We invite readers to visit the Publications page of 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.

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

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*Marketplace Realities* is updated periodically throughout the year.
As the world emerges from the depths of this startling recession, organizations are rethinking the way they operate. As new business models emerge, new risk assessment will be needed.

INTRODUCTION

CAREFUL STEPS IN UNPREDICTABLE TIMES

Turmoil breeds opportunity and we in the insurance industry face an unusual if not unprecedented opportunity to communicate the value of what we do and to lead the way forward in these turbulent times. When I say insurance industry, I mean everyone involved in the business of risk: insurers, reinsurers, brokers and risk managers. Risk managers have an open ear at the executive level that they may never have had before.

Imminent economic pressures tend to take over in recessionary times, forcing belts to tighten everywhere, and that often means pressure to reduce the insurance spend. This is understandable, and in some cases unavoidable. But all of us charged with the task of keeping business moving and moving safely, should take this moment to explain that we’re not just buying policies at the best price. We are in the business of analysis and analytics. We offer advice. We offer loss control, alternative risk transfer. We deliver security.

As the world emerges from the depths of this startling recession, organizations are rethinking the way they operate. As new business models emerge, new risk assessment will be needed. We must be ready to answer that need.

This is a moment for partnership at many levels. As risk managers, you need to tell us what keeps you up at night. You need to work with your CFO and your operations leadership to find out where the hidden risks may lie: in investments, supply chains, political risks, cyber risks, changing laws and regulations, etc.

If we take this opportunity, if we push each other to do better, to grow, to rise to the moment, I believe we will not only have success, but sustainable success across the board. Instead of the adversarial model of client vs. market, and market vs. broker, we can move toward a culture of partnership. The risk manager wins, the intermediary wins and the markets win.

I know this is high level stuff. I know that so much of what you do as a risk professional is details: rates, dollars, wordings. The series you hold in your hand (or, more likely, view on your screen), Marketplace Realities & Risk Management Solutions, is all about the nuts and bolts of insurance. These nuts and bolts are quite unusual right now. A year ago, our crystal ball showed all the signs of a hard market. It didn’t happen. In fact, the
The marketplace today seems at times almost in a frenzy to write business, as underwriters fight to demonstrate growth. While undoubtedly appreciating the windfall of softening rates, risk managers must also consider the issues of market security and counterparty risk as never before. What if the investment markets fall suddenly again? What if losses spike? Catastrophes rarely strike with fair warning. Insurers could find themselves in a very tight spot.

The markets are moving fast and furiously. We urge our clients to move deliberately, thoughtfully, to take an extra moment and consider the broadest perspective in their view of risk. And as always, Willis will be helping our clients take careful, smart steps forward.

Below, we cover all major lines and most of our specialty practices. You may find some surprises—despite softening rates in many lines, some are hardening (Aviation, Trade Credit). Our Marine piece examines the increasingly relevant topic of supply chain risk and the Trade Disruption marketplace that is evolving to address it. In Property, we discuss the fact that catastrophe loss estimates are actually declining. But let’s not let these insights and revelations take all of our attention. Let’s keep in mind the golden opportunity that the turmoil of the past year-plus represents.

I believe the world is ready to see us with new eyes, because insurance has never been more important. Every nation needs insurance. Every business needs insurance. Every person needs insurance. That has never been clearer. Let’s make the most of this moment.

Joe Plumeri
Chairman and CEO of Willis
Where is the general insurance market at what may or may not be the start of recovery? We fared better than many other industries over the past year, but that does not mean we have a smooth path ahead.

As predicted in our previous issues of *Marketplace Realities*, the general insurance sector was not hit as hard by the financial crisis as many other financial sectors. While asset values plummeted in the second half of 2008, and realized and unrealized losses contributed to a decline in the statutory capital of U.S. Property & Casualty (P&C) insurers of approximately 15% during 2008, capital levels have recovered. At June 30, 2009, capital levels were just below those of the year before for the majority of general insurance groups, largely due to the recovery of investment values.¹

Furthermore, in the second half of Q2, general insurers successfully raised additional capital by several means:

- Issuing debt (although largely to pre-fund future debt maturities)
- Insurance-linked securities (ILS) transactions (nine ILS transactions were recorded in the five months before June 2009 compared with only two in the second half of 2008)
- Attracting hedge fund investors once again

Of course, the financial crisis also impacted the buyers of insurance. As their output and activity declined, so did their demand for insurance. In 2008, world insurance premiums fell for the first time since 1980, with the biggest drag on growth coming from North America, where premiums fell by 2.8%.

As every insurance professional is aware, most industry commentators anticipated that, as a consequence of the financial crisis and limited availability of capital, general insurance rates would begin to rise, reversing the softening market trend of the previous two years. With the exception of certain pockets of business that have seen recent losses – Aviation, Credit & Surety, Financial Institutions’ Directors & Officers and peak exposure Property catastrophe reinsurance – rate increases have not materialized. Nor do we expect them in the short term now that capacity is returning.
The long period of soft rates has in large part been fueled by the reserves built up in 2006 and 2007, when losses were low and insurer results good. The 2008 year was not good: losses soared and investment income sank. As a result, in recent quarters, general insurers have largely seen a decline in underwriting results, with accident year combined ratios deteriorating. However, these have partially been offset by continued release of reserves for prior years. Moody’s reports that the P&C insurance industry released nearly $14.3 billion of prior-year reserves in 2008, the fourth straight year of favorable reserve releases. While most insurers agree that there was some cushion in those reserves, general consensus suggests that these are now largely depleted and the trend is not sustainable. This is particularly important for Casualty business, where the tail of reserves is longer and therefore more difficult to accurately determine. Moody’s comments that, “casualty reserves/rates may have some way to go before they can be considered comfortably adequate,” and according to S&P, reserve adequacy appears to be well past its peak. This source of income is unlikely to remain available going forward, which could contribute to deteriorating underwriting results, all else being equal.

Another factor that could hurt is the way general insurers are treating their investments. In keeping with their historically conservative investment strategies, some have increased holdings in short-term investments and cash to reduce volatility. This is likely to lower investment returns in the near term. The combination of these factors could reduce capacity and herald a change in the underwriting cycle. However, most observers suggest this is unlikely to occur before late 2010 or 2011 in the absence of a major catastrophe.

A further source of major concern is uncertainty regarding the economy. While world leaders suggest the recession is technically over, they acknowledge that hard times are not, as the anticipated growth rate is slow and economic indicators such as unemployment continue to trend negatively in many countries. Economists are concerned that too rapid a withdrawal of government support and stimulus packages could push the world back into recession.

General insurers could also feel more pain in their investment portfolios; the general insurance sector continues to have meaningful exposure to housing and commercial real estate assets, whose value may drop again if the economy slips. Some economists worry that government stimulus packages are inflating asset prices while allowing unsustainable trade imbalances between the U.S., Europe and Asia to continue. The withdrawal of government support or weakening confidence in the economic recovery could lead to an asset price crash.

Yet another threat lurks: inflation. Insurers need to consider the potential impact of inflation on claim costs. For long-tail business where loss reserves tend to represent the largest liability in the balance sheet, inflationary pressures could have a significant impact on the adequacy of reserves. Indeed, a number of general insurers have recognized this danger and have increased inflationary assumptions in their reserving methodologies or have looked to hedge against inflation through the purchase of inflation-linked securities or rebalancing their portfolios toward short-tail lines. Running ahead of inflation, however, is especially difficult for P&C insurers because they generally operate with a mismatch of
longer duration assets relative to claims: when interest rates rise, the market value of their investments tend to decline at a rate that is greater than the change in the present value of liabilities. The result is a decline in insurer surplus.

What about insurers’ ability to raise capital going forward? Despite some recovery of general insurers’ capital positions, debt and equity market activity remains below levels seen prior to the financial crisis. With credit spreads on debt issued by general insurers staying well above historical averages and share prices below book value, raising capital continues to be relatively expensive. Investors are cautious about the insurance sector. Questions remain regarding the availability of new capital to the sector in the event of a major loss.

Another consequence of the current economic situation is the potential for an increase in merger and acquisition (M&A) activity. With capital positions of general insurers for the moment largely recovered and with shares in many general insurers continuing to trade below book value, M&A options may be attractive, especially as size and scale become increasingly important factors for rating agencies, investors and clients.

Current conditions may also encourage the return of share buyback activity. Before the recession, many general insurers in strong capital positions put buyback programs in place. As capital eroded during the financial crisis, these programs were largely suspended. Some share buyback activity took place in the first half of 2009, but many general insurance groups report that they may reintroduce buyback programs after the hurricane season. A continuation of the light 2009 hurricane season will be welcomed on many accounts.

The general insurance sector has escaped the global financial crisis relatively intact, with investments bouncing back and many companies still benefitting from prior year positioning. However, remaining obstacles will need to be carefully managed in these uncertain times.

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There is ample capacity in the market. Decreased demand has forced underwriters to be more competitive than they might like in order to keep business.

When we last reported on market conditions in April 2009, we – like many others – warned of a hardening market. The combination of poor loss experience ($52.5 billion in losses in 2008), rising reinsurance costs (10-15%, and 20-30% for cedants with poor loss experience) and a poor investment climate cautioned us to brace for tightening market conditions by mid-2009.

The hard market lasted a month – if that. In 2009, there has been very little in the way of loss experience (either risk or CAT losses). Combined with decreased demand due to the recession, the result is surplus capacity vying to maintain existing accounts and competing for new business.

### Observations/Predictions for 2009

<table>
<thead>
<tr>
<th>Type of Account</th>
<th>1st QTR 2009</th>
<th>2nd QTR 2009</th>
<th>3rd QTR 2009</th>
<th>4th QTR 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-CAT</td>
<td>Flat</td>
<td>+5 to +10%</td>
<td>Flat</td>
<td>Flat</td>
</tr>
<tr>
<td>CAT (or Poor Loss Experience)</td>
<td>+5 to +10%</td>
<td>+20 to +25%</td>
<td>+5 to +10%</td>
<td>+5 to +10%</td>
</tr>
</tbody>
</table>

(Note: CAT = earthquake, flood or hurricane)

The typical industry barometers concur: “Commercial property pricing is stable. Renewal rates on most accounts are currently ranging between a 5% decrease and a 5% increase compared to this same time last year, with ‘flat’ as the most common result. The major exception is accounts with significant values exposed to loss from coastal windstorms, particularly along the Gulf Coast.”

### All Factors Considered

Several factors converged to reverse the hardening trend:

- Loss experience in 2009 has been benign.
- The recession has put added pressure on insurance purchasing budgets, forcing some clients to purchase less in 2009.
The recession has caused reduced revenues/earnings for many clients which, in turn, have reduced business interruption values (part of the rating base for premium calculation).

The treaty reinsurance market has stabilized.

There is ample capacity in the market. Decreased demand has forced underwriters to be more competitive than they might like in order to keep business.

Some insurers are behind on their internal budgets and are being more competitive to make up lost ground.

On August 31, Fitch reported that the first half 2009 GAAP results reported by the top 51 Property and Casualty insurers showed a 10% aggregate increase in GAAP equity.

The turmoil surrounding AIG (now Chartis) has stabilized and most insureds are confident that the worst is behind us. Lexington, part of Chartis, is the largest CAT insurer in the market. Its demise would have been a different type of CAT event for the market.

The RMS 9.0 updated CAT model has brought loss estimates down.

The investment market is starting to produce better results for some in the insurance marketplace.

**RMS RELEASES VERSION 9.0**

Most insurers utilize RMS as their main modeling tool, and the updated model (9.0), released in July 2009, lowered hurricane loss estimates by 10% on average. The effect on California earthquake was even more dramatic, with loss estimates decreasing between 15% and 30%! This change provides underwriters with a justification to reduce pricing for CAT exposure.

### CHANGES IN HURRICANE LOSS ESTIMATES

<table>
<thead>
<tr>
<th>REGION</th>
<th>STATES</th>
<th>AVERAGE ANNUAL LOSS</th>
<th>100-YEAR</th>
<th>250-YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>FLORIDA</td>
<td>Florida</td>
<td>-10%</td>
<td>-5% to -10%</td>
<td>-5% to -10%</td>
</tr>
<tr>
<td>TEXAS</td>
<td>Texas</td>
<td>-10%</td>
<td>-5% to -10%</td>
<td>-5% to -10%</td>
</tr>
<tr>
<td>GULF REGION</td>
<td>Alabama, Mississippi, Texas, Louisiana</td>
<td>-10%</td>
<td>-5% to -10%</td>
<td>-5% to -10%</td>
</tr>
<tr>
<td>SOUTHEAST REGION</td>
<td>North Carolina, South Carolina, Georgia</td>
<td>-10%</td>
<td>-10%</td>
<td>-10%</td>
</tr>
</tbody>
</table>
As 2009 started, the reinsurance market was tightening. Insurers without loss experience were seeing 15% increases on their CAT reinsurance treaties. Those with loss experience were seeing increases in the range of 20-30%. By mid-year, the reinsurance market had stabilized. According to our own Peter Hearn, CEO of Willis Re, “Initial signs of recovery in the financial markets and a lack of major underwriting losses in the first two quarters of 2009 have worked in tandem to bring greater stability to the reinsurance market. In addition, when planning their 2009 underwriting, many reinsurers had anticipated negative pressures from exchange rate volatility and an even more difficult retrocession market. They took aggressive early steps to control their aggregates more tightly. These actions, allied with the lower open market purchasing by residual markets in Florida and Texas Wind Pool, eased the capacity squeeze in some of the most demanding U.S. peak property catastrophe zones.”

### Changes in Earthquake Loss Estimates

<table>
<thead>
<tr>
<th>Region</th>
<th>Average Annual Loss</th>
<th>100-Year</th>
<th>250-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>-15% to -30%</td>
<td>-10% to -25%</td>
<td>-10% to -25%</td>
</tr>
<tr>
<td>Pacific Northwest</td>
<td>-10% to +10%</td>
<td>-15% to +10%</td>
<td>+5% to +25%</td>
</tr>
<tr>
<td>New Madrid</td>
<td>-10% to +5%</td>
<td>-10% to -25%</td>
<td>-5% to -15%</td>
</tr>
<tr>
<td>Fire Following Earthquake (California only)</td>
<td>-40% to -50%</td>
<td>-40% to -50%</td>
<td>-35% to -45%</td>
</tr>
</tbody>
</table>

### Treaty Reinsurance Market

As 2009 started, the reinsurance market was tightening. Insurers without loss experience were seeing 15% increases on their CAT reinsurance treaties. Those with loss experience were seeing increases in the range of 20-30%. By mid-year, the reinsurance market had stabilized. According to our own Peter Hearn, CEO of Willis Re, “Initial signs of recovery in the financial markets and a lack of major underwriting losses in the first two quarters of 2009 have worked in tandem to bring greater stability to the reinsurance market. In addition, when planning their 2009 underwriting, many reinsurers had anticipated negative pressures from exchange rate volatility and an even more difficult retrocession market. They took aggressive early steps to control their aggregates more tightly. These actions, allied with the lower open market purchasing by residual markets in Florida and Texas Wind Pool, eased the capacity squeeze in some of the most demanding U.S. peak property catastrophe zones.”

### Reinsurance Rates

<table>
<thead>
<tr>
<th>Type of Treaty</th>
<th>April 2009</th>
<th>July 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAT Without Loss Experience</td>
<td>+10% to +15%</td>
<td>0 to +15%</td>
</tr>
<tr>
<td>CAT With Loss Experience</td>
<td>+20% to +30%</td>
<td>+5% to +20%</td>
</tr>
</tbody>
</table>
RETURN OF THE INVESTMENT MARKET

An important factor for the insurance market is the ability of carriers to make a return on their investment portfolios. This ability was near nil in 2008, which is a large reason why we expected the market to harden in 2009. Now, in 2009, we are seeing some signs of recovery as evidenced by Munich Re’s latest management report: “For the period January to June 2009, the Munich Re Group’s investment result showed a year-on-year improvement of 8.9%, due chiefly to lower write-downs on our equity portfolio. Furthermore, there was also a rise in the result of investments for the benefit of life insurance policyholders who bear the investment risk. In the second quarter of 2009 alone, we improved our result against the previous year by 38%.”

IT ALL CAN CHANGE IN A HEARTBEAT

As clear as it may be why the marketplace made the turn it did in 2009, it is also clear that a major natural catastrophe could change all of this very quickly. So far, the 2009 hurricane season has been a non-event, with most storms dying out over cool waters and missing landfall. There is still some time left in the season, so we will have to wait and see if the trend continues. We have also been very fortunate that we have not felt any major shakes in California. The Property market seems to be tempting fate because the last major seismic event was the Northridge earthquake in 1994, and 15 years is a long time between major earthquakes. We did experience a large earthquake in Japan in the summer, but it had no meaningful impact on the market. Absent any major events, we expect market conditions to remain flat for the foreseeable future.

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2 1st View: Capital Secured, Willis Re, July 1, 2009.  
Despite all indicators pointing toward tighter market conditions, the overall Casualty marketplace remains quite competitive, much as it has been in recent years.

However, this generalization comes with one crucial caveat: many factors must be considered before setting expectations in terms of pricing, terms, conditions or capacity for any given risks or markets in both primary and umbrella/excess. These factors override both the hardest and softest market conditions. These determining variables include industry or class of business, loss experience, coverage requirements or other unique needs, product or service exposure, financial condition, desired attachment point and overall desired limits. While always the case, our caveat is especially true in the current market, as new carriers are being formed, others are changing appetite and product offerings, while yet others have new leadership following the moves of senior executives from one insurer to another.

**PRIMARY CASUALTY**

Many of the largest primary Casualty carriers began 2009 anticipating a surge in new business from what was being called the “AIG effect.” In preparation for this demand, several carriers started the year with hefty pricing increases, but these were not supported in the market. The increases, in fact, created opportunities for other carriers to step in and take the business. Overall, AIG competitors were disappointed, as many AIG primary Casualty clients, if not most, rode out the storm and stayed put.

Similarly, some insurers anticipated that a flight to quality would support higher prices; this too never developed. Although it may seem counterintuitive, high premium pricing actually requires more capital or surplus. In anticipation of the expected market shift, some carriers reportedly released redundant reserves to increase the availability of their surplus (as opposed to simply bolstering their bottom line). In the end, this allowed them to continue to write business competitively when the main marketplace driver turned out to be a fierce battle for market share.

Insurance buyers move primary Casualty programs to new carriers less frequently than they do for other lines of cover due to service issues surrounding claims and loss control and due to the collateral requirements on loss-sensitive business. Collateral continues to lock many insureds into their market relationships. The current credit crunch and its impact on letter of credit capacity has inspired more risk managers to consider moving their program than at any time in the recent past. Many programs have gone to market to ensure that the buyers are getting the best deals with the best carriers. However, very few programs have actually moved in the end.

**Buyers’ expectations should be based on available capacity for their specific risks and not the marketplace buzz words, which may or may not apply.**
Over the past nine months, intense competition has sustained the soft market. Coupled with a much lower exposure base (i.e., declining payroll, power units and sales), Casualty carriers are feeling the pressure on the top line.

Many carriers note that they have cumulatively reduced rates by 40% over the past five years and their combined ratios on these lines of business are creeping up as losses emerge over a smaller premium basis. The Casualty reinsurance markets have tried to hold rates flat for both facultative and corporate treaties. These reinsurers have not been successful in generating true rate increases. As reinsurance is a leading indicator of what we will see at your next renewal, it is safe to say that heavy price increases are not anticipated in the near future.

**UMBRELLA/EXCESS**

While overall market capacity is approaching all-time highs – in excess of $1.5 billion – it is simply not all available for every account. The question is: how much capacity is available on any given account? Some buyers have minimum financial strength requirements for insurers, which will limit the field rather quickly. Other insureds are in classes of business that not all insurers will consider – that too will rather quickly limit the field. Other limiting factors can include:

- Mandatory required coverages or policy forms
- Insured’s limits on concentration of counterparty risk with any single insurer
- Insurer minimum requirements for rate per million of limit
- Insurer limitations on attachment points or quota share participation
- Availability of reinsurance

Traditional capacity that has long dominated the umbrella/excess landscape remains intact and true to its long-term underwriting objectives. These markets include Chartis (all divisions – Lex, CATXS, American Home), Ace, Zurich, XL and many others. These insurers have various access points (Bermuda, London, North America, etc.), which generally influence their policy forms, attachment points and (sometimes) preferred classes of business. Other traditional capacity such as Chubb, Fireman’s Fund, Liberty Mutual and Great American are also extremely consistent in their approach and generally do not change policy forms or appetite by access point.
As the market remains soft, many veteran players are cutting back their participation on risks where they determine the pricing has become too thin. The continued evolution of markets such as AWAC, Endurance and Arch has proven extremely valuable to clients looking to diversify their programs and introduce new capacity to reduce single insurer counterparty risk and increase competition among the traditional dominant players. While some of these insurers may not be able to offer the same limit as the main lead players, that should not be a discouraging factor. Layering additional insurers can often achieve the desired pricing result while assisting in diversification and other goals. Other veteran players such as Swiss Re and Allianz are either reinventing themselves or reentering the market in an effort to position themselves for the long-awaited market cycle change.

New entrants – Canopius, Torus, Argo Re, Starr Indemnity Liability, Ironshore and others – have staffed themselves with industry veteran leadership and underwriters with long-term plans that will undoubtedly increase their capacity, appetite and participation on many accounts as they mature. These markets have big plans and, like many insurers born in 2001-02, they too will likely evolve into major participants in this space.

Buyers’ expectations should be based on available capacity for their specific risks and not the marketplace buzz words, which may or may not apply. Set the bar high, but remain realistic and be prepared to differentiate your risk in a very busy marketplace. Establish your objectives in priority order, as in some instances these objectives may be mutually exclusive or less achievable when coupled. Include as much detail as possible in submissions to underscore differentiating characteristics. Pursue face-to-face meetings with potential insurer partners. Get ready to use the Polycom or similar technology, as many companies have cut back on travel to London, Bermuda and other venues where many insurers are based.

**BE AGGRESSIVE – AND REALISTIC**

Set aggressive targets, consider alternative program structures, reduce your counterparty risk through diversification, insist on contract certainty, meet your insurers and remember that carrier appetite and leadership may have changed. Explore insurers beyond your incumbents, but remain realistic about your account profile and how it fits into the overall marketplace.
Exposures decline with shrinking payrolls, but carriers are raising rates to cover their administrative expenses and maintain profits. The combination of higher rates and lower exposures often leaves buyers paying the same amount as they were before — what is sometimes called an invisible hard market.

The Workers’ Compensation marketplace in late 2009 is a conundrum – if not a series of conundrums, starting with the apparent fact that rates are hardening in an overall soft market:

- Exposures decline with shrinking payrolls, but carriers are raising rates to cover their administrative expenses and maintain profits. The combination of higher rates and lower exposures often leaves buyers paying the same amount as they were before – what is sometimes called an invisible hard market.
- All signs point to an economy on the verge of recovery in at least some sectors, but most economic predictions call for continued high unemployment.
- U.S. Workers’ Compensation writers in 2008 saw the first double-digit drop in direct written premium in decades – even as the carriers were suffering reverses in their investment portfolios.
- The California Workers’ Compensation board will file for a 22% increase in pure premium rates, and carriers have seen their rate increases approved – but in the current competitive environment the higher rates may not even be used.
- Claim frequency is down, as expected; less anticipated are an increase in severity and an unprecedented rise in the number of claims being classified as permanent total loss.

Given these cross currents, what should we expect when payroll levels return? Perhaps we should back up and attempt to answer a more immediate question: What should you expect for your next renewal? The pricing of Workers’ Compensation premium has a few key components: rates, payroll exposures, loss experience and collateral for loss-sensitive programs. These are influenced by many factors. We review a few key trends below.

**UNEMPLOYMENT AND CLAIM TRENDS**

Employment has been declining consistently since December 2007, the start of the current recession. Declining economic activity translates into reduced Workers’ Compensation exposures, seen most clearly in industries sensitive to the economy, such as automotive, financial services, real estate, construction and some manufacturing sectors. We expect claim frequency to continue to fall as companies right-size and reengineer their current workforces. One major factor contributing to the decline in exposure is that many employers focus layoffs on less skilled and less experienced workers, who tend to do more physical work and have more injuries.
Workers’ Compensation lost-time claim frequency declined 4% in 2008. Workers’ Compensation indemnity severity, meanwhile, continues to outpace wage inflation. The most surprising claim trend is the rise in claims by injured workers being classified as permanent total losses. This trend is not affecting older workers but workers under the age of 50. We and others in the industry are studying this issue to understand the drivers of the trend. Due to its appearance in the current economic cycle, many wonder if it is in fact a result of the compression of the job market and may not be permanent.

OUT ON THE LEFT COAST

California is struggling with one of the highest unemployment rates in the country at 11.9%. The California state insurance fund saw a 27.7% decline in written premium through the end of July 2009. Those trends, in connection with new loss data and the potential impact of recent legal decisions, has prompted California’s Workers’ Compensation Insurance Rating Bureau (WCIRB) to prepare to file for an increase of more than 22% in pure premium rates. Over the past year we have seen some deterioration in some clients’ California Workers’ Compensation reserves as some of the savings from the 2005 Workers’ Compensation reform ebb away. Loss ratios have deteriorated. Carriers in the market have sought Workers’ Compensation rate increases and received state approval. However, in one of the most striking ironies of the current marketplace, conditions are still soft, and the higher rates are not being used in many cases.

California is consistently out of step with other states, but the California marketplace has a large impact on the national carriers. Further, some of the Workers’ Compensation complexities there are reflected in other states, albeit on a different scale and in different political environments.

COLLATERAL

Collateral for loss-sensitive Workers’ Compensation programs continues to be one of the most volatile program costs. While marketing a program may help you lower your premium costs, seldom does marketing a program lower your collateral cost. Although this is not news, it is still timely and relevant. Sound negotiations for determining the right amount of collateral include three key steps:

- Having an accurate view of losses
- Direct involvement of the carrier’s senior credit management
- Communication

Setting of a letter of credit for collateral starts with gathering a consensus about the reserves for the outstanding losses. This can be accomplished through a claim audit during which it may be possible to close some open claims, examine reserves practices and review certain claim files to right-size the reserves. After that, we recommend agreeing on the actuarial methodologies to be used and development factors to be applied to the raw data in arriving at the ultimate expected losses. The point to keep in mind is that all losses are not the same. The loss rates and development in certain states, such as California, are often different from those in other states and, unless they are identified and addressed, this can negatively impact reserve requirements. Thorough analysis of payment patterns is also key to negotiating paid loss credits. Credits should be applied not just for current paid losses but also for expected future paid losses in the current fiscal year. Furthermore, when we work with clients we may require that a net present value calculation be applied for consideration of the future value of the anticipated payout.

