attack (i.e., truck bomb, surface-to-air missile, nuclear bomb, etc.) at a specified trophy building or target without the benefit of a history of experience is no small feat. One challenge is capturing a sufficient level of detail — e.g., identifying the specific building at risk, multiple (re)insureds that may occupy the building, the number of employees, payroll amounts and benefit levels, and so forth.



Insurers and reinsurers have yet to embrace any single probabilistic methodology and are relying on a combination of model results, internally developed accumulation tools, risk appetite and management opinion.

E-Partner Information Distribution

Willis Re has actively expanded its ePartner electronic distribution capabilities over the past two years, enabling clients and reinsurers to access vastly increased amounts of information more quickly and efficiently.

The ePartner system enables clients to access current and archived information on all their reinsurance placements as well as efficiently transfer information to Willis Re and their reinsurers. This is all managed through a secure, dedicated and customized Web site for each client. The Web site is created by Willis Re and houses information on accounting, claims, contract wording, placement and other customized areas.

From the reinsurer's perspective, ePartner is the most efficient and cost-effective way of gaining access to reinsurance opportunities. In making it easier to do business, all parties gain.

Reinsurance Optimization

With the significant increase in the cost of reinsurance and pressures for capital efficiency, insurers are now accessing expanded financial modeling services from larger reinsurance intermediaries in an effort to manage risk more proficiently. Reinsurance optimization analyses enable insurers to quantify the impact of a wide array of reinsurance structures on their financial statements and to more quickly and efficiently establish optimal reinsurance program structures. Reinsurance optimization studies utilize probabilistic models and various simulation techniques. These models look at many possible loss scenarios, typically thousands, to allow comparison of the expected profitability and associated risk for each reinsurance structure being considered. There are several stages in properly preparing a reinsurance optimization analysis. These stages can include:

- Setting capital management and operational goals
- Creating an appropriate business model
- Developing reinsurance options
- Price discovery and evaluation
- Risk transfer decision

A properly completed reinsurance optimization study will identify the best combination of reinsurance programs that will produce the largest profit while meeting capital, loss-ratio and leverage constraints.

Directors & Officers Liability

Headlines and Highlights

- **Corporate financial debacles have wrought havoc in the field of D&O insurance.**
- **Carrier capacity management and pricing regimens impact the timing and cost of program renewals.**
- **Terms and conditions are changing across the board, warranting careful examination of their impact on a case-by-case basis.**
- **While Side-A policies can be useful, they are not a panacea.**
- **The Sarbanes-Oxley Act has important ramifications that must be explored and understood.**

State of the Marketplace

The recent spate of highly public corporate financial debacles has led to a crisis in public confidence about how US corporations are governed. These recent events have also wrought havoc in the field of Directors and Officers (D&O) Liability insurance. While certain security holders have lost all or substantial portions of their investments, D&O carriers have been doubly hit. They have experienced negative results in their own portfolios while also paying out dozens of policy-limit losses—for the same companies whose failures caused their portfolios to decline. In the current market, companies will find it difficult to raise equity or debt financing and, in many cases, to obtain D&O insurance at anything close to their expiring terms and pricing.

Just as public and private companies are trying to recruit new, financially savvy board members, insuring them has become a difficult and complicated challenge. More than pricing, the terms and conditions of coverage may be subject to substantial change. One market leader has introduced several new versions of its basic D&O contract. Some versions cover only some of a company's board members, and may not cover the company as a whole at all. As the D&O marketplace continues to evolve, it is possible that in 2003 we will no longer have a "standard" D&O contract. For publicly traded companies, such contracts have historically been a crucial part of coverage for SEC claims. There is only one certainty: at renewal time, coverage will change.

Pricing

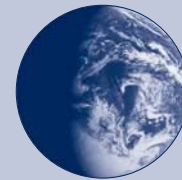
Premium levels continue to reflect market firming, but it appears that we are beyond the worst of the premium increases of 2001 and 2002. We expect that the 50 to 75 percent increases experienced in the last quarter of 2002 will slowly diminish for "good" publicly traded risks. For privately held, financially secure companies, increases should be in the 25 to 35 percent range. For buyers with claims activity or negative financial trends, however, these levels are likely to break the 50 percent threshold. Financially distressed companies, those with very large market capitalizations, companies in certain industry sectors and companies with significant claims experience should continue to expect dramatic premium increases of 100 percent or more. These companies should also expect substantial changes in terms and conditions. Protection for the corporation (entity coverage), for example, may no longer be available or, at the least, will be offered on a pre-set allocation basis.

The pricing for primary D&O programs has set the tone for more dramatic pricing on the excess layers. During 2002, we saw excess pricing reach staggering proportions. In previous years, excess pricing was calculated as a percentage of the primary pricing, and the further away from primary, the smaller the percentage. We now see excess pricing throughout all layers at 90 percent (or more) of the primary layer. Before 2002, percentages for the first excess layers were usually at 55 to 60 percent of the primary layers, and excess layers above that were even less expensive. Now, excess pricing is virtually indistinguishable from the primary for the first \$50 million, and this "burn" layer goes up depending on the size of the company.

Carriers are responding to significant claims activity in layers previously thought to be untouchable. With paid losses on roughly two dozen D&O claims exceeding the \$100 million mark over the last two years (and this does *not* include the

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financial melt-down claims of 2002), carriers have learned the hard way that attaching high in the first \$100 million is not a risk-free proposition. All of this translates into larger proportional price increases for buyers even when limits are unchanged.

Carriers

New capacity can be found in the Bermuda market, which is swiftly becoming a haven for many companies having difficulty obtaining a traditional program in the US. Bermuda is known in particular as the preeminent market for personal Side-A policies. These cover non-indemnifiable loss, protecting individual directors and officers in the event that their company is financially unable or legally precluded from providing protection. This type of policy is seeing a surge in interest, underscoring the importance of the Bermuda D&O market.

Limits

Despite the introduction of some new market capacity in the US and Bermuda markets, buyers should continue to expect a conservative limits management approach by D&O carriers. Although total capacity is close to \$1 billion for D&O, virtually all carriers are reluctant to put their entire capacity on the line for a single insured. In addition to total capacity management, carriers are also seeking to "ventilate" or space their limits by splitting their capacity between attachment points. Carrier A, for example, may be on the primary and then again on a higher excess layer, with two or more other carriers on the interim layers.

Time Crunch in Negotiations

Another important issue in the current D&O market is the time available to read the increasingly complex policy fine print. As a rule in the current climate, carriers will not provide firm terms and conditions prior to 30 days before renewal or inception of a contract. This affords a relatively short turn-around time. The time crunch is magnified by the fact that most excess carriers will not provide a quote until they have an opportunity to see the primary carrier's quotation. As we have noted, the limits management strategy being exercised by carriers today leads to multiple excess layers, each one waiting politely for those lower on the program to quote first. A time problem is unavoidable. Long gone are the days of negotiating D&O programs months in advance.

Attention to terms is particularly important with binders. Some carriers now seek *void ab initio* language that enables the carrier to re-underwrite the account during the 30-day post-binding period if there has been any change in the risk profile of the company, or if there is any delay in providing carrier subjectivities. This re-underwriting can be as simple as re-pricing, or as extreme as voiding the binder entirely.

Even when a quote *appears* to be adopting the terms of the expiring policy in large measure, careful attention needs to be paid to the exact language. Some carriers are also including "look-up provisions". These allow the carriers to review and modify pricing, which can potentially lead to endless and costly negotiations.

Terms & Conditions

Terms are changing for all types of D&O coverage.

- Entity coverage may only be an option (or not available at all for some risks).
- Co-insurance may be offered or required as an addition or as an alternative.
- Retentions are going up, and specialized provisions such as retention waivers are being removed.
- Fraud and personal profit exclusions are being tightened.
- Severability of the exclusions and/or information supplied in the application for insurance is being removed or restricted.
- Panel counsel requirements may be undergoing revision and preferred firms may be dropped.
- Expect narrower definitions of subsidiaries, and restrictions to automatic coverage for newly acquired companies.
- Broad outside directorship extensions are becoming a thing of the past where for-profit organizations are concerned.
- Failure to maintain insurance exclusions are being added.
- Claims may no longer include criminal complaints or investigations.
- Notice provisions are being significantly tightened.
- Pre-set pricing for the extended reporting period (also known as a discovery period) is being sharply curtailed and multi-year discovery options are virtually non-existent.
- Some or all of the recent bankruptcy modifications may be deleted.

Directors & Officers Liability (continued)

Issues and Perspectives

The ABCs of D&O

With D&O premiums still peaking and coverage being scaled back, one option being seriously considered by many is the purchase of Side-A D&O coverage. While Side-A contracts are not new, and many large market cap companies currently purchase a Side-A contract in addition to a traditional D&O program, few companies to date have purchased only this pared-down form of D&O coverage. Throughout 2003, we expect most public companies will give serious consideration to expanding the role of Side-A policies within their D&O programs.

At the end of 2002, some D&O markets began to reconsider the idea of providing entity coverage for D&O securities claims. Entity (or Side-C) coverage began in the mid-1990s in response to disputes over allocation. While entity coverage solved some problems, it also had unintended consequences. First, with the company's own liability covered by the policy, the amount of coverage available solely for individual board members is impaired. Second, carriers are now on the hook for the entire cost of a claim after the retention has been satisfied and the insureds no longer have any "skin in the game". Third, in a bankruptcy context, having the corporation's own liability insured under the policy may lead courts to conclude that the proceeds of the policy belong to the bankruptcy estate. These factors led several major insurers to push for removal of entity coverage in the D&O contract, and the re-emergence of pre-set allocation to avoid skirmishing at the time of claim.

Removing Side-C coverage from a policy would typically still leave both Side-A and Side-B coverage. B-Side policies cover indemnifiable loss for individual executives. Joint A and B coverage means that individual directors and officers are covered whether a claim is indemnifiable or not. News stories touting the (very real) benefits to some Side-A D&O contracts have to a large extent obscured the advantages of a combined Side-A and Side-B policy. By the end of 2002, it was likely that at least one member of every board in America had read an article pronouncing Side-A D&O coverage a great cure-all. For the insurance carriers, this may well be true. For their insureds, it may not.

Threats of Revocation

The ability to attract and retain board members is to some degree tied to a company's ability to evidence D&O insurance. For those directors and officers of companies involved in significant financial restatements, where fraud may or may not be alleged, there is heightened concern over whether their D&O carrier can or will attempt to rescind or revoke D&O insurance for some or all insureds. In 2002 we also saw some attempts by company creditors, in the context of corporate bankruptcy, to deny individual directors and officers, especially "evildoers", access to coverage under their D&O policies.

While contract language may touch on these threats, risk managers will need to work closely with their firm's legal department to address these concerns.

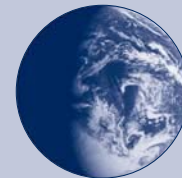
Conflicts Heighten Exposures

Two major segments of our financial system faced a harsh spotlight in 2002: accounting firms and investment banks/analysts. The result of this scrutiny was a heightened awareness of conflicts of interest and the resulting potential for damage to the financial market's system of checks and balances. As a result, one major accounting firm no longer exists and several key investment bankers have agreed to pay fines at or beyond the \$100 million mark. In 2003, we will begin to come to grips with significant changes in how these two important segments of the financial industry operate. It will not be business as usual.

The same small group of insurance carriers writes the Professional and Management Liability policies for the accountants, the banks, and their larger corporate clients. When things go wrong for the carriers, they can go terribly wrong.

New Rules, New Issues

The rules of play are changing substantially for corporate directors and officers. The passage of the Sarbanes-Oxley Act (SOA) in 2002 signaled a round robin of rulemaking: while the Act itself instructs the SEC to promulgate extensive rules and advice, various key stock exchanges are creating their own rules and the New York State Attorney General, together with a number of large public pension funds, are establishing their own playbook. Directors and officers of publicly traded



companies face accelerated reporting timetables, more extensive financial disclosure mandates and enumerable new responsibilities.

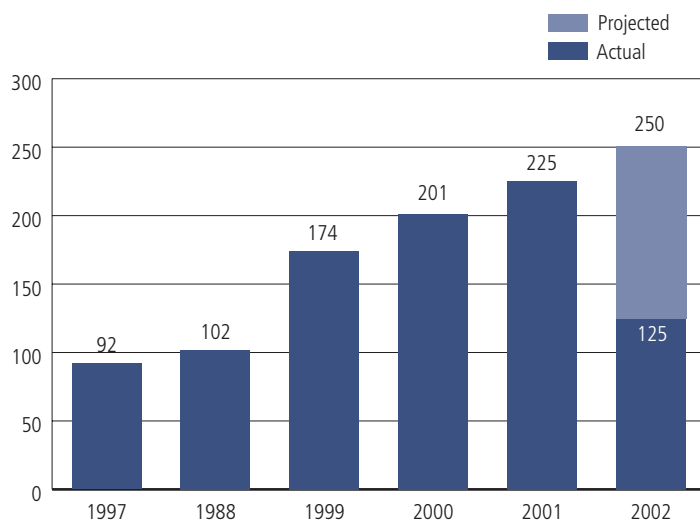
It is anticipated that plaintiffs and their attorneys in securities class action suits will allege violations of the SOA as further proof of wrongdoing by executive defendants. They can be expected to cite the executive certification as proof of intentional in illegal acts. They may use the new document retention requirements to bolster their cases and to point the way to additional sources of evidence.

Willis has prepared separate memoranda summarizing the SOA and identifying potential D&O and Fiduciary insurance ramifications, which can be obtained upon request.

Restating Financials

According to the US General Accounting Office (GAO) the number of financial restatements due to accounting irregularities grew approximately 145 percent between January 1997 and June 2002, and the GAO expects the percentage to increase to 170 percent by the end of 2002. *This translates into an astonishing one out of every 10 publicly traded companies restating its financials over the past five years.* Pure fodder for the plaintiffs' bar, this has been disastrous for D&O underwriters.

Total Number of Restatement Announcements Identified, 1997-2002



Source: GAO's analysis of relevant releases and SEC filings

A Note in Closing

Despite the increased exposures and heightened scrutiny of corporate decision making, D&O coverage is available to virtually all companies. The question is: at what price and on what terms? The details of the D&O coverage are crucial and often changing. Terms and conditions need to be negotiated to make sure that the coverage provided actually meets the needs of each particular organization.

Employment Practices Liability

Headlines and Highlights

- **Arranging program limits is complicated by carrier concerns regarding exposures across all Management Liability lines.**
- **Those with significant EPL claims experience can expect double- to triple-digit increases again this year.**
- **Legal, regulatory and economic—the external environment poses new challenges for EPL management.**

Carriers, Pricing, Limits and Terms

Carriers

While capacity remains sufficient for most EPL insurance purchasers, buyers do face two issues when looking at markets. The first involves finding markets for the foundation or primary layer of coverage: markets, as always, must be financially solid, experienced and offer acceptable terms. The second issue involves coverage above this base. Many carriers are imposing limits restrictions because of concerns about aggregated Management Liability risks (i.e., the combination of Directors & Officers, Fiduciary, Comprehensive Crime and EPL coverage). Appetites will vary between carriers and for individual carriers over time for various lines and various combinations of coverage. Coordinating the limits management issue can be especially difficult where there are different expiration dates for these coverages.

Pricing

Privately held and not-for-profit companies with good EPL claims histories can expect renewal increases in the 20 to 30 percent range, comparable to the increases seen in 2002. Publicly held companies and those with significant EPL claims may experience price increases in the 40 to 200 percent range. These buyers should also expect strong upward pressure on retentions.

Some companies who purchase EPL coverage as part of a Management Liability package, especially privately held and not-for-profit organizations, may find the EPL portion driving up the price of the entire package. We recommend these organizations consider separate limits/policies for their various Management Liability coverages to limit the negative impact of the more volatile exposure, EPL.

Limits/Capacity

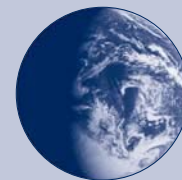
In addition to aggregate Management Liability concerns, most carriers are apprehensive about their maximum exposure on any one claim. Many insurers are trying to hold the line on the stated maximum capacity on any one risk for any given company. This is exacerbated by the changing attitudes of umbrella underwriters who, in the past, provided large excess (if not primary) EPL extensions at little cost. This source of coverage has all but disappeared. Buyers have been forced into the standard Management Liability markets, which are reducing their available limits of coverage.

Determining appropriate limits of EPL coverage is an increasingly complex undertaking. Reviewing large claims surveys, such as the one excerpted below, can be helpful, but industry sources provide no direct data and no easy guidelines.

Retentions

Retentions for many companies continue to be a moving target. During the soft market, firms were able to purchase EPL coverage at attractive rates and with low retention levels. That era is long gone. Now, buyers must carefully assess their EPL goals. If they seek catastrophe coverage for either large class actions and/or sizable punitive damages awards, that is likely to be reflected in the retention amount. Carriers today may be seeking as much as ten-fold increases in retentions, and sometimes more, based on the industry and geographical dispersion.

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Terms

The most significant change in EPL terms is the reluctance or refusal of carriers to modify the selection of defense counsel provisions (even where this liberalization existed on the expiring policy). For many clients this is a meaningful constriction of coverage.

Another important change is the resistance of some of the markets to provide coverage for third-party claims. These are claims by clients, customers or others alleging harassment or discrimination by employees. At one time, some of these claims were picked up under General Liability (GL) forms fairly painlessly. But as the potential for third-party class actions has grown, along with the possibility for sizable awards and punitive damages, GL carriers have grown more reluctant to covering this exposure. This leaves the EPL policies as the focus of coverage at a time when some of these markets are reluctant to continue the coverage. Buyers need to coordinate their GL and EPL coverages carefully.

Other coverage changes are occurring as well:

- Split (lower) retentions for foreign claims are being removed.
- Modifying claims notification provisions is becoming very difficult.
- Exclusions for claims alleging unpaid wages, overtime and/or improper payroll deductions are creeping in.
- Modifications to pre-approved lists of defense firms (panel counsel) are being eliminated.
- Deductible drop-downs and first-approved settlement deductible bonuses are being deleted.
- Downsizing exclusions are raising their ugly heads again.

Some markets have also returned to pricing punitive damages coverage separately, for an extra 10 to 15 percent in premium. The threat of incurring punitive damages is of course one of the main reasons companies seek coverage, rendering these premium increases "unavoidable".

First Party EPL Claims Settled/Decided/Affirmed \$5 Million+ in 2002

| Company - category | Claimant | Amount/Pun. Dmgs. (in Millions) | Class/Mass/Single |
|--|--|------------------------------------|---------------------------------------|
| Abbott Labs - age | Individual plaintiff | \$.7 + \$25 | 1 person |
| Advanta Mortgage - age | Individual plaintiff | \$6 | 1 person |
| Advocate Health and Hospital Corp. - FLMA | Individual plaintiff | \$11.65 | 1 person |
| American Express - gender and age | EEOC | \$31 | 31 individuals |
| Coca-Cola - gender | Office of Federal Contract Compliance | \$8.1 | 2,000 class |
| DaimlerChrysler - gender | Individual plaintiff | \$21 | 1 person |
| Dillard's - race | Individual plaintiffs | \$5.6 | Class |
| Ford Motor - age, race, gender | Individual plaintiffs | \$10.5 | Partial settlement of 400+ workers |
| Gentiva - age | Individual plaintiff | \$30.7 | 1 person |
| Hoffmann-La Roche - gender | Individual plaintiff | \$10 | 1 person |
| McDonald's - disability | Individual plaintiff | \$5 | 1 person |
| Northwest Airlines - race | Individual plaintiffs | Up to \$15 | 50 individuals |
| PeopleSoft - wrongful termination | Individual plaintiff | \$1.9 + \$3 | 1 person |
| Ralphs Grocery - workplace harassment | Individual plaintiffs | \$8.25 | 6 individuals |
| Rent-A-Center - gender | EEOC | \$47 | Class |
| Verizon - pregnancy | EEOC | \$10 | 1,000+ workers |
| Totals | | \$250 | 4,000+ persons |

Issues and Perspectives

Whistle Blowing While You Work

Events of the past year have pushed EPL issues into the public eye.

In a recent broadly publicized divorce case, financial disclosures brought embarrassing revelations about a highly respected company and one of its former executives. A similar situation may be brewing in a number of wrongful termination cases involving former analysts at investment firms. The analysts claim they were terminated for refusing to bow to pressure to change their rating of certain companies that were large clients of their employer.

Whistle blowers in the business world have become increasingly entangled in EPL cases. A recent survey of whistle blowers indicates that roughly half of employees who reported

Employment Practices Liability (continued)

wrong-doing on the job were terminated after their disclosures; most of those not terminated reporting that they were harassed and unfairly disciplined. Retaliatory suits appear to be easier to prosecute than other EPL claims. In one example, an employee won \$1.88 million in a retaliatory discharge case, only to have the decision overturned because of wrongfully admitted evidence; on appeal the individual was awarded \$2.5 million. Provisions protecting whistle blowers in the newly enacted Sarbanes-Oxley Act may further fuel this trend.

Recent corporate scandals may predispose the jury pool against employers in employment-related litigation. A recent study of mock trials indicates that the growing anti-corporate bias is likely to affect trial outcomes.

Anti-Trust Exposures?

When is a strategy to determine competitive salary data in an industry a violation of the Sherman Antitrust Act? We are likely to learn the answer in 2003 as the green light has been given to a class action alleging that a group of employers shared data on managerial, professional and technical employees in order to illegally hold down pay levels. Were the employers to lose the case, would losses be coverable under an EPL or D&O policy? That would depend on the policy and the wording of the claim. Stay tuned.

EEOC Activities

Over a recent five-year period, the Equal Employment Opportunity Commission (EEOC) purports to have prevailed in roughly 91 percent of the federal employment discrimination suits it has brought. Those victories came through consent decrees, settlement agreements or court orders. That's an intimidating statistic. At trial, the EEOC reports a 60 percent success rate on the district court level, with an 80 percent win rate on appeal; this compares to a 27 percent success rate for private plaintiffs at trial and 16 percent on appeal. These results are particularly impressive (or discouraging, depending on your point of view) given that 32 percent of all cases brought by the Commission are class actions.

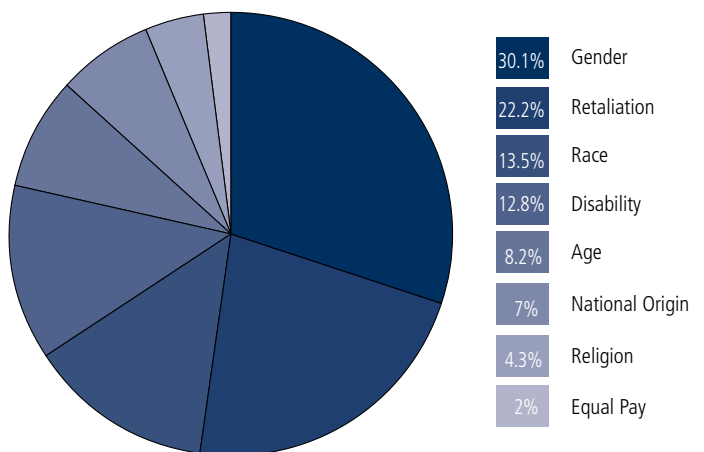
Age discrimination cases have been especially successful. While this category accounted for 8 to 9 percent of all suits brought by the Commission over the past five years, they represented

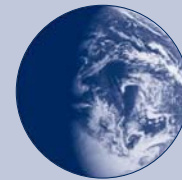
anywhere from 6 to 43 percent of total recoveries. Age has become the fastest growing discrimination category over the past two years, possibly due to the higher number of mass lay-offs.

