MARKETPLACE REALITIES & RISK MANAGEMENT SOLUTIONS

CAREFUL STEPS

2010 SPRING UPDATE
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We also invite readers to visit the [Publications page of www.willis.com](http://www.willis.com), where you will find many other articles and studies of immediate and enduring value to risk managers, financial executives and corporate governance stewards of every stripe.

*Marketplace Realities* is updated periodically throughout the year.

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CAREFUL STEPS

Buyer be glad – the soft market continues in the insurance industry. This is clearly the key theme running through this spring update of the 2010 edition of Marketplace Realities & Risk Management Solutions, Willis’ long-standing series on the insurance marketplace. The persistence of the soft rate environment in most lines, however, does not mean the marketplace is static. As these articles attest, the offerings and strategies of insurance carriers are always in motion, and the smart buyer will take advantage of a buyer’s market not only to lower costs, but to adjust and improve coverage in ways that promote organizational goals and ambitions. The subtitle of the 2010 edition of Marketplace Realities is “Careful Steps.” As an insurance buyer, you should be careful not to miss any opportunity to take full advantage of the evolving products available for your risk management needs. The insights that follow can help you in this effort.

The Great Recession didn’t spark a rise in premiums, as some had expected. Many now wonder if the recent upsurge in catastrophic events, from earthquakes to floods to volcanoes, will turn the market, but so far we see little sign of it. This speaks to many things – lower demand for one – but more importantly to the resiliency of our industry. During a period of sometimes astonishing volatility and relentlessly soft rates, we as an industry held fast. We were helped by the brief lull in catastrophes, but moreover we were supported by the essential principle we’ve stood by for a long time: if we’re the ones that have to come in and clean up after a disaster – and we do it time and time again – we have to make sure we can withstand the disasters ourselves. We’ve done it.

A big caveat is in order, for sure. A few insurers, including some of the biggest names in the business, expanded into activities prior to the economic meltdown that reached beyond their core insurance business, activities widespread in the financial services sector that hobbed the global credit system. These entities needed the help of governments around the world to stay afloat. Most of us, fortunately, stuck to what we know, and our clients were better off for it.
Reflecting on the upheaval in the financial services world over the last few years, and focusing ourselves on what we do best and – in our view, better than anyone else – we recently put into words exactly what drives us to excel. What do we stand for at Willis? What do we do for our clients? What emerged was a simple declaration we call The Willis Cause:

- We thoroughly understand our clients’ needs and their industries.
- We develop client solutions with the best markets, price and terms.
- We relentlessly deliver quality client service.
- We get claims paid quickly.

...with integrity.

That’s it, a great insurance broker encapsulated in four lines – and two very important words at the end. That’s what we strive for and that’s what we achieve, day in and day out, for our clients everywhere. This publication is one way we deliver on that promise.

Joe Plumeri  
Chairman & CEO
Much of the insurance industry’s fortunes hinge on the whims of nature, i.e., natural disasters. Yet the recent earthquakes in Haiti, Chile, Mexico and China, as tragic in human terms as they were, serve to remind us that man-made disasters, especially of the financial variety, can have a lasting global impact unlike anything delivered by Mother Nature. The Haiti losses were largely uninsured; the reinsurers who will bear the brunt of the multibillion dollars in Chile claims, can handle it. Meanwhile, the decline of world economies following the credit crisis, especially in the U.S. and Europe, continues to impact the insurance industry.

WHERE WE WERE AND WHERE WE ARE

During 2008, significant declines in the market value of most classes of investment impacted the balance sheets of financial institutions – including insurers – with substantial reductions in the reported value of their investment portfolios. Anticipating a decline in capital adequacy, many insurers cut back their maximum exposure limits to ensure that risk appetite reflected the reduced surplus levels.

During 2009 the financial markets rebounded markedly, with the S&P 500 climbing 23%, the greatest annual increase since 2003. Credit spreads tightened considerably, as confidence in the markets improved. The tendency of insurers toward conservative investments (due to a number of factors, including the influence of regulatory and rating agency capital models and the requirement for high liquidity in order to meet claim requirements) has been a key factor in the preservation and recovery of capital levels for the insurance industry.

- Improving financial market conditions in late 2009 and early 2010 helped boost insurance industry capital positions but sluggish economic conditions are impacting demand and insurers’ top line.

- Market competition and market churn continue to drive premium rate declines across most classes of business, with minimal tempering from recent earthquake losses.

- Underlying underwriting profitability is deteriorating, a trend anticipated to continue in the near term.
For the majority of the general insurers, reported underwriting results also improved in 2009, partly reflecting a significant reduction in catastrophe losses. The fact that 2009 was the quietest hurricane season in over a decade more than offset heavy losses in some lines, particularly trade and credit business. Operating profits for 2009 overall showed significant improvement; Moody's reports an average 58% improvement in net income compared to 2008 for the U.S. P&C industry.

These factors combined have greatly supported growth of capital in the general insurance industry. S&P reports that capital levels are now close to those reported at year end 2007 (generally regarded as the cyclical high point) and general insurers are looking to deploy this capital.

**UNDERWRITING DISCIPLINE AND THE COST OF CAPITAL**

Notwithstanding the tail winds supporting insurer results in 2009, economic recovery is sluggish in most developed countries. For general insurers, the associated reduced sales, lower payroll and increased tendency of insureds to retain a larger part of their risk continues to suppress demand for insurance.

The result has been a competitive environment with most lines of business reporting declining premium rates. Fitch and AM Best both estimate a decline in net written premium (NWP) of around 3-4% for 2009, representing an unprecedented third consecutive year of annual decline in NWP for the industry.

A closer look at the combined ratios reveals some adverse trends. The benign level of catastrophe events in 2009 and favorable reserve development masks a moderate deterioration in the underlying accident-year combined ratio, which excludes the impact of prior-year development. For 2009, this exceeds 100% despite the benign catastrophe environment in 2009.

AM Best reports that in 2008 and 2009 favorable reserve development for the U.S. P&C industry reduced the combined ratio by 2.0 points and 2.9 points respectively. Both S&P and AM Best comment on the sustainability of this income and caution against reserving practices being too optimistic about loss trends with reserves being released prematurely. Although further reserve releases are anticipated throughout 2010, the amount that is released is expected to fall as redundant reserves have been eroded. The economic recovery also raises the risk of inflation, which would negatively impact the adequacy of reserves for longer-tail lines such as Medical Professional Liability, Workers’ Compensation and General Liability.

In Q4 2009 an increasing number of insurers highlighted adverse development in specific primary Casualty lines such as Italian Medical Malpractice, European Professional Liability, Executive Assurance and Commercial Auto Liability. In addition, the world's largest insurer, Chartis, reported $2.3 billion of adverse development on its long-tail Liability lines, particularly excess Casualty and excess Worker's Compensation lines. Other major players may yet follow. Also troubling is the reality that the benign North Atlantic catastrophe environment cannot be expected to continue. In December 2009 forecasters from Colorado State University predicted a return to above average activity in the Atlantic Basin in 2010 as El Niño conditions subside.

Indeed, 2010 has already brought several catastrophe events, including the volcanic eruption in Iceland, earthquakes in Chile, China, Mexico and Haiti, Windstorm Xynthia in Europe and winter storms in the U.S.
With a deterioration of underlying accident year combined ratios (largely due to declining premiums, moderately increased loss frequency, reduced relief from prior year reserve releases and cat losses returning to normal levels), underwriting profitability is likely to deteriorate. A continued move toward more cautious investment strategies will further pressure profitability.

In 2008 and 2009 many general insurers undertook derisking exercises on their investment portfolios, reducing exposure to equities, alternative investments and other more volatile assets. Furthermore, to mitigate the risks associated with inflation, many insurers have shortened the maturity profile of their bond portfolios. These moves, combined with reduced dividend income and reduced interest rates on "risk free" assets, are likely to cut investment income, thereby increasing pressure on underwriting results in order to meet the cost of capital. The historical importance of investment results is highlighted by statistics from AM Best showing that in the past 10 years the U.S. P&C industry produced an underwriting profit in only three, yet produced operating profits in all but one.

**CAPITAL MANAGEMENT ACTIVITY RESUMED**

The increased capital, reduced demand and deteriorating underwriting position may increase the likelihood of M&A activity in the industry. However, these factors may be offset by difficulties in raising capital to finance the deals. Insurance company shares today are generally trading below book value, therefore reducing insurers’ ability to use their stock as a funding source, but potentially making them vulnerable to external interest.