Working with a partner that has strong working relationships with the credit management people of the largest domestic Casualty insurance companies can be very useful. We encourage our clients to engage with these individuals in open and direct financial discussions. Bring together your financial team and your carrier’s credit management team. These discussions generally improve outcomes by establishing a broader corporate relationship that helps deliver the best possible credit rating by the insurer.

NEW VERSION OF AN OLD IDEA: BUNDLED PROGRAMS

In the past 12 months we have seen a reemergence of bundled Workers’ Compensation claim programs. These are not the bundled programs of years past. Carriers have revived the concept of bundled claim services to help them aggressively compete with the claim and risk management services of third-party administrators. The competition is not just based on claim management pricing and medical cost containment charges but also on the delivery of improved claim outcomes. In many cases, these services
can be selected à la carte. One strategic advantage the carriers have is that when they believe their claim management services will result in favorable claim outcomes, then their loss picks and collateral requirements are lower. Another factor in favor of bundled services is Section 111 of the Medicare, Medicaid and SCHIP Extension Act of 2007, which defines specific requirements for Workers’ Compensation carriers and self-insurers designed to ensure compliance with the Medicare Secondary Payer statute (MSP). Failure to comply with Section 111 carries stiff monetary penalties. Failure to report carries a $1,000 per day, per claim penalty. Generally, the insurance carrier is the responsible reporting party under bundled insurance programs. The insured becomes the responsible reporting party under most unbundled programs. These reporting and financial advantages make bundled programs appealing again.

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1 “Workers’ Comp Writers see First Double-Digit Drop in Decades,” A.M. Best, September 14, 2009.


3 A.M. Best, op. cit.
A year ago, as the world was facing a deepening economic calamity, economic winds of change were blowing at gale force, if not hurricane intensity. Since then, massive governmental intervention has added some stability to the financial markets, but much concern and uncertainty remains regarding the duration of the economic crisis and how the world’s economy and the various regulatory bodies will respond.

On the heels of the collapse and near collapse of a number of previously esteemed financial institutions, there was much talk of greater federal oversight of financial sector companies, including (re)insurers. However, more recently, the topic of health care reform has consumed Washington, providing the P&C sector at least a brief respite from potentially invasive regulation. For reinsurers, this relief comes alongside continued favorable underwriting results, notably aided by the lack of any severe weather-related losses thus far in 2009.

However, this relative good news for reinsurers is dampened by the lackluster performance of the industry’s investment portfolios. Poor investment returns continue to hurt reinsurers at a time when reserve redundancies are substantially depleted and questions remain over the viability of reinsurers raising additional capital post-event. Additionally, particularly at the outset of the year, many reinsurers had significant concerns regarding the availability and affordability of retrocessional capacity. These factors have placed a premium on capital preservation and have engendered a renewed focus on conservative and disciplined underwriting in the reinsurer ranks.

From this posture, many reinsurers took aggressive steps at the outset of the year to control their aggregates more tightly, which meant limiting capacity available to insurers. With this came the specter of substantial rate increases for cedants.

While some capital-intensive, unprofitable or hazardous reinsurance programs experienced significant rate increases at the June 1 and July 1 renewals, in the main, the pace of increase has not been commensurate with the hopes of reinsurers and fears of cedants as the year began. Most buyers have been able to complete their programs at higher but still acceptable rates due to a greater availability of capacity than originally anticipated, particularly after it became apparent in the days leading up to mid-year renewals that several key residual markets would scale back their reinsurance purchasing. In short, declining supply was more or less matched by declining demand.

Reinsurers’ attempts to secure pricing increases have been dampened by the insurance pricing environment. While some cedants had hoped that increasing reinsurance pricing would drive increases in the primary marketplace, the marketplace has not obliged. Competition is still heated,
particularly in the Casualty sector, where a number of start-up enterprises have joined the fray. Insurers are reckoning with these new competitors and with weak financial markets, both directly in their investment portfolios and indirectly via declining exposure bases among their insureds. While the decline in insurance pricing may be slowing, the reality is that insurers are in difficult fiscal positions and are reluctant to purchase any more cover than absolutely necessary at this point.

Given the uncertainty in the capital markets and the prospect of change in the regulatory environment, forecasting 2010 reinsurance rates is, at best, a guessing game – especially in the middle of hurricane season! A single significant catastrophe would likely jolt both capacity and pricing. Barring such an event, our expectation is that reinsurers will continue to push for marginally higher pricing and more favorable contractual terms. However, we suspect their efforts will meet with limited success, and most insurers will find sufficient capacity to complete their programs without too much discomfort.

**CASUALTY**

- Reinsurers remain disciplined in a very challenging market.
- More start-ups have emerged, and those that are obtaining reinsurance support are getting it at very restrictive terms and conditions.
- Original pricing is still very competitive with no signs of relief in the immediate future.
- Diversification and syndication are the prevailing trends in the large-account Casualty market segment.
- The Casualty reinsurance market is looking for partners to ride out the soft market and will be more competitive for those clients with a proven track record of profitability and/or more focused and realistic business plans.

**LOOKING AHEAD**

- The Casualty (re)insurance market is expected to remain as is for now. Reinsurers are holding the line at pricing, continuing to view start-ups and new ventures skeptically, and trying to find the best partners to help them ride out a tough market. There is a wide divergence between insurance and reinsurance pricing and, while that could continue to widen over the next 6-12 months, there is also some talk of flattening.
- Most insurers are trying to follow the reinsurers and hold the line on pricing and terms, but the economic pressures on typical Casualty insurance buyers (contractors, manufacturers, etc.) means a greater percentage of renewals will be shopped. Insurer hopes of raising rates will likely continue to be offset by reduction in exposure, but less than robust interest rates mean there will be little room for error. We would not be surprised to see increased (albeit spotty) loss totals emerging in 2010-11 out of the more recent (2004-08) accident years. This would finish off the reserve release balm of the last few years and ultimately force insurance (and reinsurance) companies to change direction. Failing some catastrophic Casualty event, we expect the ensuing market hardening would more likely occur by type and/or classes of business and not across the entire line.
CAPITAL MARKETS

- The Catastrophe Bond market has resumed business after a lull to reassess ways to deal with structural weaknesses exposed by the collapse of Lehman Brothers.
- Roughly $1.4 billion of issuance in 2009 so far is expected to reach $3 billion for the year.
- Issuance is dominated by U.S. perils and primary companies.
- Pricing, or spread, on bonds has increased substantially, with very little issuance at spreads of less than 10%. This has deterred issuance among some sponsors who have preferred either less expensive reinsurance alternatives or have trimmed exposures appropriately.
- Sidecars have been scarce, despite significant demand among sponsors – when they have not balked at a risk profile, investors have generally demanded very high expected returns. This is hard to achieve in a world without easy leverage, but Ren Re managed to place a small U.S. wind facility late in the summer. For most of 2009, investors were not attracted by illiquid private deals, wary of the downside risk, and went with alternative investment opportunities that looked relatively more attractive. There are signs that investors are loosening up a bit, but significant progress is unlikely until late this year or early next year.
- The subordinated debt market is dead for now and public equity markets largely closed to (re)insurers.

LOOKING AHEAD - CAT BONDS

- We expect increased issuance in 2010.
- 2009 issues to date have been expensive compared to reinsurance and spreads need to tighten to get more sponsors interested, but we believe that this is starting to happen as investor demand increases.
- The market is currently dominated by U.S. Wind, leaving unmet demand for non-U.S. Wind risk.
- Structural issues highlighted by the Lehman bankruptcy have been dealt with; bonds now have more restrictive (safer) collateral arrangements and more transparency.

LOOKING AHEAD - SIDECARS

- Despite strong sponsor interest, finding investors was hard for 2009 vehicles, but success might be easier in 2010.
- Lack of debt leverage in the current market means sidecars will have to be focused on high return business to generate necessary equity returns.

HEALTH CARE

- The positive effects of prior year reserve releases are fading.
- Continued good loss performance offsets some of the pricing pressure.
- Fear of plaintiff-friendly developments in tort reform are rising.
- Awareness of systemic risk is steadily increasing in the marketplace.
- Tremendous uncertainty over national health care reform is a major issue.

LOOKING AHEAD

- Rates will remain stable in response to expected loss performance, in part because Medical Professional Liability continues to outperform the overall P&C industry.
- The main dislocation comes from changes in the health care delivery system – particularly the increasing trend for physician groups to be purchased by larger hospitals.

MARINE

- A sense of disconnect exists between buyers and sellers over the pricing of Gulf of Mexico energy-exposed business.
- Co-insurance and/or higher retentions are increasingly used as a strategy to deal with the Gulf of Mexico pricing confusion.
- Inconsistency across the market means considerable variation between reinsurers over rating levels.
- Capacity is in adequate supply for non-Gulf of Mexico business, but reinsurers are actively moving away from attritional losses.
- In general, the depressed shipping sector and lower cargo volumes have yet to affect the reinsurance market.
LOOKING AHEAD

- After rising through most of 2009, rate increases are now starting to slow down, but much of what happens in 2010 will depend on the outcome of this wind season, in progress as we write. While no major losses have come so far, storms can form through early November.
- Absent any major hurricane loss or any major claims affecting the Marine and Energy markets, rating levels are likely to be flat in 2010.
- In the meantime, with the possible exception of the Energy sector, a gap between insurance and reinsurance pricing remains, although we expect the lower cargo volumes and contraction of the shipping industry to start impacting the reinsurance market.

PROFESSIONAL LIABILITY

- Directors & Officers (D&O) reinsurance capacity remains limited, awaiting an improved economic environment and positive rate change.
- Terms and conditions have tightened, depending on the degree of exposure to subprime issues and bankruptcies.
- Loss caps are prevalent on public company D&O treaties.
- Errors & Omissions (E&O) capacity is robust for all but the largest risks.
- Terms and conditions are generally flat.

LOOKING AHEAD

- Many believe that the full impact of the recent economic crisis is still to be felt and numerous dormant claims await.
- These claims – and the extent to which they are successful – will likely set the tone for pricing, terms and capacity for insureds exposed to generic economic pressures.
- For those insureds far removed from large public company/financially exposed transactions, the market is expected to be increasingly competitive, with abundant capital to underwrite risks.

U.S. PROPERTY – FLORIDA

- At mid-year, we saw a flight to quality, as top-tier carriers received most favorable terms and capacity commitments from reinsurers.
- Initial market hype about demand far outpacing supply was eased due to budgetary constraints for buyers, a shift from near-term to long-term PML coverage, and the lack of participation from Florida residual markets.
- In general, the reinsurance market reacted rationally, with most carriers able to complete core reinsurance placements.
- Overall year-over-year pricing increases on a risk-adjusted basis were in the single digits to low teens.
- A surplus of capacity existed for reinstatement premium protection, Third Event and retention buy-down covers. Quota share capacity remained tight as reinsurer’s deployed capacity on excess of loss contracts. Wider variation in quoted prices was seen in the London, Bermuda and domestic/international markets.
- Most contract terms renewed as-is with the exception of language related to the Florida Hurricane Catastrophe Fund (FHCF). Reinsurers looked to clarify language in this area.
- Ratings agencies (both A.M. Best and Demotech) are scrutinizing FHCF coverage, reinsurance coverage and financial stability of carriers, especially those with heavy Florida exposure.
LOOKING AHEAD
- Year-end renewals will be affected by the reported lack of full utilization of SE/Florida wind capacity at June 1 and July 1. Coupled with positive earnings generating more capacity, we expect prices for SE/Florida wind at year-end to be lower than those at mid-year.

U.S. PROPERTY – NATIONWIDE
- Catastrophe capacity is scarce for new programs, but capacity is generally available for renewals.
- Client differentiation and a well thought out marketing plan are increasingly important at renewal.
- Risk capacity is generally steady.
- New pro rata capacity for catastrophe-exposed accounts is very scarce and expensive.

LOOKING AHEAD
- Some brokers in the U.S. have recently been debating likely pricing trends for nationwide and regional Property business. With no market-changing event before year-end, nationwide business will likely be flat year-over-year and regional rates down 5-10%.
- The reasons for the more aggressive regional forecast are that this business is less capital intensive than nationwide business and that more reinsurers chase the regional accounts. The loss of IPC Re will also have a small influence on nationwide pricing as they were a recognized market lead in this line.

WORKERS’ COMPENSATION
- Working layers are experiencing stable to modest rate increases.
- Medical inflation and historically low interest rates continue to pressure reinsurance pricing.
- Payrolls continue to drop due to economic conditions. Unemployment is only one factor; reduced hours, natural attrition, furloughed work days and wage reductions are others.
- The catastrophe market continues to soften slightly on programs with stable exposures.
- Reinsurers are taking firmer stands on their minimum rate-on-line thresholds.
- The number of Workers’ Compensation legislative bills under review has doubled since 2008. While the majority of these would increase costs for insurers and employers, it appears few are making it out of committee, most likely due to the tough economic conditions.

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In looking at employee benefits trends, only one word matters: *reform*. Given the magnitude of what health care reform could bring, virtually all other employee benefits issues pale by comparison. If corporate strategic planning in regard to benefits is challenging under optimal circumstances, strategic planning in the face of change on the scale under consideration by the current Democratic administration is in many ways impossible.

In looking at the immediate task ahead for benefits providers, another word takes precedence: *cost*. Although some financial indicators have started to suggest that the world economic situation is finally improving, many companies are still struggling to find ways to lower the costs of their overall benefits programs while still serving the needs of their workforces.

For the moment, we turn our focus to the big picture: the issue of reform. A quick recap of recent legislative activity at the federal level may be a useful way of framing the health care reform battle.

**RECENT ACTIVITY: COBRA, CHIPRA, HIPAA**

Last February’s landmark economic stimulus package included a temporary COBRA subsidy provision that went into effect for most plans on March 1, 2009. Under those rules, the government will pick up 65% of the COBRA payments of qualified individuals through offsets to payroll taxes. The law also requires that employers give certain employees involuntarily terminated on or after September 1, 2008 a “second chance” at COBRA election. Although the COBRA subsidy is temporary, some believe that if the economic climate does not improve meaningfully before the law expires, Congress may be tempted to extend it. (*For additional information about the COBRA subsidy, please see Willis’ Employee Benefits Alert, Vol. 2, No. 4 and No. 5.*)

A less discussed but also important development was passage of the Children’s Health Insurance Program Reauthorization Act of 2009 (CHIPRA). This law extends the Children’s Health Insurance Program (CHIP) established under the Social Security Act. CHIPRA essentially gives states the authority to directly subsidize premiums for employer-provided group health coverage for eligible children and families. The law encourages states to provide premium assistance to low-income employees who want to change their single coverage to family coverage in order to include a CHIP- or Medicaid-eligible dependent. Some observers have pointed out that CHIPRA shifts financial liability from state and federal governments to private-sector employers, who often share premium costs with employees. As such, the CHIPRA requirement represents a new indirect tax on employers who end up absorbing the additional health coverage burdens.
The economic stimulus bill also brought significant changes to privacy and security regulations in the Health Insurance Portability and Accountability Act (HIPAA). In late August, the Department of Health and Human Services (HHS) published new regulatory guidance governing HIPAA privacy breaches. Health plans subject to those requirements will need to reevaluate their compliance duties. For example, HIPAA-covered entities will need to update procedures to identify significant breaches, determine when HHS safeguards are triggered, and be aware of when prescribed notification activities advising participants of breaches may be needed.

HIPAA privacy and security standards are intended to promote “unifying rules” controlling how medical information travels. This uniform system is also intended to pave the way for broad national health care reforms. Many plan sponsors have instead found HIPAA compliance an ongoing challenge and have been deeply frustrated by the requirements.

The recent federal legislation reveals Congressional readiness to institute reforms that give employers pause for several reasons:

- Loading private sector plans with new coverage mandates
- Overlooking administrative burdens associated with reform
- Failing to consider costs borne by employers

**CURRENT REFORM PROPOSALS**

After the 2008 election, sizeable Democratic majorities in both the House and Senate plus a president focused on health care led many to expect the passage of a reform bill this fall or next year. In the face of unexpected political headwinds, those early assumptions have changed. While the president remains committed, opposition groups are now making their voices heard.

The passing of Massachusetts Senator Edward Kennedy may play a role in the outcome of the evolving debate. Senator Kennedy ardently supported comprehensive health care reform, and the emotional chords struck by his death may help reform efforts recapture some momentum. Other legislative observers suggest that the chance of a compromise between pro-reform and anti-reform legislators may be slimmer without Kennedy, whose skill as a consensus builder and legislative strategist will be missed by many. The prospect of a stalemate that kills health care reform entirely seems more likely without Kennedy’s leadership. Action on Capitol Hill will almost certainly have to wait until a successor is elected or appointed to fill Senator Kennedy’s seat, presumably restoring the Senate Democratic majority to the 60 needed to shut down a Republican filibuster.
The bills that have been reported out of committee are highly complex and detailed, as demonstrated by their length (1,000+ pages). Even the president indicated that he is unfamiliar with all of the details. Addressing the fine points of reform proposals is difficult, as legislative provisions change frequently – often daily. The following summarizes key provisions of the two primary competing proposals as of early September.

**SENATE PROPOSAL**
- Insurance market reforms to promote access to individual coverage
- A national insurance exchange in which a variety of insurers must offer coverage to qualifying individuals who have no access to other coverage sources
- Play-or-pay mandates that would require employers to offer a base level of health coverage to employees or pay an excise tax, and would require employees to maintain health coverage or pay a tax
- Subsidies to employees who cannot afford coverage
- A government-run plan that has yet to be defined
- Comparisons of effectiveness and other efficiency requirements for all plans

**HOUSE PROPOSAL(S)**
- Reform of the market for individual insurance
- Limiting ERISA protections
- Pay-or-play mandates that would require employers and individuals to offer or buy insurance or pay penalties: employers not providing a base level of coverage would incur an excise tax of 8% of payroll; an individual who does not obtain coverage would incur an excise tax of 2.5% of modified adjusted gross income
- A government-run plan
- Comparisons of research and administrative protocols

**HEALTH CARE REFORM COSTS**

With universal coverage touted as the key goal, little effort seems to be directed at the fundamental cost problems that plague the health care system. Leading reform proponents have stated that they intend to reach universal coverage but have not outlined cutbacks in services or other steps that could save money overall.

The nonpartisan Congressional Budget Office (CBO) has indicated that the House and Senate proposals would cost an additional $1 trillion to $1.5 trillion over the next budget cycle, which does not address at all the significant increases in program costs as the peak of the baby boom hits retirement age. The CBO also estimated that the plans would achieve 96-97% coverage of the population. Although the CBO review scrupulously avoided identifying possible service cutbacks, virtually all commentators on both sides of the issue acknowledge that some health care “rationing” in the future is unavoidable. The question is really the degree, severity and the methodology for rationing.

Although neither of the key proposals includes funding details, various options have been floated, including taxation of the value of the benefits that an employer offers – a contentious issue in the last presidential campaign. One option currently being considered in the Senate Finance Committee is a tax on any plans that are more valuable than $20,000 per year. Although the president has repeatedly indicated he will only accept a budget-neutral proposal, none of the current proposals are actually budget-neutral (according to the CBO). The difficulty in finding opportunities to offset reform program costs is one reason there has been no bill yet from the Senate Finance Committee.

Many business community leaders who have yet to make up their minds about health care reform are still waiting for Congress to respond to concerns about the impact of the current reform proposals on the cost of health care and the federal deficit, in addition to concerns about who will pay for it.

**FEDERAL MANDATES FOR PRIVATE PLANS**

A common theme in all the bills is federal mandates. The ultimate goal is to make employer plans and individual insurance comply with federal rules (still to be designed and implemented by a government commission).
Although the president has indicated that people who like their current health benefits programs will be able to keep them, that is only true in the most literal sense. Under the reform bills, individual policies that change in any way, even in cost, will be required at that time to conform to federal rules. Since policies constantly change, most observers acknowledge that maintaining existing individual program offerings would prove difficult, if not impossible.

The leading health care reform proposals would ultimately restrict an individual’s ability to keep an employer plan as well. Employer group health plans would be granted a five-year transition window and then be forced to change to the government mandate.

Both the House health care reform bill and the Senate bill, produced by the Health, Education, Labor and Pensions Committee (HELP), would require that employers either provide a prescribed set of medical benefits or pay a penalty to the federal government based on the number of their employees.

**PUBLIC OPTION – A SKEWED PLAYING FIELD?**

Another key element of the proposed new system is the so-called public option – a government health insurance offering for individuals and their families. This is the subject of some of the fiercest debate. While some see the approach as a useful means to ensure universal coverage, others see the public option as a path toward inefficient, ineffective socialized medicine. The current proposals envision public and private options coexisting, and even competing, but a closer look reveals important concerns about the effect the public option would have on the marketplace.

In the current bills, the public plan would pay health care providers and services using Medicare’s artificially low payment rates. This would confer an immediate competitive advantage on the public plan, as it could charge significantly lower premiums. Moreover, the public plan would be under no obligation to produce profits. Opponents of the current reform proposals say that reform of the marketplace for individual insurance, which many agree is urgently needed, would be impossible because the public option would, in time, simply wipe out the marketplace altogether.

Some believe that the public option would also impact the group insurance market. In five years, when all employer plans would fall under the same federal guidelines, marketplace options could be severely limited. The lower premiums in the public individual market could put the group plans out of business. The health benefits industry would lose the advantages of a competitive, open marketplace where product innovation and superior service are theoretically rewarded.

Opponents of the public option argue that the way to reform individual health care is to make sure that individuals can enroll in any private plan regardless of their personal health status. New rating rules would need to be created, and accommodations would have to be made for those unable to afford any kind of coverage. Supporters of a market-driven approach favor vigorous competition among private health plan options in a reformed insurance market.

**ERISA – THE GOOD OLD RULES?**

When the Employee Retirement Income Security Act (ERISA) was enacted in 1974, Congress added strong “preemption” language that reserved for the federal government all authority to regulate employee benefits. The preemption rule prevents states from enacting laws that
infringe on this exclusive federal authority. ERISA contains an important exception that allows states to continue to regulate “insurance,” and employers who buy health insurance plans do so under state insurance laws. Self-funded plans are generally free of such state guidelines. ERISA provides these plans a single set of federal rules so that they can offer uniform benefits to all their employees, regardless of where the employees live, without being subject to varying and often costly sets of state regulations governing the content and administration of their plans.

Perhaps in comparison to the variety of state regulations, employers generally consider the ERISA rules flexible and efficient. Many are afraid that the proposed legislation would erode ERISA’s uniform and consistent regulatory touch. The House proposal in particular would increase employer burdens and costs by requiring all employers to meet highly detailed federal standards for health coverage after five years. Employers are afraid they would lose the flexibility to offer benefits tailored to their unique circumstances and the needs and desires of their workforces.

POWER TO THE STATES

The House proposal would also give a big lift to state authority. The bill would require the federal government to waive ERISA’s uniform regulatory framework for any state that enacts a single-payer health plan, which would force all residents in that state to obtain health coverage through a government-run plan and eliminate employer-sponsored coverage altogether. That would potentially have consequences similar to those in Hawaii, where the state government obtained an exemption from ERISA. (ERISA contains an important exemption specifically regarding the Hawaii Prepaid Healthcare Act, which was enacted by that state before ERISA was signed into law.)

In Hawaii, state-mandated benefits are blamed for creating an environment where very few carriers provide coverage. Employers also struggle to obtain state approval for self-funded plans. As a result, many employers provide a lower level of benefits to their Hawaiian employees than they do for employees in other states because it is simply easier to provide the state-approved plan.

Another fear is that the House bill would increase litigation by compromising ERISA protections against the applicability of state law. This would, some contend, open the door to unlimited state law remedies against employer-sponsored health coverage. Many health industry watchers say that not only do the Congressional bills fail to effectively address the issue of much-needed medical liability reform, but they have the potential to exacerbate problems by enabling an explosion of new litigation over state law claims.

Exemptions to ERISA protections at the state level could force employers to deal with many sets of rules and regulations. This could well be the case for self-funded plans that were historically protected from state laws.

Many reform opponents underscore the point that federal mandates, which can be costly to businesses, do nothing to address the overall rise in health care costs – which is a primary reason some employers are not able to offer health coverage to their workers.

States may become more active in the search for reform. Some experts predict that if federal efforts stall, unlikely as that may be, the inaction would set off a stampede of state legislatures and local municipalities racing to enact their own reforms. State proposals likely would range from relatively innocuous mandates on employers (such as providing Section 125 cafeteria programs for all workers) to more in-depth requirements, such as a San Francisco-style pay-or-play health coverage mandate.
TIGHT AROUND THE MIDDLE

Mid-sized employers would likely be hurt most by the current health reform proposals. Small employers are already subject to onerous mandates in the state insurance laws (being too small to offer self-insured plans that are free of state control), and large employers are expected to sufficiently influence the final version of proposed legislation so as to secure rules that protect their interests. By contrast, many mid-sized employers may find themselves having to choose between restrictive plan designs that might not work well for their company cultures or turning the entire process over to the federal government – and very likely paying higher taxes to help fund the government plan.

Though generally opposed to the health reform proposals now before Congress, some employer groups favor reforms that would more precisely target the goal of delivering health coverage to the large number of uninsured Americans. Specifically, tax incentives and credits, access to association health plans and incremental reforms modeled on 1996 HIPAA legislation, would, they say, go a long way toward universal coverage. HIPAA has changed how preexisting condition exclusions may be applied and introduced numerous helpful safeguards governing the individual health coverage market. Many employers point to the Patient's Choice Act and other alternative reform proposals, which retain the employer-based system.

MOST OF US ARE MOSTLY SATISFIED

Many insurance industry leaders continue to urge Congress to bear in mind that the current employer-based system covers more than 160 million Americans and according to most surveys, people are overwhelmingly satisfied with their coverage and access to care. A recent Rasmussen poll indicated that almost two-thirds of people who do not have health coverage are nevertheless satisfied with their care and access.

While most industry observers acknowledge the need to make health care cost more sustainable and insurance more affordable, making wholesale changes that put the coverage and care of so many Americans at risk is something that needs to be considered carefully.

1 http://www.rasmussenreports.com/public_content/politics/current_events/health_care/may_2009/70_of_insured_rate_health_insurance_coverage_as_good_or_excellent

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A year ago, the Bermuda Property market was beginning to see a gentle hardening of rates, reflecting underwriters’ declining investments and fears that carriers would be unable to recapitalize in the event of future losses. All variables pointed toward a perfect marketplace storm. Between Gustav and Ike causing $20 billion of insured losses, Midwest floods and an unprecedented number of tornadoes, 2008 was the third costliest year for catastrophe losses. The overall industry combined ratio finished at 105% in 2008, compared to 95% in 2007 – while 2008 investment income fell by nearly 50%. And yet, no perfect storm.

Moreover, as of this writing (admittedly in the middle of the Atlantic Basin storm season), no dramatic hurricane. So far, 2009 has not seen the severity of losses either from a Nat-CAT or on a risk-loss basis that we saw with monotonous regularity in 2008. Even with quake losses in Italy, Japan and Indonesia, and a typhoon in Japan and monsoons in India, the market here would need a $25 billion to $30 billion loss to trigger reinsurance programs and cause significant increases on the direct side.