Distressingly for small businesses, the EEOC reports a 75 percent jump in bias claims against companies with fewer than 500 employees. These companies are the least able to bear the increasing EPL insurance deductibles and they may be considering dropping the coverage. We recommend that they avail themselves of the loss-control assistance that is part of the insurance protection packages offered by some of the larger carriers—before this service disappears due to cost cutting at the insurance carriers.

The EEOC reports roughly 80,000 total charges filed in 2002. They believe they are just scratching the surface. Funds, however, are being cut. In a recent review of the federal funding of enforcement efforts, including the EEOC's, the US Commission of Civil Rights stated that "reductions in funding and staff continue to undermine our national enforcement of civil rights."

EEOC Claims by Category





The Possibilities for Mediation

While most EPL observers have been skeptical about the EEOC's Mediation Program, a recent independent study reveals changing attitudes. Regardless of whether they won or lost, 91 percent of plaintiffs and 96 percent of defendants indicated they would be willing to participate in the program again. Even more strikingly, of the plaintiffs who were *not* satisfied with the outcome of their mediation, 89.9 percent said they would be willing to participate in the future. Mediation proponents hope that the recent cost-cutting measures (replacing outside panels of mediators with the Commission's own personnel) will not adversely impact the program.

Approximately 14,000 cases a year are being mediated through the EEOC.

Homeland Security—Post-September 11 Impact

The press has reported and we have observed a dramatic surge in claims alleging discrimination based on country of origin since September 11, 2001. The EEOC recently counted 350 such first-party claims. As a result, the Commission has created a new tracking category for new religious and national origin discrimination cases thought to relate to terrorism. Serious consideration is being given to forming a special, independent, civil rights office within the new Department of Homeland Security. The Office of Rights and Liberties would oversee compliance with civil rights and civil liberties as part of the larger efforts to maintain national security.

Damage Trends

Some federal as well as state employment statutes limit the size of, or bar entirely, punitive damage awards. Some claim that, in response, juries may be following the lead of wily plaintiff attorneys and labeling parts of their awards as "pain and suffering" rather than punitive damages. According to data amassed by Jury Verdict Research, the median for all EPL lawsuits rose to \$218,000 in 2000, from \$151,000 a year earlier. If this jury behavior continues, we can expect the upward trend in these numbers to continue as well.

Issues in the News

Followers of EPL issues will need to keep up on current litigation. Here is a review of some notable recent activity.

- Requiring employees (including women) to wear pants in a manufacturing job is *not* a form of religious discrimination; suit was brought by a potential employee.
- An employee cannot be terminated for discussing company bonuses with fellow employees, according to the courts in California.
- An employee returning from vacation to find her belongings packed and her office being used for storage, *does have* a potentially viable claim for constructive discharge.
- The EEOC is apparently supporting the religious rights of a member of the Church of Body Modification to wear an eyebrow ring on the job.
- Not all trends are simple to interpret. A federal judge ruled recently that a UPS driver who wore his hair in dreadlocks and was fired for refusing to wear a cap was not a victim of racial discrimination. In another case an individual who alleged that he couldn't get a job driving a bus for a private national bus company because of his dreadlocks won his suit based on religious discrimination—the claimant was a Rastafarian, for whom wearing dreadlocks is part of the faith.

Fiduciary Liability

Headlines and Highlights

- **Linking Fiduciary Liability and D&O coverages—carrier preferences vary.**
- **Expect another year of price increases, rising deductibles and tightening of terms and conditions.**
- **Off-balance-sheet pension obligations may be a "trillion dollar time bomb".**
- **Legislative and regulatory actions have complicated the picture.**
- **New procedures may reduce benefit-related litigation—in the long run.**

Markets: Carriers, Pricing, Limits, Terms

Carriers

For insurers of Management Liability, one of the first questions is how to approach the intersecting lines that make up Management Liability: Fiduciary, Directors & Officers (D&O), Employment Practices and Comprehensive Crime. For Fiduciary Liability (FL), the relationship between FL and D&O is crucial and intricate. For some carriers, aggregating Management Liability risks is such a concern they may decline to cover FL altogether. Others insist they will only cover FL if they *also* write the D&O. A major factor here is that D&O premiums traditionally represent the lion's share of Management Liability costs. Some carriers want those premiums but do not want the FL risk. Others will take the FL risk only if they can also charge the D&O premiums. Adding to the complexity is the trend in the new Management Liability market where FL costs are beginning to rival those for D&O.

Pricing

For the second year in a row, we predict FL increases averaging in the 15 to 30 percent range. The upper end of the pricing spectrum, however, may top 200 percent. FL premiums have traditionally been modest, and although absolute dollar increases may not appear to be dramatic, this will change as prices rise. For companies with significant portions of company stock in their pension plans, FL premiums can be expected to approach or exceed those for D&O.

Deductibles

In some cases, increases in deductibles will have more impact than increases in premium. Faced with Employee Retirement Income Security Act (ERISA) claims involving employer securities, some carriers have indicated that they are looking for substantially higher per-claim deductibles. Just as FL prices are approaching D&O prices, self-insurance through deductibles for FL may well match those for D&O programs. For larger companies, this will mean deductibles for company-stock claims in or above the million dollar range.

Limits

Due to misconceptions or lack of information about FL issues, many companies today may be underinsured. As these issues become more prominent, many companies are seeking FL limits reviews and/or increased amounts of coverage. Supply, however, may not always meet the increased demand. Some carriers may reduce coverage or insist on D&O involvement. As a result, there are no more \$50 million blocks of coverage available, and precious few \$25 million layers to be had.

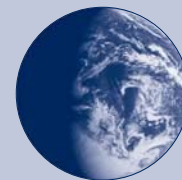
Another issue affecting limits is the changing interpretation of rules. ERISA rulings establish personal liability for plan fiduciaries while limiting a company's ability to indemnify the fiduciaries. Underwriters now perceive increased exposure in the upper layers of high limits programs. Companies that seek to maintain such programs should therefore expect to pay more.

Terms

New exclusions or modifications can be expected for:

- Failure to effect and maintain insurance
- Terrorism
- Stock fluctuation
- Benefits wording

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Policy definitions may also be narrowed. Loss may no longer be extended to include punitive damages. The scope of the term "subsidiaries" may be more narrowly construed.

Underwriting requirements are being tightened. In some cases, buyers may need to list all of their pension plans (not an easy task for most large organizations). Submissions may require considerably more information for non-qualified and/or foreign plans. Similarly, companies that contribute to an industry or multi-employer plan may be required to supply information they have never previously gathered or had access to.

Coverage is being whittled away. Thresholds providing automatic coverage for new plans or new subsidiaries may be lowered. Sublimits are being lowered or dropped altogether. Coverage for fiduciary penalties (Closing Agreement Program penalties or delinquent filer fees) might be lost.

Issues and Perspectives

Sarbanes Who?

While the major focus of the 2002 Sarbanes-Oxley Act was corporate governance and oversight, the new federal law also raised some serious concerns relevant to FL. The law stipulates new penalties and most carriers with whom we have spoken so far seem unwilling to cover them. Some violations, however, may also fall under currently existing ERISA regulations (i.e., Prohibited Transaction Rules), meaning that fines or penalties are already covered. The ultimate implications of the law are uncertain, but benefit managers who had expected their lives to become simpler will be disappointed.

The Magic of Pension Forecasting and Accounting

Statistics show that the 50 largest US corporate pension funds lost about \$36 billion in value during the last year, when they had projected gains of \$55 billion. While some companies are lowering their pension performance expectations, others cling to predictions of 8 to 10 percent returns. Carriers are concerned that companies faced with continuing disappointments will take contentious steps to restrict benefits and limit costs as they try to recoup plan losses.

Another concern is pension accounting. Accounting rules (FAS 87) can lead to pension plan assets and liabilities vanishing from a company's balance sheet. Credit Suisse estimates that the S&P 500 carried approximately \$992 billion in off-balance sheet pension liabilities and \$900 billion in off-balance-sheet pension assets by the end of 2001. Ten top companies were burdened with off-balance-sheet pension obligations in excess of \$15 billion each. One does not have to be a corporate governance expert to see trouble coming. Some have labeled this the "trillion-dollar time bomb".

Double Exposures?

For many years, common wisdom held that that Fiduciary risk was limited to Employee Stock Ownership Plans (ESOPs). The plaintiffs' bar has clearly awakened to the fact that employer securities are found in other retirement plans, such as 401(k) plans. According to Hewitt Associates, about 29 percent of employees have 75 percent of their 401(k) assets in employer securities.

FL underwriters today typically want to know about company stock in any and all of a buyer's employee pension plans. From the underwriters' viewpoint, issues such as whether the investment was discretionary or not, and whether or not the investment is offset by other diversified pension plans, are secondary when they are faced with the possibility of defense costs and claims in the millions of dollars.

Carriers and employers are still absorbing the impact of legal decisions that ESOP trustees breached their fiduciary duties under ERISA when they purchased company stock for the ESOP. In one case, the court held trustees liable for overpaying for the shares.

401(k) Litigation Takes Center Stage

Ten years ago, companies who were asked about FL insurance often said that because they offered only a 401(k) plan they could not be sued. Untrue then, it is singularly untrue now. One law firm has filed suit against more than a dozen leading companies relating to their 401(k) plans. The same firm is considering suing at least 20 more.

Fiduciary Liability (continued)

The unifying theme here is the sizable concentration of company stock in the company's pension plan combined with the diminution of the value of this stock. This lack of diversification coupled with a failure to disclose pertinent information about the prospects of the employer securities is, it is argued, a breach of fiduciary duty.

As a result, Fiduciary underwriters are asking detailed questions:

- Are employers removing or planning on removing some of the restrictions on trading in company stock when stock is delivered to employees in the form of (often restricted) matching contributions?
- Has any advice regarding the value of asset diversification been supplied to plan participants?
- Is the company tracking large individual concentrations of investments in the company's stock in its 401(k) plan; and if so, what action, is being taken if such investment blocks are detected?

The outlook for employers is not all bleak. Recent cases centered on these issues have settled fairly quickly for relatively small amounts. One alleged \$635 million Fiduciary loss settled at \$10 million. Clearly, to bring a suit is not to win the day. Some potentially influential suits, however, are pending.

The Strategy in ERISA Suits

Nearly identical language is used in the pleadings of a number of the top ERISA cases today. The words follow along the lines of the Department of Labor's Friend of the Court brief in the Enron litigation. The Department takes the position that a company's administrative and compensation committee members, as well as its chief executive officer, are pension plan fiduciaries under ERISA, charged with acting with the exclusive purpose of prudently managing the plan's assets (the company) in the best interest of the plan beneficiaries. The government argues for a "knew or should have known" standard instead of a "clear on the face of it" standard. Adopting this standard would have a significant impact in all related ERISA cases.

Cash Balance Plans Waiting in the Wings

Cash balance litigation is being fought on two fronts: as

breaches of ERISA's fiduciary duty and as violations of the Age Discrimination in Employment Act (ADEA). During 2002 the General Accounting Office (GAO) analyzed 60 cash balance plans and concluded that 13 of the 60 underpaid certain groups of employees. The GAO estimated that some 300 to 700 cash balance retirement plans underpay participants to the tune of \$85 million to \$199 million annually. Many rebutted the findings. But for the legislative and media focus on the current financial implosions, this would have received more attention in 2002. We are waiting to see if there are going to be any repercussions in 2003. Legislative and legal activity is brewing. Awaiting the outcome, employers will likely hold off on any further cash balance conversions, despite new IRS regulations issued in December 2002.

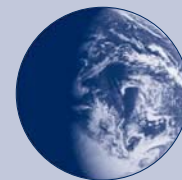
Maybe It *Is* Over Before It's Over

With continued inflation in medical costs and general economic pressure on the corporate bottom line, cost shifting and cost sharing are likely to increase. From the carriers' standpoint, this means a heightened likelihood of increased FL claims activity. Regardless of outcome, defending these cases can cost millions of dollars.

Government Help?

New claims procedure regulations for both retirement and welfare benefit plans are designed to decrease benefit litigation. In the long run they may, but in the short run, the adjustments and the changes in expectations may result in an increase in suits. Many of these cases will be fairly easily dismissed if the plaintiffs failed to avail themselves of the plan's internal claims resolution procedure. Eventually, we believe the rules will lead to a decrease in high-frequency, low-severity claims.

New regulations also apply to small plans that continue to be exempt from annual outside audits. Persons handling "non-qualifying plan assets" will need to be bonded and more information will need to be included in the plan's summary annual report (SAR). Reports will need to be written in what the government considers to be "plain language". We will have to leave it to expert benefit consultants to determine what the US government might mean by "plain language".



Headlines and Highlights

- Although there is ample capacity, many carriers continue to ration it.
- Growth in the number of claims piercing excess layers has put pressure on pricing and deductibles.
- Underwriter scrutiny has heightened—particularly with respect to global operations, vendor fraud, "high tech" inventories and corporate governance.
- For superior risks, the year 2003 should see moderation of market conditions.

For the Fidelity Bond industry, 2002 was a tumultuous year. Underwriters implemented 30 to 60 percent increases on their renewal books, carefully reviewed the adequacy of deductibles and returned to stricter underwriting basics. While Bond insurers struggled to return to profitability, the frequency and severity of Fidelity Bond claims continued to rise. The number of eight-digit fidelity claims both paid and/or reported during the 2002 year served to reinforce the need for adequate pricing, deductibles and underwriting.

Loss Ratios

The loss ratios for the 2002 year will not be available for some time, but the Surety Association of America's recently released 2001 figures show mixed results at best. While the two largest Fidelity Bond underwriters have seen some improvement since reporting disastrous results, many of the top 10 Fidelity companies have shown little reduction in loss ratios, and some have shown a marked increase.

Further compounding the difficulty of achieving a settled market is the increased number of large Fidelity claims that were reported and paid during the 2002 calendar year. While the Fidelity Bond industry is no stranger to large claims, the recent frequency is unparalleled.

| Insurer | 2002 Capacity |
|----------------------|---------------|
| ACE USA | \$15 Million |
| Chubb Group | \$25 Million |
| CNA | \$25 Million |
| Crum & Forster | \$7.5 Million |
| Fidelity & Deposit | \$25 Million |
| FM Global | - nil - |
| Great American | \$25 Million |
| Gulf Insurance | \$25 Million |
| Hartford | \$50 Million |
| Kemper | \$50 Million |
| Liberty Mutual | \$10 Million |
| Lloyd's of London | \$130 Million |
| National Union (AIG) | \$50 Million |
| RLI | \$25 Million |
| Royal & SunAlliance | \$25 Million |
| St. Paul Group | \$30 Million |
| Utica Mutual | \$10 Million |
| Zurich-American | \$50 Million |

Capacity

Outlined above is a schedule of Fidelity Bond capacity as of year-end 2002.

On paper, there has only been a modest reduction in the industry's overall capacity. The withdrawal of FM Global, the twelfth largest bond underwriter in the country, pulled \$50 million in limits from the market, a reduction that certainly helped to sustain the current hard market.

Of greater importance, however, is the failure of the majority of leading Fidelity Bond markets to actually provide their full capacity for any one risk. While the leading markets may elect to use their full capacity for existing clients with a standing \$25 million limit, new clients are often capped at limits of \$10 million and \$15 million. Such capacity control requires insureds to write larger programs on either a co-surety or layered basis. As more companies look to minimize their exposure on large accounts, some underwriters will press to write excess limits only, leaving primary placements to a handful of leading underwriters.

Another issue is the size of treaties. As treaties renew in January 2003, many underwriters will question the wisdom of purchasing a large treaty when only a fraction of it will ever be utilized.

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Fidelity (continued)

Pricing

Premium increases averaged 30 to 60 percent for most insureds in 2002. Those clients that had experienced bond losses, significant growth or financial deterioration were subject to even greater increases.

With the exception of the few remaining companies coming off multiyear programs, most insureds can expect a more moderate increase in the year ahead. We expect underwriters to seek increases of 10 to 30 percent for those clients that sustained a significant increase in 2002.

One area to watch in the 2003 year is the pricing for excess bond placements. Underwriters are taking a harder view of excess limits because large claims are piercing underlying limits with greater frequency. What was once thought to be catastrophic loss coverage is starting to be viewed as having greater frequency potential and will be priced accordingly.

Lessons from Large Fidelity Claims

When reviewing the profile of large fidelity claims, underwriters have noted several commonalities. Expect Fidelity Bond underwriters to focus on these exposures:

- *Global Operations*—Bond losses sustained by multinational companies have made up a large percentage of total claims. In the eyes of underwriters, a parent company's unconditional or laissez-faire reliance on local management, coupled with cultural differences and geographical distances, creates a greater opportunity for theft.

While some insurance companies are declining to underwrite entities with a heavy foreign exposure, most are still willing to cover foreign exposures but will want assurance that internal controls are being diligently followed at all locations.

- *Vendor Fraud*—Losses involving actual or purported use of vendor services continues to be one of the most frequent fraud schemes used by dishonest employees. As a result, clients should expect underwriters to focus on the internal controls implemented to prevent such schemes from occurring.

- *Technology Inventory*—The most frequent large inventory losses continue to involve technology companies, whose microchips are highly marketable. The microchips' small size presents a greater opportunity for theft. Companies with such exposures will need to demonstrate adequate security and inventory controls if they are to obtain competitive renewal terms.
- *Corporate Governance*—Some Fidelity Bond companies are expressing concerns about underwriting large publicly traded companies. While these companies have not had a disproportionate share of bond losses, there is concern among some Fidelity underwriters that the current close scrutiny by regulators and accounting firms will uncover previously unnoticed corporate theft.

The collapse of Arthur Anderson is fueling concerns by some underwriters that the CPA firms auditing publicly traded companies will be more diligent in their audits. They will be looking for problems in their effort to avoid the fate of Enron's accountant. As a result, the 2003 year will find some Fidelity underwriters waiting out the storm before they resume underwriting large publicly traded companies.

A View Forward

The year 2003 may have some bright spots. While many Fidelity Bond underwriters were not "hungry" in the last quarter of 2002, having already met their annual budgets, the new year will present them with a fresh challenge. Their 2003 budgets will likely be more aggressive, and the desire to close deals, coupled with the expectation there will be ample capacity in the market, should go a long way towards moderating unreasonable renewal terms in the 2003 year.



Headlines and Highlights

- **Capacity crunch expands use of co-surety arrangements.**
- **Surety reinsurers post sharp increases in premiums, attachment points.**
- **Industry loss development, poor margin performance deter capital.**
- **Underwriting selectivity, scrutiny impel strategic approach for clients.**

It may be hard to imagine, but the Surety marketplace of twelve months ago is now considered the good old days. Even more worrisome is that in the coming months, December 2002 may be viewed with disturbingly similar nostalgia. Nevertheless, there are opportunities for well-managed firms to prosper in spite of, and to some degree because of, the current conditions. As with previous forecasts, this report identifies and evaluates the factors driving marketplace conditions and suggests steps companies can take to turn these challenges into competitive advantages.

The Capacity Crunch

Capacity is the foremost issue facing the industry and its customers. In the absence of an unanticipated influx of Surety capital, this will continue to be the case through next year and into 2004. Most affected are the largest contractors (those with work programs above \$250 million), contractors on the opposite end of the industry spectrum (with work programs under \$10 million), and buyers of Commercial Surety bonds. For large contractors, we believe the number of sureties that are capable of handling work programs in excess of \$500 million, on a sole surety basis, is down to four. In most cases, these sureties prefer one or more co-surety partners on such a facility. Clients with work programs as low as \$100 million might be well-served by co-surety structures. For Commercial Surety buyers, programs have marketplace support from perhaps half a

dozen underwriters. Most will require co-surety participations and will only work with clients of investment grade. Commercial Surety facilities of \$100 million or more are receiving increased scrutiny from underwriters and their senior managers.

Surety Reinsurance

Surety reinsurance rates will increase again in 2003. Currently, these increases are expected to be in the 20 to 25 percent range. This would mean Surety reinsurance rates have increased, on average, by 100 percent or more since the year 2000. The full cost of reinsurance, of course, also includes the impact of terms and conditions. Ceding sureties will be required to hold higher retentions on each client's program and will be forced to partner on facilities to generate the capacity required for clients with large programs. The primary focus of Surety reinsurers in today's marketplace is the aggregation of liability on any single client's facility. Credit quality is a close second.

Major Determinants

Apart from the IVI-Petrobras loss (over \$200 million) and certain Commercial Surety claims, the industry's 2002 loss experience was not materially worse than that of 2001. Despite this, potential returns on surety capital remain under pressure from three fronts:

Loss Development

Unfavorable loss development of prior years' claims is likely to result in an industry performance in 2002 that shows little improvement over 2001's poor outcome. Keeping in mind our comment from prior forecasts that surety reinsurers still await their first profitable year since 1998, it is to be expected that capital allocation decisions will be made with caution and apprehension.

On the positive side, and in the absence of new losses in Q4 2002 or the early months of 2003, existing reinsurance capacity shows indications of stabilizing. However, if additional losses of the magnitude of an IVI-Petrobras enter the market, one or more of the remaining seven surety reinsurers may exit the business.

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Surety (continued)

Industry Performance

Potential capital sources may regard the industry's near-term outlook with pessimism. There is uncertainty about the Encompass Group, the outcome of Enron and Petrobras litigation, and anticipation that construction industry results will be in decline as 2003 moves on. These factors are forcing underwriters to adequately price and secure their risk on existing portfolios of Surety business to simply maintain reinsurance support. In 2002, for example, there have been "capacity surcharges" charged by some sureties for large single project contract bonds and additional security provisions added to indemnity agreements. We foresee the possibility that some underwriters may seek to charge commitment fees to put reinsurance in place for large surety facilities and commit their own capital to them.

Capital Commitment and Capacity

Losses, reinsurance pricing, and repayments to reinsurers for prior year losses continue to put pressure on sureties' margins. Rate increases and more disciplined underwriting practices will take time to favorably impact industry results. With no near-term prospect for attaining the expected returns on capital, Surety managers will have a difficult time making a case for diverting capital from other insurance lines that have both attracted higher rates and, unlike Surety, offer more flexibility in the risk attachment points.

Limitations to the industry's ability to support bonds on very large projects will, in the absence of large net retentions by a surety, result in percentage bonds on mega-projects and, for some clients, phasing work in smaller increments that can be supported by 100 percent performance bonds. Surety users whose Surety rates rose in 2002 should for the first time in recent memory, and perhaps ever, anticipate that back-to-back years of industry-wide rate increases will occur when their bond lines renew next year. We expect increases in 2003 will be more modest than those implemented in 2002, when Surety rates for contractors rose by an average of 15 to 20 percent.

Capacity is not just a financial issue for sureties and their reinsurers. The current marketplace and its difficulties have put underwriting staff and resources under great strain. As in many industries, the absence of investment in training programs and

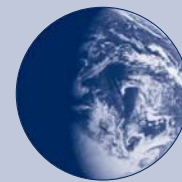
recruitment could affect the industry's ability to retain, now and in later years, enough quality, highly-trained people to support the industry. We expect more spending on training programs as firms compete for talent.