An alternative means of improving shareholder return is through share buyback activity. During 2008 many insurers suspended share buybacks, but in Q4 2009 and early 2010 a number have resumed and increased share buyback authorizations.

In summary, the changing economic conditions have resulted in a shift in the challenges facing the general insurance industry from ensuring capital adequacy to maintaining adequate profitability. Rating agencies suggest that improved enterprise risk management within the industry will help to limit the soft phase of the cycle. In December 2009, AM Best affirmed its stable outlook for U.S. personal lines, commercial lines and reinsurance sectors, while S&P, Moody’s and Fitch maintained their negative outlook on the personal and commercial sectors, largely reflecting the macroeconomic trends impacting the industry. Fitch, however, stated that near-term downgrade actions are unlikely to match those of early 2009 and S&P has commented that despite the overall negative outlook, it believes the insurance sector is in relatively good shape.

**Sources**

AM Best – *Best's Special Report, Review & Preview*, February 8, 2010

S&P – *Global Reinsurers enter 2010 on stronger financial footing but face weaker pricing*, January 26, 2010

S&P – *Global Economic Outlook; Recovery in different gears*, March 4, 2010

S&P – *Enterprise Risk Management continues to show its value for North American and Bermudan Insurers*, February 1, 2010


Moody’s – *Moody’s comments on US P&C Insurers’ Q4 2009 Earnings*, February 2010


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The soft market persists – and is continuing to soften – even for accounts with high CAT exposures.

On recent renewals, we have seen decreases of up to 10% on CAT accounts.

Lexington’s recent efforts to reduce Cat capacity appear to be over, which should help sustain soft market conditions.

As the soft Property market marches on, one countervailing pressure on the marketplace – Lexington reducing its Cat capacity – no longer appears to apply. Lexington’s careful corrective action to reduce its overall PML is done, except for certain insureds that have already been identified. Lexington is now offering the same Cat aggregate as on prior renewals subject to pricing stipulations. Any upward pressure therefore on primary pricing arising from the withdrawal of Lexington’s primary capacity has been removed and we expect the rating environment on primary business will now fall in line with recent excess reductions.

The soft market is continuing to soften – even for accounts with high CAT exposures. On recent renewals, we have seen decreases of up to 10% on CAT accounts.

WHERE WE LEFT OFF IN 2009:

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FACTORS INFLUENCING THE MARKET IN 2010:

- Insurers’ Surplus
- Investment Results
- Insurer Loss Ratios

= Softening Market Conditions
LONDON/CONTINENTAL EUROPEAN PROPERTY MARKET

- Insurance buyers have more markets to choose from, including three new Lloyd's syndicates that started up during the second half of 2009.
- Under pressure to grow top line, many underwriters have increased their capacity significantly and capacity in Lloyd's is now at record levels. Recent exchange rate movements will push underwriters to be increasingly aggressive to win business.
- RMS version 9.0 is now having an impact and we are seeing markets here competing increasingly on California Quake business.

LOSSES: UP FROM HERE?

Losses in 2009 were $26 billion ($22 billion CAT losses, plus $4 billion man-made or risk losses), a decline of 50% from $52.5 billion in 2008. In 2010, we probably will not be as lucky as we were in 2009. Thomas Hess, Chief Economist for Swiss Re, commented: “The probability that we see NAT CAT losses as low as those in 2009 is less than 35%. We have already seen significant events in 2010 with Winter Storm Xynthia in Europe and the earthquakes in Chile and Haiti. The industry is therefore well advised to prepare for much higher losses. Given their high volatility, losses could easily be three to five times what they were in 2009. In 2005, insured losses set a record when they soared to $120 billion. I would not be surprised if this record is broken in the not too distant future.”

These initial loss events are not expected to move the market, but they serve as a reminder of how frail the current market conditions really may be. The February earthquake in Chile rocked the Richter Scale at 8.8 and was followed by a 7.7 magnitude quake a week later. Several billion dollars of losses resulted. Imagine if similar events were to occur in California, which has not seen a major earthquake since 1994. The persistent soft market could easily vanish.

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1 Swiss Re – 1/2010 SIGMA study
Although the economy is showing signs of recovery and cost reductions have been the rule rather than the exception for the past few renewal cycles, risk managers and corporate insurance buyers continue to feel internal pressure from their senior management to focus on further reducing both cost and collateral burdens.

Casualty insurance buyers are eagerly seeking market and broker competition and entertaining ideas for changes in program design through RFP solicitations, all strategies to achieve reductions in frictional and risk transfer costs.

The long soft market is creating challenges and opportunities for insurers. Incumbent insurers who have been reducing pricing in recent years are often struggling to retain accounts in the face of even more aggressive pricing by competitors hungry for market share in the face of declining exposures and, in some cases, rate levels.

Carriers are also quoting depressed collateral in an attempt to write new business, but only where the insureds’ financials are strong. In the current economic environment, this strategy can only be used selectively.

- Soft market conditions strategies often include carriers lowering collateral requirements.

- To further lower their costs, insureds are examining loss costs, which represent up to 65% of total cost of risk.

- Umbrella/excess carriers are competing for business on service as much as price.

- To further lower their costs, insureds are examining loss costs, which represent up to 65% of total cost of risk.

- Umbrella/excess carriers are competing for business on service as much as price.
Collateral is also being used defensively. Carriers may threaten to increase collateral levels if the insured decides to move to another carrier.

Another carrier tactic in the battle for market share is the development and marketing of new products. One example is a middle market offering that combines ISO CGL coverages with enhancements and broadened pollution coverage parts. The cost increase for the additional coverage appears to be modest for most insureds.

The search for savings has also inspired a greater focus on managing loss costs, as these costs typically represent upward of 65% of the total cost of risk. For larger insureds with retention programs, the loss cost figures can rise to 80% or more of the total cost of risk. Reducing losses can potentially generate greater savings than reducing frictional costs, and we are seeing increasing interest in this area.

UMBRELLA/EXCESS CASUALTY

Despite predictions of a market turn, umbrella/excess capacity and access points are as plentiful as ever, with many more options than many buyers once thought possible. Amazingly, this marketplace sector continues to attract new participants, new capacity commitments by some existing carriers and development of new players with appetites leaning toward lower attachment points and in some instances tougher classes. We continue to see little if any constriction in capacity, markets or terms and conditions. With premium rates approaching historic lows and claim trends holding steady or worsening, the soft market continues to buck predictions and even contradict, some may argue, common business principles.

CARRIER COMPETITION

Carriers and other risk capital providers are searching for innovative ways to distinguish themselves, given that ongoing rate reductions are not sustainable in a long-tail line of insurance like Casualty. Carriers are trumpeting improved policy service, expanded breadth of coverage, more efficient claim procedures, contract certainty and overall global compliance. Improved compliance and operations will of course help carriers as well as their clients. Improvements in emerging risk identification and efficient risk transfer will make for better Excess Liability underwriting.

An area that might be ripe for change in the underwriting process is the annual renewal cycle. Is there a more efficient basis on which to create risk finance agreements? Other lines, especially Marine, seem to think so. We are not afraid to make suggestions to the carriers and set the bar high, as carriers are working harder than ever to stand out from the pack.
PUNITIVE DAMAGE COVERAGE

This coverage is in a state of uncertainty as insurers strive to distinguish their offerings. Another marketplace factor is that coverage within base policy forms is usually available only through an occurrence-reported or claims-made policy form procured offshore, typically in London or Bermuda. Most domestic insurers remain silent on the coverage, thereby allowing coverage to apply only when not contrary to public policy.

Historically, buyers solved the domestic limitations through offshore stand-alone policies that mirror domestic policy terms and conditions with one addition – DIC coverage to fill the punitive damage gaps. Referred to as Puni-Wraps, these stand-alone policies demand higher premium to cover their costs of issuance and other administrative expenses associated with procurement and maintenance by all parties to the transaction.

An emerging alternative to offshore base coverage or a Puni-Wraps (or allowing your policy to remain silent) is a most-favored venue (MFV) endorsement. MFV endorsements range in breadth and scope significantly from one insurer to another and are not offered by all markets.

Likewise, not all markets will offer Puni-Wraps around a domestic policy, so it is vitally important work with your broker in developing an action plan that meets your risk finance goals and objectives with regard to punitive damages. Equally, you may want to seek legal advice as the terms and conditions are anything but standard for a risk about which too little claim history is available to draw reliable conclusions. Finally, if you are building a follow-form tower of participants, don’t let this coverage be the spoiler. In other words, determine up front which markets will follow the language you seek and develop a marketing plan accordingly.