**MARKET UPDATE**

**ACE**
Continues to be active. Unlike ACE USA and Westchester, ACE Bermuda’s appetite for CAT and overall line size has remained steady throughout 2009 and as a result they were able to take advantage of higher pricing in the first quarter. This additional deployment, particularly of tri-counties aggregate, has meant an increase in their minimums for this exposure. However, they are still willing to deploy aggregate on what they consider to be good risks. There has been strong growth on the book this year.

**ARCH**
Remains conservative. They have the ability to write $50 million of non-CAT (in some instances up to $100 million) and $10 million of CAT and their renewal retentions are attractive. However, in recent months they have experienced some large non-CAT losses on food processing accounts and are now being far more vigilant on attachment points and satisfactory engineering data.

**ARIEL RE**
Very strong and competitive on heavy industry in excess positions. However, they have been challenging and somewhat conservative on renewal and new business with respect to CAT-driven accounts, as their modeling data requirements can be onerous. On CAT-driven accounts, Ariel flourishes during the hard markets and retracts in the soft.
AWAC
They have been tough on anything that is CAT exposed, as they attempt to manage their internal PML contribution following an increase on their treaty renewals. While retention levels on renewals have been very good, new business is still challenging. The coming RMS version 9.0 rollout should see them adopt a softening stance. They predominantly write a primary book, with a maximum line size of $10 million. On the energy side, they are maintaining a $2 million line.

IRONSHORE
In transition globally since management changes earlier in 2009. They initially brought down their line size from $50 million for Fire and $25 million for CAT to $15 million for Fire and CAT combined. This decrease in line size continued in stages until they ended up with $5 million for Fire and CAT combined, although Ironshore Bermuda now has the ability to write $10 million combined for Fire and CAT for renewal business. While they continue to roll out their U.S. and London platforms, Ironshore will continue to be more aggressive in pursuit of market share. They have plenty of new CAT aggregate at their disposal after scaling back in the first half of the year in the hope that the market might harden. They will look to utilize this going forward.

LEXINGTON
Lexington Bermuda remains very strong on heavy industry where they will agree to follow the London form, which is one of the key differentials between them and Lexington U.S. As with other Lexington offices, they have restraints on CAT aggregate. However, they are looking to write more soft occupancy accounts in order to balance a book of business heavily weighted toward industry risks.

Lancashire
They have looked closely at their CAT book in terms of PML contribution, and while they have maintained their position on non-CAT risks as they try to put out a $75 million line, they have been moving further up programs where CAT is involved. However, we have been successful in maintaining their position on the lower portions of programs. They have the ability to write Terrorism business both on a stand-alone basis and also embedded within an All Risk program and have been more competitive of late.

MAX
They are active on quota share and excess-of-loss risks, although still targeting working layers above the primary. They have been more flexible on writing accounts below their current minimum premium levels of $100,000. Their CAT line is $10 million. A clear demarcation has now been drawn between Max Specialty in the U.S. and Max Bermuda, with any account over $1 billion having to be underwritten in Bermuda.
MONTPELIER RE
A good year so far. Our business with Montpelier Re is significantly up as a result of their being more flexible and their more aggressive approach on new business, particularly if it carries some catastrophe risk. They have the ability to write a max $50 million All Risks and $10 million CAT line.

XL
Hampered by access points. When we do get clearance we have had some success this year on new accounts. In one case, XL was able to put up some meaningful CAT and non-CAT dollars on a hospital account. Their line size is still $300 million on All Risks and $10 million on CAT. They can play on both excess and quota share.

NEW CAPACITY
Some markets (Amlin and Hardy) have made murmurings about starting a facultative book but nothing has come to fruition yet. Unless rates start to harden dramatically, we suspect Amlin will carry on writing a CAT treaty book. Hardy, like Amlin, has a London platform and is currently doing their due diligence on the viability of doing business here.

Any new start-up operation will need stellar credentials along with excellent financial backing. Conditions might be ripe for some mergers and acquisitions. This would be unusual for Bermuda, where markets have traditionally assembled enough capacity to maintain their own equilibrium. However, the current economic climate might dictate otherwise.

CASUALTY
This remains a confusing time for Bermuda Casualty, as the market is reluctant to harden despite losses, deteriorating combined ratios and rating agency downgrades of carriers. All signs suggest the market is ripe for significant change in 2010, but the number of markets in Bermuda alone (16, with total capacity of $1.5+ billion) and very competitive lead pricing in the U.S. domestic marketplace seem to be mitigating pricing pressure. Additional competition from new Bermuda markets (Torus, Iron-Starr, ArgoRe and Canopius) is also driving premiums lower, although the technical rate is actually increasing in many cases as buyers report significant declines in revenue and exposure. Premiums overall remain flat to reduced for most classes of excess Casualty business with few exceptions. Those exceptions include large pharmaceutical, energy and life science risks, which are encountering pricing increases or a lack of alternatives as carriers are reevaluating their appetite for these classes of business. That being said, the Bermuda market continues to be very attractive overall with regard to price and coverage, as terms and conditions remain consistent with those of 2008.

Placement strategy has changed, as most insureds look to diversify on their Liability placement to help mitigate credit risk. The days of placing large blocks of capacity with one carrier to influence price and/or to achieve consistent terms and conditions are coming to an abrupt end. Insureds that may have had as much as $100 million to $250 million in limit with one insurer are now placing smaller lines with multiple insurers; $50 million blocks are becoming the preferred maximum capacity with any one carrier when possible. This diversification not only spreads counterparty risk but maintains limit continuity and expands insurer relationships.

MARKET HIGHLIGHTS
- The Torus Casualty team located in Bermuda now has $50 million of excess Casualty capacity to deploy on general Casualty for energy, construction and power utility risks. Torus is A.M. Best rated A – (Excellent). Torus has also recently announced that very soon they will be offering lead terms ($25 million) that will sit excess standard primary limits (as opposed to Endurance and Allied World, who prefer to sit excess larger SIRs).

- Standard & Poor’s has assigned its A- counterparty credit and financial strength ratings on Max Capital Group Ltd.’s operating insurance and reinsurance companies. At the same time, S&P raised the counterparty credit rating on the group as a whole to BBB from BBB-. The outlook on both of the ratings is stable.

- Aspen Insurance Ltd. (S&P and A.M. Best rated A) has opened up an office in Bermuda. The primary focus will be excess Liability for all classes with the exception of marine and energy. Aspen currently has a $50 million line to offer Casualty clients.
Aspen also has $10 million capacity for Food & Beverage Recall coverage.

- **Arch Bermuda** and **Endurance Specialty** have introduced a “Bermuda Shorts” follow form occurrence and claims-made policy form. The short form includes a notice, cancellation and a non-followed section. There are no other standard exclusions in the form itself so theoretically, an insured could purchase $100 million of consistent follow form coverage through both Arch and Endurance.

- **ArgoRe** continues to be a very strong partner, offering $50 million of A.M. Best rated A capacity.

- **Allied World** has increased their line from $50 million to $75 million and has begun to offer lead terms excess large retentions.

- A joint venture between CV Starr and Ironshore, **Iron-Starr** began writing business in Bermuda earlier this year and is offering a $75 million line with a minimum attachment point of $75 million. They are A.M. Best rated A.

**EXECUTIVE RISKS**

The Executive Risks marketplace in Bermuda continues to be segmented between commercial accounts and financial institutions. Most commercial Directors & Officers (D&O) accounts are renewing flat or with decreases up to 10% – and 15-20% selectively. Capacity for commercial accounts remains abundant. Financial institutions (FIs), on the other hand, are experiencing significant price increases, where warranted by claims or other financial difficulties. Many carriers have scaled back the limits they will offer FIs, especially on Errors & Omissions (E&O) cover. A few carriers are willing to take on this exposure and are earning significant premium for it, but claim settlements from the world financial crisis may be looming. No one can be sure they are writing this business profitably. The marketplace expanded in 2009, with the addition of Argo Re now writing Professional lines and Casualty. Ironshore has also hired two Professional lines underwriters and expects to begin writing business by the end of 2009 or early 2010. The market now numbers 12 carriers that can offer a total of approximately $400 million in capacity on each line of coverage including D&O, Employment Practices Liability (EPL), E&O 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 strong 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 CAT Excess (Chartis), with Argo Re also considering introducing a primary form. Six carriers offer lead Side-A D&O forms: CODA, XL, CAT Excess (Chartis), Allied World, Chubb Atlantic and Max Bermuda (and possibly Argo Re or Ironshore). Bermuda carriers continue to offer competitive advantages with their abilities to manuscript policy language, provide full punitive damages coverage and offer large blocks of capacity. A few years ago, Bermuda carriers would rarely breach the so-called pricing floor of $10,000 per million. In the past year we have seen that floor weaken as Bermuda carriers continue to follow pricing trends downward in an attempt to maintain loyal clients that are viewed to be healthier risks. While Bermuda carriers aren’t always the least expensive option, they have offered pricing as low as $6000 per million for desirable D&O accounts. Again, pricing is significantly higher on FI business, and we have seen several carriers non-renew or decrease limits that they offer to FIs in an attempt to mitigate further losses and continue to diversify their underwriting portfolios. FI placements remain challenging, and often companies cannot purchase as much coverage as they would like, which contributes to a harder market than commercial accounts are seeing. Another general market trend in Bermuda Executive Risks is the rising buyer focus on higher rated carriers and on diversifying programs to mitigate counterparty exposure. Some clients are shifting lower rated carriers higher in the
program while others may limit the amount of capacity that any carrier can have on their program, regardless of the carrier’s rating. With increased focus and scrutiny from both the underwriters and insurance buyers combined with growing capacity for most accounts, we expect the Executive Risks market in Bermuda to remain relatively stable. We expect to see market conditions similar to those we experienced in 2009.

HEALTH CARE

In late 2008, we predicted a stable market based on:

- Significant declines in investment income
- Significant losses from Gustav and Ike
- Lack of available capital

In fact, the market continues to soften. Why? We have identified three contributing forces:

- Reserve releases
- Positive trends in frequency and severity
- New markets

TAKING DOWN RESERVES

The broad collapse of the financial system and the increase in the cost of capital left markets with few options for raising funds. Taking advantage of a light year in losses thus far, many carriers have taken down prior reserves as a new source of capital. Many in Health Care Professional Liability have raised concerns about this practice because reserve adequacy is particularly important for such a long-tail business. This issue is gradually making its way into the spotlight, with opinions divided. Some contend that the industry reserves were inadequate to begin with while others believe such early releases are concerning but the industry reserves are adequate in the aggregate.

This practice has allowed some carriers to show better results for the short term but the long-term implications are unclear. Certainly, the rating agencies will pay close attention as they reevaluate carrier financial strength. The risk of a downgrade is certainly an issue.

MEDICAL MALPRACTICE TRENDS

The news is good on claims. Frequency continues to go down while severity is moderating. Most agree that tort reform of the last several years has helped tame the runaway verdicts that have influenced the marketplace for years. As a result, combined ratios are at an all-time low, setting the table for further rate reductions by carriers competing for business.

NEW CAPACITY

New carriers are entering the Health Care space. Most don’t necessarily represent new capacity to the industry as a whole, but are existing carriers expanding into Health Care and other lines. New players include Iron Health, Allied World U.S., Endurance U.S., Max Managers in the U.S.; Barbican in London; and Torus, Iron-Starr, Canopius and Hiscox in Bermuda.

The impact of these new carriers is seen mostly on excess capacity, where we continue to experience double-digit reductions. We have also noted a more aggressive approach from some of the new entrants to win more business, which has pushed traditional Health Care carriers across all three jurisdictions (U.S., London and Bermuda) to cut rates further in order to keep business.
THE YEAR AHEAD
One hesitates to hazard a prediction when last year’s proved untrue. However, given the forces at play in today’s market, it seems clear that unless we experience a surprise catastrophic event like 9/11, a surge in major storm activity or another collapse in the stock market, we will likely see several more quarters of softening rates.

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The recession forced many clients to treat insurance as a commodity and buy the least expensive program available. Incumbent market relationships and even breadth of coverage were less important.

**LONDON**

**PROPERTY**

As we go to press in the middle of the 2009 hurricane season, the London Property market appears to be in limbo. Underwriters, in general, retained the levels of business that they expected at renewal. However, the anticipated flow of new business during the build up to the hurricane season did not materialise.

**RATING**

London and European underwriters started the year under huge pressure to increase rates on U.S. Property business, largely because 2008 was the first bad hurricane season since 2005, and non-CAT risk losses reached unprecedented levels during the year. The result was an increase in rates when treaties renewed, amounting, in the main, to increases of between 20% and 30%. Retention levels were generally higher and limits purchased were, in many cases, much lower.

By May, underwriters were routinely asking for 20% rate increases on catastrophe exposed renewals. Since then, we have seen a significant decline in the rate increases sought. Underwriters are now looking to apply increases of between 5% and 10% on U.S. CAT business and we expect to see non-CAT rates remain static. As always, there are exceptions to the rule. Mining and steel business, for instance, due to recent adverse loss experience, continue to face upward pressure on rates. These pressures are offset, particularly for Business Interruption, by reduced exposures resulting from reduced global economic activity.

**CAPACITY**

The global recession has reduced demand for insurance capacity. Where underwriters had been looking for significant rate increases, particularly on off-shore energy business, capacity has not been taken up as expected. Where premiums do not reach required levels in certain classes, spare capacity is being redeployed into other classes. More capacity has come into the Property arena and rate increases have been moderating as a result.

RMS and AIR have both launched new software based on the Next Generation Attenuation Modeling (NGA). Although unlikely to have an impact in 2009, the new modeling tools are expected to eventually reduce insurer and reinsurer aggregates by 5-15%. We should therefore see an increased appetite for California quake business and slightly less of a squeeze on capacity.
MARKET EXPANSION AND MOVEMENT

Whilst 2009 has not seen the unprecedented marketplace movement we saw in the summer of 2008, there is still considerable activity in the London market. We expect this to continue. Some of the key market changes include:

- Two new start-up syndicates entered the Lloyd’s market – WR Berkeley and Ren Re.

- Nick Jones and Andrew Rowland, formerly of Heritage, are seeking final Lloyd’s approval for their new syndicate, Apollo 1969, to commence underwriting with effect from January 1, 2010. Apollo will be managed by Marlborough Underwriting agency and in the meantime Jones and Rowland will underwrite a Property book from October 2009 on behalf of Marlborough syndicate 1861.

- Ironshore’s Lloyd’s syndicate, Pembroke, will begin growing a worldwide Property account from October 2009. Rod Todd returns from Bermuda to underwrite the account.

- Richard Housley and Jonny Rowell have resigned from their respective positions at Axis and Beazley. Both are believed to be looking to start new ventures within the Lloyd’s market.

IN SUMMARY

Increased capacity is being pledged to Lloyd’s for 2010. Current estimates suggest that capacity in the Lloyd’s market next year will increase by 24%, or £1.9 billion. We have already seen the majority of our key Property syndicates confirm that they have expanded capacity for 2010. Lloyd’s itself is reviewing how it brings in new capacity as it competes with Bermuda for new capital flowing into the insurance sector. This will take on increased importance when we are faced with market-changing events.

The insurance cycle is at a pivotal juncture. Continuity of the benign hurricane season to date will put pressure on underwriters to ease rates, whereas a significant catastrophe in the remaining months of the year would provide insurers and reinsurers with the justification they seek to increase rates further.

CASUALTY

More than a year since AIG and XL fell into financial turmoil, we continue to see the London Casualty market softening. In that time, more than $300 million additional capacity has entered the market, largely in the mid-excess arena (above $25 million), with a view to taking advantage of the financial burden of these established carriers, which many assumed would lead to a hardening of the market. Not so!
Soft conditions notwithstanding, the lead layer remains the most difficult area for any carrier to compete in consistently. Despite the commotion, AIG/Chartis has largely retained their significant lead positions – especially in London, where Lexington London enjoys a very high client retention ratio.

Why the success for Lexington London? Several reasons apply, including staff retention, pricing, and terms and conditions. The crucial factor, however, may be the London tradition of face-to-face meetings between clients and underwriters. This likely contributed to the clients’ sense that on the whole they’d been treated fairly in a time of great economic pressure on all parties.

The huge push in the London market toward contract certainty and compliance may also have brought clients and underwriters closer together and helped them find common ground. Some insureds have sought and received terms early in the process, in return committing to bind their business early, which has allowed them time to navigate the many options that are now available in the mid and high excess arenas.

With significant tranches of capacity now available from a multitude of carriers, often based in multiple operating centers, choosing the best access point is paramount, and this is often best decided early in the negotiation process. Again, the value of face-to-face discussions in the entire underwriting process through to binding cannot be understated.

With the availability of such levels of capacity to clients in London from carriers such as Aspen (London and Dublin), Catlin, Argo, Liberty International, XL (London and Dublin), Swiss Re (Zurich), SCOR (Paris), Max (Dublin) and Torus, it is possible to meet with the key decision makers from all of these entities in one visit.

The ability to reduce counterparty risk is an option that all clients should consider before they commit to large limits of capacity from one carrier. However, it is likely that CAT Excess and XL will be far more reluctant to cut back their capacities given that, in their opinion, they have weathered the financial storm.

Ultimately, these factors could lead to further softening of the mid and high excess marketplace as the remaining carriers seek new business and incumbents endeavor to hold rate. But as one senior underwriter recently put it, “How will the limited pool of reinsurers providing carriers capacity react to reduced premiums coming through for the same risk they were receiving from an incumbent?” As these reinsurance renewals come through we will be closely watching the impact on the marketplace.

**DIRECTORS & OFFICERS**

In 2009, the Directors & Officers (D&O) product area has seen a growing divide between finance-related accounts and others, with the market for financial institutions hardening significantly whilst the market for the rest remains competitive – yielding an average decline in premiums of 5%. There is still significant capacity in the marketplace and coverage remains broad. (For more on D&O and financial institutions, see the separate pieces in this report.)
For non-finance-related commercial companies, insurers are actively competing for clients that exhibit strong risk profiles: companies that can show they have weathered the economic downturn successfully and do not have large amounts of debt on their balance sheet. Insurers require a higher level of detailed information to underwrite risks. Meetings between insured and insurer are encouraged, not just to discuss the insured's financial situation and competitive strength, but also for the insured to hear from the insurers what their concerns are and what's happening in the marketplace. The stronger the relationship between client and insurer, the better the insurer response when something does negatively impact the client or when a complex claim arises.

One particular area of coverage that has seen a significant uptake during the economic crisis has been the purchase of A-Side-only coverage. The recent Towers Perrin D&O Liability Survey reported a 33% increase in purchases of A-Side coverage. The benefits of this cover are many, but in short it provides broad, ring-fenced, dedicated cover explicitly for directors and officers.

Lloyd's continues to see a considerable increase in enquiries from risk managers exercising greater diligence in selecting carriers with strong ratings and profitable results.

Capacity available for U.S.-domiciled D&O risks ranges from $20 million to $25 million on a primary basis to $50 million or more on high excess and A-Side placements. Coverage is broad for both traditional ABC coverages and also A-Side DIC. Lloyd's enjoys a very good reputation for strong client relationships, including coverage flexibility and excellent claim handling. The Beazley syndicate is the dominant provider of capacity as a lead for ABC and A-Side DIC cover, with capacity of $15 million for ABC policies and $20 million for A-Side DIC. Brit has recently announced they will no longer renew/support ABC policies but are still a market for A-Side DIC. Catlin is a new entrant for U.S. commercial D&O, supporting Beazley-led programs.

Employment Practices Liability is another area where we have seen an upturn in interest in London. Lloyd's syndicates have been most competitive on firms with up to 30,000 employees. Coverage is broad and can include limited wage and hour coverage. Capacity is in the region of $15 million for U.S.-domiciled clients.

**PROFESSIONAL INDEMNITY**

For U.S. Professional Indemnity/Errors & Omissions (E&O) accounts, London has led the way in trying to increase rates. This has been most noticeable in law firm business, where London has a lead position on primary placements and has pushed hard to keep rates stable or at increases of at least 2-3%. It has been possible to achieve flat renewals, but not easy. As a consequence, business has left London for the domestic U.S. market. For larger firms with significant limits, London has remained on accounts.

Other classes of E&O, such as Technology and Construction/Architects and Engineers, have faced similar challenges, but aware of U.S. domestic alternatives, London has generally remained competitive on these classes.

Capacity is still widely available and stable. In the technology sector, for example, we have seen a number of new participants provide significant increases in capacity. Market security is an ongoing issue, and whilst we have experienced some of the same challenges that U.S. domestics have, the fact that our leading markets are Lloyd's syndicates has been an important factor in retaining business and attracting new opportunities.

We expect to see an ongoing attempt from London to keep rates stable over the next 12 months. If the expected increase in Professional Liability claims as a result of the economic downturn does come about, buyers should expect upward pressure on rates. There is certainly a sense in the lawyers' market in London that an increase in claims against large law firms is coming and that the lead markets available to those clients will diminish.
Looking forward, we are anticipating the arrival of a new Professional Liability syndicate run by Jonny Rowell, formerly head of specialty underwriting at Beazley. This should give London an even greater role in providing primary capacity to U.S.-based Professional Liability buyers and should also give London brokers an alternative route to the more established names of Beazley, Brit and Hiscox. We believe that London will remain very well positioned to retain its position as a lead market, but we also expect London primary markets to strengthen their offerings.

**HEALTH CARE**

After several years of 5-15% rate reductions, most underwriters in London predicted – and hoped – that rates would firm in 2009. During the first quarter, carriers tried to hold the line, insisting that rates had to remain flat and only decreased exposures (fewer occupied beds, fewer surgeries, fewer employed physicians, etc.) could generate decreased premiums. If a client faced increased exposures, premium increases were sought.

However, after losing several clients to competitors, underwriters here realized that rate decreases were not only unavoidable, but accelerating. Instead of 5-15% reductions, clients were seeing 20%, 30%, even 40% reductions if they had good loss experience.

The recession forced many clients to treat insurance as a commodity and buy the least expensive program available. Incumbent market relationships and even breadth of coverage were less important. Markets that had managed to keep reductions in single digits by expanding coverage or restructuring programs in previous years had run out of tricks.

By the second quarter the market was in a frenzy. We saw reductions of up to 50% on July 1 renewals. And they continue today.

What contributed to this furious softening?

- New capacity and aggressive underwriting from markets like Ironshore
- AIG’s desire to retain business even if rates had to be reduced
- Underwriters who were told by management to hold the rate line on renewals were still expected to write new risks
- Clients embracing the benefits of global competition and marketing their programs widely
- Underwriters’ continued good results

These results, however, may in the long run prove illusory. The London/European market for Medical Professional Liability coverage is primarily an excess market. Carriers ask clients to retain expected losses and only provide coverage for larger, unexpected claims. Retention thresholds for health systems vary significantly – from $2 million to $20 million – depending on venue. Over these large retentions, underwriters are sheltered from all but the worst unforeseen losses. This means that nine in 10 risks are loss-free and highly profitable. The tenth may be wildly unprofitable, but the long tail on Medical Professional claims means that it can take years for an underwriter to know if they wrote the profitable ones or the unprofitable one.

Given the current rate cutting, it is inevitable that some carriers’ results will deteriorate and they will be forced to reverse the rate trend. In the meantime, there is no end to the soft market in sight. We expect the field to be very competitive through 2010. Clients with good experience who continue to market their programs globally will continue to see improved pricing and terms.
The worldwide economic downturn that caused the collapse or temporary nationalisation of some of the most highly respected financial institutions in the U.S., combined with the Madoff and Stanford scandals, resulted in a knee-jerk reaction by London markets. Unsure if reinsurers were prepared to continue in this class of business, and anticipating a deluge of claims from class action lawsuits, carriers immediately hardened rates for any financial institution (FI) client with exposure to potential litigation in the U.S. Rate increases, whether imposed by reinsurers or caused by detrimental material changes to risk profiles, played out to varying degrees in 2009. Looking forward, we see:

- A clean risk with a strong and long-standing partnership in London should expect to receive an initial 15-20% increase.

- A risk with exposure to potential losses arising from the economic downturn will likely face intense underwriter scrutiny, specific exclusions and rate increases of 30-50% depending on size and loss history.

- A risk with one or more total loss of limits over a five-year period should expect a doubling or tripling of premiums – or an outright declination.

The hardening of the London market has come with a contraction in capacity, as expected. We anticipate $10 million to $25 million depending on the risk profile of the FI. The amount currently available for U.S.-domiciled FI risks is probably closer to $10 million. We anticipate this might be a maximum line for 2009 and 2010 renewals with U.S. Liability (D&O and E&O) exposure.

Meanwhile, U.S. and Bermudan markets are still competitive. Some of the main U.S. FI primary carriers have kept rates down regardless of claim activity, just to keep market share away from various aggressive excess layer carriers. In Bermuda, carriers who are relatively new to writing FI business are not saddled with losses for which the London market is currently aggregating and reserving. We believe that only increases in rates will draw the London market back into the U.S. FI Liability field with any sizeable capacity.

On the other hand, we do predict that distressed community banks in the U.S., those facing cease and desist orders, will continue to seek capacity from the London market. Where incumbent U.S. carriers have declined a renewal, London remains competitive on D&O, E&O with prior acts exclusions and Crime programs. Approximately 10% of the 400 community banks in the U.S. with cease and desist orders have come to London to renew their D&O, E&O and Crime programs in the last few months. There will be more to come.

For Crime-only policies, London remains competitive, with capacity exceeding $100 million.

Although rate increases have begun to ease in some cases, we believe London may lose more market share over the next 12 months, as underwriters seek to make up losses sustained since the current crisis began. We remain, however, optimistic that if and when more attractive market conditions develop, the London market will once again be the competitive market it has traditionally been.

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Pricing is largely a function of available insurance capacity. For companies that are succeeding in these rocky times, capacity can be almost ridiculously abundant.

Over the last year, corporate giants and captains of industry have suffered major reverses in the most severe financial crisis of our lifetimes. This has not gone unnoticed in the world of Directors & Officers (D&O) insurance. For many, the enormous challenges of 2009 can be expected to continue in 2010.

- New D&O claims reported to Willis have increased by 18% from the same period last year. This follows a 50% increase for newly reported D&O claims in the previous year.
- Last year’s turmoil at several major D&O carriers resulted in increased competition from many others looking to take over lead positions or profit from rate increases seen in certain industry sectors.
- Overall, in 2010, corporate executives and their firms can expect continued competition for attractive risks, which should result in stable pricing or price decreases.

PLAYERS:
RESHUFFLING THE DECK

The financial upsets suffered by several of the top D&O markets over the past 12 months and the reexamination of risk portfolios by other big-name D&O carriers has reshuffled the list of D&O markets. Previously dominated by three or four names, the list of potential lead markets on many accounts is now often as long as 12. The relative newcomers to the lead role, as well as those that restaffed with top executives from the old guard, can be expected to supply additional capacity and competition in 2010.

