Willis Group is a leading global insurance broker, developing and delivering professional insurance, reinsurance, risk management, financial and human resource consulting and actuarial services to corporations, public entities and institutions around the world. With over 300 offices in more than 100 countries, its global team of 14,500 Associates serves clients in some 180 countries.

Additional information on Willis may be found on its web site www.willis.com.
Marketplace Realities
and Risk Management Solutions

A World of Risk 2005
For the broadly defined insurance industry – clients, brokers, carriers and regulators – the action taken by the Attorney General of the State of New York on October 14, 2004 was an epochal event, ushering in a new era in which business practices, relationships, service offerings and expectations are undergoing varying degrees of transformation.

Certain practices that had become part of the architecture of the industry have been challenged, with issues of equity, transparency and consumer interests coming squarely to the forefront. For insurance carriers and capital providers of every stripe, how they address customer expectations will determine their individual and collective roles and fortunes in the business of risk transfer and related services.

The central, operative term is transparency. In the context of the traditional insurance transaction – exchange of a certain premium for the assumption by the insurer of an uncertain risk of loss (and, often, for associated services) – transparency is neither inert nor generic. It is the comprehensively and uniquely crafted answer to a fairly basic question: "What am I getting for my money?" The contract of insurance itself is the core deliverable. Each is a multidimensional construction that sets forth a certain scope of coverage with defined limits over a specified period of time, and each dimension comprises its own bundle of individual characteristics. Insurers have a fabulous opportunity to illuminate and differentiate their offerings by delineating, qualifying and quantifying those attributes that make their policies, programs and services more comprehensive, more cost efficient, more reliable, more secure, more responsive – more.

Transparency therefore provides a level playing field where insurance companies should be able to compete, excel and thrive based upon objective determinations of quality, quantity and customer needs. The role of the broker as Client Advocate continues much as before, albeit with heightened emphasis on providing carriers with continuous feedback and guidance regarding client needs and choice criteria. As Client Advocates, we evaluate the relative appropriateness and value of marketplace offerings; assess competing carriers’ relative strengths and weaknesses; determine the values – in all dimensions – conveyed by product and service offerings; and articulate reasoned recommendations.

Transparency and value are bound together.

*            *            *

All of us bear responsibility for maintaining an open, responsive and financially vibrant marketplace in which insurance products and related services are vended equitably and efficiently, providing financial security for people, companies, institutions, governmental bodies – for all customers of our industry.

In the past we have spoken on this page of insurance being part of the DNA of capitalism, part of the free market system in which capital is directed toward investments for the purpose of creating value – extraordinary value for the common good. The people of Willis are delighted and honored to serve our clients and to work with insurers and others in the industry in creating value that protects, sustains and lifts up the lives and fortunes of an ever-growing constituency. We will do our utmost to continue to earn your confidence and trust.

Mario Vitale
CEO
Willis North America

Postscript – A World United
The catastrophic damage to coastlines bordering the Indian Ocean and Bay of Bengal as a result of the recent tsunami has been extraordinary. The scale of destruction, loss of life and upheaval is enormous, and implications for the insurance industry are yet to be assessed. As we go to press, people and nations are undertaking immense relief efforts to preserve life and rebuild shattered communities and economies. Our world is once again united in grief – and by a shared resolve to heal, protect and nurture survivors and their families.
The observations, comments and suggestions we have made in this report are intended to provide readers with general information regarding developments in areas relevant to their risk management needs. Content is based upon conditions observed, research undertaken and information available as of the publication date, but should not be assumed to be exhaustive in nature or address every potential exposure or solution.
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Issues and Imperatives for a World of Risk

Moving clockwise from the northwest quadrant, our cover images represent technology, the forces of nature, industry and the estimated 6,400,000,000 souls who walk the earth. Protecting people and assets, physically and financially, is the business of the insurance industry. Reducing or removing uncertainty, facilitating capital investment as an engine of growth, encouraging innovation and exploration — these things are also within the domain of the industry. In the best sense of the word, risk is a byproduct or companion of the good stuff of life: doing, making, building, striving, creating and reaching for the stars.

Treating the family of such risk so as to support life’s needs and quests is a profession and a calling — a calling that of necessity also addresses other risks, most notably terrorism, that are devoid of good or reason.

Our 2005 Marketplace Realities report is subtitled "A World of Risk". In reviewing and assessing risk management tools and insurance products designed to treat the good and the bad, we look at the multitude of exposures, experiences, aspirations, objectives and interdependencies that are shared or held in common and that make one world out of many countries. Corporate governance, environmental concerns, workplace safety, and global economic and insurance marketplace conditions are themes and issues that span 24 time zones. In this overview article, we present summary and forward-looking comments on:

- State of the Marketplace
- Future States of the Marketplace
- TRIA — "As We Go to Press"
- Corporate Governance
- Postcards from the World

State of the Marketplace
Soft and softening are the predominant adjectives used to describe conditions for virtually all market segments. The underlying factors are familiar to all who have previously experienced a turn in the market cycle:

- Quantum premium increases of the hard market leading to rapid rebuilding of surplus, with
- Attraction of new "non-legacy" capacity, followed by
- Relatively superior overall and catastrophe loss experience.