LOCAL COMPLIANCE

Basic umbrella/excess policy forms are generally global – the covered territory is the whole world and the coverage should respond to claims in many countries and jurisdictions. On the ground, matters can be complicated by local laws. Increasing scrutiny by local governmental entities is resulting in tax levies, fines, penalties and in some instances the requirement for local admitted policies. These problems have historically been avoided through local underlying admitted and non-admitted DIC policies, self-insured retentions or in some instances local compulsory coverages that determined primary coverage. Of course, newer umbrella/excess policies have their own terms and conditions and usually stand on their own regardless of underlying policy wordings. This means buyers must be particularly vigilant about how umbrella/excess cover will respond to a claim and about the local compliance issues in any jurisdiction where local admitted coverage is required.

The focus on local jurisdiction compliance has fueled the quest for contract certainty. The quest has yielded a wide variety of conclusions, but the genesis of the increase in compliance enforcement seems clear: the search for new tax revenue. Insurers addressing this trend are inconsistent in responding to the many factors involved, which include location of exposure, local licensing and insured objective. Unless they have particular jurisdictional concern or mandate, most buyers are leaving existing procedures in place.

GLOBAL MARKETPLACE/ACCESS

Gone are the days when London, Bermuda and balance of the global marketplace were reserved for difficult classes of business requiring unique coverages or some other creative solution. Of course they are still well equipped to handle such items, but these days equally keen to balance their portfolio with less hazardous classes as well as policies written on standard occurrence forms.

This change means buyers can think beyond traditional borders and approach insurers they may not have considered previously. Buyers should also consider access point to the markets they like. Access point is often overlooked, though it can be as important, if not more, than market selection. The insurance world has evolved to the point where brokers and insurers trade in real time with outstanding results anywhere on the planet.
THE CAST OF CARRIERS

Traditional umbrella/excess carriers that have been globally committed retain the dominant market share. Emerging markets, whether new carriers or those new to the line, will face an uphill climb. As underpricing risks is an unsustainable business model, newcomers will have to attract interest through clean balance sheets and innovative thought processes.

The recent consolidation of a lead market and a reinsurer in this space remains too new to say what it will mean for both parties and their respective policyholders.

Movement by individual underwriters from one carrier to another remains prevalent. This changing of guards creates significant work for clients and brokers alike as individual knowledge and relationships continue to be important ingredients in creating any sizable program.

SUGGESTIONS FOR BUYERS

Just as carriers must make an effort to differentiate themselves, clients should do the same to ensure the best possible results. Quality submissions should include detailed explanations of exposure, loss history, overview of business operations as well as exceptional communication, transparency in procedures and processes and finally establishment of strategic goals. While aggressive targets are always worth pursuing, they can only be met with details, details and more details.

While the overall marketplace has not changed much in the last half year, neither are the umbrella/excess waters stagnant. Buyers should keep an eye on the currents ahead, and be prepared to react. Strategic buyers are likely to be rewarded with better program designs, superior terms and conditions and state-of-the-art service. We believe in being aggressive yet realistic in setting goals. Work with your insurance adviser to understand your products, services and key exposures as well as your underwriters – and think beyond just premium.

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Health care reform is here.

Although legal challenges and repeal efforts loom ahead, and many provisions do not actually take effect for years, employers face a multitude of changes that must be addressed in coming months. Although grandfathered plans are exempt from some of the new mandates, several key changes may apply to the 2011 plan year. Employee benefits related provisions generally go into effect after September 23, 2010. For plan years starting in October, November or December 2010, these issues may need to be addressed fairly soon. For more on health care reform, including detail about application of the law’s grandfather rules, plus a timetable and an in-depth analysis of the law, click here.

EARLY RETIREE REINSURANCE
For employers providing retiree medical coverage, a temporary federal program will provide reinsurance for a limited threshold of claims for retirees over age 55 who are not yet eligible for Medicare.

COVERING ADULT CHILDREN
Group health plans that offer coverage for dependent children must allow employees to cover their children until they reach age 26, regardless of student status. Grandchildren (children of a covered dependent) are not covered by the requirement. It is unclear if plans have to cover those dependents at the current dependent rate or at anything less than the individual COBRA equivalent rate. That is subject to the interpretation of the Department of Health & Human Services (HHS), which will be drafting regulations implementing this provision. Corresponding changes to federal tax law generally shield parents from additional tax liability for the value of health benefits received by an adult child.
The legislation does not require coverage of children or dependents at all. But if a plan does cover dependents, it must include coverage for dependent children up to age 26. Also, nothing in the federal law changes rules under state law. Consequently, insured programs subject to state coverage mandates that extend beyond age 26 would continue to apply. (For example, in New Jersey insured coverage generally applies for dependents until they turn 31.)

Although coverage for dependent children generally must remain available through age 26, until 2014, grandfathered plans may exclude children who are eligible for other employment-based coverage. (In other words, grandfathered group health plans would only have to cover dependents that do not have another source of employer-sponsored coverage.)

The expansion of health coverage eligibility for adult children applies to group health plans – both insured and self-funded. Although employers are likely to see increased plan costs due to the anticipated higher enrollment numbers, tax code changes should also generally help simplify payroll administration. In addition, plan sponsors will need to carefully review and update all of their health plan materials (e.g., summary plan descriptions, plan documents, enrollment materials, employee handbooks and related miscellaneous documents) to ensure that participants are accurately advised of the newly expanded enrollment opportunities.

**ELIMINATING LIFETIME MAXIMUMS**
The law eliminates lifetime maximums on “essential benefits” as defined by regulations. Although this will presumably happen automatically with insured plans (with pricing increases to match), self-funded plans will need to have some serious discussions with their stop-loss carriers and determine the appropriate levels for stop-loss in the future.

**RESTRICTING ANNUAL MAXIMUMS**
The law prohibits annual dollar maximums. Forthcoming regulations will tell the tale here as well. Despite lifetime and annual limit prohibitions, the legislation explicitly provides that the plans can set lifetime and annual limits in some cases for specific covered benefits to the extent not otherwise prohibited by law. A plan could cap, for example, the amount it will pay for all prescription drugs. Such caps may, however, run up against laws, such as the ADA and Mental Health Parity Act, which prohibit discrimination on the basis of a disabling condition or mental health treatment. Our best assessment is that specific conditions cannot be targeted. Nevertheless it does appear that plans will still be able to manage their downside risk with annual and lifetime limits for various benefits.

**ELIMINATING PREEXISTING CONDITION EXCLUSIONS FOR CHILDREN**
No limitation or exclusion for preexisting conditions may be applied to a child under age 19 (a mandate that expands to all enrollees in 2014).

**EXCLUDING OTC MEDICATIONS**
Health flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs) may not reimburse (and health savings accounts may not reimburse on a tax-favored basis) the cost of over-the-counter medications, other than insulin, unless obtained with a prescription. Medical savings accounts (MSAs) and health savings accounts (HSAs) are also subject to this rule.
HSA Penalties
The penalty for HSA withdrawals for reasons other than reimbursement of medical expenses rises from 10% to 20%.

Reporting the Value of Health Coverage
W-2s for 2011 (issued in 2012), will include the value of each employee’s health coverage.

Eliminating Rescissions
Rescinding coverage for reasons other than fraud or intentional misrepresentation is prohibited.

Uncertain Prognosis
Looking ahead, many health care observers are wondering about the question of funding. No universal health care solution is free. Given the federal government’s financial commitments, no politically viable revenue stream substantial enough to support health care reform exists – apart from taxing the value of employer-provided health care coverage. It may be that Congressional attention will return to that funding source. The coming requirement to report the value of health coverage on W-2 forms lays the groundwork for the government to more accurately measure how much revenue could be collected by opening this tax channel.

Many health care experts are also concerned that with all the attention centered on health coverage access legislators have overlooked another fundamental issue – health care cost. Ultimately, regardless of the final details of health care reform, employers can rest assured that health care issues will stay on the legislative agenda. As the employer requirements mandated by reform unfold, employer organizations will need to consider not only the compliance issues, but the long-standing challenge of finding strategic approaches to managing health care costs – a challenge more difficult in this turbulent and chaotic period.

Other EB Issues
Other health care and benefits legislation may pale next to the health care reform action, but many other initiatives are at work that will directly affect organizations sponsoring employee benefits programs. HR professionals should be aware of COBRA changes, the use of state resources to subsidize private sector health coverage, aggressive compliance efforts to bolster federal revenue, state level reform activity and Medicare second payer enforcement.