Some of the newer or reinvigorated D&O markets include CV Starr, Endurance (USA), Everest National and W.R. Berkley, in addition to Freedom Specialty and Ironshore, who had their coming out in 2007 and 2008.

CAPACITY

For financial institutions and those firms facing the toughest financial challenges, it has been a hard battle to find the D&O capacity that they and their executives have sought – assuming that they could afford to pay for it once they’d found it. For others, however, there has been – and there is expected to be – an abundance of insurance markets eager to write their business. Some of this is newer capacity attracted by higher...
A-SIDE COVERAGE ARE BEING TESTED

During the past year, the A-Side policies and the A-Side of traditional D&O policies have been hit by a raft of nonindemnifiable claims and claim settlements. This is expected to continue in 2010, with the economic and legal drivers in place to spur more derivative claims and claims against insolvent companies. If this impacts the profitability of these lines of coverage, a countervailing trend may emerge, i.e., price increases. (For more on A-Side coverage, see our recent Alert, “Picking the Right Lead A-Side D&O Carrier.”)

PRICING

Pricing is largely a function of available insurance capacity. For companies that are succeeding in these rocky times, capacity can be almost ridiculously abundant. For them, even if they face an increase in external risk factors, pricing is likely to be stable. For those that are best-in-class, reductions in pricing are possible, in some cases, in the double digits.

TERMS OF ENDEARMENT

New forms for traditional and A-Side coverage, both primary and excess, are providing additional clarity of coverage as well as new enhancements. Some of the terms and conditions previously only available on the best broad A-Side forms are making their way down into underlying traditional (A+B+C) policies. Expanding coverage in the underlying forms takes pressure off of the excess A-Side forms to drop down on a difference-in-conditions basis – potentially removing obstacles to price reductions on these excess layers.

Some of the terms now more readily available include new A-Side triggers, financial insolvency drop-down provisions, clarification of the exhaustion of limits wording, and expansion of the definition of “subsidiary” under some forms to clearly include limited liability corporations. Additionally, as mentioned below, new coverage for independent directors is available from select markets.

INDEPENDENT DIRECTORS ARE SPEAKING UP

While separate coverage for independent directors (also known as nonexecutive directors) has been around for some time, these contracts have not attracted wide attention. This appears to be changing, with both buyer interest and coverage options on the rise.

On the demand side, a series of widely read articles questioned the practice of combining coverage for both directors and officers in the
same insurance contract, while others suggested that the independent directors might want some additional, dedicated coverage for themselves. Further impetus was provided by the recent Peregrine Systems settlements, which brought the total payments demanded of Peregrine’s outside or independent directors to $61.5 million, making this one of the largest such securities settlements.¹

On the supply side, several A-Side carriers in 2008 began offering additional limits of coverage for independent directors and in 2009 a major carrier introduced this partial reinstatement of limits into its traditional primary D&O form. Such moves are often emulated by others.

**CHANGING D&O PURCHASING PATTERNS**

In the wake of their own financial challenges as well as the credit crisis at large, buyers of D&O insurance continue to reassess their buying patterns. For one, many are now reconsidering where they buy their insurance due to counterparty risk. In some cases, this means that otherwise attractive, credit-worthy and competitive carriers may not be included in the final D&O carrier selection process.

While we believe that the market will not harden in 2010, carriers are hoping otherwise. Some are already pushing for higher rates. But the insurance buyers in this marketplace are being challenged as never before to do more with less, to protect their companies and executives with a shrinking insurance budget. This means softer demand, which has a softening effect on the marketplace.

¹In re Peregrine Systems, Inc. Securities Litigation, Case No. 02-CV-0870 BEN
Cyber incidents are on the rise, and so is spending on security, data breach notification, credit monitoring and regulatory compliance. What are vulnerable organizations doing about it?

Outsourced IT, disgruntled employees and regulatory risk highlighted Cyber Risk developments in 2009.

- In January, a security breach was discovered at a leading credit card processor affecting thousands of corporations. Hackers installed malicious software that lifted data as it crossed the credit card processor’s network. The data included credit card numbers, expiration dates and additional information on the magnetic stripes of cards owned by the customers of thousands of merchants and financial institutions. The loss will exceed $100 million. *Scary Fact:* The processor was payment card industry (PCI) compliant.

- Regulators imposed fines and penalties for organizations remiss in protecting personally identifiable data or health information.

- The downturn in the economy and consequential employee layoffs coincided with the rise in internal hacks.

- “Encrypt, encrypt, encrypt.” This cyber security chant was apparently ignored too often by organizations with sensitive data. *Scary Fact:* Only 21% of the systems breached in 2008 had encryption or other strong security features in place to thwart fraud (Source: Identity Theft Resource Center).

- Underwriters paid large losses arising out of data breaches. *Scary Fact:* In one case, hackers accessed more than one million credit cards and stole more than $10 million – in two days. The underwriter paid their policy limit.

- Notification and credit monitoring expense coverage under Cyber policies is expanding. *Scary Fact:* One underwriter paid $4 million in notification and credit monitoring expenses following an insured data breach. *Scary Fact:* Each breached record can cost a responsible party $90-$305, depending on whether or not fraud was perpetrated and whether the breached corporation was in a regulated industry, according to a 2008 Forrester survey.

- Premiums flattened, even in the face of increased litigation and regulation.

- E&O/Cyber products are the fastest growing part of our Executive Risks Practice – for the fourth year running.
RISING REGULATORY BAR

As the year draws to a close, thousands of organizations are grappling with new regulations imposed by:

- HIPAA/HITECH Act (Health Information Technology for Economic and Clinical Health Act) – Greatly expands the scope of HIPAA's applicability and enforcement and increases civil monetary penalties for violations for failure to protect the privacy of health information.

- Federal Trade Commission (FTC) Red Flags Rule – Requires certain businesses to develop a written program to spot the warning signs – red flags – of identity theft. Compliance will be enforced by the FTC beginning November 1, 2009.

- State security breach notification laws – 46 states plus the District of Columbia, Puerto Rico and the Virgin Islands have now enacted laws requiring companies to notify consumers of security breaches when personal information about those consumers may have been acquired by an unauthorized person. The Massachusetts law is one of the toughest. Though pushing compliance to March 2010, the state will require encryption, access controls and written information security programs to protect personally identifiable information of customers and employees. Some expect other states to follow suit.

RESPONSES

Cyber incidents are on the rise and so is spending on security, data breach notification, credit monitoring and regulatory compliance. What are vulnerable organizations doing about it?

- Implementing robust intrusion detection services – In the January credit card processor incident and several other recent data breaches, hackers were inside the network several months before they were detected. Most were found out by an outside vendor performing an assessment.

- Access controls – Employers are encouraged to limit employee access to certain applications that contain personally identifiable information, especially employers going through workforce downsizing.

- Encryption – More corporations are focused on not only the encryption of laptops, thumb drives and other peripherals, but encapsulating or masking data sent over transmission lines.
Vendor indemnification and insurance requirements – Review of new and existing contracts has revealed limitations in indemnification and vendor insurance coverage. Transferring Cyber Risk to the responsible party (i.e., the credit card processor) is now a major goal of risk management and procurement. Data breaches are often caused by a third-party service provider or business partner (44% of the time, according to the Ponemon Institute’s February 2009 “Cost of a Data Breach”).

Incidence response plans – Damage to reputation and loss of customers/clients often depends on how a breached entity responds to an incident. Organizations are preparing for breaches by documenting plans that will send the right message to affected customers. Timely notification and the offer of credit monitoring services have mitigated potential damages.

Cyber Risk insurance – Risk managers and IT security professionals reviewing Cyber Risk insurance coverage for the first time in 18 months or two years have been astonished at how the insuring agreements and language have responded in almost real time to the developing risks. They are also pleased to find that despite a rising demand, the premiums for cover have decreased.

Key insuring agreements in Cyber products focus on privacy breach coverage and privacy liability – liability arising out of the breach of personally identifiable or health information, whether the disclosure is committed intentionally, negligently, electronically or non-electronically (i.e., laptop theft, dumpster diving, lost thumb drives, etc.).

Cyber policies will usually 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

MARKETPLACE CONDITIONS

Several new underwriters and revised policy forms entered the market in 2009, responding to the demand for coverage. Key underwriters of Cyber Risk coverage include ACE (U.S. and London), Arch, AXIS, Beazley, Chartis, CNA, Chubb, Darwin, Hartford, Hudson (Euclid Managers), Hiscox, Kiln and St. Paul/Travelers. New forms from Beazley, Chartis, Hartford, Arch, RLI, ACE, Valiant and others have kept pace with the developing risk and pushed the competition for both primary and excess placements.
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. Towers of follow-form coverage/limits are built to satisfy the capacity need.

The demand for notification expense coverage and the increased market competition has allowed buyers to build notification sublimits with the excess markets. The excess sublimit drops down to sit above the sublimits of the underlying layers, hence building a large sublimit to respond to the initial costs arising from a breach.

Pricing remains very competitive. Companies with demonstrably strong IT security risk management policies and procedures (with a focus on developing risks) have a negotiating advantage that will reap benefits in policy wordings as well as cost. Despite the recent large insured losses, pricing is generally flat or down (by 5% at most) for renewals, while coverage has expanded. Underwriter appetite continues to vary by industry sector.

SUGGESTIONS FOR RISK MANAGERS

The Cyber Risk insurance market has continued to mature in terms of the underwriting process and core coverage, but policy wordings still vary substantially. Careful analysis, interpretation and customization are, as always, a necessity for those seeking optimal protection at the best price.

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Desired accounts should be able to negotiate a highly competitive price and favorable terms. Accounts that may be challenging to place include financial institutions, companies in the real estate sector, retail business and financially troubled companies.

In Employment Practices Liability (EPL) circles, the past year began with a new U.S. president inspiring fear that new legislation would adversely impact employers. While a number of legislative changes have taken place that may confirm some of these fears, so far this shift has been offset by the fact that the judges hearing EPL cases haven’t changed. This balancing act can be expected to continue into 2010.

- EPL claims continue to increase: Willis experienced a 22% year-over-year increase in reported EPL matters.

- Employers still enjoy a judiciary that hasn’t yet caught up with the executive branch in terms of higher standards for employers.

- The pricing of EPL insurance is expected to remain flat in the coming year, despite of the still faltering economy and its impact on the filing of EPL claims.

**CAPACITY AND PLAYERS**

As in the marketplace for Fiduciary Liability, the EPL carrier lineup matches that for Directors & Officers Liability (D&O). This is a natural outgrowth of EPL’s history as an insurance product originally spun off from D&O for public companies and the fact that for private companies and nonprofit organizations, the two coverages are sold together (or as one product). But unlike both Fiduciary Liability and D&O, EPL is purchased largely to protect the company itself rather than executives and trustees. This means that some of the factors that go into purchasing these two more visible products often do not come into play when considering EPL insurance.

Accounts that may be challenging to place include financial institutions, companies in the real estate sector, retail business and financially troubled companies. Very large global companies have their own challenge in that until recently there were few U.S. domestic markets that entertained Fortune 250 firms on a lead or primary basis. Over the past year, which has been fairly tumultuous for Executive Risks markets, more leaders stepped forward, often with aggressive pricing. The worrisome news for some is that this disruptive pricing may be difficult if not impossible to renew with these same markets.
PRICING

When it comes to private company and nonprofit organizations, where D&O and EPL are sold together, it is largely the EPL risk that dictates the combined premium. For public companies, where these insurance contracts are sold separately, even if negotiated in tandem, EPL is the smaller ticket item for many insurers. As a result, they are willing to be more competitive in EPL – whether pricing the two as side-by-side coverages or completely separately. This is extremely good news for buyers.

TERMS AND CONDITIONS

Many buyers focus more on pricing than on terms and conditions, which can have a dramatic and sometimes negative impact on claims and claim handling. This may also explain why coverage clarifications and expansions are slower to migrate to this coverage than in the world of D&O.

Desired accounts should be able to negotiate a highly competitive price and favorable terms. These buyers – those who are not in high-risk categories and demonstrate best-in-class risk mitigation – may be able to have their cake and eat it, too.

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So far, 2009 has turned out mostly as expected: relatively flat from a pricing and coverage perspective. Insureds with no losses and a strong balance sheet have been able to retain breadth of coverage and deductibles with little or no price increase. Looking toward 2010, we do not anticipate a major shift from what we are currently seeing in the market.

Rumblings from some leading Fidelity underwriters have begun, sending out signals that market pricing is too soft, particularly in the FI Bond market. The 2008 underwriting year produced poor loss ratios for some of the bigger names in the industry, while some new capacity was also severely hit with unexpected losses. Based on Surety Association figures for 2008, four of the major Fidelity markets had very high loss ratios, which, when combined with an estimated 30% expense factor, resulted in combined loss ratios well in excess of 100%. The remaining Fidelity markets had considerably more favorable combined loss ratios in the range of 65-75%, which may mean that the year ahead will prove to be varied and unpredictable.

So far, 2009 has turned out mostly as expected: relatively flat from a pricing and coverage perspective. Insureds with no losses and a strong balance sheet have been able to retain breadth of coverage and deductibles with little or no price increase. The Commercial Crime market continues to be more competitive, with generally flat renewals. Pricing is thin and excess layers are priced even thinner.

FEAR-INSPIRING FRAUD

The Financial Institution (FI) Bond market, however, is still not over the shocks of the past two years. The unthinkable overnight collapse of leading institutions, not the least of which included Bear Sterns, Lehman Brothers, Fannie Mae, Freddie Mac and AIG, left underwriters genuinely concerned about the potential for uncovering massive fraud within these and other financially strapped organizations. While underwriters’ concerns were largely unfounded, the Ponzi schemes uncovered throughout the year left senior underwriters second guessing their earlier commitments to certain types of FI accounts.

Coupled with the recession, these large fraud losses have, to no one’s surprise, resulted in a spike in FI Bond claim activity. Amidst this bad news, the industry was somewhat relieved to learn that many of the institutions did not carry large FI Bond limits, which would have compounded the effects already being felt by those underwriters that did insure these firms. On the other hand, the instances of enormous fraud that did come to light demonstrated the inability of regulators and outside auditors to discover fraudulent activity in a timely fashion. Fidelity underwriters – along with the rest of the world – were not prepared for schemes of such magnitude. Traditionally, Fidelity underwriters viewed the first $5 million to $10 million of limit to be the burn layer for a mid-sized financial institution. The size of the Madoff and baby Madoff Ponzi schemes shattered underwriters’ preconceptions about the potential size of Fidelity losses.
Most affected by these losses were the excess FI Bond underwriters, who frequently offered their full capacity at rates of 60-70% of the underlying layer. Anything excess of $10 million to $15 million was widely deemed a “safe write” and priced accordingly. Since mid-2009, underwriters on both primary and excess layers have been carefully reviewing both their pricing and capacity. The handful of markets willing to lead mid-sized and larger institutions have been pressing for increases of up to 10-15% in London. Furthermore, both primary and excess markets have been much more judicious in their use of capacity. Many underwriters now offer something less than their full capacity for larger FIs, resulting in the need to introduce additional markets to complete a program.

On paper, capacity has never been stronger. The addition of HCC, RLI, Berkley, Endurance, CV Starr and Everest Re to the market in the latter half of 2008 and in 2009 has added $90 million to a market built on $255 million in U.S. capacity and $130 million in London capacity. With one exception, however, this new capacity is focused on predominantly excess lines and/or middle market business. Only a handful of leading Fidelity markets remain able to lead on the mid-sized and larger FI accounts and on Fortune 500 companies.

Partly balancing the addition of new capacity, the Fidelity market lost some old line capacity this past year. Most notable was Crum & Forster, which coming into the 2009 year had $25 million in capacity, but sustained some bad losses and found itself reducing capacity to $5 million. The carrier withdrew from the FI Bond market entirely and increased its focus on Commercial Crime accounts.

THE YEAR AHEAD

Looking toward 2010, we do not anticipate a major shift from what we are currently seeing in the market. Several of the largest writers of FI business stand by their warnings of premium increases, particularly on the FI Bond product. Although we do not expect a material shift in the breadth of coverage offered to either commercial or FI clients, we do expect underwriters to continue using something less than their full capacity on FI business.

In an effort to offset the lack of primary capacity on many larger risks, we expect to see the greater use of co-surety programs on a primary basis. Although co-surety programs have the disadvantage of involving more than one claim department on even the smallest losses, some insurers are far more comfortable these days taking only a percentage of the primary layer. As a result, a co-surety structure can be a very useful tool to generate competition within the industry, where limited competition might otherwise prevail.

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While we expect capacity to be stable in 2010, some of the markets that acted aggressively in the recent past are reconsidering and potentially re-pricing some Fiduciary accounts.

The past year produced new as well as continuing challenges for ERISA fiduciaries and the companies that sponsor benefits plans for their employees. Internal and external financial pressures led many firms to curtail and/or eliminate benefits. But overall, exposures are not shrinking and new potential exposures are appearing in securities lending programs and target-date funds (also known as lifestyle plans) – both previously thought to be relatively risk free. If there is a lesson to be learned from the past year, it is that nothing is risk free.

- Willis saw an increase of 130% in the number of Fiduciary Liability claims filed over the previous year (following a 70% increase in 2008).

- However, market forces at play in the overall insurance field are countering what otherwise seemed to be ingredients for market hardening.

- We expect pricing to be stable this year, with decreases still possible for best-in-class risks.

**LOSS LEADERS**

A major concern for fiduciaries is the increase in the size of the largest ERISA class action settlements. That figure hit $17.7 billion in 2008, almost a ten-fold increase from $1.8 billion in 2007, with the bulk of that coming from four large settlements. With more ERISA tagalong claims against financial institutions working through the courts, these figures may grow further.

Corporate downsizings have swelled the ranks of those who typically bring ERISA fiduciary suits – ex-employees. At the same time, courts appear to be liberalizing the rule that ERISA civil claims can only be brought by current or potential ERISA plan beneficiaries (or other fiduciaries themselves). In a series of recent cases, a more modern view is emerging that allows past participants who have cashed out of a plan to bring a claim. They may allege that a breach of ERISA’s fiduciary duty improperly resulted in the reduction in value of their interest in the benefits plan.

Litigation over fees related to some 401(k) pension plans (costs that are ultimately paid by the participants themselves) continues through the courts as well. Perhaps the most notable decision came from the U.S. Court of Appeals for the Seventh Circuit, which denied a petition to rehear en banc the John Deere 401(k) fees litigation case. The plaintiffs filed this petition in the wake of the landmark decision dismissing their claims, in the first of the many 401(k) fee cases to be considered by the federal appellate courts. Stay tuned for more while defense expenses continue to mount.
Many purchasers of Fiduciary Liability insurance buy the coverage, in part, due to their awareness of ERISA's limitations on personal indemnification of fiduciaries (whether they be corporate officers, directors or employees). This issue came up recently when an appellate court denied corporate indemnification to the defendant fiduciaries. The court held that ERISA's fiduciary and self-dealing rules should apply to any fiduciary who also serves as a corporate director or officer at the time they make a fiduciary business decision from which they could directly profit. While the ERISA plan in question here was an Employee Stock Ownership Plan (ESOP), this reasoning may apply to non-ESOP companies as well.

**PLAYERS AND PRICING**

The major Fiduciary Liability insurers continue to be the major Directors & Officers insurers, though the roster is changing. For a period in 2009, this marketplace shifting resulted in some unexpected reductions in premium pricing. Now, a number of the new markets are beginning to look less favorably on this line and unpredicted price increases are cropping up. Almost gone are the precipitous drops that buyers previously enjoyed.

While we expect capacity to be stable in 2010, some of the markets that acted aggressively in the recent past are reconsidering and potentially re-pricing some Fiduciary accounts. So while stated capacity will likely remain the same, the willingness of some of these markets to continue to price aggressively is in doubt.

Best-in-class accounts for Fiduciary Liability insurance will continue to be those where:
1. The plan sponsor is not facing significant financial challenges
2. The pension plans do not (and did not) hold sizable amounts of company stock (10%+ of total plan assets, or $1 billion or more in value)
3. Plan funding levels (if relevant) are 90% or more
4. M&A activity is at a minimum
5. Strong governance controls are in place

**TERMS & CONDITIONS**

Terms and conditions to watch for include certain provisions migrating from D&O contracts, such as exhaustion of limits wording, carrier financial insolvency drop-downs, financial condition wording, broad severability and tailored claim notice requirements. Buyers should also consider ERISA-specific provisions specifying that damages in ERISA tagalong claims are not “benefits” that are excluded under Fiduciary Liability policies. Another potential issue is higher sublimits for a host of new and/or “improved” fiduciary penalties.
CHANGING BUYING HABITS

Traditionally, buyers prefer to have the same carrier lead their Fiduciary and D&O programs. Over the last renewal period, this changed for a number of buyers and many split the ticket for the first time ever, utilizing different carriers to lead the two programs. Events in 2010 will tell us whether this new trend is likely to continue or whether there will be a return to a joint purchase with a single carrier.

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2 ERISA tagalong claims are ERISA suits arising out of a stock drop in the employer’s securities when held in a company pension plan, such as a 401(k) plan.

3 One of the more recent such decisions was Harris v. Amgen, Inc., Case No. 08-55389 (U.S. 9th Cir, July 14, 2009).


On the whole, the insurance marketplace has weathered the unprecedented financial storm of the past year and, to the surprise of many, achieved a kind of balance. Big losses in 2008 and atrocious investment results led most observers to predict a hard market turn. The recession, however, had a dampening effect on demand that more or less balanced the pressures on supply, and the marketplace remains for the most part flat. How long this will last is unclear, but for now, the marketplace forces that push insurance buyers toward or away from alternative risk options are at bay. This does not mean the captives industry is static. Below we focus on two issues that bear watching: increased use of captives for employee benefits cessions and the coming of Solvency II rules in the E.U., which will have an impact across the ocean from Europe.

Employee benefits cessions to captives are generating increasing interest in the U.S., with a growing number of corporations with U.S. employees pursuing this option. Benefits captives are much more common outside of North America, particularly where multinational pooling is involved. The reason for the delay in the U.S. is that benefits plans typically are governed by federal laws set out by the Employee Retirement Income Security Act (ERISA). Benefits cessions to captives historically have required a regulatory exception involving a lengthy and expensive application and approval process.

In 2000, Columbia Energy received the initial exception, followed by Archer Daniels Midland in 2002. Subsequently, federal officials instituted a fast track approval process, granting approvals to applications incorporating plan components such as an A-rated fronting carrier, enhanced benefits, a domestic U.S. domicile and an annual actuarial analysis. So far, the most commonly approved lines are Long-Term Disability (LTD), Group Life and Accidental Death & Disability. But other lines are possible.

Four companies (Banner Health, Memorial Sloan-Kettering, United Technologies and Deutsche Post) were approved through the first two-thirds of 2009, following six approvals in 2008. Three more are currently pending (Microsoft, Dow Corning and R+L Carriers). Coca-Cola’s application to cede retiree medical coverage was rejected for not following the requirements of the fast track process. Coca-Cola is evaluating whether to submit a complete review.¹
There are a number of traditional self-insurance and risk management benefits for using a captive for benefits funding, such as management of premiums and control of losses. However, an additional factor bolstering the appeal of captives is an IRS ruling that captive contributions constitute third-party or unrelated premium, strengthening the case for premium deductibility for traditional Property & Casualty cessions.

**SOLVING SOLVENCY II**

Two new words have entered the captive lexicon: *proportionality* and *equivalence*. The instigator of this new vocabulary is Solvency II, the European Union’s solution to risk-based solvency for the (re)insurance industry. This regulatory regime goes into effect in 2013 but is already having a significant impact on the captive industry, which must come to terms with the implications of regulation targeted at and better suited to commercial carriers. A major area of concern is the way Solvency II treats the concentration of risks, which is integral to most captive business models. A captive with a single policyholder certainly presents concentration of risk. Under Solvency II, that could incur a capital penalty.

**PROPORTIONALITY**

The European captive industry is actively lobbying the E.U. Commission to *proportionally* apply aspects of Solvency II to captives in a way that reflects their unique status. They are arguing, in part, that the consumer protection requirements underpinning Solvency II should not apply when the financial institution subject to the regulation (the captive) is actually owned and funded by the captive's only consumer (the parent company). Proposals for some form of captive exemption from the full rigorsof Solvency II are expected to be released shortly. These are expected to apply to pure captives only – entities that only underwrite the risks of the parent company.

In the meantime, what should European captive owners be doing? If not already familiar with Solvency II, they should get up to speed with the proposed regime. Next, they should participate in the consultancy process and, where possible, support captive interest groups such as ECIRO, an association of captive owners established to lobby for special treatment for captives under Solvency II. The detailed regulatory framework is under construction and now is the time to influence policymakers. Or, put another way, if you are not at the dinner table you could be on the menu.

Captives should consider conducting a quantitative impact study (QIS) to understand how their business plan might be affected by the coming capital requirements. (CEIOPS, the E.U. body currently driving the development of Solvency II, has so far solicited four QIS assessments, with a fifth due to commence in 2010.) With that information, captive owners will be in a better position to determine whether parts of their captive business plan can be modified to lessen capital drag or if they may face a potential shortfall in regulatory capital.
EQUIVALENCE

It is a fallacy to think Solvency II will only affect E.U. captives. Any captive that touches E.U. risk will be impacted by factors such as increased fronting fees and additional security requirements from local E.U.-admitted insurers. The scale of these increased costs will be dependant on the equivalence of the captive domicile’s regulatory regime to Solvency II as assessed by the E.U. Commission. The closer the regulations are aligned, the lower the costs.

Non-E.U. domiciles are aware of the potential financial burden that could be placed on their captives. To minimize the damage, many non-E.U. domiciles are implementing new solvency regimes more closely aligned to Solvency II. The trick is to move close enough to Solvency II to satisfy the E.U. without surrendering the regulatory flexibility that made the domicile attractive in the first place. One difficulty at this point is that CEIOPS has not yet issued guidance on how equivalence will be assessed.

Bermuda and Switzerland are in the vanguard of this transition and are looking to introduce solvency regimes that are very similar to Solvency II. Domiciles with a predominantly non-E.U. client base may be more resistant to extreme regulatory change, even though most recognize the need to address the core principles of risk-based regulation. In the long run, what we are seeing is a fundamental change in insurance regulation to which the captive industry will not be immune. The industry itself will need to invest significant resources over the coming years to understand the impact of Solvency II and equivalent regimes, to influence the debate about the ultimate requirements of Solvency II, and to mitigate its impact.