The Broader Environment

It is important for Surety clients to keep in mind that all of the above factors are part of the broader insurance industry and beyond the control of Surety underwriters, their reinsurers and their clients. First and foremost is the condition of the insurance industry capital pool that sureties rely upon for their funds. The rating agency Fitch recently published an advisory that indicated the US insurance industry's reserves may be under-funded by as much as \$80 billion.

Lingering concerns include potential asbestos liabilities and the uncertainty that mold exposures and future terrorist acts may pose to the industry. These concerns are keeping investor capital on the sidelines despite an improved pricing environment, higher levels of retained risk by many clients, and relatively low catastrophe losses in 2002. As in past hard markets, quality clients are rapidly pursuing alternatives that make financial sense for their businesses, thereby further depleting the ranks of sound and profitable risks for the industry to underwrite.

The industry has historically under-performed the general economy when it comes to its return on assets, but the need for replenishing reserves, combined with historically low interest rates and equity investment losses, will impair the industry's ability to recover in the near term. A number of domestic and European insurers have experienced rating downgrades, for either their financial condition or debt, during the course of 2002, further raising their cost of capital. One observer recently noted the US Property and Casualty industry has not turned an underwriting (i.e., operating) profit since 1988. Surety company CEOs are facing the reality that, for the foreseeable future, underwriting results alone will have to drive and sustain the profitability that is a pre-condition for reversing the way the industry is perceived among investors.



Underwriting Terms and Conditions

Surety reinsurers are exerting more control over the underwriting process, both on individual accounts and, occasionally, on a project specific basis. The scenarios under which special approvals must be received from Surety reinsurers have been expanded for many of the major sureties and has occasionally slowed down the ability of sureties to respond to a client. As this continues, there will be requirements for additional underwriting information for some projects that had been considered routine. Reinsurers are also more actively auditing the underwriting files of the companies they support and requiring that a given client's financial ratios vis-à-vis its Surety program comply with strict credit guidelines. The exposures between underwriters linked by co-surety relationships and bonded joint venture projects are also being examined in some quarters.

Middle market contractors, defined as those with work programs of between \$10 million to \$250 million, are seeing modest to little evidence of a hardening Surety market and continue to be well served. The affects of the Surety reinsurance crunch are less applicable to the needs of these companies, and certain underwriters have adjusted their business models to target such accounts, assuming that they otherwise meet financial and experience criteria.

Summary and Strategy

Consumers of surety credit must be prepared to work with their Surety underwriters as they would with investors or other business partners. The hard market is a seller's market. Proactive communication and full disclosure are key elements of developing and retaining the confidence of surety partners. Activities and strategies undertaken by our Surety Practice include:

- Developing strategies that insure underwriters are fully aware of all aspects of a client's business plan and that sufficient capacity is in place to support the client's needs. We use financial benchmarking and other tools to maximize the surety credit extended.
- Tailoring strategies for protecting the client's balance sheet—a major determinant of the amount of capacity extended by the surety.

- Implementing, with the client's concurrence and input, co-surety structures and stand-by surety relationships to assure capacity and continuity of surety support regardless of marketplace events unrelated to the client's performance.
- For larger projects, assisting with reviews of a client's potential joint venture partners' surety capabilities and overall compatibility from a performance risk and cultural standpoint.
- Offering specialized tools that can reduce construction scheduling risk through a proven, industry-recognized statistical modeling program.
- Examining, where appropriate, alternative subcontractor performance default risk solutions. Such solutions can increase the control a client has over its management of this risk and create opportunities to widen the participation subcontractors who might otherwise be qualified, but cannot obtain bonding in today's marketplace.

Surety risk transfer and a company's total cost of surety risk are but part of the province of innovative surety risk management. Taken together, the strategies and activities outlined above address operational needs and opportunities as well. Creative risk funding techniques and project management tools go beyond dealing with the nominal price of surety risk transfer—they can enhance project efficiency and reduce the overall cost of doing business.

Headlines and Highlights

- **Growth in committed capacity signals marketplace improvement.**
- **Global program arrangements remain difficult and expensive.**
- **Underwriting discipline will continue to differentiate risks.**
- **As ever, it pays to make one's case thoroughly.**

State of the Marketplace

The year 2002 proved to be a shock to the systems of most buyers of Property insurance. Beginning in 1999, with the advent of the "Millennium Bug", there was a gradual trend toward higher rates and leaner coverage. That trend accelerated exponentially in the past year, as we predicted it would in last year's market forecast.

Persistent Impact of September 11

While the initial forecasts of total insurable losses from the September 11 attacks appear to have been exaggerated in some quarters, throughout 2002 primary carriers and reinsurers have had to boost estimates of their liabilities arising out of the property damage and business interruption elements. One primary carrier specializing in Property recently advised that its gross loss was in the area of \$1 billion—more than doubling the original reserve. The difference will fall mainly to its reinsurers, a common situation that has evidenced itself in the rising reserves—and falling fortunes—of many of the reinsurance market leaders. It is a fact that the risks of the world are accumulated in the portfolios of a relative few, and these few are hurting.

Premium Increases

During the first three quarters of 2002, rate increases swung wildly from lows of 25 to 35 percent to highs of 200 to 300 percent. Some of the hardest hit were those programs requiring significant numbers of participants to generate needed capacity. Where fewer participants were needed—and certainly where one carrier alone could provide the capacity—more positive results were achieved. Another group of insureds

greatly impacted by marketplace conditions were those coming off multi-year contracts. The contrast between their expiring and renewal terms proved stark and painful.

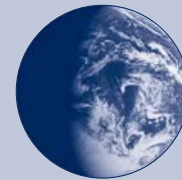
Capacity and Rationing

All underwriters guarded their capacities and a significant void developed between the theoretical (that which carriers nominally had at their disposal) and the used (that portion of their capacity actually put into play). Despite the billions of capital dedicated to new underwriting facilities in Bermuda and elsewhere, such facilities chose to be disciplined followers rather than aggressive leaders. Still, their willingness to participate did stave off even higher pricings by those underwriters whose plans were to hang on the sidelines until the bitter end of negotiations, hoping to drive premiums up even further.

Nat Cat Perils

Pressure on natural catastrophe capacity continued, with increased emphasis on geographical areas that previously had been largely ignored (e.g., earthquake risk for the Pacific Northwest and New Madrid). Coastal windstorm areas crept slowly northward, with some insurers insisting that Virginia be included in the category. Some carriers succeeded in imposing isolated windstorm annual aggregates, but this did not become a trend. And as the year wore on, such aggregates became a competitive disadvantage and cost some carriers otherwise attractive business. Flood capacity in Zones A and V, and to a lesser and less consistent extent Zone B, was sharply curtailed. Insurers involved with global programs continued to try to establish some criteria to identify equivalent exposures outside the US, where zoning practices are not as precise. Perhaps 2002 can best be described as the "Year of the DIC" program, as policyholders sought to preserve expiring limits for flood and earthquake.

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Terms of Coverage

Extensions of coverage also came under severe pressure. Among the most problematic were Contingent Time Element, Civil Authority and Ingress/Egress, Off-Premises Power and Service Interruption. These, along with Claims Preparation Expenses (also curtailed), formed significant ingredients in September 11-related claims, and underwriters and their reinsurers reacted quickly to reduce their potential accumulations from other catastrophic events. Time and distance limitations, as well as dollar sublimits, were fairly broadly applied to many of these extensions.

Another common, although not universal, restriction on coverage took the form of linking limits of liability at individual locations to values reported. We predicted this development in last year's forecast and cautioned on the need for policyholders to carefully review and be able to justify their value reporting mechanisms. Those who so prepared were likely to enjoy one of two logical outcomes: the demonstration made underwriters comfortable enough to delete the restriction or the exercise made policyholders comfortable enough to accept the linkage.

Attachment Points

Many deductibles were forced up by the market in an effort to wring out expected losses—sometimes going far beyond what previous loss history would have suggested. The common underwriting rationale for this was a mandate from management requiring pure underwriting profit across portfolios because investment returns could no longer be counted on to counterbalance an underwriting loss.

Policy Language

Timely agreement on policy language, and therefore timely policy issuance, was very nearly impossible in cases where multiple participants were needed for a placement. Almost every underwriter reserved the right to review and amend policy wording, and most exercised that right. The result was that underwriters who had never been charged with this task, and were ill-prepared and relatively unqualified for it, saw policies pile up for months awaiting their review.

Global Programs

The year 2002 was an *annum horribilis* for those needing to arrange master controlled programs with local underlying policies. The reasons:

- Fewer carriers were willing to front such programs.
- These carriers found fewer approved reinsurers and lower levels of approved capacity for each.
- Resistance arose, particularly among London and European reinsurers, to terms contained in the fronting carrier reinsurance certificates - much of this resistance had to do with the terrorism and fire-following issues.
- More premium payment warranties were required, in many cases necessitating payment of the premium up front by the parent company and delayed reimbursement by local subsidiaries.
- Fronting costs increased substantially—often 100 percent or more.

We do not expect 2003 to offer materially improved conditions for global programs.

A View Forward

Late in Q3 and throughout Q4 2002, there was a marked change for the better in a number of renewal results. Some of this was attributable to the relatively small number of US catastrophe claims incurred by the commercial market. The hurricane season came and went with little damage reported despite earlier prognostications that 2002 would be an active hurricane year. And despite several terrorism alerts, there were no terrorist acts perpetrated in North America. Most underwriters of Property business are experiencing below-expected loss ratios.

Positive Developments

Some of these positive results were attributable as well to the fact that policyholders who renewed immediately after September 11, 2001 had already sustained significant price hikes. They were determined not to be subject to the same treatment two years in a row; that, they argued, would be unwarranted and inequitable. Their message registered with underwriters, some of whom quietly sympathized with the

Property (continued)

characterization. Rate increases began leveling off, with 10 to 20 percent being common, and with no further reductions in coverage being imposed. In a very select number of cases, sizeable reductions in premium were achieved (one as high as 50 percent). These were cases in which the market had clearly overreacted in 2001. On layered programs, upper layers began to be oversubscribed, as underwriters sought to commit capacity and collect premium, albeit in the "safest" areas. Those policyholders who had holes in placements made in late 2001 found themselves with completed programs in 2002. The fact that the underwriting term "line to stand" (meaning "don't reduce my participation in this deal") is beginning to be heard denotes a tacit understanding on underwriters' parts that the tide has changed, and a good risk at the right price is going to get completed with or without a given underwriter's support.

There are certainly insurers whose stated goal is to continue the upward swing in rates, at least throughout 2003. We believe that they risk losing business, unless the particulars of an account justify further rate "rectification". Supporting only such accounts holds the danger of self-imposed adverse selection.

Many of the underwriters with whom we have spoken have confirmed they are not anticipating reductions in their capacities for 2003. On the contrary, their business plans call for narrowing the gap between theoretical and used capacities. They believe the business is now priced properly and has been well-underwritten; it no longer makes sense to hold back the capacity for which they pay via reinsurance treaties.

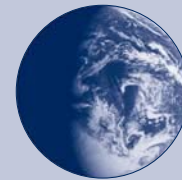
We believe policy forms will still be closely monitored, but there does seem to be an underwriting will to streamline the process. All parties understand the potential negatives of having policy contract wording open for months after inception. And many followers, in terms of percentage participation, have grown weary of trying to second-guess a proven lead underwriter's judgment.

Making One's Case

Is a softening market around the bend? While we believe there may be pockets of softness, particularly in certain industry segments where natural catastrophe exposures are minimal, there will not be a wholesale relaxation of strong underwriting discipline. It may take another year of strong positive underwriting results before carriers become comfortable with the fact that they can write Property business and make money simultaneously.

Our advice for 2003 renewals is not dissimilar to that for 2002:

- Start early.
- Continue to develop a solid and verifiable picture of your company and its exposures to loss.
- Underwriting interest in loss prevention protocols and business continuity plans remains high. It is never too late to reinvigorate your company's commitment to them.
- Meet with underwriters to outline your corporate objectives and program requirements.
- Make sure the underwriting information you supply is complete and provided in the format preferred by the underwriters.
- Do not hesitate to hire outside assistance to verify values or to provide engineering data not currently available. A dollar spent here can return multiples of dollars at the negotiating table.



Headlines and Highlights

- **Primary Insurers cautiously expand underwriting.**
- **Higher retentions remain the key to premium relief and attracting more underwriter interest.**
- **Unprecedented loss development impacts severity and frequency.**
- **The Umbrella market will continue to be very selective.**
- **New excess liability capacity tests the marketplace, while established capacity continues to impose higher rates.**

General insurance marketplace conditions are unlikely to improve until the health of the wider financial market takes a turn for the better. Even as that may happen, however, improvement in the casualty market will be tempered by the prominent trend towards larger and more frequent losses. That being said, Casualty market conditions are beginning to get better. Perhaps the first signs of a slowdown in the rate of premium increases can be found in recent program renewals where we have witnessed the onset of competitive behavior. Indeed, if one were to divide excess placements into lower, middle, and higher tiers, the recent competition observed in higher excess layers is encouraging.

Now that many casualty underwriters perceive the market to have achieved rate and premium adequacy, certain classes of business that they had shunned for the past two years are once again being underwritten. The advent of competition does not necessarily translate into premium reductions. It is more in growing capacity and enhanced negotiability of coverage terms that we find evidence of marketplace improvement. Many carriers will begin the year 2003 with ambitious new business goals, and they will aggressively seek to underwrite profitable business.

Primary Casualty

General and Products Liability

Although premium increases as a percentage of expiring are dropping, the General Liability/Products Liability marketplace continues to harden in respect of underwriter treatment of terms and conditions. Insurers are paying to pay close attention to individual coverage issues, the most prominent being:

- Terrorism
- Mold and Mildew—Certain insurers are mandating exclusions for both direct and consequential damages.
- Health Hazard
- Professional Liability
- Pollution Liability—Coverage remains difficult to obtain or maintain in a general liability policy. Certain insurers will provide environmental coverage only through their own stand-alone policies.
- Asbestos—Insurers are reverting to the absolute exclusion.
- Cross Liability

Several long-tail classes of business (e.g., chemicals, medical products, food supplements) may see the general liability marketplace attempt to change the basic policy from the ISO occurrence form to a “claims made” or “occurrence reported” form. Recasting the policy form in such a manner may provide some additional capacity, and it may result in lower premium (compared to premium charged for coverage written on the traditional occurrence form). Past experience shows, however, that initial premium savings evaporate through time as successive claims-made policies are purchased while keeping the retroactive date constant.

Automobile Liability

Automobile Liability underwriting now reflects loss experience arising out of risks not originally contemplated or not sufficiently assessed in the scope of coverage provided. Losses from Hired and Non-Owned exposures are increasing as many insureds are reducing the use of large company-owned fleets and are requiring employees to use their own vehicles or other non-owned vehicles. Uninsured and underinsured motorist losses are also on the increase. Past experience in the State of Ohio has demonstrated to carriers that this heretofore relatively innocuous or well-contained coverage can cost millions of

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Casualty (continued)

dollars a year in losses, depending on how the coverage is interpreted.

Adverse loss development is another key factor in market hardening. The trend toward greater jury awards has spiked in recent years, causing most umbrella carriers to require primary Automobile Liability underlying limits of at least \$2 million per accident. The higher limits requirement has had the obvious effect of increasing the cost of primary placements.

There are familiar alternatives to higher primary program limits, including buffer layers excess of primary and increased retentions below. Loss prevention and claims management efforts are becoming ever more important in negotiating with carriers, and positive differentiation translates into preferred treatment.

*(For **Workers' Compensation**, we refer you to the article prepared by Greg Alff.)*

Umbrella and Excess Liability

During the past year and a half, a number of carriers have ceased to underwrite lower limits of umbrella/excess coverage—roughly the first \$5 million to \$25 million above primary limits—thereby putting increased pressure on pricing of available capacity and causing a cascading effect on the structure, conditions and pricing of upper layers of coverage.

While there has been an increase in Umbrella capacity made available by individual carriers, it has been typically provided with narrower coverage and higher attachment points—on occurrence and aggregate bases—than in the past. It is common to see umbrella carriers requiring an underlying aggregate twice or three times the limit provided the previous year. Premium increases of 30 percent are common, with higher percentage increases for more difficult classes of business. The most significant impact for small to medium size companies is the increased cost of excess liability insurance, where minimum price per \$1,000,000 has gone from under \$1,000 to over \$2,750. Many insureds are seeing a doubling of their excess liability premium solely due to carriers raising their minimum premium levels.

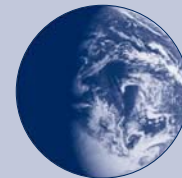
In the mid to high excess liability layers there is more capacity, and competition is, to an extent, serving to reduce the level of premium increases. Even so, average increases for entire excess liability programs range from 30 percent to more than 100 percent, with insureds often being able to negotiate a reduced level of increase only in the higher excess layers.

Worldwide Casualty capacity is approximately \$1.3 billion—about 70 percent of the high point it reached in the late 1990s. Bermuda markets provide over one-third of the capacity, with the balance coming from US, London and European markets. Some insureds who seek to purchase full market capacity may run into opportunistic pricing.

A View Forward

Renewal program placements are likely to continue to come down to the wire. Carriers are being swamped with submissions. While it may seem as if underwriters are purposely waiting until the last possible moment to deliver renewal quotations, it is often the case that they are too pressed for time to be able to produce a timely response. Planning early, setting realistic expectations, strategically limiting the number of program options, and providing thorough and concise underwriting information will ease some of the pressure.

*(This article also includes contributions from the Willis **Energy Market Review**.)*



Workers' Compensation

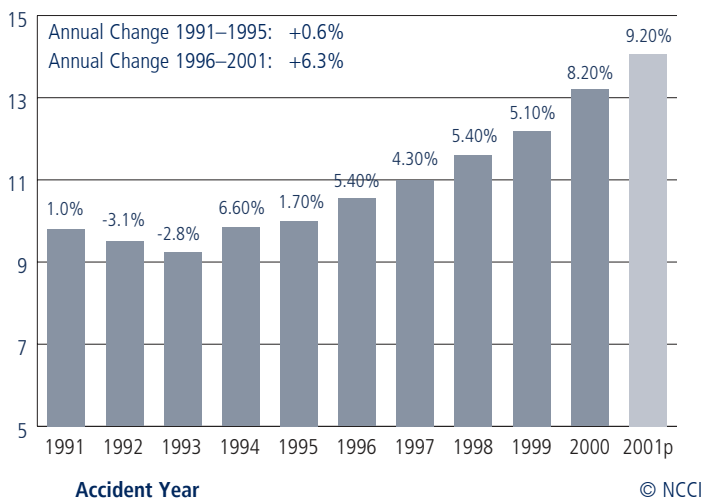
Headlines and Highlights

- Loss costs are rising at increasing rates.
- Discounting practices have put carriers in a pricing hole.
- Years of under-reserving must be faced.
- Companies are seeking alternatives to the voluntary market.
- Prices are on the rise—an average expected increase of 10 to 15 percent.

Workers' Compensation prices are rising. Prices rose steadily in 2002, and in many cases, rose sharply. Loss costs are also rising. Key data compiled by the National Council on Compensation Insurance (NCCI) and by A. M. Best in *Aggregates and Averages* indicates that Workers' Compensation loss-cost trends are accelerating faster than overall economic inflation. Just how much faster may be difficult to measure, but the trends are clear. The annual 8.2 percent increase in the indemnity loss cost in 2000 represented a sharp jump over the increases of previous years. The 9.2 percent rise for 2001 is a preliminary number, but a bracing one. The indemnity trend factor entering current rate and loss cost filings varies by state, but is averaging 6.3 percent for the past five years. For Workers' Compensation medical costs, the five-year trend is 6.8 percent and the preliminary estimate for 2001 is a double-digit spike of 11 percent.

The Rate of Change in Workers Compensation Indemnity Claim Costs Has Accelerated Since 1995

Indemnity Claim Cost (000s)



p Preliminary.

Based on data through 12/31/01, developed to ultimate.

Based on the states where NCCI provides ratemaking services.

Excludes the effects of deductible policies.

The Underlying Math

Given the increase in loss costs, carriers needed to increase prices for Workers' Compensation during 2002 by approximately 6.5 percent just to keep up with the five-year average loss-cost inflation (severity trend). Only a portion of any aggregate increase greater than 6.5 percent has any chance of working against prior year under pricing. The NCCI has estimated that overall Workers' Compensation pricing during 2002 increased in the range of 9 to 13 percent. There are certainly some examples of much higher increases, but not across the board. (*Note:* NCCI estimates are based on data for 37 states; California and Pennsylvania are among the excluded states.)

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Workers' Compensation (continued)

Increasing loss costs are not the only driver of price increases. Over the past eight years, carriers have dug a hole for themselves in the pricing of Workers' Compensation through the practice of discounting. Discounting is defined as the combined affect of rate/loss-cost departures, schedule rating and dividends to policy holders. In a recent study, the NCCI described the large impact of discounting from filed rates or loss costs that carriers employed in pricing Workers' Compensation. The NCCI data shows that average discounting credits bottomed out in 1999 at 23.2 percent, but in 2001 the level was still at 14.9 percent. The industry is struggling to get back to the discounting credit range of 7 to 8 percent, which is the long term average in profitable years.

2001 Performance

The Workers' Compensation combined ratio after dividends increased to 121.7 percent for calendar year 2001, according to *Aggregates and Averages 2000*. Investment income to offset the underwriting loss was only 12 percent, which means that the industry booked an operating loss of 9.7 percent of earned premium after investment income in 2001 for Workers' Compensation. Most of this loss was caused by previously unfunded reserve development from prior years. In 2001, unfunded totals reached \$2.1 billion. The NCCI currently estimates the industry's under reserving of Workers' Compensation financial reserves will soon top \$20 billion, including accident year 2001.

The Burden of Under-Reserving

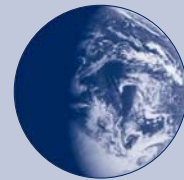
There are virtually no prior year reserve redundancies to fund any of this development. Workers' Compensation carriers are, therefore, facing a bill for prior years' under-reserving that will have to be paid off at a rate of approximately \$2 billion per year for the next 10 years. This assumes that the current year's reserves are being set adequately, which is doubtful. This means that at least 7 to 8 percent of earned premium for each of the next 10 years will be needed to cover claims that occurred prior to 2002. Some large portion of these reserve deficiencies no doubt reside in the books of insolvent insurance carriers, but this will have to be paid by guarantee funds

and will be assessed against the viable insurance carriers. Presumably, these extra costs will be passed through and charged to employers buying Workers' Compensation insurance.

The California Story

The situation is most problematic in California, where there are several insolvencies and national carriers have stopped writing new business and/or reduced their participation in the California Workers' Compensation market by not renewing accounts. This is largely because rate increases of the last several years were inadequate while loss data filed to the California Workers' Compensation Insurance Rating Bureau (WCIRB) was understated. As carriers have gone insolvent or backed away from writing or renewing business, the competitive California State Fund has grown dramatically to \$3.6 billion of written premium in 2001, or 43 percent of the total California Workers' Compensation market. The California State Fund has become the largest writer of Workers' Compensation in the nation, writing more premium in California than Liberty Mutual writes nationwide. The California state legislature is investigating the actions and solvency of the State Fund following the fourth rating downgrade by A.M. Best in two years. The current status is NR-4, not rated.