COBRA Subsidy Extended
On April 16, 2010 a new temporary COBRA subsidy extension made the subsidy available with respect to involuntary terminations during April and May, 2010. The previous expiration date was March 31, 2010. Unfortunately for employers sponsoring group health plans subject to continuation of coverage obligations, the new legislation means that revisions to COBRA election notices will be needed, and it is likely that some individuals whose qualifying events occurred after March 31 will be entitled to a new election notice and a new opportunity to elect COBRA. We expect that the DOL will provide revised model notices shortly.

Meanwhile other legislative initiatives now being considered in Congress would apply the COBRA subsidy to involuntary terminations occurring as late as June 30, 2010. There is even a Senate proposal that would set that date even later, at December 31, 2010.

In the last few years Congress has demonstrated an increased willingness to revisit COBRA to promote the availability of health coverage. Lawmakers appear to perceive COBRA mandates as easy, inexpensive and politically palatable – despite the reality that COBRA benefits are often among the most expensive. Congress also seems to have overlooked the administrative burden associated with changes to the COBRA process, especially when legislation produces awkward retroactive duties for employers to address. (For details please see Willis EB Alert, Vol. 2, No. 4 – “COBRA Subsidy Provisions Require Immediate Attention”.)

Mental Health Parity Regulations
Three federal agencies recently issued joint interim final regulations under the Mental Health Parity and Addiction Equity Act (MHPAEA), successor legislation to the original Mental Health Parity Act of 1996. The new regulations may complicate employers’ compliance efforts.
The original act required that plan rules for the mental health benefits could not be more restrictive than those for medical/surgical benefits (where a plan sponsor offers medical/surgical benefits and mental health benefits). The MHPAEA permanently expands the parity requirements and includes substance abuse treatment for the first time.

The MHPAEA statute went into effect for calendar year plans on January 1, 2010. However, the new final regulations add an additional layer of regulatory requirements that will apply to group health plan years beginning on or after July 1, 2010. This means that employers who already made plan changes to comply with the amendments may require a further round of plan changes to implement the newest regulations. For calendar year plans, the newest regulations will apply on January 1, 2011.

The government’s willingness to mandate mental health parity may offer a glimpse of the compliance challenges that health care reform will entail. Under the new law, HHS has massive power to directly mandate specific benefits under employer-provided group health plans.

DOL ISSUES MODEL EMPLOYER CHIP NOTICE
The Department of Labor (DOL) recently published a model notice for employers to use in informing employees of potential opportunities for premium assistance for group health plan coverage. The model can be used to satisfy the requirements of the notice provisions of the Children’s Health Insurance Program Reauthorization Act of 2009 (CHIPRA).

CHIPRA’s key aims are promoting the availability of health coverage for children and maximizing government efficiency in funding those expenses through cost shifting. The government learned long ago that financial obligations for health coverage through Medicaid-type programs could be eased by shifting costs to private sector plans where coverage is available. In some cases, it is significantly less expensive for the government to fund contributions to a private health plan rather than pay directly for health coverage through a public program.

Under CHIPRA, employers are required to notify each employee of potential opportunities for premium assistance or coverage under Medicaid and the Children’s Health Insurance Program (CHIP).

In addition to the employer CHIP notice requirement, CHIPRA also requires group health plans to provide, upon request, information about their benefits to state Medicaid or CHIP programs. This is so states can evaluate whether premium assistance would be a cost-effective way to provide medical or child health assistance to an individual. The DOL is also developing a model coverage coordination disclosure form. States may begin requesting this information from plans beginning with the first plan year after this model form is issued.

MEDICARE REPORTING
Last year a new Medicare Secondary Payer (MSP) reporting requirement went into effect to help facilitate data collection by the Centers for Medicare & Medicaid Services (CMS, the agency overseeing Medicare).

When certain individuals have both Medicare and group health plan coverage, the MSP rules require the group health plan to pay benefits as if the individual had no Medicare coverage – thus making Medicare the secondary payer (i.e., paying benefits only for expenses not paid
by the group health plan). In cases where Medicare pays primary when it should have paid secondary, the government will seek recovery from the group health plan. By making information about Medicare beneficiaries’ group health plan coverage available, the new reporting requirement is designed to shield the government from overpayment.

The reporting issues attached to Medicare underscore the government’s aggressive tactics in collecting needed revenue. We urge employers to use particular care when it comes to satisfying MSP compliance.

Some employers are already encountering problems stemming from violations of the Medicare Secondary Payer (MSP) rules. These plan sponsors have reported being on the receiving end of collection agency efforts. Group health plan sponsors wishing to contest the assessment may appeal under an often tedious CMS review procedure that must be exhausted prior to going to court.

**ACCURATE EMPLOYMENT CLASSIFICATION: AGGRESSIVE ENFORCEMENT**

The recession has hurt state and federal tax collections, so hard-line enforcement of employer tax rules is becoming especially important to feeding government coffers. Like CMS, the IRS is becoming more aggressive in its enforcement and collection efforts. *The New York Times recently reported* on an effort by the federal government (“U.S. Cracks Down on ‘Contractors’ as a Tax Dodge,” February 17, 2010) to find employees who are misclassified as independent contractors and collect additional taxes and penalties. Many companies use the full-time services of individuals who are treated as independent contractors. The companies report the income they pay to the contractors on Forms 1099 (rather than a W-2), and the contractors are responsible for paying their own income taxes, Social Security and Medicare taxes, unemployment and Workers’ Compensation taxes. In cases where the workers should be classified as full-timers, companies may be responsible for the employer’s standard share of the various employment taxes as well as income tax withholding.

Employers should be certain their classification of workers is accurate. The rules that govern the classification, generally known as the IRS “20 Factor Test,” are articulated in Revenue Ruling 87-41.

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The D&O market remains friendly to most buyers in 2010. One of the main factors keeping it that way is the fallout from the major primary D&O carrier changes that occurred in 2008-2009 due to the financial dislocation experienced by several markets. The new lead markets continue to protect their positions while the displaced markets seek to regain market share. As a result, competition is still a powerful force in the spring of 2010. Mitigating the competition is buyers’ reluctance to switch lead markets too frequently for such a high-profile, claims-made coverage. Buyers who made a move last year are less likely to move again and carriers know it. Changes in litigation patterns, discussed below, may also encourage buyers to stay put.

Another factor in the current marketplace is the conviction on the part of many markets that the D&O pricing would increase – even for attractive risks – in 2008 and 2009. That belief enticed new market entrants and the resulting competition created conditions the very opposite of what was expected. Long-standing D&O markets are becoming weary of the repeated rounds of price reductions. The question is, will they be able to do anything about it?

**P&C: PRICING AND CAPACITY**

Balance sheets talk, and carriers listen. For companies outside the most financially troubled industries (finance, auto, real estate) that have solid results, competition to write or retain D&O business is strong. Rather than soft, however, we would describe the marketplace as stable, as pricing is generally flat or falling up to 10%.

Small reductions on the primary or base layer are usually amplified as one moves up through the layers of coverage by reducing the increased limits factors (ILFs), which are the numbers used when pricing for an excess layer is expressed as a percentage of the layer below. This is an important part of the story as we consider the longer-term impact of the lingering buyers’ market for D&O insurance.
While conditions are stable now, long-term market observers will point out that the market has been known to self-correct: acquisitions of newer markets by the more established capacity can result in a reduction in supply and upward pressure on pricing.

**KEY TERMS OF ENDEARMMENT**

About a year ago, a major D&O carrier introduced a new primary D&O form with several novel terms and conditions for the U.S. market. This year, another major global D&O market intends to introduce a new primary policy form with a similar goal of raising the bar for D&O terms and conditions. Again, changes in the primary layers can be magnified as they are pushed up through one's insurance program.

Some icing on the cake could come from new excess forms, which have been improving over the last 12-18 months, especially for dedicated A-Side D&O coverage. These have included new definitions of claim, drop-down provisions and notice mechanisms. In addition to coverage improvements being pushed up through D&O programs, there is also a real potential for improvements to drop down.

**CONFLICTING CLAIM COUNTS**

Predicting the future is guesswork, but looking back is usually a more objective undertaking. In analyzing recent claim trends, however, we see openly contradictory opinions. According to Cornerstone Research, filings of U.S. securities fraud lawsuits fell in 2009 as stocks rose and the credit crisis eased. Investors filed 169 prospective securities class-action lawsuits in 2009, down roughly 24% from the prior year.