A final point: those wanting evidence of the truism that those who cannot remember the past are condemned to repeat it need look no further than the news of closure of many captives of U.K. residential mortgage lenders. These captives were set up after the last U.K. housing market collapse of the late 1980s to protect against borrowers’ default and guard against lax credit underwriting. After accumulating significant funds over a period of rampant house price inflation many of these captives were ultimately closed down to release valuable cash. The U.K. housing market has now gone full circle and entered another recession. Lenders have insufficient provisions to fund the cost of repossessions, many occurring as the result of poor underwriting of the loans. Expect to see a rash of mortgage indemnity captive formations in due course with assurances that the recent excesses of extending credit will not be repeated. Another truism comes to mind: Plus ça change plus c’est la même chose!

1 Source for company information: Business Insurance articles from March 2009 through September 2009.
2 The more things change, the more they remain the same.
Rates are down, but business is up. Sound contradictory? It’s the story of one insurance sector’s successful struggle against the recessionary tide. The environmental insurance industry has historically followed the construction and commercial real estate sectors, which in turn rely heavily on the credit markets. The recession continues to have a negative impact on development and many construction projects remain susceptible to delay or even cancellation. While we are starting to see the first benefits associated with Obama’s stimulus package – most notably in infrastructure and energy projects – it will likely be some time before major project-related environmental premium volume returns to previous levels.

Environmental insurers, however, have shown great resilience over the years, targeting new industry sectors and developing new products. Once again, despite the current economic challenges, many of the major environmental carriers are reporting increases in new business premium volume and growth in renewal premiums.

Reflecting the optimism about the growth potential in this space, even in these tough times, more insurers have recently entered or have announced plans to enter the highly competitive environmental market. More than 25 insurers now offer environmental products in North America. New entrants to the environmental market in recent months include CV Starr, Catlin, Ironshore, Navigators and Philadelphia Insurance Company. This growing list of insurers provides greater choice to insureds and has helped to delay the rate increases that many have been expecting in the wake of overall poor industry results.

A MATURING MARKET SECTOR

In the current market, environmental insurance premium growth is being driven by many factors:

- **Concerns over greater risk exposures.** Corporate risk professionals in the U.S. are preparing for more rigorous enforcement of environmental regulations from the Obama administration.

- **Continued realization that environmental risk is not limited to industrial sites.** More hospitals and other health care facilities, colleges and universities, owners of commercial real estate and developers are using environmental insurance to address environmental liability concerns.
- **Impact of financial distress.** Increased pressure on balance sheets and liquidity elevates the significance of environmental liabilities, for example:
  - As companies enter bankruptcy and financial reorganization under Chapter 11, bankruptcy courts and trustees often look to resolve outstanding environmental claims, sell unencumbered assets and protect future lenders from environmental liability.
  - Budget crises at the state level often motivate authorities to look for deep pockets to fund cleanup projects.
  - Under the federal Super Fund law (CERCLA), as other liable parties at a cleanup site become defunct or bankrupt, the survivor “PRPs” get a larger share of the financial liability.

- **Expanding financial assurance requirements.** Shaky balance sheets the world over have inspired greater implementation and enforcement of financial assurance provisions by regulatory bodies. Insurance has always been a competitive financial assurance compliance option, and the environmental insurers that offer financial assurance products (either surety or insurance policies) are experiencing much more activity.

- **Development of innovative new products.** New offerings aim at environmentally friendly construction initiatives, such as the U.S. Green Building Council LEED program, or climate change-related initiatives, such as carbon sequestration projects.

- **Attractive market conditions.** Companies are taking advantage of historically low rates to expand their pollution programs – for example, buying higher limits or expanding coverage, including locking in favorable terms for multiple-year policy periods.

- **Continued interest in package programs.** These programs offer competitively priced Professional Liability or Casualty policies in combination with pollution coverage. More environmental insurers have introduced new pollution package programs (such as ACE, Great American, Ironshore and Zurich), and they have enjoyed considerable success by targeting their existing P&C customers. New package policies are also combining pollution coverages that formerly required separate policies. For example, Chartis Environmental Infrastructure Solutions combines Site Pollution Legal Liability and Contractors Pollution Liability.

- **Global expansion.** Companies often expand their pollution programs when they expand operations into areas with stricter environmental regulations or even compulsory environmental insurance schemes. Most of the major U.S. environmental carriers now have the ability to provide sophisticated global pollution insurance programs and many can issue locally admitted policies, in local languages, in countries like India and China.
MARKET SPECIFICS
Insurers continue to seek profitable underwriting with increasing emphasis on short-term programs and less reliance on one-off, long-term, project-specific placements. Premiums associated with the more attractive, renewable lines of business are still decreasing – although prices are not currently declining at the same rate they did in the previous 12 months. Still, price reductions do not appear to have bottomed out yet and there are bargains to be had.

In contrast, the market has remained relatively firm on complex, long-term policies and more challenging product lines, such as Remediation Cost Cap and monoline Products Pollution coverage.

Aggregate capacity in the industry remains relatively stable, with most of the leading carriers able to provide $25 million to $50 million in limits for a single placement. In situations where more limits are required, we are placing more layered environmental programs – involving more than one insurer to build capacity.

Regarding terms and conditions, insurers continue to be aggressive in some of the more competitive environmental lines of coverage, such as Contractors Pollution Liability and Site Pollution Liability. For example, we have seen insurers offer blanket non-owned waste disposal site coverage (albeit with conditions). Coverage for nuclear, biological, chemical and radiological exposures, including the result of acts of terrorism, is being underwritten by more insurers, on more types of risks.

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If your international program has enjoyed several years of competitive pricing and loose underwriting you may want to take the time to carefully check your exposures and the coverages you are obtaining locally. A lack of underwriting scrutiny can result in too little or too much coverage.

International program carriers remain stable, and pricing is mixed but still very competitive for controlled master programs (CMPs). With the exception of newcomer AXA, the list of international program carriers accessed in the U.S. has changed little over the last few years. Chartis now appears as the new name for AIG. AWAC in the U.S. is looking for ways to enter into the international space. Zurich and AWAC recently entered the DBA market. Otherwise, the names and roles are familiar. While the buyers of international programs face a fairly calm and benign marketplace, they should be aware of several trends in international coverage:

- Casualty and Property CMPs once dominated the international program market, but Directors & Officers (D&O), Environmental and, most recently, Professional Liability are becoming more common.
- More carriers are showing greater diligence in effecting allocation of premiums and tax payments on non-admitted placements and non-admitted compliance.
- There is evidence of aggressive audits for premium tax/FET violations by authorities in Canada, U.S., Germany, U.K. and France.
- Argentina and China recently introduced mandatory green insurance requirements.
- Pooling of employee benefits continues to make progress.

**MARKET SNAPSHOT**

The international carriers accessed in the U.S. that serve multinational clients can be divided into two tiers according to their 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, the underwriting expertise to accept the most difficult classes of business and the willingness to offer premium allocation flexibility.

**Tier II** – These carriers own a limited to 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.
OWNERSHIP

All of the international carriers claim representation in 100 or more countries. Representation can be through separate affiliated companies or direct ownership. We believe that ownership is important for several reasons:

- Uniform standards and objectives
- Authority to enforce compliance
- Greater centralized influence on coverage terms
- Sharing of resources
- Common technology platform

Not highlighted in this report are Generali, HDI-Gerling, Mafre, Royal & SunAlliance and QBE. These program carriers are accessed outside of the U.S. for Controlled Master Programs (CMP).
Access to proprietary information, hence improved communication
- Efficiency at every stage
- Enhanced accountability

Most carriers own operations in the major economies where significant premium volumes are written. In some cases, as much as 90% of the premiums are in countries where they have ownership. For a multinational in dozens of countries, however, working with a completely owned carrier network is unlikely.

### INTERNATIONAL CARRIER OWNERSHIP POSITIONS AS OF SEPTEMBER 1, 2009

<table>
<thead>
<tr>
<th>CARRIER</th>
<th>OWNED COUNTRIES</th>
<th>NON-AFFILIATED COUNTRIES</th>
<th>TOTAL COUNTRIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACE</td>
<td>60</td>
<td>100</td>
<td>160</td>
</tr>
<tr>
<td>ALLIANZ</td>
<td>75</td>
<td>75</td>
<td>150</td>
</tr>
<tr>
<td>AXA</td>
<td>35</td>
<td>75</td>
<td>110</td>
</tr>
<tr>
<td>CHARTIS</td>
<td>94</td>
<td>82</td>
<td>176</td>
</tr>
<tr>
<td>CHUBB</td>
<td>27</td>
<td>100</td>
<td>127</td>
</tr>
<tr>
<td>CNA</td>
<td>14</td>
<td>94</td>
<td>108</td>
</tr>
<tr>
<td>FM GLOBAL</td>
<td>35</td>
<td>80</td>
<td>115</td>
</tr>
<tr>
<td>LIBERTY</td>
<td>24</td>
<td>112</td>
<td>136</td>
</tr>
<tr>
<td>TRAVELERS</td>
<td>3</td>
<td>100</td>
<td>103</td>
</tr>
<tr>
<td>XL</td>
<td>20</td>
<td>80</td>
<td>100</td>
</tr>
<tr>
<td>ZURICH</td>
<td>51</td>
<td>138</td>
<td>189</td>
</tr>
</tbody>
</table>

*Source: Willis International Practice*

### INSURANCE PREMIUM TAXES AND COMPLIANCE

In the 2006 edition of *Marketplace Realities*, we reported that tax payment systems in Europe had matured and become part of common insurance business practice. In 2009, we see that compliance and insurance premium taxes for global and non-admitted placements remain challenges. While Europe is adjusting to these requirements, the U.S. is lagging behind. At least U.S. clients are beginning to demand more clarity on this subject, as they understand that without international carrier support, addressing these issues would be difficult, if not impossible.

Multinationals should be ready to change premium allocations in response to adjustments carriers may make as they prepare for audits by regulators. Regulators are looking to ascertain if premiums are in proper relationship to exposures. For many multinationals, current practice involves allocating a nominal $2,500 or so for the issuance of a local policy. We believe this strategy may be on the way out for regulatory and fiscal reasons. Such a change would clearly hasten the reallocation of premiums under CMPs.
In successful cases, often with values-at-risk above US$100 million or risks out of local companies’ guidelines, fronting fees average 5%. We expect that as the market matures over the next few years, the use of global program capacity will become easier.

As local insurance companies are now able to use their corporate reinsurance treaties, local capacity has been significantly increased and co-insurance programs are appearing on more large risks.

With the introduction of these new reinsurance treaties outside the control of the IRB, local insurance carriers are changing the way they underwrite risks, using international standards and guidelines. This has created some difficulties on renewals for clients and brokers that were used to having IRB back up difficult placements in the past.

Brazil continues to be a market where multinationals will want to protect officers and directors with local D&O policies.

Indian companies are gradually waking up to the fact that D&O is a must-have rather than a should-have cover. Directors sitting on the board of any corporation are insisting on D&O protection. Multinationals operating in India should do the same. D&O policies must be local. The limit of liability will depend on the size of local operations.

Since India is an admitted market, using a global policy to protect the local directors and officers is not a legal option. It is not a practical option either, as the FEMA (Foreign Exchange Management Act) does not allow any influx of foreign capital to pay claims.

**LOCAL ISSUES**

Multinationals need to be keenly aware of local developments that impact the way business is conducted in countries around the world. Here is a review of some key developments.

**BRAZIL**

For more than 69 years, reinsurance in Brazil was controlled by the IRB-Brasil-Re SA (IRB), the state-owned reinsurer. On January 15, 2007, in a significant and long-awaited move, Brazil’s vice-president Jose Alencar signed Law 126/2007 opening up the local reinsurance market. The market officially opened on April 17, 2008, presenting opportunities and challenges to brokers, insurance carriers and reinsurers.

The market opening process is slow, as the reinsurers able to act as a vehicle to global program capacity must be registered in Brazil.

In theory, local insurance companies can now front for global programs placed outside of Brazil through facultative reinsurance via locally registered markets. However, this has been rather difficult to accomplish, with local companies often prioritizing the retention of risks within their own automatic reinsurance treaty contracts, and local insurers and registered reinsurers unwilling to act as purely fronting vehicles.

Compliance and taxes will probably challenge clients, brokers and markets for years to come. New and creative solutions to these issues must be developed. Clients, carriers and brokers need to be on the same page if measurable progress is going to be made. We are still a long way from a consistent industry position.
Over several categories. Time will tell how successful the implementation will be.

A revised national insurance law was passed this year, effective October 1, 2009. The new law aims to provide better protection for insureds and reinforce controls on insurers. The changes should mostly benefit international companies doing business and insuring their interests in China.

MORAL DAMAGES IN LATIN AMERICA

The landscape surrounding awards for injury continues to change internationally, and while keeping track of all developments is close to impossible, it is worth noting that in several Latin American countries legislation regarding suffering and affliction is being aggressively pursued.

The concept of moral damages has its origins in the French legal doctrine (Napoleonic Code), where it is known as dommages morales. Daño moral, as it is known in Spanish, is drawing interest in Latin American countries, where the concepts of liability and award levels have been significantly at odds with those in the U.S. Moral damages consist of the pain, anguish, physical or spiritual suffering inflicted on a victim by a harmful event.

In Brazil, specific legislation (Civil Law Article 953) addresses moral damages. Indemnities awarded for pain and suffering are independent of bodily injury or material damage and, where the affected party cannot prove material damages, the judge will set the value of the indemnity based on the circumstances of the event. Judges are empowered to decide the value of moral damages indemnity as well, taking into
consideration circumstances, proportion of responsibility and the economic and social positions of both plaintiff and defendant.

The Brazilian Consumer Code and the Federal Constitution also contain specific articles about moral damages. Examples of cases where moral damages may apply include those involving laboratory test errors, false information or statements, bad checks, delays in handling documents, breach of a house refurbishing contract and removal of body remains without family consent.

We have no specific data on claim volumes, but we have observed an increase in claims of this nature, as well as an increase in awards. Awards vary between US$1,000 and US$1,000,000.

General and Auto Liability insurers provide moral damages cover separately from the main limit and at an additional cost. The cover, however, is normally limited to pain and suffering from accidents that result in bodily injury. For D&O and Employment Practices Liability (EPL), cover for moral damages is normally included in the main limit.

In Colombia, families have started civil proceedings to recoup losses sustained in traumatic events. The most publicized case involved a prince-and-the-pauper story where two babies were given to the wrong mothers and grew up in opposite socio-economic circumstances. Several lawyers have actively pursued clients and encouraged them to seek significant sums of money. Judgments can come slowly as defendants counter arguments and fight to reduce awards.

Chile recognizes the concept of moral damages, and insurance policies typically include coverage within the policy limit.

Mexico’s legal framework follows the Napoleonic Code and recognizes suffering and moral damages. However, in practice, injuries and loss of income are covered through the Mexican Social Security Institute (IMSS), and courts do not recognize any form of suffering.

In Central America, most national legal systems do not allow the simple pursuit of civil damages for injury, lesser still for moral damages – for now. It will be important to monitor the region to ensure clients are properly aware of the exposures they face and are properly protected.

**DEFENSE BASE ACT COVERAGE**

This market is still dominated by Chartis, with CNA, ACE and Chubb very active. Zurich in recent years has entered into this space, and most recently AWAC has been licensed.

**CAPTIVE FRONTING PROGRAMS**

The cast of carriers offering fronting programs and the limits they offer remain stable. Most carriers are able to front in all countries where they have a presence, whether the local office is owned or affiliated.

As carriers expand their capabilities we are seeing a more competitive environment for these programs, but security requirements for the insurers for whom they front remain stringent.
After decades of steady development, multinational pooling has become a tool for some 3,000 multinational companies around the world. These vehicles offer economy of scale and can help ensure compliance, consistency and competitiveness for local benefits plans. Multinationals are choosing among nine main providers of multinational pooling networks:

- Chartis
- All Net
- Insurope
- Generali
- IGP
- ING
- Maxis
- Swiss Life
- Zurich

**INTERNATIONAL POOLING AND BENEFITS CAPTIVES**

**FRONTING CARRIERS**
**AS OF SEPTEMBER 1, 2009**

<table>
<thead>
<tr>
<th>CARRIER</th>
<th>MAXIMUM FRONTING LIMITS</th>
<th>SECURITY REQUIREMENTS</th>
<th>GUARANTEED CASH FLOW (STANDARD TERMS)</th>
<th>CAPTIVE FRONTING PROGRAMS</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACE</td>
<td>Property/$500M Liability/$50M</td>
<td>Committee Approval</td>
<td>Paid by the 25th, out the 15th of following month</td>
<td>U.S. - 50 ROW - 40</td>
</tr>
<tr>
<td>ALLIANZ</td>
<td>Property/$500M Liability/$10M*</td>
<td>S&amp;P AA Rated Committee Approval</td>
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<td>U.S. - 30 ROW - 230</td>
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<tr>
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<td>CHARTIS</td>
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<td>25 days selected countries</td>
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<td>FM GLOBAL</td>
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<tr>
<td>ZURICH</td>
<td>Property/$500M Liability/$25M</td>
<td>Committee Approval</td>
<td>5 days owned, 30-60 days affiliated</td>
<td>U.S. - 50 ROW - 150</td>
</tr>
</tbody>
</table>

*Excludes the U.S. and only applies to non-U.S. companies (Liability only)

*Source: Willis International Practice*
Meanwhile, interest in transitioning from multinational pooling to a captive arrangement has increased significantly over the past five years. While all networks have knowledge and opinions about captive solutions, only a few have proven solutions. Less than 50 companies have implemented employee benefits captive solutions. In those cases, multinationals and advisers have worked hand in hand to ensure captive feasibility and determine premium volume, frictional costs, lines of cover and claim statistics.

In response to the interest in captive structures, the pooling networks have developed pooling solutions that transition all or most risk to the multinationals. Narrowing the difference between multinational pooling and captive solutions has sparked competition. For more on the use of captives for benefits in the U.S., see the *Marketplace Realities* piece on captives.

Many multinationals are fairly relaxed about laws requiring admitted policies, thinking that because fines have been minimal there is no compelling reason to place a local policy. Those companies may want to rethink their stance as the stakes are rising. We hear reports that Russia is stopping non-admitted loss payments into their country and in China, engaging in commercial insurance activities with a non-admitted insurer can be a criminal and/or civil offense. In circumstances where it is not a criminal offense, the Chinese Insurance Supervision and Administration Department may confiscate all illegal gains and impose a fine.

If your international program has enjoyed several years of competitive pricing and loose underwriting you may want to take the time to carefully check your exposures and the coverages you are obtaining locally. A lack of underwriting scrutiny can result in too little or too much coverage. Work closely with your insurance adviser to assess where you stand. This will put you ahead of the curve when the market hardens.

**STRATEGIES FOR 2010**

In the current market, we expect that some multinationals may consider restructuring their international programs, but most will continue to do what they are already doing. Multinationals with CAT exposures may consider splitting their program between the U.S. and the rest of the world. This would allow them to access additional carriers.

Competition between international and local carriers is likely to continue. Multinationals whose overseas subsidiaries might attract local competitive pricing will have to carefully weigh the pros and cons of opting out of global programs. This is less of an issue for multinationals who exert close management control of their overseas operations.

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Personal Umbrella Liability continues to be one of the best buys in Personal insurance, with most companies charging less than $1000 for $5 million of coverage per year, and some less than $500 depending upon the exposures covered.

Personal fortunes may rise and fall with the gyrations of the general economy, but Personal Lines of insurance are often immune to some of the more dramatic turns of the general commercial insurance world. A review of the market for key Personal Lines follows our discussion in previous issues of Marketplace Realities, with some notable updates, including a new section on international exposures.

PROPERTY

The Personal Lines Property market remained relatively stable in most parts of the U.S. this past year. Notable exceptions were coastal catastrophe areas like the Southeast U.S. and states bordering the Gulf of Mexico, plus other coastal areas such as Long Island, New York and Cape Cod, Massachusetts. In these areas, market capacity remains limited, despite the emergence of a number of non-rated or low-rated Property carriers in Florida. Earthquake-prone areas such as California and the Pacific Northwest are likewise limited in capacity. In the standard market, the impact of these trends on rates is moderate, as most carriers take gradual increases or depend on rising dwelling values to realize small increases in premium. Home values have not recovered from the declines of the last year and a half. Underwriting appetite tends to drive the current market, particularly for properties in the areas mentioned above.

When reviewing Property insurance be aware:

- Wind exposed coastal states will be affected negatively by a poor hurricane season. Hurricane and other catastrophe losses surged in 2008, reaching $26.2 billion as of July 2009. In response to the 37 catastrophes in 2008, the highest number since 1999, Personal Lines carriers will seek to make up for their losses – as well as for losses dating back to 2005, the year of Hurricanes Katrina and Rita. Last year, Property & Casualty insurers paid out $10.7 billion in losses from Hurricane Ike, $2.1 billion from Hurricane Gustav, and $3.6 billion from tornadoes and related damage.

- California, Washington and other states near major faults (such as the New Madrid fault in the Midwest) will be affected by any earthquake activity as far as availability of coverage is concerned. In California, companies are required to offer Earthquake coverage when a dwelling or Personal Property policy is placed. Many companies will limit the amount of EQ they will provide. Recently, companies have become increasingly concerned with brush fires in California and most will consider fire risk in addition to earthquake risk prior to making an offer to provide coverage.
Capacity changes from year to year. The more time that lapses after an earthquake or hurricane, the more capacity is available.

Companies leave and enter markets. There are new underwriters in the market since the 2005 (post Katrina) and more carriers interested in the high-net-worth market.

ACE Private Risk has boldly entered the market serving the insurance needs of the affluent. Perennial leaders in the field, Chubb, Fireman’s Fund and AIG Private Client Group (now part of Chartis), have clearly taken notice and continue to modify and improve their products and rates to counter the competition. Another fairly new entry into the marketplace is PURE. PURE is a reciprocal insurance exchange that provides an alternative for affluent clients in Florida, South Carolina, New Jersey, Connecticut and New York.

A good agent or broker will guide clients through market changes and make you aware of new players and new products each year.

AUTOMOBILE

In 2008, private passenger Auto insurance was the largest line of insurance based on net premiums written, making up 36% of all Property & Casualty insurance and 73% of Personal insurance. Automobile claims have been down for quite a few years and as their loss experience has improved most companies have expanded their Auto insurance capacity. Although Auto coverage is more of a commodity, with heavy regulation from consumer-driven insurance departments, companies have invested heavily in new technology that can more accurately rate drivers with varying underwriting factors. Most companies are using many more variables and rating tiers. This allows them to more accurately set premiums with the intention of rewarding good drivers and penalizing poor drivers. This generally helps the consumer, and many drivers are seeing rate reductions in their Auto insurance as this technology is put in place.

When reviewing Auto insurance be aware:

- It is best to come clean regarding your accident and violation record at the beginning of the application process. Companies find out in an instant whether your application is accurate through Motor Vehicle Reports and claim history reports.

- Credit scores are still a factor in the Auto insurance rating process.

- The cost of repairing a car, not just the car’s value, is a major factor in physical damage coverage premiums.
Multi-car discounts are available from most companies.

Multi-coverage discounts are also available. Check with your existing Property insurance carrier to see if placing Auto insurance with them affords any benefit.

**PERSONAL UMBRELLA LIABILITY**

This continues to be one of the best buys in Personal insurance, with most companies charging less than $1000 for $5 million of coverage per year, and some less than $500 depending upon the exposures covered. Up to $50 million is available where appropriate and $100 million still available in special cases. Carriers specializing in coverage for the affluent usually offer options for EPLI (Employment Practices Liability Insurance), Nonprofit Directors & Officers Liability and the more traditional Excess Uninsured/Underinsured Liability, all of which may be added by endorsement to the Personal Excess Liability contract.

**INTERNATIONAL EXPOSURES**

Although not a regular occurrence, more people are purchasing property outside of their country of citizenship. If you work with an international insurance broker, it may be possible to have your broker place coverage for you, possibly with the same insurance company that provides your domestic Property and Casualty coverage. More often than not, however, property purchased outside the country of your primary residence will require a separate policy placed by an insurance agent or broker licensed in the country where the property is located.

Automobiles must be insured in the country where they are registered and/or operated. Owners must comply with the financial responsibility laws or the specific legal requirements of that country for motor vehicles. There may be some coverage afforded between countries, but it is typically limited. Coverage should be confirmed before driving an automobile in a foreign country.

Although some Personal Excess Liability policies do provide some coverage on a worldwide basis, this does not typically include coverage for foreign residences or automobiles operated in a foreign country without prior agreement. Cars must be listed on the policy as a covered location or vehicle.

In all cases, you should check with your domestic agent or broker regarding coverage limitations or coverage that might be available under your domestic policies and for assistance in obtaining the appropriate coverage for foreign exposures.

**NEW PERSONAL COVERAGES**

New coverages emerge in Personal insurance in response to changing risks and needs.

- Workers’ Compensation coverage can be purchased for domestic staff, including housekeepers, nannies, personal assistants and caretakers. Chartis recently provided an option to provide basic health insurance for domestics as well.

- Specific coverage may be secured now for a variety of personal watercraft ranging from large yachts to waverunners and jet skis.

- Golf carts, ATVs and utility vehicles utilized to service client properties can be covered on personal contracts.

- Kidnap & Ransom coverage is available in the Personal insurance marketplace today as well.

Personal insurance continues to evolve and adapt to the needs of this select consumer group. The Madoff case reminded policyholders that protection for theft of securities is limited under Homeowners policies. Some carriers now cover this exposure for an additional premium as a separate endorsement to their Homeowners coverage.
STATE BY STATE

Personal Lines insurance is heavily regulated on a state-by-state basis. In most states, rates must be approved by insurance departments. It takes time for significant rate changes to happen, even in states like Florida and California, where catastrophe losses have significantly cut into companies’ policyholder surpluses.

Rates can also vary significantly from company to company, even in a heavy regulatory environment. Massachusetts recently transitioned from a system in which the commissioner of insurance set automobile rates for all companies to a (managed) competitive rate environment. Based on their loss history and underwriting appetite, companies can and will charge a wide range of premiums. Underwriting guidelines also vary and will impact premiums from company to company as well.

Individuals should select an agent or broker who works with a variety of companies. Knowledge of a changing Personal Lines marketplace is a must, and a good agent or broker will do a risk and premium analysis to ensure the individual is with the right company with the right coverage at the most cost-effective price.

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Political risks continue to rise the world over, largely as a result of pressures generated by the global financial crisis.

In emerging markets, where politics matter at least as much as economics, investors face a unique exposure: political risk. Today, that risk grows steadily, as unprecedented global economic misfortunes fuel civil unrest, political instability and pressure on governments to revert to protectionist practices. The resulting ominous combination of economic trouble, global interdependence and uncertain political environments makes Political Risk insurance (PRI) for equity investments a highly valuable source of protection.