In a bid to rebuild a competitive marketplace, the California Department of Insurance allowed a 10.2 percent increase in loss costs (underlying rates) effective January 1, 2002 and a second increase of 10.1 percent effective in July, compounding to a combined increase of close to 21 percent for the carriers that implemented both changes. A benefit change effective January 1, 2003 will raise the maximum wages used to calculate temporary total and permanent total disability benefits substantially. The WCIRB estimates this will cause a 7 percent increase in total Workers' Compensation benefits paid in 2003. The combination of this benefit change and continuing poor results resulted in a 13.4 percent increase filing by the WCIRB proposed for January 1, 2003. The Department of Insurance allowed an average increase of 10.5 percent effective January 1, 2003 for new and renewal policies, and a 4.9 percent midterm increase effective January 1, 2003 for the unexpired term of policies in force.



Voluntary Market Alternatives

The problems in Workers' Compensation have caused stricter underwriting and sharp price increases in the voluntary market, which is driving an increasing number of insurance buyers with "tough" exposures into the assigned risk markets. The residual markets which faded away to a nationwide total of \$300 million of premium in 1998 and 1999 have increased to include written premiums of an estimated \$623 million in 2001. They are growing rapidly, according to the NCCI. Another response to the tighter underwriting and sharp price increases has been an increase in the number of large corporations forming captives to cover Workers' Compensation, with premium being stripped from the market as these companies reduce their risk transfer to high-level excess and aggregate stop-loss coverage.

Premium Forecasts

Workers' Compensation premiums will continue to rise at least through 2003 for three reasons:

- Loss-cost trends are once again accelerating and may approach 10 percent per year in 2002 and 2003.
- Even after increases in 2002, premiums are still discounted below a sustainable and profitable level against current loss costs.
- Payments for prior accident years' losses are due. Given years of under-reserving, some \$2 billion plus per year must be funded.

In California, most accounts renewing in the first half of 2003 will face increases of 20 to 25 percent, with increases in the second half moderating to around 15 percent. In some states like Tennessee, where the loss-cost change effective March 1, 2003 will be zero or a very small negative, moderate increases averaging 5 to 10 percent can be expected. The industry should expect Workers' Compensation price increases to average approximately 10 to 15 percent in most jurisdictions during 2003.

Headlines and Highlights

- **Marketplace conditions are beginning to ease.**
- **Airlines, Products and General Aviation sectors—underwriting treatment varies.**
- **The Homeland Security Act has a direct and immediate impact on aviation liability.**

The events of September 11, 2001, coupled with the general reduction in market capacity that followed, produced dramatic rate and premium increases in the Aviation sector through the third quarter of 2001 and into the first half of 2002.

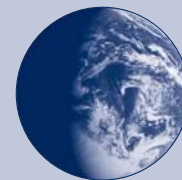
Coverage limitations, restrictions and special surcharges for terrorism still apply, but they have stabilized. Overall, there has been no measurable further reduction in capacity. Current estimated capacity is shown to the right.

2003 Global Aviation Market Capacity

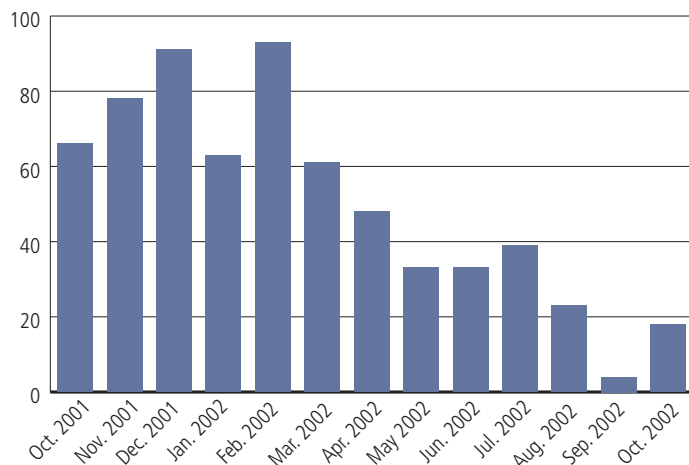
Estimated Percentage of Capacity Supplied by Individual Markets Based on Limits of \$1.5B for Airlines and \$1B for Products

| Airlines | Products | | |
|--------------------------|------------------------|--------------|--------------|
| US | AIG | 10.00 | 10.00 |
| | Brockbank XL Specialty | 7.50 | 7.50 |
| | USAIG | 15.00 | 20.00 |
| | | 32.50 | 37.50 |
| US & London | Global Aerospace | 17.50 | 20.00 |
| Lloyd's of London | ACE Global Markets | 8.00 | 12.50 |
| | Amlin | 5.00 | 5.00 |
| | Brit Insurance | 2.50 | 5.00 |
| | Chartwell | 5.00 | 5.00 |
| | Faraday | 5.00 | 5.00 |
| | Hope | 2.50 | Nil |
| | Kiln | Nil | 2.00 |
| | St. Paul | 5.00 | Nil |
| | Wellington | 5.00 | 10.00 |
| | Markel | 1.00 | 1.00 |
| | Catlin | 1.00 | 1.00 |
| | | 40.00 | 46.50 |
| London | Generali | 1.50 | 3.50 |
| | Wurttembergische | 1.50 | 2.00 |
| | | 3.00 | 5.50 |
| France | AXA | 5.00 | 5.00 |
| | La Reunion Aerieenne | 12.50 | 12.50 |
| | | 17.50 | 17.50 |
| Germany | Alliance (AFA/WAIG) | 15.00 | 15.00 |
| | GE Frankona | 10.00 | 7.50 |
| | Munich Re | 10.00 | 10.00 |
| | | 35.00 | 32.50 |
| Rest of the World | AXIS Bermuda | 5.00 | - |
| | Converium | 3.00 | 1.00 |
| | Inter Hannover | 3.75 | 4.00 |
| | Swiss Re | 5.00 | 5.00 |
| | Tokio Marine & Fire | 1.00 | 1.00 |
| | Endurance | 2.50 | 2.50 |
| | | 20.25 | 13.50 |

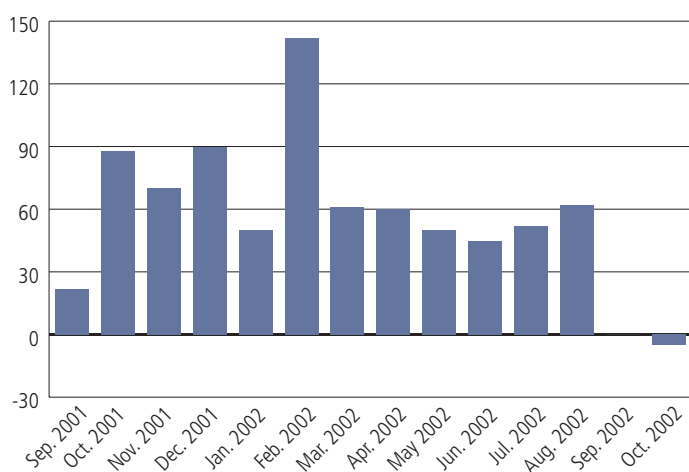
Prepared by
Joseph J. Trotti
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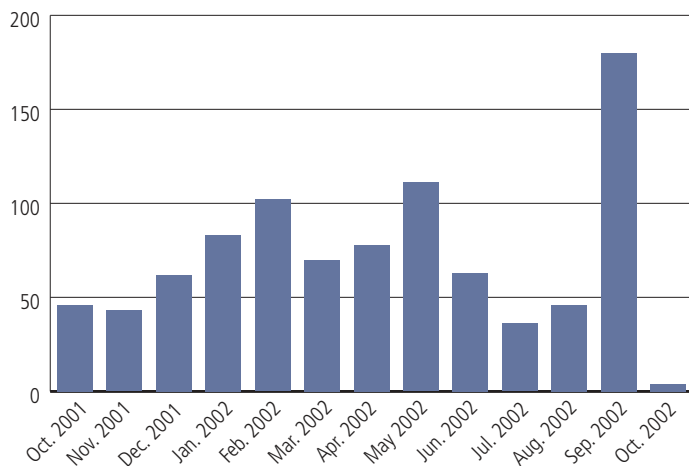
Hull Rate Change %



Liability Rate Change %



Premium Rate Change %



Market Sectors

Airlines

For Airlines, the market has begun to show signs of softening. Renewal underwriting is predicated upon individual exposures and loss records. This can be taken as an indication of market satisfaction with current premium levels. During the first three quarters of 2002 accounts with increased exposure bases were placed at premium levels essentially as expiring. Recently, most accounts have been placed with premium reductions.

Products

The Products line has seen a return to vertical marketing, albeit on a reduced scale. While rates and premiums have continued to rise, the pace of increase has diminished. There is more than enough capacity to place a risk but, given the long-tail nature of the business, underwriters are exercising caution.

General Aviation

The market for General Aviation is still variable, depending on the nature of the risk. Limits are generally lower and coverage enhancements are more difficult to obtain. Pilot experience and training are as critical as ever. There is competition for industrial aid jets with good loss records. However, even companies with good records and high-end equipment are experiencing increases and some coverage restrictions. Limits over \$300 million are extremely expensive. Rates for commercial operators, especially those who have sustained losses, continue to rise substantially as a result of the withdrawal of capacity from this segment. These operators are also seeing restrictions in coverage.

Aviation (continued)

Terrorism and Legislation

Two key pieces of US legislation in late 2002 will impact Aviation clients and underwriters: The Terrorism Risk Insurance Act (TRIA) and the Homeland Security Act. (TRIA is treated elsewhere in this book.)

The Homeland Security Act

This law reinstates the \$100 million cap on an airline's liability for third-party damages caused by a terrorist act. The cap was originally enacted shortly after September 11, 2001 and expired 180 days thereafter.

The Act applies to:

- Acts qualified as terrorism *after the fact* by the Secretary of Transportation. (The law does not define terrorism.)
- Terrorist acts occurring through December 31, 2003.
- Third-party liability. Presumably, this means there is no cap on an airline's liability to passengers.

The law also extends excess third-party War Risks Liability coverage to airlines through August 31, 2003, and grants authority to the Secretary of Transportation to further extend it to December 31, 2003. This coverage is useful to other aviation concerns as it allows the insured airline to name service providers (airports, lessors, etc.) as additional insureds. The service provider is only protected, however, if the terrorist act is connected to the insured airline's operations.

War Risks coverage is expanded by the Act to include aircraft hulls, passengers and crew, and makes all coverage *first dollar*. It is possible that airlines may simply cancel their Hull War and AVN.52D coverage and opt for the federal program. However, the expansion of coverage to include additional risks is subject to the terms set forth by the Secretary of Transportation.

The law instructs the Secretary to investigate alternatives to federal insurance. One such alternative is a risk retention group, which was floated by the major US airlines. This approach failed to win government support because it covered passenger exposures and required the government to reinsure the group for a number of years.



Headlines and Highlights

- Capacity is ample and market conditions remain favorable.
- Six product areas predominate—mold coverage, contractor's pollution liability, programs for legacy liabilities, property transfer coverage, remediation cost caps and underground storage tank programs.
- EU contaminated land legislation has spurred the demand for environmental insurance in Europe.
- Environmental reinsurance and Surety marketplace conditions bear watching.

During 2002, the environmental insurance market performed as anticipated. As many major components of the insurance market continued to harden, market conditions for environmental insurance remained relatively soft, with most renewal programs experiencing price increases of less than 10 percent. A number of insureds experienced virtually no increase in their environmental insurance rates. We believe that the 2002 trend will continue through 2003, with environmental insurance market conditions remaining relatively soft due to the continued influx of new carriers and the significant capacity available from established carriers.

Anticipated Demand for Environmental Coverage in North America

Six insurance products—two new and four established offerings—will dominate the market in the year 2003.

Mold Coverage

Mold emerged as one of the hottest topics of 2002 and will continue to be a major issue in 2003. Accentuated by headline cases such as the \$32 million Ballard judgment in Texas and trumpeted by the media as the next "asbestos", mold was a concern for every underwriter during 2002. As a result, mold

exclusions were being added to virtually every Liability and Property policy issued. Late in the year the environmental markets finally came to terms with the mold issue and started to offer coverage under their Pollution Liability forms.

In 2003, property managers and commercial property owners will be able to obtain mold coverage to include bodily injury, property damage, remediation and defense expense. Limits from \$1 million to \$50 million per occurrence will be available. Underwriting requirements will remain strict, with the insured being required to develop mold management protocols, conduct in-house training, and provide mold survey results as part of the underwriting submission.

One very positive result of the mold and fungal activity is the development of bio-terrorism coverage. Based on the standard Pollution Liability policy, the inclusion of terrorism coverage for biological agents will provide a significant increase in coverage for hospitals, laboratories and other establishments susceptible to biological attacks.

Contractor's Pollution Liability (CPL)

Since the birth of the environmental specialty market, Contractor's Pollution Liability (including forms combining general or professional liability) has been a key coverage product. Due to exclusions in their General Liability coverage, contractors working in the building trades will be faced with the need to protect themselves from the ever-widening web of mold claims. This burden will fall to Contractor's Pollution Liability insurance. Significant limits for mold coverage (\$1 million to \$20 million) will be available. Contractors will be required to undergo a stringent underwriting process, similar to that described above, prior to coverage being bound.

Blended Finite Programs for Legacy Liabilities

A major area of emphasis for the environmental insurance market during 2003 will be the structuring of blended finite programs for the management of legacy liabilities. Three factors will predominate. The first driver for finite programs will be the increasing need of organizations to cleanse their balance sheets of environmental liabilities in light of heightened investor and regulator demands for full disclosure of all liabilities.

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Environmental (continued)

The second driver is the desire of an organization to develop a proactive financial strategy which will allow it or a group of Potentially Responsible Parties (PRPs) to "walk away" from environmental liabilities associated with remediation and long-term Operation, Maintenance and Monitoring (OM&M) activities. This is normally accomplished by the organization or group transferring its environmental liabilities to a contractor backed by a rated environmental carrier.

The final driving force is the requirement to provide financial assurance for closure/postclosure care of waste management facilities and for the reclamation of mining activities. With the disappearance of uncollateralized surety as a method to provide financial assurances and with carriers becoming increasingly reluctant to provide closure/postclosure or reclamation financial insurance (due to their inability to withdraw from a program once they enter into it), self-funding and finite risk options will play a much larger role in the financial assurance arena.

Introduced in the UK in late 2002, the use of blended finite programs is expected to spread across Europe in 2003.

Property Transfer Coverage

Uncertainty in the global economy, manifested in part by the continued consolidation and retrenching of many industry segments, will continue to stimulate the use of property transfer coverage in 2003. As mergers and acquisitions increase, as firms continue to divest non-core business activities, and as redevelopment of abandoned properties (brownfields) and underutilized properties (grayfields) proceed, there will be strong demand for property transfer insurance programs to back environmental representations, warranties and indemnities and to protect both buyers and sellers from the financial consequences of unknown environmental contamination. Coverage enhancements such as Natural Resource Damages, Non-Owned Disposal Sites, and contingent protection in the event of financial failure of any of the parties to a transaction will ensure the continued growth of this market segment.

Remediation Cost Caps

Following the trend of the past several years, Remediation Cost Cap programs will remain a significant segment of the environmental market. Projects with values less than \$2 million will continue to be difficult to insure under a Cost Cap program. The most significant development will be the increased use of probabilistic cost modeling to set attachment points, establish co-payments, and compute premiums. For insureds looking to utilize Cost Caps, engaging a broker with probabilistic modeling experience will be critical in formulating an optimal program.

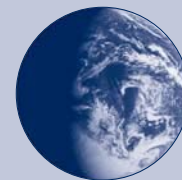
Underground Storage Tank (UST) Programs

After a number of years of declining importance, underground storage tank coverage will re-emerge as a significant issue during 2003. With the rising insolvency and sunset provisions of many State UST Funds, the method of choice for providing financial assurance for underground tanks is increasingly UST insurance programs. Policies will range from coverage of individual tanks operated by contractors to multi-site convenience store portfolio programs.

Issues and Perspectives

Anticipated Demand for Environmental Coverage outside North America

The demand for environmental insurance outside North America will continue to grow as insureds search for methods to mitigate the impact of environmental liabilities on balance sheets, merger and acquisitions, and property transfers. This growing demand for environmental insurance is being spurred by contaminated land legislation in the European Union, the increasing need for organizations to protect their assets from environmental liabilities as the global economy continues its uncertain course, and the recognition of the inherent limitations of many of the European pollution pools. The growing importance of this market segment is illustrated by the strengthening of underwriting units throughout Europe by the major global environmental underwriters (Allianz, AIG, XL, Chubb, and Zurich).



Warranty and Indemnity Coverage (Property Transfer)

The negotiation of warranties and indemnities forms a significant part of structuring corporate transactions. Such contractual mechanisms are regularly used to allocate liability for environmental risk. Often this issue can become a deal breaker. Warranty and Indemnity policies offer back-to-back cover for contractual liabilities flowing from indemnities and warranties. Coverage is limited to liability arising from the relevant contract. Definitions and provisions of the contract are written directly into the insurance policy, which removes any possibility for potential gaps in cover. We anticipate that Warranties and Indemnities coverage will lead the global environmental market during 2003.

Market Capacity

In 2003, the market spotlight fall on two new market entries, ACE Environment and Combined Environmental. ACE entered the market in late 2002 while Combined is expected to start accepting risks in early 2003. The entry of these two new carriers and their capacity will help sustain favorable market conditions during 2003. While reinsurance remains a factor in the type and duration of coverage, we believe that adequate reinsurance capacity will be available throughout 2003 to meet market needs. The following table summarizes environmental market capacity for 2003.

Carrier Ratings and Limits

| Carrier | Ratings | | Limits ¹ |
|---------|---------------------------|-----------------------------|---------------------|
| ACE | A.M. Best: A (Excellent) | S&P: A+ (Superior) | \$50M |
| Allianz | A.M. Best: A++ (Superior) | S&P: AA (Very Strong) | \$25M |
| AIG | A.M. Best: A++ (Superior) | S&P: AAA (Extremely Strong) | \$150M |
| Chubb | A.M. Best: A++ (Superior) | S&P: AAA (Extremely Strong) | \$100M |
| ECS/XL | A.M. Best: A+ (Superior) | S&P: AAA (Extremely Strong) | \$100M |
| Gulf | A.M. Best: A+ (Superior) | S&P: AA (Very Strong) | \$25M |
| Kemper | A.M. Best: A (Excellent) | S&P: A (Strong) | \$50M |
| Liberty | A.M. Best: A+ (Superior) | S&P: AA (Very Strong) | \$25M |
| Seneca | A.M. Best: A- (Excellent) | S&P: BBB (Good) | \$15M |
| Zurich | A.M. Best: A+ (Superior) | S&P: AA (Very Strong) | \$75M |

¹ - Limits are based on available information and may vary from those shown. Limits shown do not include potential capacity available through facultative reinsurance arrangements.

Renewals

Terms for environmental insurance will remain stable during 2003. Premium increases are expected to be similar to those experienced during 2002, ranging between 10 and 15 percent.

Policy terms for legacy policies will generally be limited to a maximum of 10 years. Policy terms for prospective and contractor coverage are expected to be limited to a maximum of five years, with significant resistance to providing coverage beyond a period of three years.

Reinsurance

Reinsurance will continue to be an area of concern for environmental insurance carriers during 2003. While no major environmental reinsurer has left the marketplace, a number have indicated that they are still re-examining their positions in the market and may be reducing their future participation, particularly for facultative placements.

Most environmental carriers will be able to successfully negotiate new reinsurance treaties in 2003. As stated earlier, the only major restriction will be the limiting of policy terms to 10 years—less for non-finite legacy coverage and three years or less for prospective coverage.

Additional Areas of Concern

Surety

Surety in the environmental arena will mirror surety in the general market during 2003 and continue to contract significantly. The most promising solution to the lack of environmental surety will be the use of finite programs.

Environmental Coverage in Umbrellas

In past years many excess and umbrella underwriters have provided limited environmental coverage in umbrellas. We expect the few carriers still providing this coverage during 2002 to completely withdraw in 2003.

Increasing Complexity

The environmental insurance market is becoming increasingly complex and is experiencing some of the effects of the overall market hardening. While the environmental market will remain strong and responsive throughout 2003, clients with intricate needs will stand to benefit from the services of environmental coverage specialists.

Headlines and Highlights

- **Construction market conditions remain challenging—for General Liability, Umbrella/Excess, Auto and Workers' Compensation.**
- **Primary layer attachment points have increased sharply.**
- **Mold, Asbestos and EIFS coverages are problematic.**
- **Residential construction will be highly restricted with alternative funding approaches becoming commonplace on larger placements.**

For contractors and construction risk, commercial insurance marketplace conditions indicate a continuation of tight underwriting, premium increases and limited appetites for more hazardous classes. We do, however, anticipate some leveling off of price hikes in early 2003.

Umbrella and Excess Liability

This segment of the marketplace for construction risk was most volatile in 2002. Key carriers reduced the limits they were willing to provide. Several underwriters that had been aggressive in prior years simply exited the market. The carriers that remain seek to attach their coverage at higher limits. Coverage restrictions have created concerns about non-concurrency of coverage from primary policies through the excess layers.

Pricing increases have varied from 20 percent at the low end to several multiples on the high end of the spectrum. Contractors with losses large enough to touch their umbrella layers will need to spend a lot of time explaining those losses and will face a restricted underwriting appetite. Heavy vehicle fleets face two problems: the umbrella carrier is likely to require a higher primary auto liability limit of at least \$2 million, and umbrella pricing will likely be driven by the higher cost of reinsurance.

Some moderation in price increases is expected this year as most programs have by now experienced at least one cycle of significant pricing increases. New capacity is starting to flow into the Construction sector, spurred by the sustained high pricing levels. Increased competition may also have a market softening effect.

General Liability

Last year's predictions of difficulty in General Liability were largely accurate.

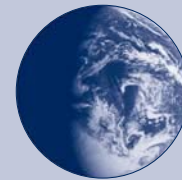
Mold became a pervasive coverage issue, with most carriers excluding or limiting coverage. There has been some new coverage available under pollution policies but not every carrier has agreed to include mold coverage.

The exterior finish insulation system (EFIS) situation has worsened. Where most carriers were trying to exclude the exposure, now many simply refuse to insure companies that have any exposure at all. Coverage for EFIS-related losses will be completely excluded in most cases.

Residential construction continues to be almost impossible to insure in traditional ways. Many residential contractors have seen exclusions for property damage arising out of completed operations. At present, there is little to no insurer interest in this segment of the market, and alternative funding may be the sole answer for those seeking coverage.

Pricing and deductible levels rose significantly through the first half of 2002, with average price increases of 20 to 40 percent. Premiums for General Liability may level off in the coming year, although the need to purchase higher limits to satisfy umbrella requirements could drive up total program costs.

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Auto

The need for higher primary policy limits has become almost standard. Minimum limits of \$2 million are in many cases necessary to get umbrella carriers to respond. Many carriers do not have such large primary capacity in house, and they are buying expensive reinsurance. The Auto line is seeing some of the heaviest price increases.

The issues impacting Excess Liability for heavy truck fleets were discussed above. Companies with such exposures will be scrutinized closely by underwriters, and those with poor loss experience will find depressed market appetites and higher pricing.

Workers' Compensation

At renewal time, most large Workers' Compensation accounts (over \$400,000 in premium) can expect to be pushed toward more loss-responsive programs. Those who currently have loss-responsive programs face higher levels of risk retention (deductibles and aggregates) as well as limited reinsurance for more hazardous exposures.