Advisen, on the other hand, found that 910 new securities suits were filed in 2009, up from 804 in 2008, a figure which itself was one-third higher than that of 2007. "The first half of the year was dominated by credit crisis- and Madoff-related lawsuits," said a senior analyst at Advisen. "Those types of suits fell off sharply in the second half, but plaintiffs' attorneys had a backlog of other cases waiting to be filed."

What's the real story? Oddly enough, both of these groups may be right because they are measuring different things. Cornerstone Research keys in on D&O securities class action suits, but Advisen takes a broader view of the universe of securities claims, including shareholder derivative actions, suits from bond holders, enforcement activity and M&A-related suits – claims that may or may not be brought as securities class actions.

Our own count, meanwhile, shows an increase of 24% in D&O claims in 2009.

**THE WAITING GAME: FILING DELAYS**

An unusual finding in the Cornerstone study is that some lawsuits are taking longer than expected to be filed. Traditionally, D&O suits are filed within weeks after the realization that a fraud might have taken place. Cornerstone found the average lag stretched to 100 days, or about 14 weeks, in the second half of 2009. Experts have suggested that this may be the result of law firms initially pursuing claims against the financial sector in 2008 and early 2009, thereby delaying potentially weaker claims that are more likely to be dismissed or settled for lower amounts.

These delays, whatever their cause, result in more uncertainty for D&O underwriters who may take out their discomfort on buyers, ultimately, through increased pricing, decreased limits and higher retentions. If a D&O placement is moved from one carrier to another and a claim for events taking place before the move is filed after the move is made, all parties may regret the complexities that ensue. This is a factor that may give
buyers pause before switching insurers, which may influence the tone of renewal negotiations.

**U.S. COURTS AND NON-U.S. COMPANIES**

As the world goes global, so do D&O cases. The issue of non-U.S. companies facing securities litigation in U.S. courts remains one of the hot topics in D&O. In addition to the National Australia Bank D&O case pending before the U.S. Supreme Court (Morrison v. National Australia Bank 129 S. Ct. 2762) we are waiting for a damage verdict on the adverse Vivendi decision (In re Vivendi Universal, S.A. Securities Litigation 02 Civ. 5571). The first case was a terrific win for the corporate defendant and its executives, and the second is likely to be one of the largest mega securities class actions ever as damages may reach hundreds of millions of dollars if not billions.

**LIFE’S A STAGE: ENRON**

In a case of art imitating life, the play *Enron* is coming to Broadway after an acclaimed run in London. Inspired by the financial collapse of the energy company whose name has become synonymous with corporate fraud, the play’s characters, such as Jeffrey Skilling and Kenneth Lay, are based on the firm’s real-life former employees. *Enron* is scheduled to begin preview performances at the Broadhurst Theater in early April of this year. We can only hope the play is edifying in a way that is more entertaining and less destructive than the actual events on which it is based.

Focusing on the individual personalities behind business actions is a useful reminder that the D&O world is ultimately about individuals, which in turn is a reminder that the D&O marketplace is often about individual relationships. Buyers who know their carriers and whose carriers know them are usually better off when the unexpected happens. Pricing, terms and conditions certainly rule the bargaining table, but there are many considerations for buyers taking the most strategic view.

**BERMUDA UPDATE**

The Bermuda marketplace expanded in 2009 with the addition of Argo Re and IronStarr. This raises to 12 the number of Professional lines carriers that can offer a total of approximately $400 million in capacity on each line of coverage, including, Directors & Officers Liability, Employment Practices Liability, Errors & Omissions and occasionally other lines, such as Crime, Fiduciary and Cyber Liability.

Bermuda carriers remain particularly competitive on EPL and Side-A D&O. Bermuda has traditionally been thought of as an excess market but carriers are now attaching lower and becoming stronger primary markets for EPL, Side-A D&O and even E&O in the past few years. Four carriers will write primary EPL: Max Bermuda, XL, Chubb Atlantic and Chartis Excess. Seven carriers offer lead Side-A D&O forms: CODA, XL, Chartis Excess, Allied World, Chubb Atlantic, Max and Endurance. The competitive advantage of Bermuda carriers lies in their ability to manuscript policy language, provide full punitive damages coverage and offer large blocks of capacity.

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1 Securities Class Action Filings 2009: A Year in Review, Cornerstone Research.

Cyber

- Cyber risks are rising in both frequency and severity, partly because of increased reliance on technology but also because of increasing regulation.

- The Cyber insurance marketplace is keeping up with demand by offering expansive products.

- Pricing is soft, despite increases in claims.

*If current trends continue, Cyber insurance coverage just may take its place alongside Workers’ Compensation, General Liability, Fire and Auto insurance in the core commercial Property and Casualty package, meaning business would be foolish to open its doors without it. – National Underwriter, March 15, 2010*

The more digital we become, the more exposed we are. More stringent data privacy regulations raise the risk of fines and penalties, and serious Executive Risks exposures (D&O, E&O) will emerge if proper precautions aren’t taken. If third parties are involved, the cost of repairing a cyber breach can be very expensive – just ask the retailers who’ve had to pay for credit watch services for millions of consumers whose personal information may have been compromised. According to the Ponemon Institute’s latest *Cost of a Data Breach* report, the average cost-per-record in breach incidents in the U.S. is $204. Add to that the intangible costs of damage to reputations and customer confidence.

“Here is real cause for alarm: most indicators point to future cyber crime attacks being more severe, more complex, and more difficult to prevent, detect, and address than current ones, which are bad enough.” (*Cyber crime: A clear and present danger*, Deloitte & Touche LLP White Paper, January 22, 2010.)

We don’t have to wait, however, for the threat to arrive. It’s here. According a recent Advisen Special Report (*Data Security Issues Escalate as Risk Management Evolves*), “As many as 85% of U.S. organizations had at least one data breach in 2009, elevating data security issues from the IT Department to the executive suite and the boardroom.”
WHY BUY CYBER RISK INSURANCE?

1. **Rising regulatory bar** – Government is responding to cyber vulnerability at several levels:
   - The Massachusetts Privacy Regulation took effect March 1, 2010, placing stricter requirements on data protections for companies doing business with Massachusetts residents. Compliance standards include encryption, portable devices and wireless networks, access controls, employee training and vendor compliance with the standards. This law could be a template other states will follow.
   - The HITECH Act, which went into effect February 17, put teeth into the federal rules about disclosure of personal health information.
   - The Federal Trade Commission’s Red Flags Rule (effective June 1, 2010) requires certain businesses to develop written procedures for spotting the warning signs of identity theft.
   - State security breach notification laws in 46 states (plus the District of Columbia, Puerto Rico and the Virgin Islands) require companies to notify consumers of security breaches when personal information may have been acquired by an unauthorized person.

2. **More litigation and more insured** – The loss potential grows, but coverage is keeping up: for the biggest publicized breaches in 2009, Cyber insurance responded to the policy limit losses.

3. **More IT and tech outsourcing, more commerce** – As the cyber world takes over, the exposure will only rise: a large credit card processor announced in early 2009 a breach that may have involved the personal information of more than 100 million individuals.

4. **Standard P&C policies include more cyber exclusions** – General Liability policies are seeing more exclusions pointed at Cyber risks, which widens the risk.
Fortunately, the Cyber market is maturing alongside the risk. As more companies seek Cyber protection, more carriers are coming up with Cyber solutions.

Hiscox, Aspen and Darwin are introducing new Cyber policies in April 2010. The policies will be added to a competitive marketplace that already includes ACE (U.S. and London), Arch, AXIS, Beazley, Chartis, CNA, Chubb, Hartford, Hudson (Euclid Managers), Kiln, Barbacan and Travelers.

Capacity of up to $350 million is available, depending on the exposure and loss experience. Companies seeking catastrophe-level coverage should find the market capable of meeting their needs. Most carriers cannot support more than $20 million each, but towers of follow-form coverage/limits can be readily built to satisfy the capacity need. Negotiation with certain specialist capital providers can increase the limit to $600 million. London presently has the ability to deploy up to $120 million in capacity.

Sublimits for notification and credit monitoring costs have risen to $1 million or more due to competition. Due to the continued softness of the market, the waiting periods for Business Interruption purchases have been reduced, in some instances, to as little as four hours in some markets. Broad triggers for business interruption include malicious attacks and administrative and operational errors.