So far, 2009 has been a year of contrasts for the Equity Political Risk market, as the global economy has proven itself to be a double-edged sword. For buyers, rising exposures have been countered by budgetary constraints. Comparable conflicts exist for the carriers, as their hunger for new, sustainable business relationships has been tempered by rising claims, financial stress and an uneasy reinsurance climate. In contrast to 2008, which saw softer market conditions, rising interest in Political Risk insurance from buyers in 2009 has battled a contraction in the number of markets able to underwrite aggressively.

**WHAT IS POLITICAL RISK INSURANCE FOR EQUITY INVESTMENTS?**

Many companies have a wide array of investments abroad. These take the form of manufacturing subsidiaries, build-own-operate or transfer projects, mobile assets used in construction projects and joint ventures with foreign governments. Foreign investments will prosper, however, only as long as the host countries tolerate them. However prudently a company researches counterparties and monitors events, adverse political circumstances can put the balance sheet at risk. The prudent investor needs to assess the specific political and economic risks that could – in the long run – undermine the viability of the investment.

**RISKS ADDRESSED BY PRI PRODUCTS**

- Confiscation, expropriation or nationalization of an investor’s permanent or mobile assets
- Deprivation or inability to export finished products from a foreign locale or to repatriate mobile assets
- Discriminatory governmental actions or acts of expropriation, which deprive investors of their rights or render operations uneconomical
- Export or operating license cancellation/revocation
- Currency inconvertibility, or the inability to convert and/or freely transfer dividends or other scheduled payments from the host country
- Political violence and war: physical damage to assets caused by military action, civil war, terrorism, etc.
- Forced abandonment/forced divestiture of an investment or mobile assets
- Breach of a production, concession or government agreement following political violence or war
SUPPLY

The Political Risk market for equity investors has hardened since 2008. The change is attributable to three interlinked forces: claims, reinsurance pressure and capacity constraints.

CLAIMS

While PRI has traditionally been a low-frequency, high-severity market, current trends are pointing to higher frequency. Extremism in one country seems to encourage extremism in others, and weakened multinationals, often lacking domestic political backing, are seen as easy targets. Since early 2008, Political Risk claims have come from countries as diverse as China, the Ukraine and Venezuela. Coupled with the significant rise in Trade Credit claims borne by many Political Risk insurers, these claims have driven carriers into more conservative underwriting positions, particularly as the risk of loss from political activity continues to rise in many countries.

REINSURANCE PRESSURE

Insurers are under pressure to generate premium, not least because of rising PRI reinsurance premiums. The deterioration in their Credit insurance business means PRI insurers are more dependent on their other leg – Equity Investment insurance. This has opened a window to good deals in the PRI market. This window may close, however, as losses worsen, reinsurers withdraw (Swiss Re) and insurers suffer (AIG, Atradius). Senior managers, with a view to enterprise risk management, may also turn against PRI, given the losses and potential for more, and decide instead to reduce their exposure to political risks. Further market tightening could follow in 2010. Rather than look back to the more benign 2008 market, buyers might be better off moving quickly in case of a rougher road ahead. The availability of non-cancelable policy terms of up to 15 years (a typical policy period being in the three- to five-year range) is of particular benefit when viewed from this perspective.

MARKET CAPACITY

<table>
<thead>
<tr>
<th>INSURER</th>
<th>RATING</th>
<th>MAXIMUM CAPACITY EXPROPRIATION RISKS (MILLION $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACE</td>
<td>S&amp;P A+</td>
<td>80</td>
</tr>
<tr>
<td>ASPEN (LLOYD’S)</td>
<td>S&amp;P A</td>
<td>70</td>
</tr>
<tr>
<td>ATRADIUS</td>
<td>S&amp;P A-</td>
<td>65</td>
</tr>
<tr>
<td>AXIS</td>
<td>S&amp;P A+</td>
<td>65</td>
</tr>
<tr>
<td>CATLIN</td>
<td>Moody’s A</td>
<td>90</td>
</tr>
<tr>
<td>CHARTIS (EX-AIG)</td>
<td>S&amp;P A+</td>
<td>120</td>
</tr>
<tr>
<td>CHUBB</td>
<td>S&amp;P AA</td>
<td>75</td>
</tr>
<tr>
<td>COFACE</td>
<td>Fitch AA+</td>
<td>65</td>
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<tr>
<td>KILN (LLOYD’S)</td>
<td>Moody’s A-</td>
<td>60</td>
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<tr>
<td>LANCASTER</td>
<td>AM Best A-</td>
<td>200</td>
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<tr>
<td>QBE</td>
<td>S&amp;P A+</td>
<td>50</td>
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<tr>
<td>SOVEREIGN (100% ACE)</td>
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<td>125</td>
</tr>
<tr>
<td>ZURICH</td>
<td>S&amp;P AA-</td>
<td>150</td>
</tr>
</tbody>
</table>
There are additional company markets, but beyond the group listed above, the focus is increasingly on Lloyd’s (S&P A+).

Political Risk market capacity – around $1.4 billion in total for the private market – took a hit with AIG’s decline in 2008. Long a leading market in this field with a per-risk capacity of $120 million, AIG (now Chartis) was suddenly a difficult name for corporates to consider. However, Chartis (which often writes on the S&P A+ rated National Union Fire Insurance Company of Pittsburgh, PA paper) continues to write Equity Political Risk business, and in 2009 seems to have benefited from an easing of buyer concerns. Some of this is due to the government support it has received, although it is no doubt also due to the carrier’s long-standing presence in the market on a large number of buyers’ other insurance lines.

The second Political Risk insurer to face hardships recently was Atradius Trade Credit Insurance, which was downgraded to S&P A-, negative watch earlier this year. Most recently, Atradius’s rating was affirmed by S&P at A-, and its negative watch revised to a negative outlook. The avoidance of a downgrade below the A- level is an encouraging sign, and hopes remain that the worst has passed.

**DEMAND**

Even as the market has hardened, corporates involved in single, key projects in emerging markets, or in a multitude of emerging markets, have renewed policies or successfully entered the market as first-time buyers. These buyers, attentive to the political risks they face, have been able to secure capacity and favorable terms.

**EXTRACTIVE INDUSTRIES**

The extractive industries are among the most vulnerable to political risks in emerging markets. Due to their importance to host economies, projects in the extractive industries (such as mining, oil and gas) can easily become flashpoints for nationalist debate, often leading to governmental expropriations, license cancellations and contract “reviews.” These experiences are familiar to commodity producers in many countries, especially as resource nationalism resurfaces: Shell and BP in Russia, Glencore in Bolivia, several companies in Venezuela, Occidental in Ecuador, BHP and Rusal in Guinea-Conakry, CalEnergy in Indonesia and Union Resources in Iran have faced these pressures. Meanwhile, extractive projects often become targets of political violence and terrorist threats as a result of their easy association with home governments. In other cases, the presence of wealth-producing assets in destitute areas can lead to bombings and other attacks as local ire is directed against the symbolic assets.

**RENEWABLE ENERGY**

Growth in the renewable energy field has led to new interest on the part of groups sponsoring projects in emerging markets. This growing demand has not fallen on deaf ears, and it is being met by innovations from Political Risk carriers.

For instance, Zurich in early 2008 released a new dimension to its existing Political and Trade Credit product suite, now offering cover for carbon credits (also known as certified emissions reductions, or CERs) generated by renewable energy products. CERs can either be insured by a Trade Credit policy (covering the income stream from their sale), or by a Political Risk policy (covering expropriation, confiscation or deprivation of use by the host government).
CONSUMER MANUFACTURING

The market for manufacturers with assets in multiple countries has hardened somewhat in the past year, yet retains its excellent value. Corporates with plants, equipment, inventory and other assets in a multitude of locations – sometimes as many as 75 countries – are well served by a Political Risk policy that protects all of their emerging market locations, or in some instances, all of their international locations.

The mere presence of so many foreign exposures leaves companies in this sector – traditionally not as frequently targeted as the energy, power or extractive sectors – at heightened risk, especially as a geopolitical risk issues in one country could spread regionally and affect others in the portfolio. Such portfolios, often containing countries as diverse as China, Colombia and Croatia, expose manufacturers to an array of risks that can be covered by a broad Political Risk policy that includes any combination of perils, including Expropriatory Acts, Political Violence, Business Interruption and Currency Inconvertibility. A single portfolio policy with sublimits for each peril and country is an excellent risk management tool for companies that face, for example, the threat of expropriatory acts in China and India, the risk of political violence in Sri Lanka and Colombia, and the specter of currency inconvertibility in Argentina. Forward-thinking multinationals, seeking to protect themselves against all of these political risks, have been showing interest in the Equity Political Risk product.

COUNTRY BY COUNTRY

Political risks continue to rise the world over, largely as a result of pressures generated by the global financial crisis. Indeed, Willis’ thrice-yearly Political Risk Index notes that the investment climate in 25 of the 40 countries analyzed has been downgraded, while only four have registered an improvement. Many of the “usual suspects” (e.g., Venezuela) continue to exhibit high risk. The following key countries have displayed heightened risk to investors:

CHINA

Economic troubles have raised the risk concerns within the market, primarily related to the possible devolution of what is sometimes described as a tacit contract between the Chinese government and its people: support for the government in return for jobs and economic prosperity. Indeed, with millions of migrant workers losing their jobs, the potential for civil unrest has risen. In January 2009, a state-controlled newspaper warned of a coming “peak period for mass incidents,” and the potential for “more conflicts and clashes that will test even more the governing abilities of all levels of the Party and government.”

COLOMBIA

Numerous bombings over the past year damaged transit systems and retail outlets, including an explosion at a Bogota Blockbuster store earlier this year later attributed to an extortion attempt. Meanwhile, war risk with Venezuela remains a concern after that country’s build-up of troops at the Colombian border in early 2008. One encouraging risk mitigant is Ecuador’s recent pronouncement that it will not let Venezuelan president Hugo Chavez drag it into war with Colombia.

INDIA

Protectionist leanings remain, as do bureaucratic hurdles and the influence of subnational entities. Meanwhile, the Mumbai terrorist attacks, as well as numerous other terrorist incidents, have shone a spotlight on the continuing problem of political violence in the country. War risk with Pakistan has eased somewhat, although the neighboring country’s destabilization is of serious international concern.

INDONESIA

The experiences of Temasek Holdings and Exxon Mobil raise concerns of increased nationalist and protectionist activity, and the economic crisis may swing emphasis toward protecting local companies and interests from foreign competition. Meanwhile, Political Violence risk has steadily risen, influenced by ethnic and religious conflicts as well as civil unrest over prices of consumer goods. Strikes and demonstrations are common – in January 2009 a protest targeted a branch of the U.S.-owned KFC food chain. Finally, July’s twin terrorist bombings of the Marriott and Ritz-Carlton hotels in Jakarta revived fears of broader terrorist activity.
ISRAEL
War risk with Iran remains a much-debated topic, with hard-line politicians gaining power in Israel and considering military action against Iran to prevent its development of nuclear capability. The recent reelection of Iran’s President Ahmadinejad also does not bode well. Meanwhile, Israel continues to be vulnerable to rocket attacks and suicide bombings, and some underwriters are declining to write Political Violence risks for the country.

PHILIPPINES
A string of bombings and bombing attempts have been attributed to a rebel group, Moro Islamic Liberation Front, which continues to operate in the south, targeting transport hubs and department stores. In 2008, the Political Risk market paid at least one Political Violence claim to an insured whose assets were bombed by a rebel group.

SOUTH KOREA
The return to leadership of hard-liners with respect to North Korea has reignited tensions. North Korea has undertaken several aggressive moves in response, including test-firing rockets, conducting a nuclear test, pulling out of negotiated peace agreements and withdrawing from its armistice with South Korea – the armistice that ended the fighting in the Korean War in 1953. (The two countries are still officially at war.) For the first time, North Korea threatened to use nuclear weaponry for offensive, rather than defensive purposes. The country also has threatened to turn South Korea into a pile of “debris.”

THAILAND
When political upheaval pushed Thailand to the brink of civil war in late 2008, some Trade Credit insurers stopped underwriting credit risks in that country due to its political risks. Although the situation has eased somewhat, some analysts believe that the conditions that nearly led to civil war remain, and that the country is by no means out of the woods.

TURKEY
Kurdish nationalists and various Islamist groups have staged a number of terrorist acts recently, causing multiple fatalities and occasionally targeting foreign businesses. The rise in terrorist acts is not likely to recede, especially given the deterioration in economic conditions.

MARKET CAPACITY IN HIGH-RISK ZONES
The following countries are proving to be the most difficult in terms of obtaining capacity from the Political Risk market, mostly due to the high political risks, but sometimes also due to heavy demand (i.e., Russia). It should be noted that with the exception of Zimbabwe, none of these countries are “off-cover,” and capacity does exist, particularly for the right deal.

- Argentina – key risks: Expropriatory Acts and Currency Inconvertibility
- Bolivia – key risk: Expropriatory Acts and Currency Inconvertibility
- Ecuador – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Pakistan – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Russia – key risks: Expropriatory Acts and Political Violence
- Ukraine – key risks: Expropriatory Acts and Currency Inconvertibility
- Venezuela – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility
- Zimbabwe – key risks: Expropriatory Acts, Political Violence, and Currency Inconvertibility

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1 Attributed to Ian Bremmer
2 Hiscox, a Lloyd’s carrier rated Moody’s A-, can offer up to $100 million per transaction for Standalone War. Similarly, Ascot, a Lloyd’s carrier rated S&P A+, can offer up to $50 million per transaction for the same peril.
3 http://www.reuters.com/article/newsOne/idUSTRE5050F520090106
Kidnapping and extortion are evolving crimes. Newer styles, including express kidnapping and phantom extortions, pose less risk to kidnappers and enable criminals, experienced or otherwise, to target a wider cross section of society. No longer is this a crime aimed solely at ultra-high-net-worth individuals.

Kidnapping in its various forms continues to represent a powerful means of extorting money, winning political concessions and garnering attention for an ideology or cause. These crimes are most prevalent in countries where there is a significant gulf between rich and poor, where law enforcement is weak, poorly resourced and susceptible to corruption, where the judicial system is ineffective and where criminal syndicates, drug cartels, guerrillas or terrorist groups wield significant territorial influence.

Governments have been fighting back with some degree of success. In Colombia, which has suffered for years at the hands of the rebel groups FARC and ELN, President Uribe has overseen a reduction in kidnapping and extortion incidents.

Unfortunately, when the situation improves in one country, it appears to deteriorate in another. Mexico experienced a significant rise in kidnapping and extortion following the economic crash of 1994, and is now experiencing the highest levels in the region. In the Mexican states along the drug routes leading to the U.S. border we have seen rising violence and an increase in kidnappings as federal forces battle with the drug cartels. The challenge to governing authorities is vast when their enemy is well armed, well trained and well funded. Companies with operations in this region face a renewed challenge to improve physical security measures and personal security.

Kidnapping and extortion are evolving crimes. Newer styles, including express kidnapping and phantom extortions, pose less risk to kidnappers and enable criminals, experienced or otherwise, to target a wider cross section of society. No longer is this a crime aimed solely at ultra-high-net-worth individuals.

The surge in piracy off the coast of Somalia and in the Gulf of Guinea has continued. The international maritime community remains challenged to ensure appropriate protection through the deployment of naval forces, hardening of vessels and suitably training ship crews.

In some regions, notably in Latin America where there is a long history of kidnap and extortion, kidnappers mostly value the life of the victim, as the living person represents collateral in negotiating for ransom. Unfortunately, some gangs, most notably in Mexico, have been more violent in recent years and are likely to become increasingly so.

Regions with assertive terrorist or separatist groups or drug cartels will continue to suffer kidnap and extortion in its various forms – mostly because it is an effective means of generating monies. Kidnapping and extortion also arise as a source of income in the aftermath of war, as we saw in Iraq immediately following the invasion in 2003.
Terrorism continues to threaten the safety of business travelers, expatriates and the local workforce in many regions around the world. The hotel attacks in Mumbai in 2008 and Jakarta in July 2009 reminded us how immediate the threat is. The Mumbai event in particular demonstrated how quickly hostage situations can develop. These events can impact companies not only in terms of potential fatalities or injuries but in the ensuing disruption to operations and regional security. The implications of an event go even beyond the disruption of operations – the time and strain of dealing with an incident can present an enormous burden. The overall impact can be catastrophic. For companies and organizations who send employees, aid workers or independent contractors into conflict regions, security planning is imperative.

**THE EMPLOYER’S RESPONSIBILITY**

International travel is of paramount concern to companies, large, mid-sized and small, who have a responsibility for their executives and associates at all levels. Arguments will continue about whether ransom payments encourage these crimes, but the experience of the last several decades tells us that the involvement of professional response consultants in careful negotiations yields the best resolutions. Fulfilling an organization’s responsibility to protect its employees requires the assistance of a crisis response consultant.

The security consulting firms with a proven response capability will offer some or all of the following services: 24/7 emergency number, country and city information subscription services, daily and periodic briefings, alerts, travel tracking and emergency evacuation services. They will variously provide assistance in responding to a range of security incidents beyond kidnap and extortion, including physical threats to persons or property, hostage taking, disappearance, threats to proprietary information, customer identity extortion and political unrest. Companies are increasingly recognizing the need for advanced understanding of the crisis response process across specific corporate functions – risk management, corporate security and human resources – to ensure the safety of executives and associates.

Crucial to all of this is having a coordinated approach and implementing effective crisis management plans. One step in this direction has come from companies centralizing their travel through one booking agency. This offers various benefits:

- Leveraging cost savings
- Instilling tighter travel protocols
- Centralizing data, which enables companies to more easily identify their global travel exposure and crucially link travel data to a security provider who can be a source of information
- Helping monitor travel
- Providing a single point of contact for emergency situations
Plans and procedures provide a road map for addressing an incident. However, the most crucial element is having a strong team of individuals who are able to maintain calm under pressure, think logically and make intelligent decisions. Training and procedures are needed to ensure effective incident reporting and escalation through the overall crisis management structure. At the same time the core team of individuals involved in managing the crisis should be restricted to a small circle to maintain sufficient confidentiality. Tabletop exercises, often conducted by response consultants, can help organizations prepare for the issues and challenges they may face.

**THE MARKETPLACE**

As in the insurance industry at large, the marketplace for Kidnap & Ransom insurance is competitive these days. Terms and conditions are negotiable, as the established carriers seek to maintain their position and relative newcomers look to win business. As always, you as a buyer must take care that your policy addresses your specific exposures. Your requirements will vary depending on the nature of your business, the size of your operations, your international reach and where you have permanent locations. For example:

- A financial institution with largely domestic operations will be more concerned about vulnerability to cyber attack, disruption, sabotage or computer system hacking. They might also be concerned about potential threats and extortions targeting executives and associates and the potential for a hostage situation at one of their premises.

- A manufacturing company with facilities near the U.S.-Mexico border will be concerned about physical security surrounding the facility and the exposure of their expatriate and local workforce to intimidation, assault, express kidnapping and phantom extortions. They will also be concerned about journey management issues and security for executives crossing the border.

- An international pharmaceutical company with global operations might be concerned about its research and development facilities, which may be located in more remote or higher risk countries and may also face intimidation and threats from direct action groups due to the nature of their operations.

- A hospital system or day-care facility will be acutely aware of the risks of infant or child abduction.

- A non-government organization with aid workers and advocates working in hostile environments, notably Afghanistan, Iraq, Pakistan and Somalia, might be deeply concerned about political detention, political threats or the potential need to evacuate the country in a hurry.

- A shipping, transportation or charter company with transit exposure through the Gulf of Aden will be mindful of the exposure of vessels, cargo and crew to pirates.

- A university or school will be conscious of their domestic exposure to issues of campus violence and the international security threats that students and faculty are exposed to when participating in study abroad programs, sabbaticals or other research field trips.

**CARRIER + RESPONSE & PREVENTION PARTNERS = PROTECTION**

Carriers team up with response specialists as part of their Kidnap & Ransom risk management offering. In choosing a carrier, terms and conditions are important, but most crucial is access to the appropriate resources to help with prevention and crisis response. It is important to evaluate your exposures and ensure that you have the right support. There is little value in a team of consultants whose expertise and resources are limited to Latin America.
when your footprint requires global capability. By the same token, if your exposure is predominantly in Africa, the Middle East or Asia, you want to ensure that the crisis response firm you retain has the capability and understanding of the styles and tactics of the kidnap groups and security issues in the region.

THE PLAYERS AND THEIR PARTNERS

- ACE – retains Neil Young International Ltd.
- Chartis – retains Clayton Consultants
- Chubb – retains The Ackerman Group
- Great American Insurance Company – accesses Control Risks through their partnership with Hiscox
- Hiscox – exclusively retains Control Risks
- Liberty International Underwriters – retains Neil Young International Ltd.
- PIA – retains Corporate Risk International
- Travelers – retains ASI Global
- QBE – retains Terra Firma

PRICE CONSIDERATIONS

The marketplace is competitive but also complex. First, the right response partner must be considered. Second, a broad range of coverage is now available through endorsements. You need to determine whether a competitively priced quote is offering “apples to apples” coverage. The track record and experience of your underwriters in policy wording and claim handling should all form part of your evaluation. The role of a specialist broker may be invaluable in determining the extent of coverage available and marrying your risk exposure to applicable coverage.

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In terms of underwriting results, the good news is that the industry loss ratio at June was approximately 33%, a level at which profitability can be sustained. The bad news is loss activity is increasing.

In our last Market Realities report in April, we predicted a storm would develop in the Surety industry following the dramatic economic events of late 2008. While the storm remains offshore for now, clouds are gathering, and landfall is all but certain.

Surety executives expect 2009 will be a profitable year for the industry, but at a level well below the record performance of recent years. Slowing revenues were evident in 2008, as written premium volume for sureties increased at a declining rate for the first time in seven years. The first two quarters of 2009 did not offer much encouragement. Industry written premiums were down by approximately 9%. Many major Surety writers are projecting reduced premium volume for the full year and have begun addressing the expense side of the ledger in the face of declining revenue.

In terms of underwriting results, the good news is that the industry loss ratio at June was approximately 33%, a level at which profitability can be sustained. The bad news is loss activity is increasing. The June 2009 loss ratio figure is nearly double the level of June 2008 and the highest in nearly four years. While lower premiums contributed to an uptick in the ratio, incurred loss dollars reported at June equaled nearly 50% of the total combined industry losses over the two prior full-year periods. Underwriters currently expect losses to increase, both in frequency and severity, as the industry moves into 2010. Given contractors’ general expectations of a very poor 2010, sureties expect 2011 may be worse yet.

Many top contractors reported record revenue for 2008 and they expect to finish out this year with strong numbers as they consume backlog built up in better times. But as jobs won during the boom reach completion, the reality of today’s troubled market is settling in, leaving large firms nervous about what late 2010 and 2011 could bring.

—ENR Insider, September 10, 2009

AS CONSTRUCTION GOES, SO GOES SURETY

Construction activity in the U.S., which began a dramatic decline in the third quarter of 2008, has continued to falter through the first six months of 2009. While many contractors began 2009 with sufficient backlogs and margins, they have been dealing with a quick intensification of competition for work since the second quarter. McGraw-Hill reports an uptick in construction starts in July compared to June, but the
year-on-year results show a decline of more than 20% in non-residential construction. Ken Simonson, Chief Economist of the Associated General Contractors of America, notes total spending for both public and private non-residential construction dropped in July. Most analysts are skeptical of the ability of the U.S. government’s stimulus spending to drive a quick recovery, but acknowledge the public cash has cushioned what otherwise would have been an even more precipitous decline (although stimulus spending to date has accounted for only 6% of new construction starts). The fundamentals strongly suggest that the recovery of commercial construction will be slow. Many state governments, facing significant deficits, will be challenged to match federal funds for road and bridge work. Sureties remain wary that sectors that remain active (health care, institutional, government) will not generate adequate margin for builders due to increasing bid competition.

Analyzing the Surety industry in isolation can be misleading. Surety is, of course, largely dependent on the health of construction activity, which generates 65-70% of Surety industry revenue. Capital support for Surety writers, however, is reliant on the U.S. Property & Casualty (P&C) industry capital pool. The U.S. P&C industry’s return on capital was lackluster in 2008. Historically, this business has generated below-average returns in comparison to those of the Fortune 500. A multiyear period of low interest rate returns and the impact of collapsing credit markets gave insurers a double blow in 2008. Sureties competing in this capital pool are subject to high standards regarding capital allocation and the prospective returns they offer. The current environment suggests that scrutiny will only intensify over the next five years.

The chart above tracks the performance of the U.S. Property & Casualty industry’s return on capital over the past 10 years – a period that included some of the largest insured loss events in the industry’s history. The years shown in RED are those in which the industry, as a whole, generated an underwriting loss. It is worrisome that in seven of the past 10 years the industry has lost money conducting its primary business activity – underwriting insurance risk. Surety is a capital intensive business. Underwriting practices over the longer term, whether disciplined or not, will determine whether sureties achieve the required return on capital to remain attractive to capital providers. These hurdle rates are set with little room for flexibility...or forgiveness.

Source: Insurance Information Institute data
Capital providers are cognizant of the volatility and potential severity associated with Surety industry loss results. Some analysts are hopeful the expected loss cycle will be more moderate than history suggests. They argue that contractors’ balance sheets have been bolstered during the most recent boom cycle and are better positioned to withstand the downturn. They also suggest that contractors, generally, are more proactive and sophisticated managers of their resources and are moving quickly to deal with reduced volumes in a way that will allow for a more orderly wind-down of backlog levels.

As illustrated below, despite the consecutive run of record profitability from 2005-2008, the accumulated underwriting results from those years does not fill the hole created by losses incurred in the preceding four years. Shadowing the industry today is the concern that capital providers may be less patient with loss activity than in the past. Further clouding the picture are the difficulty of reliably projecting Surety loss severity on an actuarial basis and the high level of aggregate exposures inherent to the line. In recent years, the Surety line clearly has not delivered the certainty of returns most capital providers seek.

SURETY RESULTS

YTD gross losses incurred by the Surety industry equaled $867.2 million at June 2009. Given current conditions and the outlook for surety loss activity over the coming 18-24 months, the Surety industry has a long way to go to fully regain the confidence of its capital providers.

Source: Derived from Surety & Fidelity Association of America data

In comparison to the banking sector, the insurance industry has largely preserved capital through the current financial turmoil. This has not, however, provided immunity to actions affecting the financial ratings of insurance groups – which can move with little or no warning. This uncertainty mostly affects large Surety buyers, as their Surety programs tend to require co-Surety structures (two or more participants) to generate the required capacity for their businesses. Only four sureties currently play a major role in this area, and these companies remain vigilant regarding their inter-creditor risk to co-Surety partners. This inter-creditor risk assessment is driven by a surety’s (or its parent group’s) financial rating.
Rising corporate bankruptcy filings and the restriction of available credit to refinance balance sheets may herald an increase in Commercial Surety loss activity over the near term. Many Commercial Surety bonds (such as license and 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.