Property and Equipment

For construction industry clients, property at risk consists chiefly of plant and related contents and builder's risk exposures. Coverage has been impacted by reduced capacity for flood, earthquake and wind, especially in catastrophe-prone areas. Builder's risk costs in 2002 went up at least 25 percent, with coverage restrictions, lower sublimits for earthquake and wind, and substantial increases in deductibles. The complexities of underwriting requirements for mold, terrorism and locality all will continue to limit single carrier capacities in many geographic areas. The cost of reinsurance in this line also has caused significant rate disruption and we expect conditions to continue in 2003. Layered and quota share programs will become more common on larger projects (\$50 million to \$75 million).

Contractors' Equipment rates will continue to rise as this line has been historically very unprofitable for insurance carriers. We expect deductibles and rates to rise in 2003 by another 15 to 30 percent.

Alternative Risk Strategies

Many contractors have started to look at alternative risk strategies as a way to reduce cost of risk. In the current market, some risks may not be economically insurable. Funding for these through alternative markets may be the only choice certain contractors have. We refer you to the articles in this book that treat "Alternative Risk Financing" and "Captive and Captive Management".

A View Forward

We anticipate continued rate increases, coverage restrictions, a pull-back in underwriters' risk appetites and a search for alternative solutions for managing risks. The early part of the year 2003 will provide an indication of underwriting appetite for construction risk.

While we see new capital coming into the marketplace, we anticipate continued cautiousness regarding high-risk classes of business. Those segments of the construction industry with exceptionally high risk activities and exposures will face the most challenging renewals ahead.

The Energy Market

In December 2002, Willis published the Energy Market Review, our semi-annual comprehensive overview of the global energy market. Electronic copies of the EMR are available upon request. From that review, prepared by the London-based members of our global Energy Practice, we have excerpted the article titled "Enterprise Risk Management & the Utility Sector". The concepts and practices discussed below apply to many industry sectors.

Enterprise Risk Management & the Utility Sector

Risk management is undergoing significant change and elevation in corporate stature and culture as evidenced by the recent formation of the position of Chief Risk Officer (CRO) in many organizations. Departments once managed individually and separately, such as procurement, treasury, trading and insurance, among others, are now increasingly being managed, as for risk, under the auspices of the Chief Risk Officer. In many companies where the CRO position is not yet implemented, corporate risk management committees have been formed to identify, assess, dispense responsibility to manage those risks, and to measure and audit those risks on an on-going basis. Corporate governance pronouncements have helped to fuel this process globally, as have recent, highly visible corporate scandals and their impacts on some of the world's largest corporations.

Corporate Governance Expectations

Boards of publicly traded companies and their senior executive officers are being increasingly held responsible for knowing and sharing with the public the material risks faced by their organizations. Shareholders of these corporations are becoming increasingly demanding that the material risks be economically and strategically mitigated as evidenced by share price volatility in the equity markets, particularly when earnings targets are not met. Enterprise risk management (ERM) is an effort to achieve a common understanding and measurement of all risks of the corporation and to find an integrated means of systematically managing those risks. ERM is achieved through a balance of financing techniques with operational and strategic changes and processes. By developing a comprehensive understanding of the firm's risks, competitive advantage can be achieved by controlling or leveraging the risk position, and therefore, safeguarding against "earnings surprises" can be more readily achieved.

Growth and Financial Risk in the Energy Industry

The energy market is undergoing changes of its own, from deregulation in many countries, to volatile fuel prices and the impact of environment regulations, such as those necessitated should the Kyoto protocol be implemented. At the same time, the demand for power is escalating, with some countries reporting double-digit increases. To meet all of these increasing demands, substantial capital resources will be necessary, but with this comes significant financial risk.

For example, to meet the ever-increasing demands for electricity, utilities are building new power plants and upgrading older, less efficient power plants. However, because electricity cannot be stored, generation is built for peak demand plus some operating reserve. Through a combination of adverse weather conditions and generator outages, a utility may find it necessary to import excess generation capacity from another area of the country. Depending upon the extent of the outages or weather conditions (e.g. a widespread heat wave during a time of widespread planned maintenance outages), the spot market price of electricity could be orders of magnitude higher than normal.

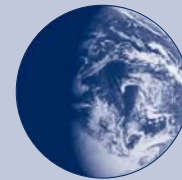
This combination of extremely high requirements for power importation coupled with extraordinarily high prices could spell financial disaster for many economically strapped utilities. Add to this situation the following:

- Volatile nature of commodity prices such as natural gas, fuel oil and coal.
- Increasing environmental regulation and its attendant costs.
- Counterparty and credit risk.
- The move toward more competitive energy markets and the need to compete on price.

Thus utilities are finding it increasingly necessary to understand and manage risks from a centralized perspective.

The Tenets and Process of Enterprise Risk Management

The key requirement to being able to achieve some of the objectives of ERM is for the Board and key senior executives to embrace the tenets of ERM and to drive its implementation



from the top. This often involves the formation of a corporate risk management committee or the installation of a CRO, who is beholden to the Board. Either of these structures makes it possible for the necessary corporate resources to be marshaled within the organization and ensures buy-in of all the constituent parties with applicable interests.

The first step in ERM, following a board-level or executive level mandate, is to engage in a process of risk identification, which often leads to the creation of a risk map. This stage of the ERM process involves some combination of questionnaires, workshops and key interviews that cut across the numerous divisions of the organization.

In order to ensure that a consistent response is achieved, a common framework regarding the definition and measurement of risk is introduced and utilized throughout the questionnaire, workshop and interview process. Normally the questionnaires are addressed to the broadest base of employees, the workshops are utilized for the management level of the key functions of the company, and the interviews are reserved for the highest senior executive. Following this process, the risks are ranked and mapped on various dimensions such as likely frequency of occurrence, probable range and possible severity (magnitude), and potential volatility.

Data, Metrics and Mapping

One important consideration in this exercise is to develop a preliminary understanding of the data available for potential future quantification. Often companies have not collected nor maintained sufficient internal data to complete an in-depth quantification. The end product of the risk mapping process is a qualitative understanding of the major and lesser risks facing the organization and an understanding of the potential financial impacts of each. This "catalog of risks" provides a roadmap to the next step, an in-depth assessment and quantification of the key risks, as a starting point, and of all material risks, as an end point.

The quantification of risks involves analyzing the data in an effort to arrive at commonly accepted metrics that "measure" the risk in differing and meaningful ways, including notional exposure, volatility, value-at-risk (VaR), earnings volatility,

earnings VaR, risk adjusted return on capital (RAROC), economic value added (EVA) and correlation to other risks, among others. These risk metrics and the methodology used to create them will provide for a continuous, consistent, proactive and rigorous framework for risk assessment and decision making for all parts of the firm.

Often mathematical models are constructed that permit the risks to be simulated via Monte Carlo, especially in concert with material correlated risks. Such models are a key to the successful modeling of the risks in an integrated manner and their potential treatment within a portfolio. For risks that are less quantifiable (e.g. intangible risks), scenario analyses might be an appropriate method to gauge financial impact.

Achieving the Optimal

Ultimately, the value of ERM lies in the management of the material risks in a consistent and coordinated manner, whether the solutions are financial or organizational. Financial solutions include insurance, reinsurance, capital instruments and credit lines. Organizational solutions are often taken to address and manage the risk at its source through a combination of contingency planning, accountability, divisional realignment, communication and risk control. Enterprise Risk Management is fundamentally driven by the concept: "from change management to performance management."

Because of the drastic changes facing the energy sector and the unknown challenges that already exist, enterprise risk management processes are a natural fit with this sector. The 1996 Harvard Business Review states that "Corporate Governance is not, at its core, about power; it is about finding ways to ensure that decisions are made effectively." In turn, an enterprise risk management approach is not simply a process to identify and quantify risk, but a framework to allow companies to navigate changing currents with strategic and comprehensive approaches to risk. Because of the diverse nature of risk relating to the energy sector, and the unusual way that these risks are often positively correlated, the energy sector has been and will continue to be a leader in enterprise risk management initiatives.

(To download a pdf file of the *Energy Market Review*, please go to www.willis.com/news and click on "Publications".)

Headlines and Highlights

- **Following major recent losses, the Marine market continues to harden.**
- **Reinsurers have been hardest hit, especially those in continental Europe.**
- **Price increases in 2003 are expected to begin at 20 percent.**

The Marine market is facing the hardening conditions that have affected virtually all insurance markets. A series of major losses has reinforced this trend across the spectrum of Marine lines. In some cases, however, available capacity has softened the impact.

US Marine Market 2003

2001 and 2002 saw continuing negative rates of return from capital markets and this continues to have a great impact on the US Marine insurance market as a whole. Combined with a decade-long price war, the post-September 11 environment and mounting major losses, the pressures on the current hard market remain.

2002 in the US market saw increases in net premium written while investment returns continued their downward spiral. In addition, underwriters were typically taking a much more conservative approach to renewals and new business as they attempt to identify and reduce their exposure to terrorism risks.

The Terrorism Risk Insurance Act of 2002 will begin to take effect through the course of 2003 as regulations are passed. Although the legislation is now in force, the implementation lags behind and much confusion abounds as to the ultimate impact of this legislation on the market.

By the end of Q3 2002 commercial rates were seeing increases of 20 to 50 percent on renewals, with the largest increases being felt by the small to medium sized accounts.

Generally, the market perception seems to be that the current hard market will flatten through 2003 and 2004. This depends to a great extent on the performance of the capital markets

through this period. The Marine market historically has tended to run ahead of the general commercial market and may well lead the turnaround to a softer market in 2005 and beyond. This places the Marine sector in a competitive position especially for Cargo coverage that can be placed alternatively in the P&C market.

US Marine markets saw strong growth in 2002 in the Cargo and Yacht sectors, which make up about 50 percent of all US insurance premium. US markets continue to be well capitalized and this has created a competitive edge in the international marketplace. Although the *Prestige* was a largely US placement, many of the other recent major losses were not placed in the US market.

Marine Hull

Marine Hull has seen some of the steepest increases in the Marine sector. Hull underwriters in latter part of 2002 were applying a 20 to 25 percent cash increase for loss-free accounts; following the recent slew of losses (*Prestige, Hanjin Pennsylvania, Diamond Princess, Hual Europe* and *Treasure Bay*, among others), these base increases have risen to 35 percent. Adverse results are being treated harshly and increases of 100 percent or more are not uncommon. Deductibles are likewise being increased in cases where they are below average or as a means of diluting price increases.

Marine Cargo (Transit Risks)

Global marine markets have generally viewed Fortune 1000 cargo accounts with caution over the last two years. Regardless of improved profitability in the Marine Cargo sector, continuing pressure brought on by increasing treaty costs and higher self retentions are driving underwriters to demand corrective action for entire portfolios of business. Most accounts are seeing tandem increases on pricing and deductibles. It is the rare account where policy wording remains "as is" on renewal. Global clients requiring significant policy limits need to be

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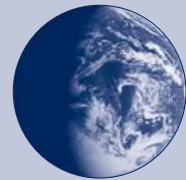
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cognizant of substantially higher costs; premium levels for excess capacity have easily doubled in past 12 months.

Within the current environment many companies have witnessed the following trends:

- Cargo accounts with satisfactory profit records are witnessing increases of 10 to 15 percent; rates for inventory coverage are considerably higher. Minimal deductible levels are established at \$5,000 to \$10,000 per claim for relatively profitable programs.
- Domestic US marine markets are aggressively attacking "client friendly" clauses found within manuscript broker forms; domestic markets are rejecting broad form Extra Expense clauses, Brands/Trademark clauses and Debris Removal clauses. Underwriters are demanding a greater say in the claims process, often leading to difficult negotiations as to the intent of existing policy wording.
- In London, pricing is comparatively higher on accounts with mixed results. The London Cargo account, with its higher limits, specialist treatments and bespoke needs saw a general increase of 20 percent in 2002 and we anticipate a further 15 percent increase in 2003. The larger limits are proving more challenging as capacity for big volume placements has shrunk meaningfully. Local, indigenous Cargo business is generally profitable and continues to be underwritten according to local requirements. Standalone storage can be problematic in view of the uncertainty over the approach that will be taken by reinsurers for 2003.
- While there are a few underwriters bucking the trends, true Marine Transit US capacity has been reduced. Most markets will offer \$15 million to \$20 million vessel limits. London generally remains unaffected in this area.
- For the large majority of risks, underwriters have generally reduced policy limits for traditional marine extensions of coverage. Most domestic underwriters are reluctant to offer meaningful capacity beyond \$10 million for Inventory limits and \$5 million for Inland Transit exposures. Additionally, these storage or static risks face greater underwriter scrutiny and tend to attract specific price and deductible increases than they have in years past. Marine markets will now routinely mandate sublimits or introduce aggregate limits for Flood and Windstorm as well as Quake.
- Markets are less flexible for global manufacturers operating in territorial "hot spots" (e.g. the former Soviet republics of Central Asia and portions of South/Central America). Many markets will incorporate an extended list of coverage warranties and/or sublimits for transits within these target countries.
- While it is difficult to predict Marine market reactions to the US Terrorism Risk Insurance Act of 2002 (TRIA) we believe underwriters will implement premium surcharges similar to the surcharges assessed in late 2001 for War Strikes Riots rates.
- Clients can expect increases of at least 10 percent and in some cases nearly 100 percent when purchasing US Terrorism Risk Coverage.
- We foresee minimal market change in 2003 with underwriters trying to sustain profitability realized in the past 18 months.

Marine (continued)

Clients must be prepared to:

- Arrange face to face meetings with interested markets.
- Deliver quality exposure data and offer a sound risk management profile to differentiate themselves in the marketplace.
- Live with higher retentions to mitigate premium increases.
- Analyze terms/clauses/limits in context of "nice to have" versus "need to have"—being specific will help navigate today's marketplace.
- Accept the fact that everything takes more time.

Protection and Indemnity

As the P&I Clubs suffer losses to their equity portfolios, and as these losses coincide with a period of poor results, pressure mounts on underwriters to stabilize reserves. The P&I Clubs have recourse to both advance and supplementary calls to balance their accounts, but the size of these calls has a bearing on the competitiveness of the Club and, hence, on its long-term viability. For early 2003 renewals, increases are likely to be substantial; clubs are talking about a rise of 20 to 30 percent. Renewals are expected to incorporate additional provisions allowing for sizable increases in Club reinsurance costs, which may result in an additional 5 to 7.5 percent price boost. For reinsurance, the International Group of P&I Clubs has enjoyed preferential terms from the market (their three-year deal concludes in February 2003). The collective reinsurance placement has been broadly arranged with the insurance market, allowing this substantial "reinsurance" contract to sidestep the demands of the retrocessional market.

Marine Liability

Increases of 20 percent were broadly applied for 2002. Insurers may be looking for similar increases in 2003, but the availability of capacity will probably mean that the price hikes will be closer to 10 than 20 percent. As we noted regarding the P&I market, the Marine Liability market keeps a wary eye on the fluctuations of the reinsurance market and will respond accordingly to balance its portfolio.

Marine War

The immediate response to the events of September 11 was to increase prices across the board for both Marine Hull War and Cargo War. All ship owners were charged large increases and passenger vessel owners, being potentially high-profile targets, incurred still higher rates. These Hull War rates have generally remained steady since then; any inclination by insurers to reduce the rates has been stemmed by the highly publicized *Limburg* terrorist loss.

For Cargo War, the immediate post-September 11 reaction was to increase rates for the War & Strikes coverage and to focus closely on the extent of Onland (Storage) coverage. This gave rise to the Termination of Transit (Terrorism) Clause, which defines the length of coverage after arrival at port or warehouse. The almost universal application of this clause in reinsurance contracts has meant that this trend is holding strong and will continue in 2003.

Marine Reinsurance

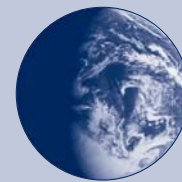
Reinsurance terms were sharply increased for 2002: retentions increased by substantial amounts, premiums rose and exclusion clauses were created and/or reintroduced. The increased retentions were not tested until late September and early October 2002, when, in a two-week period, losses occurred:

Mitsubishi's Shipyard in Japan had a massive fire to the *Diamond Princess*, causing a loss expected to ultimately reach close to \$300 million.

Hual Europe (owned by Leif Hoegh) grounded and was declared a total loss (\$55 million Hull & Machinery and Increased Value combined, plus and a potential Cargo loss of up to \$40 million).

The tanker *Limburg* was attacked outside Yemen and incurred damage (classified as War in the Marine market) of up to \$30 million, with P&I on top.

The hurricanes Isidore and Lili also wrought damage to jack-up rigs (towards \$100 million) and to the casino boat *Treasure Bay*, valued at \$18.5 million (a total loss).



Another major loss came in November, as the *Hanjin Pennsylvania*, built in 2002, caught on fire south of Sri Lanka on its maiden voyage (Value of Hull is \$46 million with Cargo unquantifiable, but potentially huge).

In the context of the worldwide catastrophe reinsurance market these amounts may appear insubstantial, but in the context of the Marine Reinsurance sector these losses are significant. Of a world-wide bluewater (including building risks) premium income of \$3 billion the Mitsubishi loss alone represents up to 10 percent. Significant indeed.

The impact of these losses has been felt broadly. The Japanese, London and Norwegian Hull markets have been hit hard. Hardest hit are marine reinsurers, whose involvement on the Japanese Pool and other prominent reinsurance placements has concentrated the losses into the hands of a few carriers, notably in continental Europe. The continental European insurance and reinsurance markets were also hit hard by the recent flooding in Europe, which impacted Marine accounts through the Cargo market, particularly car storage accounts.

For marine reinsurers, 2002 underwriting results were supposed to launch a return to profitability following the miserable results of 2001. Reinsurers wrote better original insurance terms to improve their smaller proportional treaty portfolios and more stringent terms to produce a choice return on the non-proportional Excess of Loss business. Excess of Loss, however, operates on its own timetable: results may be mitigated by higher retentions and enhanced premiums (along with reinstatements), but the final outcome is always vulnerable to extraordinary loss. The Mitsubishi shipyard loss is certainly extraordinary in the context of Marine Hull values: approximately 95 percent of all bluewater vessels (by insured value) are valued at less than \$50 million. Any Marine Hull Loss over \$50 million will inevitably have a disproportionate effect on reinsurers.

Reinsurers are also incurring higher costs for their own Retrocessional coverage. The remedial action imposed by Retro underwriters for 2002 meant increased premiums on the one hand, but also higher retentions, which have ensured that the

Retro market should not be greatly affected by recent losses. Reinsurers are likely to be charged more in 2003, but will have received little benefit from their protections in 2002.

In 2003, reinsurers are likely to offer yet more restrictive proportional treaty coverage, although current underwriting guidelines from insurers should make proportional coverage more practicable for 2003; for Excess of Loss, reinsurers will probably acknowledge that a lot of the remedial work was applied for 2002, given the recent premium and retention increases, but will still be seeking higher premiums. Renewals will be based on a reasonable increase for all, but with an appropriately steep increase for reinsurers with losses.

The list of clauses is likely to expand to include an amended radioactive exclusion clause and a bio-chemical/electromagnetic weapons exclusion, which should plug any loopholes between Marine and Non-Marine reinsurance wordings. Long-term Cargo storage is also under scrutiny and exclusion clauses are being proposed to try to reposition the storage into the Property market. This would constitute a substantial change in practice and in mindset for the Marine Cargo market.

Marine Reinsurance is closely linked to the fortunes of the Marine insurance market. In recent years the reinsurance market has reacted severely to the adverse results whereas the primary Marine insurance market has adopted a more pragmatic approach to remedial action. These different approaches are creating difficulties for insurers.

In all, the reinsurance market remains one of the main drivers of the hardening conditions in the Marine sector.

Employee Benefits

Headlines and Highlights

- **Medical costs keep rising, pushing insurance costs up with them.**
- **Increased prescription drug costs are a driver of overall medical costs.**
- **HMOs may have wrung out as much cost savings as they can.**
- **Employees will be asked to bear more of the burden.**

The demand for quality employee benefits in the United States remains strong, as employers compete for talent. The US Employee Benefits marketplace continues to be driven by the pressures of increasing medical costs.

Global Market Conditions and Capacity

Through 2003 we expect average price increases of 14 percent. These are expected to range from 12.5 percent average increases for point of service (POS) plans to 15.5 percent average increases for indemnity. Price hikes for preferred provider organization (PPO) and health maintenance organization (HMO) plans are expected to fall within that range. Prescription costs will remain a significant driver, as increases of 18 to 20 percent are expected. Fixed costs of self-funded plans will experience greater increases as we anticipate a challenging stop-loss market with some restricted capacity.

Employers with retiree medical plans can expect even greater cost increases, largely because retiree plans involve more prescription drug usage than the plans for active employees. Most retiree plans utilize the PPO or HMO forms of managed care. However, we project costs for the pre-65 retiree plans to increase by 15 to 16 percent in the coming year. There is also some adverse selection affecting the cost of these plans-people with more health problems tend to select managed care plans, which drives up their costs.

For the post-65 group, we expect costs to increase 16 to 17 percent next year, driven primarily by significant prescription drug use. Most employers are carefully assessing the design, eligibility and cost-sharing aspects of these plans.

Dental plans continue to be desirable to employees, although benefit limits remain restrictive. Most plans utilize some form of managed care; increases of five to six percent are anticipated for the majority of plans in 2003. These increases reflect inflation plus growing usage due to the aging of the insured population.

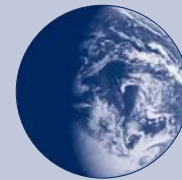
In recent years, Group Term Life, Accidental Death and Dismemberment (AD&D), high limit AD&D, and Business Travel Accident plans have been very aggressively priced. Additionally, multi-year rate guarantees have been the norm. These conditions are changing, albeit gradually. Prices are less aggressively priced and carriers are less willing to negotiate multi-year rates.

The Long-Term Disability marketplace has seen upward price movement in base rates in recent years. This will continue in the primary market; along with it will come limited capacity in the excess and specialty marketplace.

Healthcare Legislation

The most immediate issue on the political/legislative front is HIPAA (the Health Insurance Portability and Accountability Act). This will require all healthcare providers to maintain patient medical information so that it can be used only for permitted purposes and by people who have a right to see it. A further major goal of HIPAA is to simplify and streamline medical administration, and ultimately HIPAA may save the industry money. However, in 2003 and 2004 at least, health plans can expect to spend substantial sums (six figures in many cases) to comply with the law. It is safe to assume that the cost of compliance will be passed along through increased premiums or administrative fees.

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Still on the legislative agenda is a Patient Bill of Rights. Like all mandates, this would likely drive up costs. The legislation is stalled over differences on liability issues and limits on punitive damages. The bill has failed several times in the past few years and there seems to be less impetus than there has been in the past, but the issue may resurface.

The current Mental Health Parity law was extended again this past year. Efforts are underway to reintroduce a comprehensive and wide-ranging mandate requiring many more treatment options that would drive up costs. Most politicians are against the broad mandates but President Bush has said he favors mental health parity so a broader law may be on the horizon.

Prescription Drug provisions in Medicare may ease burdens on retiree medical plans and reduce costs. Again, President Bush is in favor of this so it is likely that some form of this coverage will pass.

The legislature is likely to address the so-called Erie County case in which the 3rd Circuit Court of Appeals ruled that pre- and post-Medicare health benefits for retirees had to be the same or they would violate the Age Discrimination in Employment Act. Although the case was settled (with the pre-65 retirees having their benefits reduced) the case has troubling implications. In many current plans, benefits are reduced at age 65. The court ruling could ultimately force a reduction in benefits for all pre-65 benefits or an increase in post-65 benefits, unless a legislative remedy is found.