The coverage in Cyber policies is broad and getting broader. Many Cyber insurance clients are amazed at how quickly Cyber forms change to reflect the rapidly changing risk. A typical Cyber policy could cover:

- Vicarious liability for intentional or negligent acts committed by IT vendors when systems or processes are outsourced
- Intentional acts committed by a disgruntled or dishonest employee or a former employee
- Fines, penalties, “consumer redress” and defense costs incurred by regulatory action alleging the failure to comply with state or federal laws designed to protect against consumer identity theft
- Notification costs required by state or federal law
- Credit remediation and credit monitoring – the cost to protect the identity of your customers/patients/clients
- Public relations expenses
- Forensic costs in identifying the cause of the breach or intrusion
- Liability as a result of the physical theft or loss of hardware or firmware
- Network or application disruption caused by a malicious attack (including cyber terrorism), software failure or power failure

The demand for notification expense and regulatory coverage and the increased market competition has allowed buyers to build notification and regulatory sublimits with the excess markets. The excess sublimit drops down to sit above the sublimits of the underlying layers, creating large sublimits to respond to the initial costs arising from a breach.
As the increased supply lowers the price, the Cyber insurance option appears more valuable and more available every day. Companies with demonstrably strong IT security risk management policies and procedures (e.g., encryption, access controls, incidence response planning and vendor management) have a negotiating advantage that will reap benefits in policy wordings as well as cost. Despite large recent insured losses, pricing is generally flat or down (a 5% decrease is the norm) for renewals, while coverage has expanded.

Underwriter appetite, however, varies by industry sector and policy wordings still vary substantially. Careful analysis, interpretation and customization are, as always, a necessity for those seeking optimal protection at the best price.

**LONDON SPECIALTY**

The London insurance marketplace is one of the leaders in providing innovative primary contracts for Cyber Liability, including Privacy & Network Security Risk. Several key primary carriers are located in London, and the ability to manuscript contracts and also create new language to provide coverage for first-party and brand reputation exposures has convinced a number of Fortune 500 organizations to purchase their Cyber cover through London.

London's strength in Cyber Liability stems from several factors:

- The financial strength of insurers – the majority of carriers have a financial rating of A+.
- Most carriers have been writing esoteric coverages for more than 10 years, providing continuity.
- Carriers effectively underwrite Cyber risks on a global basis, as London is considered a global hub.
- Underwriters are willing to manuscript primary contracts.
- Many markets provide capacity.

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The insurance industry continues to compete for construction business aggressively and we expect that to continue in most lines for the duration of 2010.

Changing project delivery methodologies combined with new technologies will continue to challenge the insurance industry to respond to a blurring of risk allocations.

The impact of federal work programs and continued credit challenges (including the impact of collateral concerns) will be key factors through the rest of the year.

These are tough times for the construction industry. As economic recovery remains tenuous and the residential sector lingers at historic lows, the industry is facing unprecedented revenue and margin pressures. The lack of work is exacerbated by difficult credit markets seeking opportunities that have little risk in them, which reduces the amount of capital in play on any particular project. As a result, competition for new construction projects is fierce. Many construction firms are pursuing projects in new regions of the country and new types of construction work. Many are also entering the public works market, crowding the bidding process. In addition, joint ventures are becoming more common as contractors look to complement their skills and geography to differentiate themselves and reduce risk.

For the work they do get, construction firms are often facing increasing risk. Delivery systems for construction are continuing to evolve and new risk allocations are challenging contractors, owners, designers and insurance carriers. Notably, contract terms are getting tighter, resulting in more liability being pushed down on contractors and subcontractors. This trend may ultimately lead to risks being taken that cannot be fully insured. We encourage dialogue between the contracting parties early in the contracting and building process to provide risk allocation clarity. We also urge builders to seek appropriate tools to address their risk challenges.

If construction insurance buyers are under severe pressure, so are the construction insurance markets. Significant capacity, a declining exposure or premium basis (construction payrolls and revenues being down) and rising competition in most lines have sustained a soft rate environment.
We see this trend continuing throughout 2010 with no significant upward rate pressure on the horizon. With few exceptions, it’s a buyer’s market for all lines of coverage: Workers’ Compensation, General Liability, Excess Liability, Property, Builders Risk, Professional Liability, Environmental, etc. Renewals in the first quarter of 2010 tell the story, with benchmark rates remaining flat to declining in a number of cases and broad coverage terms available.

**EVOLVING CONSTRUCTION RISKS**

Technology and new delivery systems are bringing change to an industry that usually evolves slowly. New requirements in the construction process are pushing construction owners, designers and contractors to reevaluate how they manage risks, as the traditional lines between the parties continue to gray. Here are a few trends to watch:

**LEED DESIGNATIONS FOR GREEN CONSTRUCTION**

The green revolution in construction has moved from a new technology and branding idea to a given on most commercial structures. The risks associated with LEED are now as much about reputation and expectation as they are about the delivery of an energy efficient building. Failing to achieve an expected designation (Silver, Gold, Platinum) can create conflict – and liability questions – over who is responsible for the failure. New contract documents address these issues but at this point the risks are still evolving. Care should be taken to closely look at contract responsibilities and Professional, Environmental and General Liability coverages that would apply to LEED certification.

**DESIGN/BUILD**

While this is now an old concept, owners are using the design/build approach to package most of the risks of a project and have the contractor assume total responsibility for them. This creates a need to look closely at Professional Liability and at how to engage with sub-design firms, which often have minimal balance sheets and low limits of insurance.

**INTEGRATED PROJECT DELIVERY**

In IPD, a next-generation building process, all participants work collaboratively from the contract and design phases through building turnover, including dispute resolution at any point along the way. While representing an appealing ideal, IPD requires discipline by all parties to work in close cooperation and quickly address challenges that arise. For some, the result is immediate efficiency in cost and schedule. In many cases today, however, IPD is not well defined from a liability allocation standpoint and carriers are looking closely at how to underwrite the perceived risks. At present the insurance industry does not have a great answer for these projects and the various parties’ risks, but IPD offers great promise for complex jobs in the future.

**PRIVATIZATION AND PPP**

In 2009, we saw more tentative movement toward public and private partnerships (PPP), and there is some indication that this trend may soon gain enough momentum to finally have an impact in the market. While increasingly common
around the world, PPP has been a political football in the U.S., and many government bodies are hesitant to pick up the ball. The U.S. PPP projects that have gone forward are typically huge and take a long time to come to fruition. The underwriting community is starting to understand how to address the liability risks, including those associated with extensive design work. The complexity of these projects, with numerous interests to be addressed (owners, contractors, investors, operators, concessionaires) makes these an ongoing challenge to the insurance underwriter.

FEDERAL WORK
A notable trend in 2009 and 2010 is the increase in federal work as a percentage of total construction activity. Many of these jobs involve either a hard bid or a combination of qualitative and quantitative selection. Another key aspect of most federally funded work is the use of the federal acquisition regulations (FAR). These require transparency, subcontractor controls for general contractors and diligence to avoid conflicts of interest and inflated costs. The regulations include a number of civil and criminal penalties. Clearly, a complete understanding of FAR is necessary for builders. Key issues from an insurance and risk perspective include cost allocations that accurately reflect true costs of risks and insurance. Much detailed work is needed to comply with FAR rules in that regard. Many federal jobs involve some design/build combination, and a few require equity positions (for example, military base and housing projects). These issues must also be taken into account when designing an appropriate risk financing program.

CREDIT RISKS
Credit risks are among the most difficult exposures to measure and control in the construction process. This applies to owners, general contractors and subcontractors. A response to this challenge – one on the rise in the current economy, where credit risks have spiked – is increased due diligence on the part of contractors and other construction participants in selecting appropriate jobs, hiring subcontractors and setting up controls and contracts. A key tool in this effort is Subcontractor Default insurance, which to date has been only available in the form of Subguard, a Zurich product. Now it appears that a new player may be adding capacity in 2010, and we expect that ARCH will be underwriting risks early in 2010 for a different slice of the general contractor market than that which Subguard supports.

THE EVOLVING CONSTRUCTION RISK MARKETPLACE
The struggling construction economy may be the driving force in construction risk these days, but several other issues have grabbed the attention of underwriters and must be recognized as construction firms build appropriate risk and insurance programs.

CHINESE DRYWALL
Court cases focusing on contaminated drywall imported from China are wending their way through the legal system and the media. Most carriers are responding with significant coverage restrictions on General Liability policies to avoid paying for the remediation work. We are seeing some Environmental carriers beginning to offer some form of coverage, and we will be watching closely to see how key details, such as the definition of drywall-related damage, play out during 2010.

APPLICATION OF LIABILITY LIMITS
When subcontractor, general contractor and owner are all involved with a Liability claim, whose policy pays first? The priority of limits, also called vertical vs. horizontal limits application, often varies by state. Even in cases where additional insured coverage spells out the priority of payment, however, state courts have disagreed often enough to create considerable confusion over the issue. A variety of solutions are available to restore the intent of the parties and have coverage respond as expected, but this remains a moving target, and one that can have a strong impact on losses and coverage.