Privatization (PPP/PFI) schemes may well attract more interest from public owners in a marketplace where government bodies cannot finance needed projects solely from tax revenues or where their capital market access is limited or closed. Some owners have expressed a willingness to accept letters of credit in lieu of surety performance guarantees for privatized projects. Some non-U.S. groups have demonstrated an ability to bring comprehensive development, design, finance and construction solutions to some of these opportunities.

**CONSOLIDATION**

In many industries, consolidation is a response to tough times. So it goes in Surety. The most recent major M&A deal affecting Surety was the combination of Liberty Mutual and Safeco last autumn, creating the industry’s second largest writer. The market share of the four largest writers (as a group) has increased by approximately 50% in the past 10 years and these four sureties now account for more than 60% of industry written premium.

The impact of consolidation is not limited to the Surety carriers, but also includes their customers. Strategic considerations, along with weakening of the U.S. dollar, are anticipated to promote attractive opportunities for suitors. (The recent Balfour Beatty/Parsons Brinkerhoff deal is an example.) Business continuity strategies may also contribute to M&A activity in the construction business. Where a prospective deal involves two firms with large Surety programs, the Surety industry’s ability to provide the required aggregate capacity will be tested, particularly as economic conditions begin to improve for construction.

### 2008 - TOP 12 SURETY WRITERS

| TRAVELERS | LIBERTY MUTUAL | ZURICH | CNA | CHUBB | HARTFORD | HCC | INTERNATIONAL FIDELITY | ACE | GREAT AMERICAN | ARCH GROUP | NAS / SWISS RE |

### WHAT’S CHANGED SINCE 1999

| FIREMAN’S FUND | MERGED WITH ST. PAUL |
| ST. PAUL | MERGED WITH TRAVELERS |
| RELIANCE | MERGED WITH TRAVELERS |
| SAFECO | MERGED WITH LIBERTY MUTUAL |
| FRONTIER | EXITED THE BUSINESS |
| AMWEST | EXITED THE BUSINESS |
| CRUM & FORSTER | EXITED THE BUSINESS |
| KEMPER | EXITED THE BUSINESS |
| XL SURETY | EXITED THE BUSINESS |
| AIG | NO LONGER TOP 12 |

The past 10 years have seen unprecedented consolidation among U.S. surety writers. Losses earlier this decade drove some of the activity, but parent group financial ratings also were a factor. On one hand, this consolidation has contributed to a measure of stability, but further consolidation, particularly among the top five writers, could have a significant effect on large capacity programs.

*Source: Surety & Fidelity Association of America data.*
UNDERWRITING ENVIRONMENT

The general insurance marketplace remains soft, even in an environment of poor investment income returns. Catastrophe losses in 2009 have been low, and competitive pressures have provided most contractors (with good loss experience) with attractive renewal terms. Sureties, in turn, are trying to strike a balance between supporting clients’ efforts to acquire or maintain profitable work in a very competitive environment and trying to underwrite ahead of a loss curve sureties expect will steepen in the coming months. Sureties are being selective in writing new accounts for fear of acquiring a predecessor surety’s unrealized problem.

The focus on contract terms and conditions remains intense. Despite overall soft conditions, contractors have lost the leverage of a seller’s market. Damage provisions, schedule, warranty/facility performance and payment terms are areas of particular scrutiny. Underwriters are challenging contractors’ business plans and financial projections, particularly in regard to fixed overhead expenses and debt service costs. Sureties want more detail about owner financing and the aging and collectability of accounts receivable in order to better assess their clients’ credit risk and cash flow management disciplines. In the public sector, a trend toward “gap” financing of work holds the potential to cloud balance sheet analysis (a key driver of determining the level of surety provided to a contractor). Underwriters are trying to carefully assess the risks associated with contractors financing work for the owner – which usually involves full payment beyond project completion.

The examination of subcontractor prequalification, selection and performance management remains 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 strains in the subcontracting community and may soon see increased default frequency.

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 the programs of some large “reverse flow” projects (involving U.S. subsidiaries of non-U.S. parent groups). The sources and quality of the collateral acceptable to sureties is now more restricted, and some sureties are capping aggregate collateral levels accepted from any one collateral source.

PRICING

Except for pricing on large individual projects, no significant changes in industry pricing are anticipated in 2010, unless loss activity rises suddenly. One key reason is surety reinsurance. The current outlook is for flat reinsurance renewals in the coming season, despite concerns on the part of surety reinsurers about prospective losses. New players have entered the surety reinsurance arena in recent years and this will mitigate price increases for 2010. The industry’s overall reliance on reinsurance is lower than it was 10 years ago. Major Surety writers have either foregone coverage altogether or structured their reinsurance agreements with high attachment points. These high attachment points require sureties to deliver low loss frequency (driven by underwriting discipline) in order to hit the return-on-capital expectations of management.
Users requiring large Surety capacity can expect their rates to remain, on average, higher than the rates for middle-market buyers. This is in part because large buyers tend to be involved in large, complex projects that often include extended contract duration terms or other factors. Prices for large individual projects are rising significantly – to the point where even some public owners are seeking means to waive Surety requirements on public work.

Sureties remain committed to credit model pricing and contractors are encouraged to understand these credit models. This will help avoid surprises in the pricing of individual Surety bonds. It may also suggest steps contractors might take to improve the results of the sureties’ modeling and favorably impact their Surety pricing.

**AN EFFICIENT FORM OF CAPITAL**

Sureties are more than a credit provider. For contractors, they provide a highly efficient form of contingent capital that allows contractors (and others) to efficiently leverage their balance sheets. In a certain sense, they represent a shadow investor – a partner that can offer useful perspective on the construction industry. Companies that remain committed to transparency and clear financial reporting know that this investor/partner’s support is an outcome of good business performance, not a driver of it.

One result of the current crisis may well be an increased emphasis on performance risk management in the coming months and, perhaps, the next few years. This could raise the bar for Surety requirements as the economy recovers. Well managed, disciplined construction firms will find their Surety relationships have become a greater competitive advantage than ever before. A focused investment of time in this crucial business relationship will enhance a company’s ability to prosper when economic recovery takes hold.

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1 Surety & Fidelity Association of America data.
4 Ibid.
Trade Credit insurance is bought by corporations wishing to transfer the risk of nonpayment of receivables due from debtors in the U.S. and abroad. Policies cover nonpayment due to financial problems (insolvency, protracted nonpayment, etc.) and political turmoil. Lately, the world has seen plenty of both, and the demand for Trade Credit coverage has risen accordingly.

**TRADE CREDIT IN THE GREAT RECESSION**

Many economists agree that the Great Recession that began in late 2007 is the most severe since the 1930s. Few agree on what will come next. Here are some theories:

- A classic V-shaped recovery – Full recovery of the world economy, the best possible outcome
- An uneven recovery – Economic stagnation for developed countries but strong recovery in the emerging markets
- A double-dip recession – The effects of the government-backed stimulus programs will expire and, in the absence of any other stimulus to world economies, growth will again turn negative

The range of these scenarios demonstrates the uncertainty about the world economy over the next several years.

Regardless of what comes next, the numbers available on what’s just happened show a severe deterioration of corporate profits. After several years of an extremely benign credit environment with very low insolvency rates, insolvencies jumped in the past year, and the trend is expected to continue into the near future. In 2007, defaults occurred at a rate of about 0.5%. By the end of 2008 the numbers spiked to over 2% in the U.K and to almost 3% in the U.S. These results have had a profound effect on the Trade Credit insurance market, both on the demand and the supply.

**DEMAND**

The uncertainty surrounding the financial solvency of companies and their customers coupled with tough macroeconomic experience over the course of the last year has increased the demand for Trade Credit insurance dramatically. Since the Trade Credit insurance market penetration in the U.S. is still relatively low, the rise is particularly
dramatic. More companies than ever are looking at Trade Credit insurance as a way to cover their exposures to risky customers. Credit managers are also viewing their entire portfolios of customers with more skepticism and are looking for ways to mitigate their risk.

**SUPPLY**

From the end of the last brief recession in 2002 until the start of the present one, Trade Credit insurers operated in an extremely benign credit environment, with extremely low loss levels and correspondingly high profit margins. This created a very soft marketplace, which persisted until late 2007. Rates fell precipitously, but the lure of profits attracted new entrants into the market (QBE, Houston Casualty Co.). In 2008, we saw the market beginning to harden, and this has gathered steam in 2009. Carriers have experienced large increases in claims submitted and paid in terms of frequency and severity. Here are some results reported by the monoline Trade Credit carriers, which represent about 70% of the overall market:

- **Euler Hermes**: Reported a nominal net profit of €700,000 in the first six months of 2009, down 99% from the year before. No recovery is expected in the second half.

- **Atradius Trade Credit**: Reported a large net loss of €193 million in 2008, reversing a net profit in 2007. Company and insurer ratings have been downgraded by S&P and Moody's to A-/A3, respectively. Remains on credit watch.

- **Coface**: First half of 2009 net loss of €103 million, Insurer Credit Strength Rating downgraded to A2 from Aa3 as a result.

- **Other Markets**: The Trade Credit results of general P&C insurers are not reported separately, but have reported similar experience to the big three: increased claim frequency and combined ratios, tighter capacity overall and higher reinsurance rates.

**INSURER RESPONSES**

There have been two main responses to the current economic environment from the carrier side:

- Capacity: Capacity in the market has decreased for various reasons. Insurer appetites for riskier credits have decreased substantially due to the increased claim activity. Increased interest in Trade Credit coverage as well as growth in the market has meant that available capacity is snatched up by better risks, leaving decreased capacity for some common credit risks and especially for poorer quality risks.
Pricing: As is the case in most hard markets, Trade Credit insurance premium rates have increased considerably. Premium rate increases range from 25-50% for policy renewals with limited to no claims and new business is being quoted at rates about 75-150% higher than similar submissions last year. Due to both recent history and the uncertainty surrounding the market, we do not expect to see rates decrease or even flatten in the coming year. We anticipate a continuation of mild rate increases above current levels as demand outstrips supply for the product.

ALL IN PERSPECTIVE

Despite hardening conditions, several factors bode well for buyers of Trade Credit insurance in the current marketplace.

- Even though premium rates have returned to levels not seen since the recession of 2001-2002, we must keep in mind just how far rates fell in the soft market of the last several years. Trade Credit insurance premium rates in 2007 were many times lower than those of 1997 or even 1987. Along with many other types of risk transfer, Trade Credit premium rates had fallen to the point where they were lower than the cost of risk, meaning that 2007 purchasers of the product were getting a fantastic deal. Despite the rise in rates being quoted today, they are still lower than they were 10 years ago. Given the legitimate fear of large-scale insolvencies around the world (the press throws around such household names as General Motors and Circuit City) the Trade Credit rates in today’s market still offer exceptional value.

- Although capacity has contracted for many tough-to-insure corporate credits, there is still an active market for reasonable counterparty risks and even some tougher risks. These may command additional premium, but they are still insurable in some cases. For example, a buyer/customer that is posting net losses currently but that has a reasonable capital structure on debt maturities on its balance sheet is in many cases still insurable.

- Many Trade Credit insurance products include insurance against insolvencies and peripheral credit services. These peripheral services include credit intelligence services that involve financial monitoring of customers supported by the insurers’ expert credit risk management staff. This can help companies in the current environment (especially those with limited credit management staff) to fully round out their risk management processes on credit risk by both transferring credit risk to the insurance market and enhancing internal credit procedures.

Due to the drastic increase in insolvency risk in the overall economy, Trade Credit insurance coverage is increasingly appreciated as a valuable risk management tool. Many believe that once the recession ends (from a technical standpoint) the risk of Trade Credit losses will decline. Historically, however, insolvencies and bankruptcies peak 12 to 18 months following the end of a recession. So even if some of the rosier forecasts prove true, the risk of corporate insolvencies remains high. So will the demand for Trade Credit insurance.

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1 “Expected Default in Western Europe and USA,” Atradius Economic Research and KMV Credit Monitor.
The aviation industry, which has enjoyed almost uninterrupted growth from its beginning, is facing a period of unprecedented contraction as a result of the recent economic turmoil. The global financial crisis has left no sector untouched, and the global downturn in passengers has clouded the short-term future of air transport.

The legacy airlines are dealing with a sharp reduction in revenues as their business class passengers make their way toward the rear of the aircraft or to their low-fare rivals. Airports are facing fewer departures and the same downturn in passenger throughput.

A recently developing area of air transport – one that represents the evolution and diversification of the industry – is the corporate and fractional ownership sector. These operations have also been hit hard, with a sharp fall in aircraft utilization. In the current environment, they face a challenge in justifying their cost to businesses.

Airframe manufacturer order books remain healthy, but with deferrals and cancellations increasing and uncertainty over the next generation of aircraft, this segment, too, is having to adjust to changing circumstances.

**AVIATION INSURANCE**

Aviation insurance market results are, unsurprisingly, intertwined with the global aviation industry, and in the face of recent trends the market is significantly hardening its stance on premium levels, particularly for airlines.

The market is driven by two simple factors: the capacity available to accept Aviation insurance risks and the claims that result from Aviation losses. The majority of Aviation insurers now represent a niche area in what are otherwise large and diverse organizations that, in light of natural disasters in recent years, might see the sector as a relatively predictable catastrophe market. That helps explain why insurers will tolerate short-term underwriting losses. However, 2009 is looking increasingly likely to be the third consecutive loss-making year for underwriters. Many feel that insurers will not let 2010 be the fourth in a row.

Capacity is available, but its redeployment away from Aviation risks, coupled with a significant rise in losses over the last two years, has made the hardening inevitable. Aviation insurers have long deployed capacity strategically to manage the boom and bust insurance cycle. In times of low losses and high overall insurance capacity, redeployment kept premiums from falling too far. Market conditions meanwhile put a limit on the ability of underwriters to raise premium levels.
A drastic redeployment of capacity is unlikely. The commitment and costs associated with establishing Aviation underwriting teams, along with an increasingly technical and disciplined approach to underwriting, may encourage these markets to stick to their tasks longer than they might have in the past. For now, we do not expect significant underwriters to withdraw from the class as a result of their Aviation portfolio performance. Capacity levels are therefore expected to remain reasonably stable.

**AIRCRAFTS**

Airlines are failing, merging and deferring aircraft deliveries. The survivors will be asked by insurers to pay more for their insurance as the carriers attempt to maintain a viable global premium volume to deal with the catastrophe nature of the business.

Airline catastrophes are indeed on the rise, with 2008 representing the worst underwriting result since 2001. This was followed by the tragic Colgan Air, Air France and Yemenia losses during the first half of 2009.

This year, the Airline insurance market saw its highest first-half losses ever: in excess of $1.8 billion in claims. If an average end-of-year loss pattern emerges, with no further major losses, we estimate total 2009 airline losses will be in the region of $2.25 billion.

Given the global Airline premium of $1.8 billion during 2008, it is clear that insurers will require at least 25-30% increases in premium to generate the approximately $2 billion in premium income they will need for 2009. This figure does not take into consideration reinsurance or any other associated operating costs, so even that premium level would still likely mean a loss for the markets.

The major losses of the year are expected to increase reinsurance costs for Aviation insurers, further intensifying the pressure on underwriters to increase premium.

With airlines largely projecting reductions in exposures, and thus generating less premium, the actual rate increases in many instances will need to be greater than 25-30% in order for the markets to have any hope of achieving profitability in the near term. We see these conditions holding throughout 2010.

Geographic differences are going to play a larger role in the airline marketplace. Differences in market experience and in the maturity of local markets are going to become increasingly pronounced, with differing geographic requirements for wide-bodied or regional equipment. Risk profiles will differentiate accordingly across the globe. The extent to which this manifests itself in premium and claims remains to be seen.
AEROSPACE LIABILITY

The excellent Liability record of the airline industry over recent years and the subsequent knock-on effect in the Aerospace market means that there continue to be differences between the two largest market sectors. It is unclear if the recent airline catastrophes will impact the Aerospace market.

The Aerospace sector has seen single-digit premium reductions virtually across the board in 2009. While we expect some firming, it is difficult to escape the fact that the Aerospace sector has only contributed 18% of total Aviation market losses over the last 10 years but in 2008 contributed 37% of the total Aviation market premium. These are desirable risks.

The risk profiles are not uniform, of course, and buyers in the Aerospace sector should be prepared to clearly differentiate their risks. Greater underwriting discipline and closer individual account analysis are expected to continue to develop. We anticipate that market underwriting capacity in this sector will remain at existing levels and the majority of underwriters will continue to deploy their capacity much as they have recently.

MARKETPLACE NOTES

The Aviation market has seen considerable fluidity in terms of staff moving from insurer to insurer. In an industry sector with a limited number of market experts, the merry-go-round will continue, increasing carrier costs at a time of declining revenues. There is no doubt that buyers, already smarting from hardening rates, will be looking for partners willing to share their pain.

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Difficulties continue in several construction industry segments. Worrisome credit markets continue to impact many projects, causing delays or outright cancellations. The credit crunch continues to decimate the residential market and much of the commercial market, including the gaming, office, retail and hospitality sectors. Lower overall construction volume means enhanced competition in almost every market sector and fewer opportunities for contractors and subcontractors. The financial health of the construction community will be increasingly stressed. Declining backlogs will likely lead to consolidation and bankruptcies as the year progresses.

Construction insurance underwriters are all experiencing premium decreases. Coupled with increased competition from new markets and fresh capacity, the result is a continued soft market for the foreseeable future.

The federal government’s stimulus package is one bright point for the construction sector. The following are several key areas where the federal dollars will be spent:

- **Transportation** – $49.3B
- **Defense/veterans** – $7.8B
- **Energy** – $30.6B
- **Buildings** – $13.4B
- **Water and environment** – $20.1B
- **Housing** – $9.6B
- **State fiscal stabilization** – $53.6B

Unfortunately many in the industry feel the stimulus will not be large enough to reverse the widespread declines. While the federal input may help drive growth in infrastructure, energy, power and health care, nonresidential building construction continues to decline at record levels. Another critical issue is the fact that the stimulus projects and funds are not materializing soon enough.

The trend toward privatization of public projects continues, but political forces combined with current credit market environments make such projects very uncertain.
In construction insurance, Property and Casualty capacity is abundant. Pricing remains very competitive and we are seeing flat renewals or premium reductions on the majority of non-CAT business. Contributing to the soft market are smaller regional carriers aggressively entering into new markets with very competitive pricing. In the first half of the year some insurers anticipated a hardening market and lost business due to internal mandates to drive premium increases. In the third quarter of 2009, with most insurers’ production levels down, insurers responded as expected. Retention has become the number one priority, as new construction and project-specific opportunities have all but disappeared. With reinsurance rates flattening, we do not anticipate a hardening market anytime soon.

BUILDERS RISK AND PROPERTY

To the list of factors contributing to the soft Construction market, we add one in regard to Builders Risk and Property insurance: a relatively quiet 2009 storm season to date. We see nothing reversing the soft Builders Risk market well into 2010. Here are some issues to consider as buyers take advantage of the current market for annual Property programs, master Builders Risk and project-specific Builders Risk policies.

- **Competitive pricing.** Nationally, master Builders Risk programs are renewing flat or in some cases with reductions of 5-10% if competition is involved. Project-specific placements are highly competitive. The continued soft market is driven largely by increased capacity (traditional markets offering higher limits and European markets establishing domestic operations, i.e., Beazley and Hiscox), reduced construction activity, underwriter premium production pressures and flat reinsurance treaties – as well as reduced utilization of facultative reinsurance.

- **Broader terms/conditions.** This is an opportune time to negotiate broader terms and conditions on both master Builders Risk programs and project-specific placements. Buyers should expect increased limits and sublimits, lower deductibles, lower number of days related to soft costs/delay deductibles, manuscript forms and removal or modification of key exclusions. Many buyers will be glad to see the departure of wording along the lines of: “Rain, snow, sleet or ice, whether driven by wind or not. This exclusion applies only to personal property left in the open.”

- **Coverage for green construction/LEED certification.** Many carriers now offer green construction coverage enhancements via endorsements. These endorsements address the growing number of green/LEED-certified projects and their associated exposures. A large number of projects associated with the federal stimulus package are expected to have LEED-certified requirements.
- **Know your exposure.** Review your upcoming year’s construction pipelines and estimated annual receipts. The current climate may have altered your exposure base significantly. Being aware of these possibilities well in advance will help you manage your renewal more effectively. Make certain your coverage reflects actual exposure.

- **For Marine policies (such as Contractor’s Equipment)** consider how the equipment is being used. In some cases, equipment is being stored for extended periods. It may be appropriate to change your policy to cover only catastrophic exposures (such as a tornado hitting the yard or a major fire) rather than all operational risks on job sites. This strategy should only be applied to pieces of equipment that will be truly mothballed. Some contractors are reducing ownership of their equipment and renting when needed. Contractors should be sure to review equipment values, as most policies cover actual cash value (replacement cost less depreciation). With the surplus of equipment in the current market, prices have flattened on used equipment, which can lower the insured value.

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Is it over? Are we done with the bombshells that started exploding in the financial sector in February 2007? No. Not by a long shot. But while there will be pain, you can take your finger off the panic button because, after a year to adjust to a shaken up world, the financial sector is gradually figuring out ways to move forward. This goes for the Financial Institutions (FI) insurance market as well. Yes, there are still some scary risks out there. But there are also reasonable risks, and even some attractive ones. The markets are responding accordingly.

**A VARIETY PACK OF RISKS**

Any analysis of the FI sector should begin with a caveat: that the sector includes a broad range of businesses that are as different as they are alike. The sector includes hedge funds, insurance companies, banks of all kinds and private equity firms. The Willis FI Practice tracks more than 20 subsectors, and each faces a different set of economic conditions and risk factors. They also face their own set – or sets – of regulatory requirements that affect how they handle capital and interact with their customers.

For some FI sectors, big changes have been unavoidable. Many of the largest institutions, the financial superstores that offered everything, are in the process of changing their business models. The same will likely hold for companies that edged into non-core businesses where profit margins – before 2008 – were irresistible. Many investment banks have put themselves under the more protected, and more regulated, heading of bank holding companies. This is not to say that the investment banks have gone away, but the risks have changed for many of them.

For other subsectors, the Great Recession has hurt but has not been calamitous. Insurers – who are of course part of the FI sector that they also serve – are hanging in. In many cases, insurers can put themselves forward as poster children for prudent, conservative investing in the context of workable regulation. Many mutual funds are getting back on track. While some hedge funds have crumbled, others are seeing considerable returns. Many banks are looking at a long road to recovery, but a road they should be able to navigate.
WHAT’S NEXT

The next shoe to drop in the credit crisis is another potential $1.5 trillion in write-downs, according to International Monetary Fund estimates – beyond the $1.3 trillion in write-downs since the start of the credit crisis. Along the way will be a rising tide of bank failures, in particular, small community banks. Close to 100 banks have folded, but the number could rise to 10 times that. The FDIC could be hard pressed to cover the insurance on the depositor losses, as the FDIC appears to be have fully depleted its surpluses of a year ago. Another source of drag on the economy is likely to be trouble in mortgage-backed securities (MBS) for commercial property.

This time, many banks are braced for the bad news. They have been beefing up reserves. They have already been writing down anticipated losses. They should be better prepared after the shocks of the past year. The regulations regarding private equity-backed merger and acquisition activity in the banking sector have been loosened and deals are being structured in innovative ways. In many cases, newer, healthier banks are buying troubled banks that are unloading their toxic assets beforehand, so the new owners will not have to take on the bad with the good. In several instances, the owners of the troubled bank sell their non-toxic assets for nothing, while keeping only the toxic assets. The owners may only be able to get pennies on the dollar for the toxic assets, but they can keep those pennies, and do not need to answer to former depositors – who are mostly glad to be involved with a new entity less burdened by the toxic assets.

Concern lingers about the government’s hand in the FI world. For example, since the deterioration of Fannie Mae and Freddie Mac, the Federal Housing Authority (FHA) has been involved in the vast majority of homeowner loans – by some accounts over 80%. The FHA has been involved in direct loans and in backing commercial loans. Some fear that the FHA sources may dry up; others are concerned about what the mortgage marketplace would do without the federal support.

Government involvement is expected to ramp up in one key area: regulation. In the middle of the health reform debate, President Obama appeared on Wall Street to remind us that he still intends to change the regulatory structure to make sure no collapse like the one we have just seen will happen again. No one knows what that commitment will mean in the long run, but the less regulated FI sectors are certainly on notice that change could be coming.
INSURING FIs

Here’s one way to chart the response of FIs to the financial meltdown, which, in retrospect, some observers saw coming long before September 2008:

- 2007-2008: denial
- 2008: panic
- 2009: adjustment
- 2010: moving forward

For underwriters (in discussing insurance for FIs, the focus leans heavily toward Executive Risks, as that is the largest and usually most volatile exposure), moving forward is certainly the operative idea of the moment. The tide is turning. The period of large increases that began in late 2007 may be coming to a close for many in 2010. There are, to be sure, some very tough renewals ahead for some, but for others, we are starting to see flat renewals and even the occasional reduction. The market will view risks on a case-by-case basis when pressed, which puts a focus on individual risks and the task of differentiation. For FIs that managed to stay sheltered from the storm, buying opportunities are appearing.

Property & Casualty risks are not generally affected by the rush of litigation that targets bank directors and officers after a financial crisis. That is mostly the case now – but P&C exposures are still affected by the recession. Bankruptcies and defaults rippling through every sector of the economy are leaving properties in the hands of banks holding loans of all kinds. These properties are suddenly the banks’ responsibility, exposing the banks to Property, Contingent Liability and Liability issues. From the trucker in Boston who could not meet the payments on his rig and simply abandoned it, keys in the ignition, in the bank’s parking lot, to the condo developer in L.A. who walked away from a partially completed project, bank customers in default are leaving the banks no choice but to understand what risks they have inherited.

MADOFF GOING AWAY

As Bernard Madoff begins serving his 150 years and fading from public view, his miserable legacy is starting to hit the industry. Fortunately, it appears the damage may not be as widespread as many initially feared. Losses associated with the Madoff scandal, coupled with the credit crisis, have severely impacted the excess SIPC market and, to a lesser extent, the Fidelity bond market. However, the impact on other Management Liability lines, including Directors & Officers and Professional Liability, has not been as material as first anticipated. It is suspected that in many cases, the firms involved with Madoff were unregistered investors who chose not to buy Management Liability protection.

THE FI TAKEAWAY

If there is one lesson to be taken from the financial mess of the last year, it may be that having underwriters and others with an eye for risk sniffing around is a good thing for all concerned. In the 2010 marketplace for FI insurance, we believe that FIs that take the time to clearly document their own exposures and work closely with underwriters to explain their risk profiles, will find their efforts rewarded, and perhaps amply.