Trends to Watch

While we have not seen drastic changes in any specific types of coverage, we are seeing trends worth watching in 2003 and beyond.

In terms of cost containment, managed care in its current form has probably achieved nearly as much as it can, given the issues of patient rights and resistance on the part of physicians and hospitals. As a result, employers will be looking to increase the share of cost that employees bear or to change the design of benefits programs. These changes are likely to include increased deductibles and co-pays in order to moderate the impact of cost increases in 2003. We also expect employers to

seek ways to educate employees in better personal health management and more efficient use of medical providers. While defined contribution plans remain on the horizon for some employers, we do not foresee a dramatic move in that direction.

We are also seeing increasing interest in moving away from true HMOs and exploring what are being termed "open access" HMOs. These models typically cover preventative care and have a smaller network of providers, but do not limit coverage exclusively to network providers and do not require a cumbersome referral process.

Managing Program Costs

Companies faced with ongoing price increases will be under increasing pressure to manage their benefits programs more effectively. We expect to see more effort devoted to several areas:

- Better understanding of medical costs
- Better monitoring of medical costs
- Clearly and efficiently communicating information to employees
- Efficiently monitoring employee compliance with company policies
- Minimizing operating expenses for chosen benefits programs

Healthcare Professional Liability

Headlines and Highlights

- **Withdrawals, failures and ratings downgrades have reduced capacity.**
- **Claims severity continues to rise.**
- **The industry is hoping for tort reform.**
- **Some HPL sectors—Reinsurance and Excess—have seen increased capacity.**
- **Buyers will need more time for renewals and should expect higher retentions.**

Tumultuous Conditions

The medical malpractice insurance industry has been in a state of turmoil for the last two years. A significant number of malpractice insurance companies have failed, withdrawn from this line of coverage, or received ratings downgrades due to the marked deterioration of their financial results. Senior leadership has changed at many companies. All aspects of the Healthcare Professional Liability (HPL) market have been impacted.

The most notable withdrawal from the market was St. Paul. The most notable failure was PHICO, placed in liquidation by state regulators in February 2002. These two events alone reduced capacity by 16 percent. The most notable aspect of the ratings downgrades was how widespread they were. For a few, such as ERC/Medical Protective (A+), MLMIC (A-) and Zurich (A), the downgrade at least did not cost them their A rating. Others were not so fortunate. Loss of an A or A- rating can affect buyers' ability to select that carrier due to healthcare facility bond covenants or medical staff bylaw requirements. Likewise, brokers may be constrained in their ability to work with carriers rated less than A- by market security concerns. Those carriers receiving downgrades to less than A- include: Reciprocal Group of America (B-); MIIX (C+, now NR-4); SCPIE (B+); TIG (B++); FPIC (B++); Princeton (B+).

Underlying the industry tumult is, of course, activity in the courts. Soaring verdicts and settlements and rising legal and related expenses to defend cases have caused medical malpractice insurance to be the worst performing line of all property and casualty coverage, according to A.M. Best. The National Practitioner Data Bank reveals a 77 percent increase in the number of reported payments exceeding one million dollars from 1999 to 2002.

As a result, premiums have skyrocketed for institutional and individual providers. This has directly impacted the affordability and availability of healthcare. Affordability and availability of malpractice coverage is becoming an issue for many buyers whether they are institutional or individual providers. The industry's combined ratio was a poor 139 percent in 2001 and was projected to go higher at year-end 2002. The total market for healthcare professional liability grew to \$7.5 billion, a 22 percent increase that was entirely rate driven. The rate increases have moved buyers to various alternative risk financing strategies, particularly deductibles, self insurance retentions at and above \$1 million, and the creation of captives and risk retention groups.

The Underwriters' Response

Malpractice carriers have responded in a number of ways in their efforts to restore profitability. These responses include withdrawal from HPL coverage, double- to triple-digit rate increases, restrictive underwriting of certain classes of business and in certain territories, raising attachment points/mandating deductibles and offering lower limits of liability. Aggregate protection is being withdrawn or substituted with "each and every" attachment language. Coverage restrictions include punitive damages, terrorism, mold, and sexual abuse claims.

Underwriters are also requiring more and better information than ever before. Institutional buyers in particular can expect

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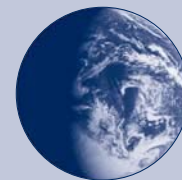
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heightened scrutiny of their risk management structure and claims experience. Virtually all large accounts are receiving actuarial review with very little room for buyers to negotiate price breaks. Actuaries are being extremely conservative in developing loss-trending models due to the problem of "frequency of severity". Underwriters desire to be above the working layers of any type of healthcare account. Higher limits will be more expensive due to the exceedingly poor results of reinsurers in the field. On the whole, there has been a renewed emphasis on pricing, terms and conditions not seen since the mid-1980s.

Market Segments

Primary HPL

Primary HPL capacity has been greatly affected by the withdrawal of St. Paul, the liquidation of PHICO and the downgrading of certain carriers. The regulatory barriers to entry are significant unless new entrants elect to use excess and surplus lines paper. This segment needs new capacity over the next few years. There are no longer any dominant national players—a role played in the past by St. Paul, PHICO and CNA. The provider-owned (both physician and hospital sponsored) carriers control larger market share here. Commercial carriers such as AIG, Zurich and Chubb will write Primary HPL, but it will be difficult to attract new entrants given the poor recent industry results.

From those who continue to offer Primary HPL, there is more careful scrutiny of submissions and a major push to have insureds retain risk through various self insurance vehicles, particularly higher deductibles. First dollar coverage is difficult to find for this line. Hospitals purchasing Primary HPL can expect rate increases ranging from 20 to 50 percent. Increases might climb higher if there is adverse claims experience, or if buyers are located in distressed states or territories.

HPL Excess and Reinsurance

Amidst widespread firming of all areas of the insurance industry, the HPL Excess and Reinsurance lines witnessed especially extreme hardening in 2002. Reinsurers, acutely impacted by the severity trend of recent years, are now carefully selecting attachment points and restricting capacity.

Aggregate caps are not viewed favorably by underwriters. Reinsurance pricing is now subject to stringent actuarial analysis, not just from the lead underwriters but from the majority of reinsurers on the placement.

Running somewhat counter to this trend, more capacity became available in this segment due to the arrival of new entrants. While pricing remains conservative in an attempt to avoid the underwriting mistakes of the 1990s, there may be some leveling off of price increases in HPL Excess and Reinsurance. Even so, most insureds will see price increases from 20 to 50 percent in 2003.

Physicians & Surgeons

This market is dominated by the provider-sponsored companies along with one strong commercial carrier, GE Medical Protective. Almost all physician carriers have eliminated discounts and credits and are writing at manual rates in order to restore profitability. While there have been downgrades of certain companies in the last two years, this market segment remains financially strong where the focus is the provider-sponsored companies (PIAA). There are only a handful of physician carriers able and willing to write (or front) on a national basis, such as TDC and GE Medical Protective.

Of much greater concern is the affordability and availability of insurance in certain states and territories within a state. Certain specialties have been dramatically affected, including obstetrics, emergency medicine, neurosurgery and radiology. Physicians have been forced to abandon practices or discontinue services as a result.

Hospitals and health systems will be challenged to create innovative, albeit expensive, malpractice insurance solutions for their medical staffs so that the quantity and quality of services is not affected. These solutions will need to withstand legal scrutiny under the Medicare and tax laws. Physicians and groups can expect premium increases of 15 to 50 percent in most states and much higher increases in certain specialties, states and territories.

Healthcare Professional Liability (continued)

Long-Term Care Facilities

Long-term care is the most distressed of all the lines of healthcare professional liability and will continue to be for the foreseeable future. Long-term care facilities will continue to see dramatic high double-digit and triple-digit premium increases and will be faced with much higher retentions. The number of carriers willing to write this line of coverage is very limited. AIG remains a major player here. The London market is still active for LTC. Most, if not all, carriers still underwriting LTC are now doing so on non-admitted paper.

Managed Care Organizations

There are fewer markets for MCOs than for any other line of medical professional liability. Chubb and AIG are virtually the only carriers with capacity. They are requiring higher retentions with no aggregate protection. Coverage for class action suits is problematic. Most small-to medium MCOs will see 40 to 60 percent increases in 2003. As high as these numbers are, they represent a leveling off from 2002.

The Forward View

There are a number of significant factors that will influence healthcare industry insureds and malpractice carriers over the next two years. These include:

- Claim severity
- Rate adequacy
- Tort reform
- The influx of new capital into the market
- The move to alternative risk transfer vehicles/higher retentions

Claim Severity

Many commentators have noted that the current problem in medical malpractice insurance has been the "frequency of severity": the unprecedented numbers of large verdicts and settlements experienced nationally. Jury attitudes are driving excessive awards. Double-digit medical inflation pushes up the costs of settlements and awards (by increasing the amounts of indemnity payments to injured parties because the medical care costs more). Accelerated claims payout patterns pressure carriers reeling from lower investment returns. While frequency is thought to be flat, Jury Verdict Research reported a

43 percent rise in the median medical malpractice award between 1999 and 2000, hitting the highest median ever: one million dollars. As mentioned above, the National Practitioner Data Bank shows a 77 percent increase in the number of claims exceeding one million dollars since 1999. The PIAA Closed

Claim results indicate a significant increase in the percentage of paid claims over one million dollars rising from roughly 3 percent of all claims in 1995 to 7.9 percent in 2001. Without meaningful tort reform, it appears there will be no abatement in the number and size of large malpractice verdicts and settlements.

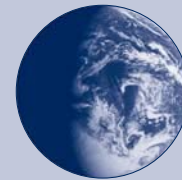
Rate Adequacy

There is no certainty that the huge rate increases being implemented by malpractice carriers will restore profitability in the long term. Pricing increases may continue to be offset by the ongoing, dramatic rise in the number of large awards and settlements. Actuarial predictability has been lost in the current environment. Pricing must stand on its own as lower investment returns are expected to be the norm in the short term.

Tort Reform

The industry is crying out for tort reform on the state and federal levels. The AMA lists the following states as experiencing a crisis due to the medical liability climate: Pennsylvania, Texas, Florida, West Virginia, Mississippi, Nevada, Ohio, New York, New Jersey, Oregon, and Washington. However, few states (Pennsylvania, Nevada, Mississippi and others) are attempting to remedy their poor environment through legislation. The trial bar remains powerful and determined to thwart reform initiatives. The judiciary in many states has overturned tort reform laws enacted in the 1970s and 1980s.

The Bush administration is pushing for federal tort reform with the April introduction of H.R. 4600, a draft bill encompassing many of the features of California's MICRA laws, especially damage caps set at \$250,000. The president addressed reform in a major speech in July of 2002, preceded by a DHHS report on repairing the medical liability system. The prospects for



federal tort reform are more promising in light of the Republican control of Congress after the November 2002 elections, but the new Congress must still be persuaded that malpractice reform is linked to affordability and availability of health care, thereby making malpractice reform a politically popular public health issue.

The Influx of New Capital

The number of new companies entering this line of insurance, especially in the Excess and Reinsurance lines, is encouraging. New players include: Berkley Medical Excess Underwriters; Endurance Specialty, Ace USA, One Beacon, Arch Healthcare and XL. Most of these new entrants can offer at least \$25 million in capacity or more. The new markets are being selective as they underwrite new business. They are carefully choosing correct attachment points, taking into consideration each account's experience, range of services offered and geographic location. The companies are staffed by respected industry veterans. They also enter the market without the baggage of poor results from prior years. However, there have been almost no new entrants willing to write primary coverage of any type.

The Move to Alternative Risk Transfer Vehicles and Higher Retentions

The rate of participation in the current alternative market for HPL is estimated to be as high as 50 percent. More buyers than ever are willingly-or unwillingly-retaining amounts typically ranging from \$5,000 to \$10 million or more. Buyers are considering the full range of risk retention strategies. Primary, Excess and Reinsurance underwriters no longer want to be involved in a buyer's burning layer, and thus are adjusting their attachment points and forcing the issue.

At one end of the spectrum, even smaller physician groups and small healthcare facilities of every type are considering or being mandated to take deductibles. Many facilities, especially hospitals and nursing homes, are considering the creation of self-insurance trusts.

The number of healthcare captives created has exploded in recent years. Risk retention groups and risk purchasing groups have also been created and continue to be actively considered. Those entities with a history of self insurance are moving

towards funding for higher retentions, either driven by market conditions or in a move to reduce long-term cost.

Meeting the Challenge

We expect the hard market for HPL coverage to continue for at least the next two years. While triple-digit pricing may be leveling off, buyers can generally expect mid-double-digit increases as well as tighter terms and conditions. There is no quick fix in sight-certainly none that will bring immediate price relief. There are, however, measures that buyers can take to anticipate and control insurance costs:

- Buyers will need to continue to expend a great deal of time and effort on renewal, preparing high quality renewal submissions and developing renewal strategies at least four to six months in advance.
- An essential element of any renewal strategy is to analyze the direct and indirect costs of retaining more risk. Actuarial review of the last 10 years' comprehensive loss experience can be critical in performing this analysis.
- Facility buyers must devote more resources to their risk management programs in the form of additional staff and patient safety initiatives.
- As loss experience is the ultimate driver of rates, the insured must aggressively manage claims. Patient and family interventions after adverse incidents are an essential element of an aggressive risk management program. The insured must provide underwriters with detailed explanations of remedial measures taken to prevent the recurrence of circumstances resulting in large claim payments.
- Buyers must monitor carrier financial ratings. The number of downgrades, liquidations and withdrawals in the HPL market accelerated in 2002 and may well be a factor in 2003.

Headlines and Highlights

- **Cyber Risk awareness continues to grow.**
- **Cyber Risk exclusions in traditional Property and Casualty policies increase demand for specialized Cyber products.**
- **Several markets are offering a wide range of coverages.**
- **Price increases in the 20 to 30 percent range are expected in 2003.**

Introduction

"Today, the cyber-economy is the economy."

—Condoleezza Rice, US National Security Advisor
(September 2002)

As the comment by the US president's advisor implies, the cyber world is becoming more and more integral to the business world. At the same time, Cyber Risk emerges as a separate and crucial piece of the risk management puzzle. While perhaps not as ubiquitous as computers themselves, Cyber Risk products are here to stay.

Risk managers have largely come to recognize that their businesses are dependent in many ways on computer networks to connect offices, production facilities, suppliers and banks and to interact with customers. E-mail, Web sites and electronic documents are used by most companies. E-commerce, online supply chain and customer relationship management, and electronic enterprise resource planning are more and more common. The list of dependencies grows. A global survey released in September 2002 by the National Association of Manufacturers, RedSiren Technologies and the Internet Security Alliance found that 88 percent of respondents said their firms now recognize information security as an issue essential to the survivability of their business.

Insurer recognition of the pervasiveness and unpredictability of Cyber Risk has led during the past year to the exclusion of Cyber Risk coverage from most conventional policies except for limited coverage in some media liability and technology E&O policies. These resulting gaps in coverage are adding to the demand for Cyber Risk products.

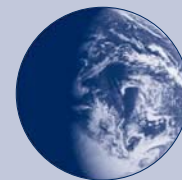
Insurers are also showing a commitment to providing specialty Cyber Risk insurance products to fill the gaps in conventional forms. Written premiums are increasing and the number of insurers responding to demand for this new specialty niche is growing.

Despite increased reliance on information networks and focus on information security, security incidents continue to increase. The CERT Coordination Center has documented year-to-year increases in security incidents. Incidents rose 212 percent in 2000, 242 percent in 2001 and 139 percent through the third quarter of 2002.

The release of a draft of "National Strategy to Secure Cyberspace" by the President's Critical Infrastructure Protection Board may advance the developing standards for legal liability. The report, purporting to represent a consensus of the industry, places responsibility on the corporation and its board to secure information technology assets in the light of the severe harm that can come from security failures. The report goes on to outline best practices for security. These recommendations may provide a standard to be used by a claimant in the event of a security breach. Importantly, among the report's recommendations is 2-5: "Corporations should consider active involvement in industry-wide programs to: (a) develop IT Security best practices...and (d) work with the insurance industry on ways to expand the availability and utilization of cyber security insurance."

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Traditional P&C Lines

During 2002, most Property and General Liability underwriters imposed restrictions on Cyber risks. Many insureds will enter 2003 with property policies bearing strict exclusions for damage to or corruption of data caused by viruses or hackers. The current ISO Commercial General Liability policy has been clarified with regard to the Web. Advertising content on-line is covered for libel and copyright infringement but almost everything else displayed on a Web site is not. For insureds in the online or traditional media businesses, coverage is entirely excluded. Other liability forms impose a variety of restrictions. We do not envision that such restrictions will be relaxed in 2003.

The Cyber Risk Market

The market is growing. During 2002 the number of participants grew with the addition of Arch and Hartford. The number of stand-alone Cyber Risk policies grew substantially and continues to grow. We estimate the current number at several thousand and climbing. The figure is actually higher when one considers the large policies written to blend Cyber Risk coverage with other specialty liability forms such as Media Liability and Technology E&O.

The market offers a broad range in terms of the different policy wordings and coverages available. There is also a wide variety in the types of underwriting information each insurer requires. In addition to the completion of a security assessment by the insured, many insurers require an on-site security assessment by a security firm. Underwriting scrutiny usually depends on the limits being sought, whether first party income and asset protection are included in coverage, and the type of business being insured. Some insurers have arrangements with security firms to perform these assessments at the insurer's cost. Others require the insured to pay the cost, but will accept assessments from a number of security firms.

An overview of the insurers currently offering third-party, first-party or combined first- and third-party Cyber Risk coverage includes:

| | |
|---------|--------------------------------------|
| Admiral | Hartford |
| AIG | Liberty International |
| Arch | Zurich |
| Chubb | Media Pro |
| CNA | St. Paul |
| Gulf | Lloyd's (various syndicate programs) |

There were no major withdrawals from the market in 2002.

The Outlook

For 2003, we expect premium increases in the 20 to 30 percent range. Negotiations for lower e-risk premium pricing will be based on the applicant's score on its security assessment. Limits available on a primary basis will run from \$10 million to \$25 million. We expect that overall limits in excess of \$80 million will continue to be available to the determined buyer.

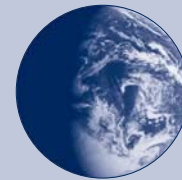
Restrictions and exclusions of coverage by traditional Property and Liability insurers are driving more businesses into the e-business market. At the same time, we expect to continue seeing vastly different pricing and product offerings in the e-risk marketplace. While some insurers will offer a first- and third-party combination wording, others will restrict their products to third-party only. We also expect to see variation in insurers' willingness to combine off-line exposures for media and technology and Cyber Risk exposures under one policy.

Cyber Risk (continued)

E-risk coverage buyers need to take extreme care in reviewing and comparing the various wordings offered. Although many products are called "e-risk" or "cyber", the actual coverage provided varies widely; titles can be misleading. The policies available in the market include the following, although all may not be available from each insurer:

- Hackers
- Malicious acts by employees
- Virus damage or transmission
- Denial of Service (DoS) attacks
- Business interruption
- Data restoration
- Use of your network as a "drone" to attack other systems
- Media liability for Web site contents and e-mail
- Privacy violations for misuse or theft of personal information
- Internet technology products and services liability such as software
- Internet professional services liability such as hosting or e-commerce
- Cyber extortion demands

We expect the demand for e-risk coverage to grow at a fast pace in 2003. Given coverage restrictions under traditional Property and Liability policies, and recognizing companies' increased reliance on network systems to run their businesses and allow interaction with clients and partners, companies need to fill coverage gaps for their own financial protection, as well as to meet insurance requirements that may be established by major business partners.



Headlines and Highlights

- **The Political Risk marketplace is facing increased claims and a decreased reinsurance supply.**
- **Heavy claims activity emanating from Argentina may have a long-term impact on the market.**
- **The elasticity of Political Risk demand mitigates cost increases in an otherwise hard market.**

Public and Private Providers

Political Risk insurers can be divided into two types: public sector and private sector providers. The former is comprised of government providers (the US's OPIC, Japan's NEXI, Canada's EDC) and multilateral agencies (MIGA, IDB, ADB, ATI). The private sector is comprised of numerous commercial insurance companies from Bermuda (Axis, Sovereign), France (Unistrat), Great Britain (Ace Europe, Sirius and numerous syndicates at Lloyd's) and the US (AIG, Chubb, Exporters, FCIA and Zurich).

Over the past several years, public sector providers have lost market share to their private sector counterparts. We may now see that trend reverse. In either case, cooperation, in the form of coinsurance and reinsurance between public and private sector Political Risk providers, will continue.

Product Demand

Higher risk perception and a weaker economic picture have brought about a dramatic reduction in the level of direct foreign investment. Direct statistics of Political Risk demand are hard to come by, but a reasonable proxy for Political Risk demand is foreign direct investment flows; these are now half of their 2000 highs. Although much of the decline reflects the reduced flow between developed countries, trade and investment in the emerging markets have been significantly off as well.

Industries that were once hot on emerging markets - the telecom and power industries, for example - are now reeling from losses. Some of these were commercial losses but some were also Political Risk losses. In the power industry, significant Political Risk losses emerged out of Argentina, India and Indonesia. The private power industry, like many industries, will likely limit its emerging market investments to less risky countries. Those investors prepared to accept and manage the political risk exposure that accompanies higher risk investments will likely face less competition and be able to charge more for their services or products. They would in that case be better able to afford Political Risk insurance.

Claims

In the last 12 months we have seen significant Political Risk claims activity in various industries from all over the globe. Here is a list of countries with a high proportion of claims:

- Africa – Ghana, Zambia
- Asia – India, Indonesia
- Eastern Europe – Bulgaria
- Latin America – Argentina, Uruguay

Of particular note is the claims activity in Argentina. The Argentine economy has been in meltdown for almost a year now. As a result of this collapse, foreign direct investors and lenders are filing claims under a broad range of Political Risk perils including expropriation, currency transfer restrictions, non-repossession of assets and public entity non-payment.

Argentina is one of largest country exposures for virtually all the major Political Risk underwriters. Once the dust has settled, the lessons learned from Argentina could have a long lasting impact on the Political Risk market's underwriting philosophy, reinsurance availability and policy wording refinements.

Willis has collected over \$15 million so far on the first of many Argentina-related claims; this first set of claims alone could eventually top \$55 million. An accurate overall market estimate is difficult to project due to the broad nature of the insured

Political Risk (continued)

perils, client confidentiality and each transaction's unique risk profile. We can, however, reasonably estimate that Argentine claims will cost the private market well over \$100 million, and possibly many times that amount.

Availability of Coverage

As they did in 2002, Political Risk reinsurers in the 2003 reinsurance renewal season will allocate less capital to this class of business. This trend will have the following effect on the private sector insurers:

- Continued reduction in the overall market's per-risk capacity to less than 50 percent of 2001 market levels.
- Continued constraints in underwriters' per-country capacity limits.
- Greater reliance on net capacity.

Softening the Price Impact

Political Risk insurance price increases will continue to be limited when compared to other lines of insurance. This is primarily due to the higher demand elasticity of Political Risk versus other types of insurance (e.g. D&O, Property, Workers' Compensation); of course, this is one of the reasons reinsurers are allocating their capital elsewhere.