COLLATERAL/ALTERNATIVE COLLATERAL
The current credit markets have diminished capacity for letters of credit (LOC) and have increased insureds’ carrying costs. Insurers continue to aggressively manage credit risks associated with large deductible insurance programs. As a result, collateral negotiations continue to be challenging, particularly for accounts that the carrier no longer insures – an issue construction firms should keep in mind before they change insurance carriers or alter their insurance program. Underwriters continue to scrutinize the outstanding liabilities and credit worthiness of insureds, taking an
actuarial look at loss projections, development factors, paid loss credits, etc.

We are also seeing an increased focus on finalizing the terms of future collateral adjustments (timing, loss development factors) in the insured’s payment agreements at renewal time. With a significant increase in LOC costs (up to 5%), alternative collateral arrangements (cash, asset-backed accounts, trusts and certificates of deposits) generate more attention. When companies have liquidity and insurers are willing, banks are offering trust products at competitive rates (i.e., annual fees of $5,000 to $7,500 plus 3-5 basis points on invested assets depending on trust requirements). Carriers will consider loss portfolio transfers, or the issuance of a new policy to cover unpaid losses associated with prior deductible arrangements. However, due to risk volatility and the low interest rate environment, premiums may be higher than the collateral requirement. Risk management professionals should be aware of the collateral options available in the market prior to their renewal discussions.

THE MARKET FOR SOLUTIONS
The insurance industry has traditionally been slow to embrace new risks until it can measure claim trends, develop loss expectations and then design products and set pricing. Many of the newer construction techniques have challenged the industry, as traditional products do not clearly address the risks. In many cases, existing coverages can be successfully adapted to the new risks, but we encourage discussion between buyers and carriers early in the process to assure a clear understanding of what can be insured and what cannot. Some products have evolved to address these evolving risks:

- **General Liability-only wrap-up programs**: Until recently, most project policies insuring all participants were large (often well over $100 million) but the market is now supporting GL wrap-ups at lower project levels (as low as $25 million). These programs can often alleviate the coverage disputes between carriers for multiple parties on a single job.
- **OPPI/CPPI**: Contingent products protect the owner (owner protective professional insurance) or the contractor (contractor protective professional insurance) and recognize that in design/build or traditional design/bid/build jobs the parties engaging the design professional have exposures. These products are generally affordable, as they respond after the designers’ policies in the event of a professional loss.

THE BROADER INSURANCE MARKETPLACE
The underlying insurance marketplace remains competitive, as construction specialist carriers seek growth at a time when demand is low. The continuation of the soft rate environment we have seen for the last several years is of course good news for buyers anxious to control their overhead. That being said, insurers are seeking rate increases in the face of declining exposures and premium basis, making renewal negotiations challenging in many cases. The introduction of competition is a useful technique in countering this trend at renewal. While underwriters are focused on maintaining premium volume, claim outcomes are becoming more uncertain. Contentious and difficult claim negotiations and settlements continue to be a major source of frustration for our clients. This reinforces the need to spend a significant amount of time at the front end of transactions aligning
underwriting intent with understanding of the claim coverage negotiated. This should be a top priority for any construction risk buyer. We have seen very difficult claim scenarios emerge when coverage was not in line with expectations.

We believe that the market will ultimately become firmer from a pricing standpoint as the construction industry recovers, which we expect will come, finally, in 2011. We offer some brief commentary that may be helpful in planning marketing efforts for 2010.

**CASUALTY**

- **General Liability**: The rate environment is soft. Coverage is available but needs to be negotiated to achieve broadest terms. Deductible levels are negotiable. The claim environment is not as predictable. We are seeing more contentious claims, which may stem from carrier attempts to maintain profitability.
- **Automobile**: No change from 2009. If much equipment is sidelined due to lack of work, buyers should consider “mothballing” options at renewal.
- **Workers’ Compensation**: Very competitive, with numerous carriers in the market. Use of deductibles continues in an effort to achieve cost savings but collateral concerns are driving buyers to consider alternative approaches. Carriers are looking for increased amounts of collateral as they hedge their counterparty risks.
- **Umbrella/Excess**: Many carriers, and significant capacity on a broad basis. But buyers need to be careful with the details, as carriers offer different forms. Buyers should seek follow-form policies wherever possible, especially as underlying General Liability policies are customized to address areas such as priority of limits and additional insured wordings. Insureds must be sure that their catastrophic coverage is sufficient. Markets are truly global now, with carriers in the U.S., Bermuda and London aggressively looking for opportunities. Total capacity available is more than $500,000,000.
- **Professional Liability**: For project-specific cover, an exception to the soft-market rule. Offerings are narrow and expensive and the underwriting process is often cumbersome, as underwriters struggle to understand the risks they are being asked to take on. Professional cover for contractor programs, on the other hand, is widely available and often several options can be negotiated for renewal. Use of OPPI and CPPI is a good option in many cases for contractors and owners.
- **Environmental**: Among the most competitive lines in construction. Many carriers with broad coverage are competing for business. Surprisingly, some contractors still forgo pollution coverage, despite the prevalence of the exposure and the affordability of the insurance.

**PROPERTY**

In construction, Property insurance takes on two distinct roles. The first is insuring contractor’s property, such as buildings and equipment. The second and more complex is covering Builders Risk.

- **Property and equipment lines are stable and very competitive for 2010. We expect this to continue into next year.**
- **For Builders Risk there is no standard policy form and a number of factors should be considered:**
  - Direct damage to property during the project
  - Exposure to catastrophic perils
  - Soft costs which are difficult to define and develop appropriate limits for
  - Property in transit
  - Builders Risk pricing remains soft in cases not involving severe exposure to catastrophic loss, e.g., windstorm, flood and earthquake.

- **Capacity for Builders Risk is extensive, as many carriers compete for this coverage and offer $100,000,000 in limits for most geographies. Total capacity, in the billions, is truly global, with U.S., Bermuda, London and European markets playing active roles.**
PROJECT INSURANCE

The project marketplace is being driven by a few notable trends:

- The decline in the number of major projects over the last year has increased competition. This is true in most types of construction.
- Pricing and terms for the few ongoing residential projects remain relatively firm.
- With a better understanding of litigation trends, including defective work allegations, liability policies have evolved to include coverage through the appropriate state statute of limitations, which effectively closes a much discussed potential gap in older wrap-up programs.
- The current market will create more opportunity for publicly funded major projects. Such projects are frequently insured without wrap-ups, but current trends indicate that these larger jobs may now be considered for wrap-ups and/or project insurance to address a variety of challenges, including funding, coverage consistency and support of disadvantaged businesses.

The market has expanded with the entrance of new carriers that can readily handle major projects, although they all have their particular appetites.

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SURETY

- The Surety marketplace is calm now but Surety buyers should prepare for the worst—a long-anticipated loss cycle is likely around the bend.

- The run of record profitability from 2005 through the third quarter of 2009 still does not fill the hole created by losses incurred in the preceding four years.

- Underwriter focus on contract terms and conditions remains intense.

Sureties have been bracing for a loss cycle since the collapse of the credit markets in 2008. No one minds that a loss cycle has been delayed, but indications are that the delay may be ending, as the construction industry’s fortunes continue to decline. For now, the markets are calm, but we suggest that Surety buyers should prepare for the worst—and expect something close.

MARKET CONDITIONS

All indicators point to 2009 as a profitable year for Surety underwriters. Although year-end 2009 data is not yet available, it is likely the Surety industry experienced contraction in its top line for only the third time since 1997. Third quarter 2009 information from the Surety & Fidelity Association of America reflected a drop in written premiums, year-on-year, of approximately 8.3%. The good news is that the industry loss ratio at September was approximately 43.2%, a level at which profitability is sustained. This loss ratio number is slightly elevated from 2008’s year-end result. While lower premiums likely contributed to an uptick in the ratio, the figures also indicate increasing loss activity. Incurred loss dollars reported at September 2009 equaled 70% of loss dollars for all of 2008. Underwriters’ expectations for losses in the second half of 2010, and into 2011, are increasingly bearish. Many contractors share this outlook.