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1 Stanford Law School Securities Class Action Clearinghouse, in cooperation with Cornerstone Research.
The Health Care Professional Liability insurance industry in 2009 has experienced its most competitive market environment in over a decade. The marked deceleration of pricing, which cuts across every health care segment, continues in the wake of increases in capacity over the last few years. Rate adequacy and stability prevail in the U.S., London and Bermuda markets. Competitive reinsurance terms aid both the commercial carriers and the health care providers who buy their own reinsurance. The industry combined ratio continues to be favorable, with carrier results in this line outperforming other Property/Casualty lines, historically a rare occurrence. Loss trends remain very stable. Frequency is down markedly and may have bottomed out, while severity continues to moderate. We see no signs of this market hardening for the next two to three years.

Premium reductions of 5-20% can be achieved by health care facility accounts with good loss experience, and decreases of 5-10% may be available for physicians/groups with good experience.

Some observers express concern that the classic soft market-hard market cycle may be about to repeat itself, especially given the current supply of redundant capital, including a few new entrants this year. There is no evidence, however, of any material change in the near term. Still, profit margins and underwriting results must be watched closely during the next few years, especially if the very aggressive pricing seen in 2009 continues as expected in 2010. Clearly, frequency and severity should be closely monitored for any upward trend. So far, the economic downturn has not caused an uptick of frequency and severity or any apparent shift in public attitudes toward malpractice litigation. The current public discussion of the need for malpractice reform as part of any comprehensive health care reform may favor the industry directly and indirectly, but the likelihood of reform moving forward is uncertain.

THE NATIONAL MEDICAL MALPRACTICE ENVIRONMENT

From the health care provider’s perspective, the current national medical malpractice environment continues to be the best it has been in the past four decades. Several factors are at work:

- The successful passage of malpractice reform laws in 30-plus states since 2000, particularly the enactment of damage caps
Media focus on the malpractice problem and the link to health care access, resulting in public attitudes moving away from malpractice litigation

The alignment of risk management, patient safety and quality initiatives, especially in health care facilities

The net effect has been notably reduced claim frequency and a moderation of claim severity in all but a few states, such as Florida, New York and Pennsylvania. Pennsylvania has recently reported a marked downturn in claim frequency, although the potential for huge awards still exists there without the enactment of damage caps. Malpractice remains a phenomenon best understood on a state-by-state and even county-by-county basis.

The National Practitioner Data Bank's (NPDB) results show some worsening, with average paid loss severity continuing to climb (to $311,000 in 2008) after a slight decrease from 2004 to 2005. However, there has been a marked decrease in the total number of NPDB claims paid through 2008, a decline in frequency that began and has continued uninterrupted since 2002. Two of the best examples of improved environments for claim frequency and severity may be the states of Ohio and Texas.

Many claim professionals and defense lawyers believe that claim frequency has bottomed out and the number of malpractice cases filed will slowly begin to grow, absent any unforeseen factors. Claim severity has been slowly rising, yet has not come close to the precipitous upturn experienced at the end of the 1990s.

Some concede that an extended economic downturn may cause a gradual rise in frequency and severity and reverse a trend toward increasingly unfavorable public attitudes toward malpractice litigation. There are mixed opinions on whether the increase in frequency is more likely to be gradual or steep.

The trial bar is taking more care in screening malpractice cases, which has resulted in fewer cases filed. However, those that are filed may as a result have more merit and higher damage potential. Those cases with the greatest potential for high damages involve injured children in obstetrical or pediatric cases.

The trial bar typically attempts to seek potentially high-damage cases that will not be adversely affected by state caps on noneconomic damages. By focusing on cases with younger victims involving the worst damages and high sympathy factors, the malpractice attorneys seek to maximize potential damages. These same cases can also be used to overturn malpractice reform laws and damage caps. The trial bar continues to pursue its strategy of “judicial nullification” by challenging the constitutionality of malpractice reform laws. The state of Illinois should be watched closely, as their supreme court was expected to render a decision in an Illinois case (LeBron v. Gottlieb Memorial Hospital, et. al.), which centers on this issue, at the end of 2008. As of this writing, no decision has been rendered. Other states with potential for unfavorable tort reform developments include Georgia, Nevada and Wisconsin.
PHYSICIANS AND SURGEONS

Physicians in most states are experiencing rate decreases ranging from low single digits to low double digits, typically 5-10% and sometimes more. Some of this improvement is due to filed rate decreases but more often to aggressive application of credits at renewal by physician carriers and the use of dividends. Many physician carriers are aggressively trying to expand into other areas, particularly miscellaneous facility business and allied medical professionals.

The move away from the private practice model, which represents a paradigm change in the practice of medicine, continues. More hospitals and other types of health care organizations are employing physicians than ever before. More solo practitioners are seeking employment with larger groups or facilities. The pool of potential individual physician insureds is shrinking.

Leading physician markets are Medical Protective, ProAssurance, MLMIC, The Doctors Company, NorCal, ProMutual and FPIC. AIG and CNA continue pushing to increase their writings in the large physician group market along with Hudson, OneBeacon, ACE Medical, Ironshore and Darwin/Allied World. The London and Bermuda markets continue to reinsure physician captives and risk retention groups. The number of start-up physician insurers, including captives and risk retention groups, has leveled off, but these alternative risk vehicles provide competition to the commercial carriers. This year has seen its share of mergers and acquisitions, primarily by physician carriers. ProAssurance purchased Podiatry Insurance Company of America (PICA). ProMutual is purchasing Fincor/MHA (Michigan Hospital Association Insurance Company), and FPIC recently announced it is acquiring Advocate MD.

HOSPITALS

This segment, like all others in this line, is highly competitive, particularly for excess business above $5 million and community hospitals. Favorable underwriting results and new capital over the last five years – especially for excess business – have contributed to the competitive environment. New capital entered this line in 2008 in the form of Cayman-owned Ironshore (IronHealth) and Canopius in the Bermuda market. In 2009, Torus and Hiscox Bermuda joined the field. Lexington's health care unit was rebranded as Chartis along with other AIG commercial insurance companies.

Pricing for July 1 renewals was very competitive and excess renewals in particular often saw aggressive price reductions, frequently in the neighborhood of 20% to upward of 40%. High excess layer pricing has softened, especially above $10 million. Required attachment points for excess coverage are falling and excess carriers are jockeying for the lead layers in response to the improving malpractice environment and restored profitability.

Carriers for primary Hospital Professional Liability (HPL) include ACE USA, Arch, Darwin/Allied World, CNA, Endurance US, Zurich, Chartis (formerly AIG), Hudson Insurance, OneBeacon, Max Managers, Medical Protective, Gen Star, Evanston, Catlin London and several physician-owned insurers. Domestic excess writers include Chartis (formerly AIG), AWAC US, CNA, Zurich, Munich American, Berkley Medical Excess, Arch, OneBeacon and ACE USA. London/European markets are Barbican, Beazley, Catlin, Chaucer, Liberty, Cat Excess, Aspen Re, Swiss Re, Hannover Re, Faraday, Hiscox, Starr, ACE and Amlin. Bermuda markets include new 2009 entrants Torus and Hiscox Bermuda, along with Endurance Specialty Insurance Ltd., XL, Allied World (AWAC), Canopius, Renaissance Re, Iron-Starr, ACE, Arch and Max Re.

LONG-TERM CARE

Consistent with other Health Care Professional Liability segments, long-term care is highly competitive, as increased capacity has driven down premiums. Decreases are parallel to those in other facility segments – 10-20% and more on occasion. Large chains retain a significant layer of risk but can build capacity in London and Bermuda or buy down large retentions using alternative risk structures. Chartis and CNA are major players. Others include ACE USA,
Beazley U.S., Darwin, IronHealth, OneBeacon, Colony, James River, Bunker Hill, Lighthouse Underwriters, Cincinnati, Rock Hill and Markel/Evanston, plus a variety of RRGs. London and Bermuda are important markets – London for primary and excess/reinsurance capacity, and Bermuda for the latter only.

MANAGED CARE

New capacity entrants since 2002 (ACE USA, AWAC/Darwin, OneBeacon, IronHealth and Travelers) have made this segment much more competitive. The oversupply of capacity chases stagnant demand, and 5-10% rate reductions are likely to continue until Ingenis data case losses are posted, which will be no sooner than mid-2010. Pricing thus has continued to trend downward while coverage enhancements abound. AIG’s problems have stirred up this sector, with many insureds going to market for the first time in many years. IronHealth entered in 2008, joining AIG, Darwin/Allied World, Lexington and OneBeacon. Excess underwriters include the London market (Beazley, Lexington, Starr Excess, Liberty and Hiscox) and Bermuda markets (ACE, AWAC, Endurance, Starr Excess, Max Re and XL). Domestic excess underwriters include Darwin, OneBeacon, National Union and Travelers.

MISCELLANEOUS HEALTH CARE FACILITIES

This segment of Health Care Professional Liability has consistently been more competitive than any other over the last decade and it remains the most competitive in 2009 along with hospitals. Rate decreases at renewal mirror those in other facility segments, typically 10-20% or more. Virtually the entire range of miscellaneous health care facilities (there are 50+ types, with new ones created each year) are desirable underwriting risks, as they generally have not experienced the dramatic rise in claim severity that began in the late 1990s, although large losses can and do occur. Ambulatory surgery centers are one example of a highly desired risk group. Med spas, on the other hand, are an underwriting challenge. Many excess and surplus lines carriers write miscellaneous health care facilities, while most of the commercial carriers seek these classes of business. Medical Protective has entered this segment recently, as have many physician insurers. The market includes ACE USA, AIG, Arch, Admiral, CNA, Colony, Darwin/Allied World, Evanston, GenStar, Hudson, Interstate, James River, Lloyd’s, Medical Protective, OneBeacon, RSUI, United National, Zurich and most of the other primary hospital and physician carriers. Philadelphia provides very competitive products for behavioral health facilities as well as home health and hospice facilities.

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Life science companies are tracking an unprecedented number of megatrends that are impacting their industry and creating new risk management challenges. These trends include the movement toward personalized medicine, the development of follow-on (generic) biologics, the growing use of nanotechnology in pharmaceuticals, breakthroughs in regenerative medicine, the expansion of global markets, the dramatic increase in foreign clinical trials, growth of the virtual R&D company model and the unknown impact of proposed health care reform. All of these developments will influence the direction and future of the life sciences business.

Take the spread of the virtual company model. This has the potential to radically alter the way R&D takes place. In this model, R&D firms outsource all or almost all of their services, including research, human clinical trials and manufacturing. Success requires carefully crafted legal agreements with all service partners and vendors. These agreements should contain clear indemnification and insurance clauses that are reasonable and fair to all parties so that a loss can be mitigated quickly and business operations can proceed uninterrupted.

Take also the rise of personalized medicine. Gene sequencing machines previously only used for research may now have application in the practice of medicine. As gene sequencing becomes more affordable, an individual’s genome map may be increasingly used by a physician to determine the optimal course of treatment. Companies that manufacture gene sequencing equipment used in research are now seeing emerging uses for their machines in patient care. This transforms the risk exposure for the device manufacturer, as product liability increases dramatically for a diagnostic and treatment tool versus an R&D tool.

Regardless of the industry’s rapidly shifting risk profile, we are seeing continued interest in life science risks from the insurance marketplace. More companies have dipped their toes into this industry segment, and those already there have gotten in deeper.

We expect to see premiums remain flat or decrease over the next six months for companies with favorable loss experience. Those with losses should expect to pay more premium but should not face huge increases. The trend of decreases up to 8% seems to apply to almost all types of coverage. Some insurers advise that they expect premiums to increase in the foreseeable future but probably not for 18 to 24 months.
Over the past two years, we have also seen many life science insurers broaden their policy coverage. This seems to have slowed. Some insurers are rewriting their policies but the changes are minor or they are incorporating common endorsements into their basic policy form.

**WHAT KEEPS UNDERWRITERS AWAKE AT NIGHT?**

Knowing what's on the minds of underwriters will help in the negotiation process. The potential for mass tort litigation is one of the underwriters’ chief nightmares. Makers of products and classes of products that have had losses will struggle to get coverage or will pay a higher price. The problem for underwriters is not knowing what product might be the next one to present them with a class action claim. Blockbuster claims have come from products that, on the surface, seem to be innocuous. When presenting your company to an underwriter be prepared to talk about your product’s vulnerability to potential mass tort action.

Underwriters tell us that they are also concerned with exposure aggregation. They very much want to avoid covering several products from different clients that might share a common ingredient. If that ingredient were to be deemed dangerous, multiple large losses could result.

Producers of so-called lifestyle drugs (weight loss pills, prescription cosmetics, etc.) may also find a smaller number of insurers to choose from. Underwriters often feel that defending a lawsuit is more difficult when nonessential treatment is involved.

Finally, underwriters are very concerned with quality control. Given the recent publicity over suppliers providing tainted materials that ended up in final products used by hospitals and doctors, expect underwriters to ask many questions about supply chain sources and quality controls.

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This critical exposure – the risks of late or non-delivery of product at any point in the supply chain – needs to be hedged to guarantee a smoothly functioning trade flow and maintenance of a satisfied customer base.

The headline item of the year for the Marine segment is piracy. However, piracy is only one of the threats organizations face in the transportation of assets. Several complexities increasingly put profitability at risk for companies dependent on outsourcing and global trade. These complexities can be political, physical, geographical or all of these together. Whether your organization is involved in commodities, manufacturing, industry, communications or entertainment, the risks faced in transportation are numerous. As with piracy, the threats to profit margins are not necessarily related to physical loss or damage.

We cover the topic of piracy and the related topics of kidnap and extortion in our Marketplace Realities piece on Special Contingency Risks, the Willis specialist group that is a world leader in Kidnap & Ransom risks. For our Marine insurance sector discussion, we refer readers to our recently published Marine Market Review – Riding the Waves. Below, we look at a product area that we believe should be a top consideration for any organization involved in transporting their assets by any means of transportation via any route – Trade Disruption Insurance.

As economic instability circles the world, the potential for geopolitical upheaval soars – through global terrorism, political tensions in developing nations, labor disputes and the acts of capricious governments. Political uncertainty and civil unrest frequently cause direct physical damage and consequential loss to global assets and personnel. Less readily apparent but no less serious is the impact that such events can have on the highly integrated global supply chain – the delicately balanced network of manufacturers, suppliers, shippers and retailers.

As supply chains become more streamlined, emphasizing minimum stockpiling and just-in-time delivery, the links become more fragile. If a key source of supply goes down, there can be serious ripple effects throughout the entire chain. Failure to expeditiously move product can result in loss of customers, reputational damage, reduced share price, higher cost of capital, delays in projects and failure of strategic growth plans.

This fragility has led companies to recognize that effective supply chain management is critical to profitability. In turn, this has compelled risk management to examine the internal and external forces that could lead to failure – some of which can be strategically managed and some of which are beyond anyone’s control.
Traditionally, internal supply chain management addresses operational issues, such as streamlining the production process, reducing interdependencies, developing alternative supply sources and increasing or reducing stockpiling. Little attention has historically been placed upon those external factors which are outside of risk management’s control. As the supply chains fan out and become more reliant on domestic and foreign infrastructures, the whims of domestic and foreign governments and volatile forces of nature have greater consequence.

Companies are spending more resources to assess and map these risks. As for transferring them, the traditional insurance market has offered limited options. Property, Political Risk and Marine products have traditionally focused on insuring separately those risks which are quantifiable. Traditional Property and Marine Cargo insurance responds only to direct physical loss or damage to goods in transit. Business Interruption (BI) coverage is triggered when the physical loss occurs to insured property. Contingent BI provides coverage against loss of net earnings as a result of direct physical loss or damage to suppliers. What if there is no direct physical loss to goods being shipped, but the company is unable to source or deliver them to customers on a timely basis? This critical exposure – the risks of late or non-delivery of product at any point in the chain – needs to be hedged to guarantee a smoothly functioning trade flow and maintenance of a satisfied customer base.

Trade Disruption Insurance (TDI) fills this gap.

**WHAT IS TRADE DISRUPTION INSURANCE?**

TDI covers:
- Loss of profits
- Extra expenses
- Contractual penalties
- Delayed debt repayment
- Increased operating expenses

Insureds are covered for delay or non-delivery of product due to the occurrence of:
- Terrorism, rioting, civil commotion and war
- Political risks, including confiscation, seizure, import/export license cancellation, embargoes and trade sanctions
- Damage to or closure of key infrastructure: roads, bridges, railheads and conveyances
- Fire, flood, storms, earthquake
- Port blockage, breakdown of vessels
- Insolvency of a named supplier or customer
Unusual supply chain perils can be brought to TDI underwriters for discussion and negotiation. The TDI product is generally fluid and can be molded to the needs of the insured.

**DISRUPTION WITHOUT DIRECT DAMAGE**

Recent natural disasters in the U.S., China and Thailand, and political unrest and terrorism events in Central America, Africa and the Middle East have cost companies billions of dollars because of trade disruption not related to “actual physical loss or damage” but to failure to deliver products on time or the extra expense incurred to secure an alternative source of supply or delivery. Here are some scenarios.

- A clothing manufacturer sources clothing from a factory in a Southeast Asian country where diplomatic and trade ties with the U.S. have been strained. The export license is revoked, and the clothier must find alternative sourcing to satisfy outstanding Christmas orders. Orders cannot be filled, earnings are impacted. TDI would cover the loss of earnings.

- Thousands of industries in Central America have been devastated by the effects of hurricanes over the past several years. While in many cases factories were left untouched by the storms, the infrastructure of urban areas was devastated – bridges, roads, ports, telephone lines wiped out – making export of products and crops nearly impossible. Losses have been in the hundreds of millions and many companies were forced out of business. In cases where actual production facilities were undamaged, traditional insurance would not cover their losses. TDI would have covered their extra expenses and/or loss of revenue.

- A producer of fruit juice drinks charters a vessel for the transportation of fruit concentrates. The vessel suffers an accident that damages the hull and puts the ship in dry dock. The producer must hire a replacement vessel for a short period. This cost would not be covered by either the Marine Cargo or the Marine Hull policy – but could be by TDI.

One of the features of TDI is that losses are, in effect, adjusted prior to occurrence of the event. Policies are issued on an agreed-value basis, which means that there is a predetermined daily indemnity or agreed amount to be paid in the event of a loss. Trade disruption can also provide coverage on the basis of a percentage of revenues or loss of a sales contract.

TDI can help protect major infrastructure projects, serving as a credit enhancement when a lending institution is concerned about the timely completion of a project. Contractual penalties can be included in the policy.

To make informed decisions regarding supply chain risk, companies need to undertake a careful supply chain assessment. This requires:

- Mapping end to end every step in the manufacturing and delivery process

- Identifying potential logjams, bottlenecks and other vulnerable points

- Creating a contingency plan to determine potential response tactics and costs should a problem occur
Evaluating which problems are preventable and which can only be mitigated through a properly tailored Trade Disruption program

TDI has limitations. It does not cover perils traditionally covered by Property, Marine or Political Risk insurance. The coverage is designed to work in tandem with existing risk management programs. This combination protects physical assets while hedging against the risk of late delivery or non-delivery of goods and protecting the company’s balance sheet and reputation – protection that is needed in today’s global commercial world.

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The tale of two markets continues. For risks with limited or no catastrophe exposure, the market remains soft, with year-over-year declines, albeit moderating somewhat, for virtually all lines of coverage. For those with CAT exposures, the market can be tough.

The price you pay for insurance depends on a variety of micro and macro economic factors. The micro factors tend to be more under your control: your loss experience, overall risk quality, the quality of your underwriting information, your relationship with your carrier and, of course, the ability of your broker to achieve the optimal price and broadest cover.

The macro forces are out of your hands. These are based on industry surplus and demand, which are largely a function of economic conditions.

The recession is cutting demand, as companies slow production, cut back on expansion and development, reduce staff and, in some cases, simply buy less insurance to save money. Surplus, or supply, is impacted by underwriting profits and losses and investment income. In 2008 the Property and Casualty industry saw a deterioration in the combined ratio to 105.1 – up from the 95.5 mark in 2007. Investment losses exceeded underwriting profits.

Despite the deteriorating results reported by many carriers, MarketScout recently reported that “the average rate for property and casualty insurance fell 5% in August compared to a decline of 10% a year ago.” Rate decreases continue for many clients. Why? Despite a drop of about 10% in surplus from 2007 to 2008 (due largely to investment declines), “after several years of strong surplus growth the industry can handle it,” according to Andrew Colannino of A. M. Best Co. While investment losses have increased significantly for Property and Casualty insurers, the industry overall “is not in trouble by any means,” Calonnino said.

Robert Hunter, a former federal insurance administrator and Texas insurance regulator who was quoted in the same article, said, “…the financial meltdown happened at a very good time for the property casualty industry with many, many companies enjoying a string of profits going back several years.” Hunter went on to say, “Due to strong balance sheets and generous reserves the industry’s cycle has, for the most part, yet to grind the other way.”

Another factor is reinsurance. The hardening of the reinsurance market in 2009, which many expected to raise costs for insurers and in turn push up premiums for insurance buyers, did not materialize. Now it appears the opposite may be in the works. According to a Moody's Investors Services report, “Global reinsurers have more capacity than the demand can absorb, which could mean greater price competition in 2010.”
That being said, the tale of two markets continues. For risks with limited or no catastrophe exposure, the market remains soft, with year-over-year declines, albeit moderating somewhat, for virtually all lines of coverage. For those with CAT exposures, the market can be tough. Many are reporting that risks with catastrophe exposures can expect to see higher premiums. It remains to be seen what impact a relatively quiet (to this point) 2009 hurricane season will have on rates for CAT-exposed properties. Some are predicting a softening for these risks, which, up to this point, have not experienced much in the way of rate relief. Barring a significant surplus-depleting event, we expect the total cost of risk for most insurance buyers will decline when the numbers are tallied for 2009, and that the trend will continue in 2010.

As for real estate and hotel companies, the news is particularly good as more carriers have expressed interest in expanding their writings in these industries. This is especially true for companies that carefully manage their risk profiles.

Our advice is to start the renewal process early, meet underwriters and work with your Client Advocate to tell your story. Provide the underwriters with as much engineering data as possible (especially for risks with CAT exposures) so underwriters can properly assess the Property PMLs, review reserves prior to the renewal process and request quotes well in advance of the renewal date. In other words, take control of what you can control, and keep a wary eye out for the rest.

*This analysis updates our market review from the July issue Views, the newsletter of the Willis Real Estate & Hotels Practice.*

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“Here comes the sun.” So sang Richie Havens in his legendary Woodstock set 40 years ago. The same words would make an apt refrain for the utilities industry, as solar power steps forward as an increasingly practical and promising source of renewable generation to combat global warming. The opportunities, as always, come with risks, and understanding and managing these risks will be crucial if solar is to achieve its ultimate potential. The potential is certainly great.

The total solar energy absorbed by Earth’s atmosphere, oceans and land masses is approximately 3.8 million exajoules (EJ) per year. The sun delivers more energy in one hour than all human activity uses in one year. Solar power has been around for decades, but until recently the technology has not been cost-effective enough to make it a viable component of a utility’s power generation portfolio. With new technology and favorable tax treatment by governments, plus the expected mandate in the U.S. that electricity providers will need to derive 20% of their energy from renewable sources, solar energy is now set to play a major part in the renewable energy portfolio.

HERE COMES THE TECHNOLOGY

Two main types of technology convert sunlight into electricity: photovoltaics (PV) and machines that concentrate solar power (CSP). PV has mainly been used on a small scale – from calculators powered by single solar cells to off-grid homes powered by PV arrays. For large-scale generation, CSP plants have been the norm, but recently, large scale PV plants have become more common.

CSP technology uses mirrors to heat a thermal fluid that creates steam to power a conventional steam turbine. Alternately, dish-mounted turbine units use the concentrated heat to expand helium gas that drives the electric generation process. Current PV solar farms produce from one megawatt (Mwe) to 50 Mwe. They take up a lot of room, generally spreading over several hundred acres in rural areas. New CSP projects in the planning stages or under construction will generate as much as 500 Mwe – or enough power to run 400,000 homes.
HERE COME THE RISKS

Solar facilities are susceptible to some losses unique to the solar world and others common to all power generation facilities. Exposures include electrical failure and subsequent fires in transformers, substations, cable tunnels and other combustible equipment. PV equipment can be susceptible to hail damage, and both PV and CSP units are susceptible to damage from sandstorms and windstorms – not to mention the catastrophe perils of earthquake and flood. The underwriting process is as onerous for solar farms as it is for other generation projects.

Any organization building a solar facility will need to submit information about these risks to insurers. This starts with project site information, which, at a minimum, must address the following questions:

- Site owner/lesser or occupancy? In many instances, the property is not owned by the project developer and will be leased, either from private property owners or from the federal government.

- Ground-mounted or roof-mounted? Many solar projects utilize ground-mounted equipment, but the latest PV projects use large industrial roof expanses to mount the PV equipment.

- Flood risk? Although many projects are located in desert areas, there can still be a significant exposure to flash floods.

- Earthquake, volcano or tsunami risk? If the solar farms are located in seismically active zones these risks will be an issue.

- Meteorological conditions? This will be key as both the PV and CSP farms are susceptible to wind damage.

- Proximity to vegetation? Precautions must be taken to keep roots, weeds and vines at bay.

The next area for risk review is the contractors who will be building the farm. This may be done on an EPC (engineering, procurement and contracting) contract basis or the project principle may act as its own EPC contractor and utilize the services of a construction manager and multiple other contractors/subcontractors to complete the project. Issues to document:

- Contractors’ experience and use of subcontractors
- Quality control and quality assurance capabilities
- Loss experience
- Original equipment manufacturers’ roles on site
The selection of equipment and the farm configuration will vary depending on whether it is a PV or CSP plant. Many small PV installations will connect directly to the distribution system via a transformer and effectively function as distributed generation. Larger PV sites may link to the grid system via a substation, which will also be the case with most CSP farms. Risk issues that must be taken into consideration at this stage include:

- Technology to be used and whether it is proven or prototypical
- Capacity of each unit and of the farm as a whole
- Manufacturers’ warranties
- Transformers to be used
- Configuration of the cabling linking individual units to the substation
- Substation size and configuration
- Lightning protection
- Testing and commissioning procedures
- Operational and maintenance plans
- Strategic spares retention

In addition to standard Property & Casualty protections to cover the risks outlined above, many solar plant builders will seek Time Element coverage, given how many solar projects are financed through non-recourse debt. In addition to the standing charges, net profit and debt service typically built into Time Element insurance, an important additional factor will be the tax credits the project owner may have access to.

**HERE COME THE TAX CREDITS**

The American Recovery & Reinvestment Act allows several tax incentives to a renewable energy project. These are the key drivers of many of these projects. The tax incentives range from a 2.1¢ tax credit per Kwh for plants in operation by the end of 2013 to an investment tax credit of 30% for plants in operation by 2016. A 30% grant in lieu of the tax credit is available for projects that commence construction by the end of 2010.

With public concern over global warming and a concerted move toward renewable energy, the solar option is shining brighter than ever. Continued technology developments will make solar even more cost-effective going forward.