The market will continue to underwrite policies with terms of 10 or more years. For those seeking long-term programs, especially those with significant capacity needs, more syndicated placements will be required.

In addition to per-risk capacity limits, underwriters also have per-country capacity limits on their overall book of business. This limits underwriter exposure to any one country's political risk; however, it also means that deals from high demand countries can be difficult to place when most underwriters are at or near their per-country capacity limit. Per-country limits will likely effect Brazil, China, Dominican Republic, Russia and Turkey, among others.

In addition to per-risk and per-country capacity constraints, an obvious critical factor is the country's political risk level-if it is too high, the Political Risk market may effectively close. Among the high-risk countries in this category are Argentina, Brazil, Indonesia, Venezuela and Turkey. We should add that if a transaction has significant risk mitigants, it may in rare cases be possible to overcome the constraints of a high-risk country.

Product Development

The Political Risk market will continue to generate new products for capital market transactions. Political Risk insurance, specifically currency inconvertibility and non-transfer coverage, has been used to enhance foreign currency public debt issuances of well-rated emerging market corporations, allowing them to borrow funds at or near their higher local currency credit rating, therefore reducing their borrowing costs. Additionally, Political Risk coverage has enhanced structured finance transactions. One recent example involved a Costa Rican mortgage-backed security. Perhaps we will see more US corporations with valuable emerging market subsidiaries using Political Risk to pierce the sovereign ceiling.

Conclusion

We are in a period of short-term transition for the Political Risk insurance market: reduced supply, relatively small price increases, significant claims activity and continuing product development.



Headlines and Highlights

- **The market is consolidating and capacity is contracting.**
- **Trade Credit is directly and significantly affected by the hardening reinsurance market.**
- **The elasticity of Trade Credit demand mitigates cost increases.**

Overview

Trade Credit insurance protects businesses against the risk of bad debt due to the insolvency or protracted default of their customers. This coverage is usually written on a whole portfolio of short-term receivables related to the sale of goods or services. However, certain insurers will consider covering select risks and terms longer than one year.

An insurance credit loss may be the result of:

- A buyer's insolvency.
- A buyer's refusal to pay.
- Political risks that prevent a foreign customer from paying; examples are expropriation, currency inconvertibility/non-transfer and political violence.

Losses arising from product and pricing disputes are excluded from cover. Policyholders are normally required to retain a portion of each risk.

Due to industry consolidation during the last decade, there are three major credit insurers that control approximately 85 percent of the global market - Euler & Hermes, Gerling NCM, and Coface. These three European-based insurers prefer to write "whole-turnover" policies that generally have low aggregate deductibles and require the insurer to assess the quality of most buyers in the insured portfolio. Alternatively, insurers such as ACE, AIG, Chubb and FCIA prefer to write

excess-of-loss programs with higher aggregate deductibles. Excess-of-loss insurers generally grant a higher level of authority to policyholders to approve buyer credit limits in the insured portfolio.

End of a Long Soft Market

The Trade Credit insurance market in the US experienced strong results for some 10 years prior to 2001. As major European credit insurers entered the US market, increased competition among insurers combined with inexpensive reinsurance to create downward pressure on rates. This sparked substantial growth in the Credit Risk market. However, the rates for credit insurance have hardened somewhat during the past year due to several factors, including increased claims, market consolidation and reinsurance restrictions.

The economic downturn that began in early 2001 affected the world, and Trade Credit was not immune. Credit insurers were hit by the large losses in the telecom sector and the accumulation of losses that came with the popping of the dot.com bubble. The economic repercussions of September 11, 2001 had a further negative impact on underwriting results for 2002.

Market consolidation was another feature of 2002. Gerling and NCM, two of the world's largest credit insurers, merged. Coface purchased the credit insurance business of CNA. Additionally, Kemper exited the credit insurance business. These moves further reduced competition in an already small market.

The Rippling Reinsurance Effect

According to a Moody's report entitled "Credit Insurance Industry Outlook 2000", credit insurance relies very heavily on reinsurance, with average cessions of well over 50 percent. While credit insurers did not suffer direct losses from September 11, and only suffered minimal losses from the high profile Enron and Worldcom bankruptcies, the impact of these events has been considerable. Reinsurers have been undertaking a large re-allocation of risk-based capital to Aviation, Property, and other markets that now command significantly higher returns since September 11. Also, the Trade Credit sector is generally not viewed positively by many

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Trade Credit (continued)

reinsurers. As a result, several reinsurers including General Cologne Re, Copenhagen Re and St. Paul Re pulled out of the market in 2002.

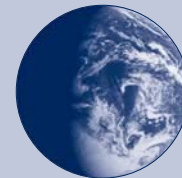
Insurers are beginning to securitize their portfolios of risks and sell them to the capital markets instead of simply buying reinsurance in the conventional way. To date, however, only a few deals have been completed. In 2001, Gerling completed the first-ever catastrophe bond for securitization of credit insurance risks. In 2002, Scor placed a EUR130-million index-linked securitization of liabilities designed to lower its exposure to credit insurance risk. Certain insurers are beginning to lay off some risk in the credit default swap market, but they have found that this market presents few affordable opportunities. It has been used mainly for higher rated, publicly traded obligations.

Moderate Rate Hikes

Because credit insurance is for the most part a discretionary product in the US market, insurers cannot command the huge price increases seen in other lines. Year-on-year premium rates rose 15 to 20 percent in 2002. While unable to significantly raise rates, insurers are taking a more conservative underwriting approach. They are avoiding large risk concentrations with a given buyer or geographical area, poorly performing industry sectors and select risk programs. Insurers are favoring short-term portfolios with a reasonable spread of risks. Policyholders are being required to share an increased portion of risk in the form of higher aggregate deductibles and/or higher per-credit retention.

Credit insurers will continue to seek business that is driven by financing needs. Specifically, insurers expect to see continued growth in the use of credit insurance to enhance trade-receivable securitizations, a financing method that is expected to become more popular in the US. The goal of a trade-receivable securitization is to raise funds based on a valuable but untapped balance sheet asset. Credit insurance is obtained to make the package more appealing, not necessarily to address a worrisome risk. These customers are therefore quite appealing to the Credit markets.

Going forward, premium rates are expected to rise another 10 to 15 percent in 2003. However, it is important to note that rates are still well below levels of eight to ten years ago. Insurers believe that the premium turned away by their more selective underwriting approach will be offset by stronger demand for coverage during the current economic climate.



The Mergers and Acquisitions (M&A) Transactional marketplace remains largely unchanged over the past year. Much of the analysis that follows reflects what was reported last year, with the addition of a description of the marketplace outside the US and additional observations as appropriate.

M&A Transaction insurance refers primarily to Representations and Warranties (Warranty & Indemnity), Tax Opinion, and Loss Mitigation/Post Event programs. M&A Transaction insurance differs from most types of insurance in that it covers one-time events and is therefore not directly subject to the typical cycle of annual (or multi-year) renewals.

Misconceptions about the Market

There has been a continuing drop in submission flow and coverage bound during the last 12 months, largely due to the general reduction of M&A activity. Companies that do undertake merger or acquisition activities generally retain a keen interest in transactional insurance. The M&A Transactional line, however, has suffered from misconceptions regarding the current status of the market. Suggestions of reduced capacity and high premiums have discouraged some potential insureds from making submissions. In the private equity world, we continue to see an increased interest in the use of insurance to reduce risk or improve the structure of a transaction. Reduced valuations in the sale of companies and a reduction in available leverage for buyers leave less margin for error, and this has helped maintain enthusiasm among buyers and sellers for products that can reduce down-side exposures.

The US Marketplace

The following insurers comprise the US marketplace for M&A risk transfer products:

- AIG, Chubb and Hartford remain committed to the transactional insurance market, though in some cases they are becoming increasingly selective in their approach.
- Ambridge Partners remains committed as well, but its focus is moving to single issue deals and Loss Mitigation. Ambridge relies on CNA and Lloyd's for capacity. (The desire of certain insureds to use Lloyd's may depend on its S&P rating going forward.)
- Kemper has pulled back somewhat from the Reps and Warranties market due to adverse results and to what they perceive as a shift in the philosophy of some buyers.
- Gulf has also become much more conservative in its approach and is largely focused on Tax Opinion insurance and single rep deals.
- Liberty International remains a significant market for Loss Mitigation and other one-off risks.
- A number of other carriers, such as ARCH, will offer one-off or excess capacity.

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Mergers & Acquisitions (continued)

The London Marketplace

The following insurers comprise the London marketplace for M&A risk transfer products:

- US-domiciled insurers AIG and Chubb have operations in London offering separate capacity.
- Gulf has recently closed its London operation but is now considering European business in its US office.
- Ambridge and Hartford also consider European business in their US offices.
- Lloyd's syndicates continue to provide important capacity including:
 - Hiscox Syndicate 33
 - SVB Syndicate 1007
 - Liberty Syndicate 282
- PRI (Professional Risks Insurance) is a major new entry into the market operating through a listed vehicle. The team is made up of experienced underwriters previously at SRS (Special Risk Services).
- Gerling's withdrawal had a major impact on the market; however, Gerling's lead underwriter was taken on by SVB. The withdrawal was due to major restructuring within Gerling and its subsequent inability to entertain long-term business.
- Ace Europe is also offering M&A products.

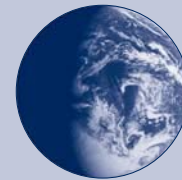
Other Markets

Insurers in locations outside the US and UK (including Bermuda) offering M&A risk transfer products are:

- Ace Bermuda
- AWAC
- MAG Global
- Star Excess
- XL Europe/Bermuda

M&A Marketplace Capacity

Significant capacity is still available in the marketplace, typically with up to \$250 million (£150 million) available per risk. This is usually more than adequate, as most M&A deals are middle market and often do not require more than \$25 million to \$50 million (£15–£30 million) of capacity. Significantly more excess capacity may be available on a single deal in the right circumstances. Many of the carriers listed above can offer at least \$25 million on any one risk. It must be noted, however, that reinsurers continue to look very closely at this type of risk, particularly Loss Mitigation policies. The insurance market at large continues to face considerable reinsurance pressures, and the "rationing" of reinsurance may continue to bring sharper scrutiny to these areas of insurance. Nevertheless, the M&A marketplace does support committed players and it is perhaps only the small players who will find their reinsurance capacity under threat.



Headlines and Highlights

- **Growth of captives and captive utilization will continue apace in 2003.**
- **New reinsurance requirements, combined with increased cost and reduced availability of fronting arrangements, have led to greater interest in direct writing captive operations.**
- **Diversity of established domiciles offers options and choices to accommodate individual tax, legal and regulatory constraints.**

Marketplace conditions continue to provide ample motivation for organizations to actively examine alternative ways to finance risk. The year 2002 saw great activity in evaluating, expanding and establishing familiar alternative risk financing vehicles and markets—captives, special purpose vehicles, structured transactions, cell captives and others. As predicted last year, 2002 will post new highs in terms of new captive licensures and expanded premium volumes for certain major domiciles. Additionally, a large number of organizations that already had formed a captive increased the participation of these captives within their main insurance programs.

Captive Participation Opportunities

Captives are used to mitigate the impact of the restrictions and demands of the marketplace:

- Increased deductibles and retentions imposed by (re)insurers
- Reduced capacity and coverage gaps in upper limits
- Reduced sub-limits for specific exposures
- Lack of (affordable) coverage for certain risks
- Fewer fronting carrier options and increasing fronting costs
- Stricter security/credit requirements
- Demand for stronger risk management
- Concerns regarding the security of certain (re)insurers

Corporate Financial Governance

Cost of risk financing is a high-visibility, high-priority topic for CFOs, CEOs and Boards of Directors. Over the course of the past year, heightened attention has been given to such issues and questions as:

- What levels of risk can/should the organization support financially? Is the balance sheet sufficiently strong to support proposed risk retention levels? What level of volatility can be accepted in the P&L account?
- What are the appropriate levels of risk that should be retained within the organization for each of its major programs? What is the availability and cost of transferring the risk? What are the exposures and how predictable are the loss levels? Is there sufficient financial incentive for retaining these risks?
- What is the most appropriate mechanism to employ in the funding of these risks? Does the organization see this as a long-term or short-term strategy? Are the funds required to support retained risks sufficient to make a captive financially attractive?
- What are the fiscal and regulatory issues to consider in order to ensure that the solution employed matches the needs of the organization?

A process that methodically deals with the above issues and checkpoints will determine whether and to what extent a captive may be an efficient tool in achieving optimal management of cost of risk.

Captive Formation Today and in the Future

Covers and Classes

The year 2002 saw acceleration of a trend that began in late 2001: the growth of traditional captive covers as retained loss layers in Workers' Compensation, Auto and General Liability, and Property lines.

Difficult lines and classes of business being evaluated for captive treatment include Construction, Trucking, Long-Term Care, Professional Liability, High-Risk Property, Products Liability, D&O and E&O.

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Captives and Captive Management (continued)

While the Workers' Compensation outlook is beginning to stabilize, the market continues to be plagued by fewer carriers willing to front and heightened security requirements. Captives seeking reinsurance will continue to see increased security requirements and higher attachment points. For some classes of business, reinsurers are requiring fully funded loss limits up to attachment points, as opposed to funding only the actuarial prediction. Such restrictive conditions continue to make captive formation a more attractive capital decision.

The increased cost of fronting arrangements has impelled many companies, particularly large US corporations, to consider forming direct writing captives. The domiciles of Gibraltar and Ireland offer these facilities.

Taxation

In the US, tax planning opportunities and transaction execution are on the increase, with developments relating to the recent Revenue Ruling 2001-31 issued by the Internal Revenue Service and the appellate court reversal of the UPS decision.

At the same time, the year 2002 is ending with the IRS taking a renewed interest in perceived abuses of the tax advantages associated with small captive insurance structures, most notably in the area of offshore, producer-owned reinsurance companies.

Structures

There is significant interest in the protected cell company (PCC) concept. Perhaps unsurprisingly, however, we are finding that the increased control and flexibility offered to organizations through incorporation of their own captive will in many cases outweigh the PCC benefits. Lack of PCC legislation in Ireland and Luxembourg has tended to preclude the use of PCCs by organizations that would otherwise favor these domiciles.

Group, Association and Affinity type programs are receiving heightened attention as smaller businesses are getting pinched severely, even in cases of solid loss history. These mutual-type arrangements create capacity where the traditional market has failed to do so. As predicted in last year's marketplace review, there were more risk retention group formations in Vermont and Hawaii last year than in the previous four years combined.

Sponsored captive structures will continue their growth as traditional insurance carriers seek to recapture market share being lost to the alternative market. These structures are typically owned by a carrier, and they perform captive-related activities.

Captive Regulatory Environment

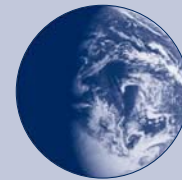
While captive owners are expanding participation in existing programs, many owners and CFOs are trying to leverage existing capital at a much higher level. These objectives clearly rub up against regulators' concerns with captive solvency.

With the increase in corporate failures such as Enron and WorldCom, domicile heads are taking a much closer look at the use of loan-backs and alternative investment techniques historically used by owners. The parent company size, while still factored, now becomes less important than other measures of the parent's ability to ultimately pay the captive's obligations.

In Europe there is increased interest and activity in captive formations. While there are tax disincentives to captive utilization in certain countries, in others there are strong tax incentives that support captive growth.

UK companies continue to look principally to Guernsey and Isle of Man for their captive needs, while other European Union countries such as Germany, France, Italy, Netherlands and Spain tend to look to Ireland and Luxembourg.

Domicile regulators are prepared for continued formation activity in the year 2003. The tried-and-true domiciles such as Bermuda, Vermont, Ireland, Hawaii, the Cayman Islands and Guernsey will attract a significant portion of formation growth.



Strategic Goals

- To buffer high pricing and the potential impact on earnings from increased risk retention in what is currently a challenging economic environment.
- To take control of managing capital at risk rather than be subject to the swings of the traditional market.

The expected growth of alternative risk financing arrangements in the wake of the September 11 attacks and dramatic market hardening was slow to develop. Although most underwriters' alternative risk financing units will achieve their revenue goals for 2002, they had anticipated consummating more deals.

The choice to replace traditional risk financing products with a structured program is a strategic one and in most cases, it is a big step to take. This fact, coupled with initial perceptions that the hard market conditions of late 2001 and 2002 might be a temporary reaction or correction to the insurance industry's financial pain, played a large part in dampening what otherwise could have been a significant shift to alternative risk financing products.

In 2003 we expect the slow pace towards alternative risk financing products to quicken, given expectations that hard market conditions will continue through 2003 and likely into 2004. With the growing belief that adequate pricing or capacity relief for certain risks is nowhere in sight, many companies have begun to seriously study the feasibility of redesigning at least a portion of their risk financing program. This re-examination includes a careful analysis of how much risk a company can afford to assume and the potential risks and rewards associated with multi-year alternative risk financing programs.

Certain strategies we see companies pursuing involve structured solutions for:

- A single or small number of risks to buffer the impact of high pricing or lack of coverage.
- The entire insurance risk portfolio to completely insulate against market cycles.
- A single or small number of non-insurance risks where no traditional products exist in any market.

Solutions

Finite Risk

Finite risk is a multi-year risk financing technique that blends elements of pure financing with risk transfer to smooth the impact of potentially high cost and difficult-to-predict losses. We see finite risk being used in cases where the price increase for a particular risk is extraordinarily high. These cases include but are not limited to risks such as E&O, General Liability, Products Liability, Environmental Liability and Property. There are also specialty risks such as Products Recall for certain manufacturers, Completed Operations exposures for large residential contractors, etc. In these cases, the finite program is typically structured over a three- to five-year term (and in some cases even longer).

Favorable insurance tax and accounting treatment for these programs remains a critical objective in order to achieve a cost advantage over self insurance or highly priced traditional products. Although we have not seen evidence that increased regulatory scrutiny of accounting practices is having an adverse impact on these programs, we *are* seeing a demand for more risk transfer (expressed as the ratio of limit to total premium) by the accounting community in order to deem the transaction as one of insurance.

Multiple Trigger Programs

Multiple trigger programs cover a specified type of loss when two events occur in the same specified period of time. This risk financing approach is used when under normal conditions the assumption of a single large insurable loss is feasible, but undue financial stress caused by another significant event (typically non-insurance related) could render the assumption of

Alternative Risk Financing (continued)

that loss a financially undesirable experience. For example, a large hotel company might be able to assume the impact of a large windstorm loss at one of its resorts if the industry overall is benefiting from high revenues. However, if the windstorm occurs during a depressed economic period when industry revenues are down significantly, then the loss might cause intolerable financial harm.

In many cases insurers are willing to offer cost-effective coverage based on the concurrence of two events or conditions because the probability of a payment is usually much less than the occurrence of the traditional insurance loss alone. We expect to see more of these programs as companies seek to reduce the impact of high insurance prices by taking a higher retention while securing a financial safety net.

Contingent Capital Programs

A contingent capital program (also called a committed capital program) is an arrangement where a company purchases an option to issue securities (either debt or preferred shares) to an insurance company upon the occurrence of a predefined event. The event can be an insurance loss or other measurable event (such as economic downturn) that has the potential to cause excessive financial harm. Contingent capital does not protect earnings. Instead, the program is intended to guarantee availability of capital at a time when the company may be financially stressed. Such programs are offered by Swiss Re and Chubb Financial Solutions, and we expect other insurers to begin offering similar products in 2003.

Loss Portfolio Transfers

Fewer loss portfolio transfer programs were written in 2002 as low interest rates reduced the discounting effect on pricing and as economic conditions made it difficult for companies to justify releasing cash required to pay premiums. However, in cases where companies have significant free cash flow and loss reserves cause earnings volatility, a loss portfolio transfer can be an effective use of cash. Despite low interest rates depressing premium discounts, insurers remain interested in transactions containing significant premium, and their interest

rate assumptions used for premium discounting can often be an attractive alternative to the low returns associated with warehousing large amounts of liquid assets on the balance sheet.

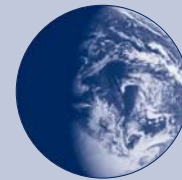
Integrated Risk Programs

Integrated risk programs combine many different risks under a single policy that usually spans a multi-year period. This approach is gaining popularity under current market conditions, although we have seen some insurers drop their integrated risk products because returns on traditional products are equally or more attractive for a lot less underwriting effort. Nonetheless, some underwriters remain interested in this approach in order to secure a long-term relationship with their customers.

Credit Enhancement

Credit enhancement was a huge issue for many companies in 2002. The Commercial Surety marketplace capacity has contracted significantly. More companies are being called upon to provide letters of credit to support a variety of obligations and activities. More companies are facing pressure to protect contingent balance sheet exposures (such as asset value guarantees related to lease portfolios or managed properties). There is no one product that can be used to manage these exposures. Rather we are encouraging companies to pursue the following strategies to ease the difficulties associated with managing credit obligations:

- Pursue loss portfolio transfers where the insurer can provide replacement security. In some cases, the after-tax cost of the loss transaction coupled with the release of letters of credit can produce a desirable outcome.
- When a required credit obligation is unrelated to a credit event of the obligee (an example is when an insured is required to post letters of credit for the benefit of a fronting company to support the credit risk of reinsurers), a credit default swap can be used.
- Evaluate terms for a credit enhancement program of an underlying asset value guarantee or a net operating income guarantee.



CAT Bonds

The market for CAT Bonds continues to be small. New bond issues, however, continue to be readily absorbed in the capital market. In 2002, the market grew by over 17 percent to over \$2.25 billion in total capacity. At this writing, the second non-insurance company bond issue is in the process of being launched. The first one was issued by Disney Tokyo. The second will likely be issued in early 2003 by Vivendi to cover its Universal Studios assets in southern California in respect of earthquake risk.

Volumetric Products

Volumetric products (e.g., weather, agriculture indexes, etc.) are showing signs of growing. The weather markets suffered a correction in 2002 following the demise of Enron, and most energy traders exiting the business. However, a good portion of the capabilities that existed in those companies has resurfaced as part of insurance companies or stand-alone entities.

Insurers are recognizing that the fortunes of many companies are reflected in published indexes that can be used as loss triggers in insurance contracts. Moreover, the risks that many of these indexes reflect can offer attractive diversification opportunities to existing insurance risk portfolios. We expect these products to grow relatively slowly, but they could possibly grow into a meaningful source of alternative risk financing capacity in the next two to three years.

The Markets

In general, insurers continue to support alternative risk financing activities despite efforts to concentrate on achieving significant increases on returns from vending traditional insurance products. There are a few exceptions to the trend—primarily from companies that have abandoned the alternative risk market altogether. There are, however, at least 10 companies, including European and Bermuda market insurers and capital providers, who are actively providing alternative risk financing products.

The Bermuda Marketplace

Headlines and Highlights

- **\$15 billion in new capital has fueled growth of the Bermuda marketplace.**
- **New ventures offer distinct capacities, specialties and territorial reach.**
- **Bermuda-based carriers continue to expand to the US and European marketplaces, providing further options.**

Starting shortly after September 11, 2001 and throughout the year 2002, more than \$15 billion in capital poured into new and existing Bermuda insurance and reinsurance companies. The past year has seen unprecedented activity in the Bermuda market by almost every measure: number of submissions, premium growth and staffing levels. Backed by solid capital and seasoned managers, new insurance and reinsurance ventures expect to generate premium of approximately \$15 billion in 2003.