“Despite near-zero interest rates and a continuing flood of credit into the U.S. economy from the Federal Reserve, financial conditions tightened in the second half of 2009, according to a new study produced by a collection of Wall Street and academic researchers,” the Wall Street Journal reported on Saturday (2/27/10). “While interest rates remain near historic lows, the availability of credit is still constrained…”

AGC of America Data DIGest - March 1, 2010
The recovery of construction activity in the U.S. still looks to be a ways off. Increasingly intense competition has been compressing margins since the second quarter of 2009. Sureties remain wary that active construction sectors (health care, institutional and government), while offering their clients volume, contain more pricing risk for builders due to increasing bid competition. The fundamentals strongly suggest that the recovery of residential and commercial construction will be slow. Many state governments, facing significant deficits, will be challenged to match federal funds for road and bridge work. Contractors seeking federal work are finding the profit opportunities as limited as they are in traditional markets.

While Surety is largely dependent on the health of construction activity (which generates 65-70% of Surety industry revenue), capital support for Surety writers is drawn from the U.S. Property & Casualty (P&C) industry capital pool. The P&C industry’s return on capital has, historically, underperformed the average returns of the Fortune 500. Several years of low interest rates and the collapsing credit markets have not helped. Sureties competing in this capital pool are subject to high standards regarding capital allocation and the prospective returns they offer. There is nothing in the current environment to suggest such scrutiny in the coming years will do anything but intensify, particularly if catastrophe losses remain low and Surety losses increase.

RELUCTANT CAPITAL MEANS VOLATILE CAPACITY

In comparison to the banking sector, however, the insurance industry has largely preserved capital through the turmoil in the credit markets and broader economy since late 2008.

![Chart](chart.png)

This chart tracks the performance of the U.S. Property & Casualty industry’s return on capital from 1999 to 2008 – a period that included some of the largest insured loss events in the industry’s history. Year-end 2009 information is not yet available, but in seven (yellow) of the preceding 10 years the industry lost money conducting its primary business activity – underwriting insurance risk.

SOURCE: Insurance Information Institute data
There is of course variance among carriers, and the level and performance of capital are the drivers of change (favorable or unfavorable) in insurer financial ratings. Rating changes, which normally occur with little or no warning, are (or should be) of great interest to large Surety buyers and the sureties themselves. Large Surety programs tend to require co-Surety structures (with two or more participants) to provide the required capacity for their businesses. Only four sureties currently play major co-Surety roles and these companies remain vigilant regarding their inter-creditor risk to their co-Surety partners. Inter-creditor risk assessment is driven by a surety’s (or its parent group’s) financial rating. Given these complexities, stand-by Surety relationships are a client’s best means of preventing interruptions in Surety support from unexpected or uncontrollable factors.

Capital providers are well aware of the potential severity associated with the Surety line. As illustrated below, despite the consecutive run of record profitability from 2005 through the third quarter of 2009, the accumulated underwriting result from those years still does not fill the hole created by losses incurred in the preceding four years. Surety loss severity is inherently difficult to project with any actuarial reliability. Add in the high aggregate exposure inherent to the line and it becomes easier to understand the reluctance of capital providers to support Surety business. The Surety line doesn’t offer the minimal certainty of return most capital providers seek or, more importantly, the patience of capital required to reduce capacity volatility for sureties.

YTD gross losses incurred by the Surety industry totaled $366.3 million at September 2009. Given recent history and the outlook for Surety loss activity over the coming 18-24 months, these loss numbers will not help the Surety industry regain the confidence of its capital providers.

SOURCE: Derived from Surety & Fidelity Association of America data

The market share of the four largest writers (as a group) has increased by approximately 50% in the past 10 years and now accounts for more than 60% of total industry written premium. P&C industry mergers or acquisitions are rarely driven by Surety considerations, but each time such an event occurs (and a Surety writer is involved) overall available Surety industry capacity tends to diminish.

Consolidation is an increasing factor in the construction industry itself. The challenges contractors will face in maintaining their balance sheets and a weakening U.S. currency are expected to promote attractive valuations for suitors. In certain instances, business continuity strategies will also contribute to M&A activity in the construction business. Where a prospective deal involves two firms with large Surety programs, however, the Surety industry’s ability to provide the required aggregate capacity to the combined entity will be tested.
UNDERWRITING ENVIRONMENT
Sureties are trying to strike a balance between supporting clients in a very competitive environment and underwriting ahead of the loss curve that they expect will steepen in the coming months. Sureties’ new business objectives for 2010 are, on balance, modest.

Underwriter scrutiny on contract terms and conditions remains intense. Damage provisions, schedule, warranty/facility performance and payment terms are areas of particular focus. In the public sector marketplace, a trend toward “gap” financing, in which contractors finance work for the owner – usually beyond project completion – until full payment is received, may cloud balance sheet analysis (a key driver of determining the level of surety provided to a contractor). The aging and collectability of accounts receivable will affect sureties’ evaluation of a contractor’s analyzed working capital and, perhaps, equity. Experienced underwriters will often challenge a contractor’s business plans and financial projections in ways that can be constructive.

Privatization schemes (PPP/PFI) are likely to grow more popular as governments struggle to raise money, either through taxes or debt markets. Some owners involved in public/private partnerships have expressed a willingness to accept letters of credit in lieu of surety performance guarantees. Some non-U.S. groups have seized these opportunities by offering a comprehensive package that includes development, design, finance and construction solutions.

Close examination of subcontractor prequalification, selection and performance management is a major underwriting priority. Whether secured by insurance or Surety risk transfer mechanisms, contractors can expect sureties to challenge their practices in a marketplace that is reflecting a heightened risk of subcontractor defaults. Many analysts expect subcontractor defaults to accelerate in the second half of the year, as banks curtail or withdraw working capital support based on financial information received in the first half of the year. Such a trend could portend the beginnings of a classic Surety industry loss cycle.

Trend lines in corporate bankruptcy filings and the restriction of available credit to refinance balance sheets may signal an increase in Commercial Surety loss activity over the near term. Many Commercial Surety bonds (such as License & Permit and Judicial Appeal instruments) are more akin to financial guarantees than performance obligations and, unlike most Contract Surety obligations, the opportunity for mitigation and salvage by the surety in the event of loss is minimal.

PRICING
No significant changes in overall industry pricing are anticipated in 2010, unless loss activity rises suddenly. Most sureties experienced a flat 2009 Surety reinsurance renewal season, despite concerns on the part of Surety reinsurers about prospective losses. The industry’s overall reliance on reinsurance is less than it was 10 years ago. Major Surety writers have either forgone coverage altogether or structured their reinsurance agreements with very high attachment points. These high attachment points (i.e., higher retention on individual risks) require sureties to deliver low loss frequency (driven by underwriting discipline) in order to meet the return-on-capital expectations of management.

Users requiring large Surety capacity can expect their Surety rates to remain, on average, higher than those paid by middle-market buyers. This stems not only from the application of reinsurance costs to the pricing model of large Surety facilities, but from the fact that
large buyers tend to be involved in large, complex projects that often include extended contract duration terms or other factors that drive project-specific pricing. Average contract values continue to rise – due to consolidating work into larger single projects – a phenomenon driven by limited project administration resources on the part of owners. Public owners are struggling to balance these pressures with the desire to let smaller firms compete for the work. Federal work increasingly includes provisions for partnerships between smaller firms that may not qualify for bonding, at least on large projects, and firms that can.

Sureties continue to utilize and refine credit model pricing. Contractors are encouraged to understand the credit model of their surety(ies) to ensure there are no surprises in the pricing of any individual Surety bond. Such understanding might also encourage steps that would improve the results of a buyer’s individual credit modeling and favorably impact their Surety pricing.

Personal indemnity remains a common requirement for middle-market contractor programs and for Subchapter S corporations. Collateral is also a common underwriting condition to support certain types of Commercial Surety bonds and, in selected instances, whole Commercial Surety facilities. Some sureties are requiring collateral as a component in some large, so-called “reverse flow” (involving U.S. subsidiaries of non-U.S. parent groups) contractor Surety programs. The sources and quality of the collateral acceptable to sureties are now more restricted and some sureties are capping aggregate collateral levels accepted from any one collateral source.

THE WAY FORWARD
A surety’s value goes well beyond that of a normal credit provider. In a certain sense, sureties are a shadow investor in their clients’ businesses and can be a source of broad perspective on the construction industry. Sureties provide contractors with a highly efficient form of contingent capital that allows contractors and other users to trade on multiples of their balance sheets, facilitating economic activity that otherwise would be delayed or impossible. Companies that remain committed to transparency and clearly presented financial reporting know that the shadow investor’s support is an outcome of good business performance, not a driver of it. A focused investment of time in this crucial business relationship will facilitate support through the challenging times to come and enhance a company’s ability to prosper when economic recovery finally, and truly, takes hold.

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