Insurance buyers typically look to Bermuda as a place to find competition, solutions and choice in a hard market. In some areas, however, the forces of market hardening forces are not expected to ease. Classes of business such as Executive Risk, Healthcare Liability and Excess Liability—particularly for difficult classes of business such as chemical, energy and pharmaceuticals - will continue to see steep premium increases in Bermuda in 2003. For Property insurance, on the other hand, premium increases are still expected, although not be as dramatic as in the recent past.

A Brief History

The story of Bermuda's rise in the insurance world is at least three decades old. In the early 1970s, OIL (Oil Insurance Limited) was formed along with other entities. In the hard market of the mid-1980s, more companies formed on the island, including OCIL, ACE, XL and others. The 1990s saw the creation of several reinsurance companies and the opening of Bermuda offices for insurance companies such as Chubb Atlantic and Zurich Global Energy. New carriers such as Starr Excess arrived as well.

Most of these companies have enjoyed tremendous growth in Bermuda (and outside) over the years. The Bermuda market has seen its share of major acquisitions (e.g., ACE/Cigna and XL/Winterthur). Most carriers have diversified their products and solutions offerings since they opened for business. ACE and XL, for example, are major carriers in the traditional lines of coverage; over the years, they have developed a broad range of tailored products and solutions in the finite, capital market, and non-traditional areas. The latter have been strong areas of growth and will continue to be in 2003.

Current Conditions

In 2002, insurance carriers in Bermuda (as elsewhere) reduced limits on most risks and at times preferred to be "moved up" in a given program. This is expected to continue in 2003. At the same time, carriers have been inundated with submissions, and are enjoying wide choice in deciding where and at what price to employ their capital. Premium volume growth in 2002 with carriers such as ACE and XL was off the charts and is expected to be significant for 2003. Insurers can afford to remain highly selective.

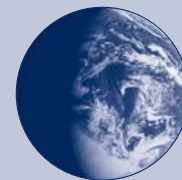
The New Capacity

Market conditions and rising premiums enticed many global insurance and reinsurance companies to open or expand operations in Bermuda.

Allied World Assurance Company (AWAC) was formed in late 2001 with \$1.5 billion of capital provided by AIG, Chubb, Goldman Sachs and other outside investors. A Dublin office was opened in fall of 2002. AWAC underwrites Property, Casualty and specialty lines. The Bermuda office focuses on US risks. The Dublin office is geared toward large EU companies seeking to add or replace capacity in the current hard market environment.

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Axis Specialty Ltd. was incorporated in Bermuda in November 2001 with \$1.6 billion in capital provided by various partners, including MMC Capital, JP Morgan, The Blackstone Group and Credit Suisse First Boston. AXIS focuses on business with a short to medium tail concentrating mainly on property-related risks with an initial emphasis on high excess and buffer layer excess programs. In the space of 11 months, AXIS branched out on both sides of the Atlantic, establishing offices in the US and Dublin. The US expansion came via the acquisition of Connecticut Specialty Insurance Company. In November of 2002, AXIS also took on 80 staff from an AON subsidiary, Combined Specialty Group.

Arch Insurance (Bermuda), a division of Arch Reinsurance Ltd., was formed in Bermuda in 2001 in response to the rising global need for strong, stable and sophisticated insurance markets. ARCH brings to the market a wide range of Commercial Property and Specialty Casualty insurance programs for Fortune 2000 or similar risks worldwide.

Endurance Specialty Insurance was formed in late 2001 with \$1.2 billion capital from AON, Zurich Financial Services and Capital Z Financial Services. In August 2002, Endurance purchased 100 percent of the equity interest owned by Zurich. Endurance currently writes Property insurance, Liability insurance, alternative risk transfer business, Hospital Professional Liability, Directors and Officers Liability and reinsurance. Like other new Bermuda carriers, Endurance has recently opened an office in London.

Montpelier Re commenced operations in December of 2001 with initial capitalization of about \$1 billion. It was set up by the White Mountain Insurance Group in response to the hardening insurance market and the void in capacity after the September 11 terrorist attacks. Montpelier raised more than \$200 million from its initial public offering (IPO) completed in October 2002. The carrier provides capacity for both all-risk property and stand-alone terrorism coverage.

While these five new companies have added the bulk of the new Property and Liability capacity to the Bermuda and world market, other existing companies are adding staff and writing greater volumes of traditional reinsurance and insurance.

Everest Re added Property insurance to its Bermuda product line early in 2002 and is considering further expansion. Max Re, established three years ago to underwrite structured reinsurance products, has seen disappointing returns on its investment portfolio and will broaden its offerings in January 2003 to take advantage of current market conditions.

Below is a recap of the capacity added to the market after September 11, 2001. Arch and AWAC expected to double their Liability capacity in 2003.

| Company | Property | Liability | D&O | E&O | EPLI |
|------------|----------|-----------|---------|---------|---------|
| AWAC | \$5MM | \$25 MM | \$25 MM | \$25 MM | \$25 MM |
| AXIS | \$125 MM | | | | |
| ARCH | \$25 MM | \$25 MM | \$25 MM | \$25 MM | \$25 MM |
| ENDURANCE | \$40 MM | \$25 MM | \$10 MM | \$10 MM | \$25 MM |
| EVEREST RE | \$10 MM | | | | |
| MONTPELIER | \$50 MM | | | | |

Beyond Bermuda

Over the last several years, Bermuda carriers have expanded into the US and Europe. This was especially true of the new underwriters of 2002, and the trend is expected to continue in 2003. AWAC, AXIS, Arch and Endurance are expected to increase the size and number of access points to maximize their visibility and to attract choice premium dollars.

This expansion has created a sometimes contentious issue for clients and brokers: if offices on different shores offer the same products, what is the best access point? Price variation may be one deciding factor. Broker-client-underwriter relationships also play a part. Most carriers do not state a preference of access point for identical products. However, some insurance companies do offer different terms in different locales. For example, smaller limits and lower attachment points might be more common in the US while larger blocks of capacity at higher attachment points would be offered in Bermuda.

Lloyd's of London

Despite the estimated net loss in excess of \$3 billion arising out of the September 11 attacks, confidence in Lloyd's remains strong. According to the Lloyd's Broker Market Update of December 18, 2002, opening capacity for 2003 "is set at a record high of £14.5 billion" (approximately \$23 billion)—17 percent more than last year's opening capacity.

Trading conditions remain very positive. Gross written premium through Q3 2002 increased by 31 percent as compared with same period in 2001. Increased rates have been supplemented by tighter terms and conditions, higher deductibles and tougher underwriting practices across all lines.

There is, however, a keen awareness that reforms are urgently required to maintain the market's appeal to investors, and with this in mind the Chairman's Strategy Group (CSG) was formed earlier this year to drive the process of modernization. Since then, the CSG proposals have received the support of the Lloyd's membership, and implementation is now underway.

Lloyd's financial strength market rating has recently been affirmed "A- Excellent" by A.M. Best and "A Strong" by Standard & Poor's. The latter has also confirmed Lloyd's as the world's sixth largest reinsurer, with net written reinsurance premiums increasing by 45 percent in 2001.

We cite the following quantitative benchmarks and organizational developments as reported by Lloyd's:

- **September 11 Loss Estimates** – As of Q3 2002, estimates remain stable. The net loss estimate is \$3.11 billion—less than a 1 percent increase over the Q1 2002 estimate. Although the gross loss is almost \$9 billion, "Good progress has been made in terms of reinsurance recoveries, and the quality of the Market's outwards reinsurance asset remains high." Further, "24% of the asset [reinsurance] has already been collected/ collateralised."

- **Source of Capacity** – The capital base is diverse, with Trade Investors and UK Listed companies providing almost 75 percent (figures are rounded, in £ million pounds sterling):

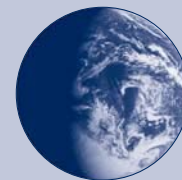
| Capacity | Source |
|----------|---------------------|
| 6.20 | Trade Investors |
| 4.24 | UK Listed |
| .70 | UK Non-listed |
| .42 | Other Corporate |
| .84 | Conversion Capital |
| 1.85 | "Names" (Unlimited) |
| 14.25 | |

- **Franchise Structure** – Lloyd's announced that Rolf Tolle, currently Chief Underwriting Officer and a Board Member of the Faraday Group (a Gen Re company) will become the first Franchise Performance Director:

"The position of Franchise Performance Director is a new post at Lloyd's, created as part of the market's reform programme. The Franchise Performance Director and his team will be responsible for working with individual Lloyd's businesses—the franchisees—to improve the commercial performance of the market. This will include monitoring each franchisee's performance against its business plan and ensuring adherence to the new underwriting and service guidelines for franchisees."

We believe that the above, coupled with the ring-fencing of earlier years within Equitas, puts Lloyd's in a strong position relative to many other insurers and reinsurers, with positive implications for its ability to compete successfully in the global market now and in the future.

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Headlines and Highlights

- Markets continue to withdraw from offering global coverage.
- Expect increased premiums and less flexibility.
- Insureds may need to consider non-admitted carriers, regional carriers and local programs.

One common thread throughout the world is that insurance market conditions are difficult, and they are expected to become more so for multinational companies in terms of scope of cover, premium and capacity. The field of the international carriers for multinational clients has remained largely intact over the past year. It can be divided into three tiers according to a respective carrier's appetite for business, global presence and product range.

Tier I - The top carriers include a broad, worldwide network of centrally owned, nationally operating insurers; these companies offer the widest range of products and have the underwriting expertise to accept the most difficult classes of business.

Tier II - These carriers own a moderate geographic spread of locally based companies, and on the whole offer a limited range of products. In general, they show some aversion to difficult classes of business.

Tier III - While operating on an international scale, these companies are supported by a limited geographic spread of nationally operating companies and offer a relatively small product range.

International Markets

| Market Tier | US Headquartered | Headquartered outside US |
|-------------|------------------|--------------------------|
| Tier I | AIG / AIU | ACE |
| | FM Global* | Allianz* |
| Tier II | Chubb | Zurich |
| | CNA | Royal & SunAlliance* |
| | St. Paul | XL Winterthur |
| Tier III | Atlantic Mutual | Fireman's Fund |
| | Liberty Mutual** | |
| | Kemper** | |

Recent departures: AXA, Gerling

* Property Only

** International only w/support of domestic

Global Snapshots

Many carriers serve world markets. We present brief reviews of key regions, indicating additional carriers that might be accessed for controlled master programs.

London

The principal markets for UK multinationals are Royal & SunAlliance, AIG, Zurich, ACE and Generali. Lloyd's is used but cannot provide local service.

Europe

In Germany, Gerling continues to be active in Europe but does not provide coverage in the US. HDI is used for German controlled master programs. Allianz is utilized for Property and Casualty (property only in the US). AXA is also used, but not in the US. In Belgium, regional insurers Fortis and MMA operate in Europe and also have representation in the US. Sweden utilizes IF and Trygg Hansa for international programs. These companies also operate in other parts of Europe, such as Denmark. Austria has access to insurers including Uniqa, Wiener Staedtische and Grazer Wechselseitige for business in Eastern Europe.

Asia/Pacific

In Japan, global insurers have expanded their overseas facilities and capabilities to operate wherever their Japanese clients are located. These carriers are Tokio Marine (now Milea Group), Yasuda Fire (now Sompo Japan) and Mitsui Sumitomo Insurance Company and Nippon Koa. Rather than providing controlled master programs, independent insurance covers are

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Global Programs (continued)

provided in each of the overseas countries by the Japanese carriers' subsidiary, branch or underwriting agency. QBE and AXA are active in Southeast Asia for regional international programs.

Marketplace Trends

We continue to see changes in the marketplace, most notably the exodus of well-known international carriers. The departure of Reliance in 2001 was followed by the departure of Gerling and AXA in 2002. AXA and its acquired companies, such as Colonia, were an important factor in certain classes of business (such as chemicals).

We have also seen several major carriers withdraw from Casualty lines. Some that remain are beginning to offer professional indemnity and financial loss covers. Allianz discontinued writing Casualty in Q2 2002 and Royal and Sun Alliance withdrew from casualty in Q4 2002. The only Tier I carriers who have international Property and Casualty capabilities are AIG / AIU and ACE. Zurich has been dropped to Tier II as we have seen limitations in their appetite for international casualty.

The marketplace may be unpredictable, but we feel it is probable that more market withdrawals will come in 2003.

Controlled master programs and captive programs have been and will continue to be significantly impacted by increased premium / fronting fees. Issues such as stiffer security requirements from the fronting carrier, unwillingness of reinsurers to "follow the fortunes" of the front, and inflexibility of the front and reinsurers regarding contract wording will continue in 2003.

Premium payment warrantees of reinsurers complicate international programs as most reinsurers want payment in 30 days and delays in local client payments and cash flow performance of fronting carriers make it difficult to comply with this. In response, we are seeing more cases where clients are paying 100 percent of the premiums in the US to the fronting carrier or reinsurer, with payment being recouped via overseas collections from subsidiary companies.

There are a limited number of carriers capable of underwriting international programs and even fewer carriers who have the ability to move cash on captive fronting programs.

Service Improvements

There are at least three carriers who have embarked on major process improvement efforts in the area of international service and cash flow. With escalating pricing on both controlled master programs and captive fronting programs, buyers are becoming more and more demanding. International service improvement was somewhat ignored during the soft market; the hardening of the market has changed the industry focus.

As underwriters wake up to the reality that continued increases in premiums and other costs may create expectations of improved service, they also find that actually delivering on these expectations is no easy task. Bringing services to an acceptable level for individual customers has been found to take 12 to 18 months or more.

Strategies for 2003

Several strategies should be considered in the current marketplace. One approach is to place a global primary with an insurer that has the capability to issue limited local policies and build a non-admitted excess program. Another is to separate the domestic and international programs if the international is small enough to be written by one insurer with the proper capabilities. Regional programs, such as Euro policies, should be considered when applicable.

Another issue to watch for in 2003 is the case of Property insurers unwilling to reinsure certain insurers or captives. There are also some insurers who want to write part of the risk but are unable assume reinsurance and cannot issue policies overseas. In these cases the fronting carrier can issue local policies to cover the bulk of the local values; the remainder that cannot be reinsured to an acceptable reinsurer is written on a non-admitted basis. In the current climate, Property fronting overseas may be cost prohibitive. One option to consider is to place local policies outside the scope of the program. Usually fire or limited perils can be obtained to minimally satisfy local admitted insurance requirements where absolutely necessary to do so.



Headlines and Highlights

- **The long soft market in Canada is over—insurers are following worldwide trends of increased pricing and reduced capacity.**
- **Carriers are focusing on core areas of expertise.**
- **Companies with US exposures are especially vulnerable to hardening conditions.**

The Canadian Property & Casualty Market

For several decades the Canadian marketplace enjoyed an abundance of capacity relative to its small size. That abundance allowed for aggressive competition for market share in all Property and Casualty lines. During this period, the market was further softened by the globalization of the insurance markets in Canada. The long soft market in Canada, however, is over.

The combined effects of adverse underwriting results and poor investment returns in the capital market for most (if not all) insurers, have resulted in serious erosion of the capital surplus worldwide. This has imposed a growing underwriting discipline in the insurance markets, which has had a major impact on the Canadian scene, already facing a depleted marketplace due to mergers and acquisitions.

Throughout 2002, Canadian insurers followed the overall global market trends of increasing rates and retentions along with restrictive terms and reduced capacity. In addition, virtually all insurers have taken the opportunity to "clean out their books" and concentrate on those classes of business where they believe their expertise will allow them to underwrite profitably.

Canadian Market Increases Anticipated for 2003

| Line of Business | Anticipated Increases |
|---------------------------------------|--|
| Property | 25% to 30% |
| Primary Liability | 50% - and more, depending upon current pricing level |
| Automobile | 25% |
| Umbrella & Excess Liability | Up to 100% |
| Errors & Omissions Liability | 100% |
| Directors & Officers Liability | 50% to 100% |
| Excess Directors & Officers Liability | 75% to 200% |

Property & Business Interruption

The Property marketplace changed dramatically in 2002 with increases of 50 to 100 percent even for those with favorable loss experience. These increases were compounded by restrictions in coverage, margin clauses on declared values and limited capacity.

Risks in catastrophe-prone zones, such as British Columbia, faced limited capacity and increased retentions. Accounts with cross-border exposures were subject to the same restrictions and pricing as their counterparts in the US. This was seen by companies with wind exposures in Florida and Texas and those with California, New Madrid or Pacific North-West earthquake exposures.

For 2003, we see these trends continuing, although (perhaps) less dramatically. The Canadian Property market continues to retrench, with most insurers concentrating on their core areas of expertise. This will undoubtedly create added pressure on less-than-favorable occupancies.

General Liability and Umbrella

The Liability market firmed substantially in 2002, with the markets increasing rates and cutting capacity. Given the nature of the Canadian economy, which exports most of its goods and services to the US, the Canadian Casualty marketplace largely mirrors its counterpart in the US. Accounts with direct US exposure were treated especially harshly as fewer and fewer Canadian underwriters would consider these risks. This resulted in an under-supply of market and, subsequently, a dramatic increase in premiums.

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The Canadian Marketplace (continued)

For 2003, the market will continue to seek adequate pricing and consider only those risks that match the underwriting philosophy of the insurers. Markets with the ability to write business in Canada and the US will continue to see tremendous growth in 2003.

Automobile

The Automobile market is facing significant challenges as insurers have not achieved expected levels of profit due to negative results, particularly in Ontario.

Insurers willing to write mono-line fleets are scarce. Long-haul fleets, facing a limited marketplace in the best of times, are struggling further as a result of the withdrawal of major insurers in that niche.

Professional Liability

As in other casualty lines, the Professional Liability market took a stand in 2002 as carriers reconsidered their positions on their entire portfolios. Although the market for the traditional Professional Liability classes remained fairly stable, the "miscellaneous" classes became increasingly difficult to place. Pricing was up substantially across the board.

The next 12 months should see more of the same, along with some further retraction of the market, as those markets with smaller books of business may simply find it uneconomical to continue.

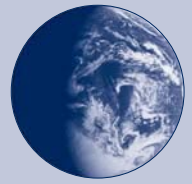
Directors & Officers

The Canadian D&O market is largely underwritten by the same markets that underwrite in the US. As such, the stresses in the Canadian market mirrored those in the US in 2002. Publicly traded Canadian companies who list on the New York Stock Exchange (NYSE) have been hit the hardest, resulting in dramatic increases in both premiums and deductibles. Excess layers are being much more carefully scrutinized and underwritten-what used to be deemed "catastrophic" capacity is now frequently considered part of the working layer.

However, aside from the reluctance or inability of the domestics to write NYSE business, several markets remain active in the class. We expect increases to track fairly closely with those in the US market.

Terrorism

The Canadian market excludes terrorism on all lines except Automobile. In the area of government support, the Canadian government is taking a "wait and see" position until the US government has passed relevant legislation. The Canadian insurance industry is awaiting Ottawa's reaction; political pressure on the part of the industry has not been strong.



Headlines and Highlights

- **Market hardening failed to materialize in 2002, yet is predicted for 2003.**
- **Worldwide catastrophe losses for reinsurers are reducing capacity, which especially impacts catastrophe-prone areas such as Mexico.**
- **Terms and conditions will tighten—for some companies, all-risk policies may give way to named peril policies.**
- **The Employee Benefits area is again awaiting the outcome of anticipated legislative activity to correct the turmoil created by last year's laws.**

Projected Market Conditions

The hardening of the market expected during 2002 did not occur in most sectors of the Mexican insurance market. Because of ongoing pressures in the world's reinsurance markets, especially in light of a series of natural catastrophes worldwide, we are again predicting that the market will firm in the coming year. We anticipate marked increases focused mainly on Property and Casualty coverages. With the mid-year treaties of 2003, when the largest Mexican companies renew coverage, we expect to see the hard market take hold.

In addition to price increases, clients are facing changes in general conditions. Deductibles are increasing dramatically. Specific exclusion clauses are more and more common. Sublimits are being employed more aggressively. Most significantly, all-risk coverage is fading in favor of named peril coverage, and the only constant is first-loss limit due to Probably Maximum Loss (PML) evaluation.

At the same time, local markets remain price driven, facing great pressure to reduce costs.

Taken together, these factors point to a more complicated insurance market in Mexico. Increased complexity was a feature of the 2002 marketplace and we expect more of the same in 2003. One result is an increasing emphasis on exchange of information. Clients need to be better informed on local market conditions than they may have been in the past. Likewise, markets are demanding more and higher quality information in the quoting and placement process.

Property & Casualty

Catastrophic losses were a feature of 2002: heavy storms in Europe, earthquakes in the Middle East, hurricanes in Latin America. As a result, reinsurers are reexamining their entire business and taking steps to guarantee a return on capital. Underwriting policies are affected. Caution in the face of uncertain exposures is the word of the day.

Mexico, of course, is no stranger to catastrophic risks, from earthquakes and hurricanes to volcanic eruptions. As both the government and private sectors are increasingly aware of the need for natural disaster coverage, increased demand for capacity is putting the Mexican market on a collision course with the toughening international market. At the same time, local market coverage for locations with high hurricane exposures can be very difficult to obtain.

Capacity is hard to come by not only for catastrophic programs but for "jumbo" risks—those industries with serious inherent risks, such as the petrochemical, steel and foundry industries.

The projection for 2003 is that insurers will exchange their proportional programs for catastrophic programs, which will put into play their retentions. The carriers are offering capacity, but only with intensifying scrutiny on both technical and financial grounds.

This scrutiny has in many cases forced insurers to evaluate the integrity of potential clients, leading to potentially awkward situations.

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The Mexican Marketplace (continued)

Employee Benefits

On January 1, 2002, the Mexican government implemented tax law reforms that threw the Employee Benefits market into turmoil. Legislative adjustments and corrections are expected in early 2003. For the second year in a row this sector awaits the activities of the government to play out.

As a result of the 2002 reforms, employee benefits are no longer fully deductible by employers. Furthermore, employees may be required, in some cases, to pay taxes on benefits received, including taxes on premiums paid by their employers on their behalf. In response, many companies cancelled efforts to develop new employee benefits plans or improve existing programs. The 2002 reforms affected all areas of employee benefits, with the exception of pension plans, which were left unmodified.

The insurance and medical services industry is now expecting a quick effort by the government to address the problems with reforms to the reforms. We are hopeful that this effort will bring a return to a more stable, predictable environment.

Changes in laws regarding pension plans provided a notable opportunity in 2002 for local insurance companies, as they were the only organizations set up to administer the new programs. During 2003, we foresee continued growth in pension and medical plans. In more cases, employees will be asked to contribute. Savings funds are also expected to grow as part of pension plans.

Auto

The Auto market will continue to grow at a steady, mostly typical rate. Increases of 10 percent are expected.

The Mexican Economy

Understanding the Mexican economy helps provide a more complete picture of the Mexican insurance market. A key factor remains the US economy. Any slowdown north of the border is keenly felt in Mexico. Despite the uncertainties of the US market, however, the economic outlook for 2003 is considered better than that for 2002.

The value of the peso is expected to show more movement than in previous years, but this should not be drastic.

Inflation is expected to increase at a rate somewhat higher than rates seen in recent years.

The Maquila industry will continue to be affected by competition with China, but it is possible that the Mexican government will start to provide inducements for growth in this important area of the economy.

The position of the Mexican economy overall is positive—especially when compared to the economies of some of our Latin American neighbors, such as Brazil, Argentina and Venezuela.

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