Even the remarkable 2004 Atlantic hurricane season, while impacting heavily on individual carriers, did not halt the growth of price competition, as detailed in our Property article.

The phrase "price competition" is a telling one, for unlike previous turns in the market cycle, this one is marked by continued underwriting discipline in the treatment of terms and conditions, deductibles and retentions, catastrophe risk exposures, interdependencies and corporate governance. For Property, Casualty, Directors & Officers Liability and other core program elements, the story is much the same: even with price competition, companies need to know what matters most in negotiating their respective policy terms and conditions.

One final note here, in the nature of a caveat: marketplace conditions and expectations for the near and medium term are always subject to change. Conditions, particularly for a given segment, can turn for the worse rather quickly — through catastrophe loss(es) or classes of litigation that erode surplus and may portend more bad news to come. It is equally valid to note that market forces may drive improvement in conditions beyond expectations, as they have at times in the past. As preconceptions often tend to become self-fulfilling prophecies, it’s wise to avoid them. The important tasks when going to market are to know where it is at all times, probe for opportunities, establish positive differentiation for client programs and make the best deal that can be made.

Future States of the Marketplace
We draw the reader’s attention to the Energy article in which we reprise the Foreword to the October 2004 edition of the Willis Energy Market Review. The subject of the article goes well beyond the energy industry. After defining the two types of
risk underwritten by the commercial insurance marketplace — single-site risk and aggregation risk — the author examines history, cycles, current events and forward-looking scenarios, posing a number of defining questions: “Do the growth of aggregation risk, heightened interdependencies and other risk-concentrating phenomena create ‘natural monopoly’ conditions for funding aggregation risk? Will government take on an expanded role as the insurer of last resort? Will tort reform be enacted to limit historical and/or going-forward exposures?” The article provides a provocative and instructive vision of the future.

**TRIA — "As We Go to Press"**

The Terrorism Risk Insurance Act of 2002 is due to expire on December 31, 2005. *The Wall Street Journal* (“TRIA Uncertainty Worries Insurers”, Dec. 1, 2004) reported that legislation to extend TRIA had been pushed "onto a legislative back burner", and that carriers were "struggling to price policies and calculate how much risk to expose themselves to."

TRIA legislation is an issue beyond the borders of the US, as it affects multinational companies, global programs and world marketplace capacity for stand-alone terrorism coverage. Implications of TRIA legislation for policies renewing on or after January 1, 2005 and other TRIA-related issues are discussed in the **Property** and **Reinsurance** articles, and we also refer readers to the *Willis Webcast Bulletin* of November 18, 2004, available on www.willis.com.

**Corporate Governance**

The theme of corporate governance resonates around the world and pervades every aspect of corporate life. At Latitude 33° 52’ S / Longitude 151° 12’ E, the Australian Prudential Regulation Authority (APRA) sponsored legislation for reform of the General Insurance Industry — legislation that was enacted by Parliament and became effective July 1, 2002. In August of that year, the Australian Stock Exchange convened a meeting of 21 organizations “representing the Australian investment stakeholder community, to make recommendations on corporate governance practices for listed companies.” In March 2003, the ASX Corporate Governance Council issued its *Principles of Good Corporate Governance and Best Practice Recommendations*, with the ASX itself adopting all 28 of them.

At Latitude 38° 49’ N / Longitude 76° 59’ W, a distance of 15,704 great circle kilometers from Sydney, the Congress of the United States enacted The Sarbanes-Oxley Act of 2002 (SOX) to “protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.” As reported in our **Directors & Officers** article, companies subject to SOX and their outside accounting firms are laboring to meet the Act’s Section 404 requirements regarding internal control over financial reporting. It is no understatement to say that the effort and expense associated with SOX compliance are enormous.

More than milestone legislative and regulatory events, these citations represent *movements* — fundamental changes in priorities, expectations, accountability and enforcement — on every continent. An old adage says, “You can’t legislate morality.” That may be true, but fines and penalties can be powerful motivators.

**Postcards from the World**

In the run-up to publication of *Marketplace Realities*, we asked country managers and other leaders from Willis offices around the world to describe for their respective countries and regions:

- Local and regional economic conditions and business challenges
- The state of the commercial insurance industry
- The impact, if any, of nat cat exposures and losses on the availability and cost of nat cat insurance
- Priorities for risk management / corporate governance

The responses reflect conditions and challenges unique to the respondent countries. In the **Global Perspectives** section of this book, we have selected excerpts and present them as “Postcards from the World”. Illuminating and sometimes poignant, they are testament also to the common ground and shared experiences that encourage us to speak so often of one world.
As noted in our Marketplace Overview article, we asked country managers and other leaders from Willis offices around the world to describe economic conditions, the business environment, corporate governance initiatives and related risk management issues for their respective countries and regions.

Although conditions and priorities vary widely country to country, there is notable convergence of interests. Corporate governance initiatives and insurance market reforms have been effected or are underway in Australia, Germany, India, the UK and other nations. Sensitivity to global economic conditions is nearly universal. Local government issues figure heavily in the outlook of people and businesses for the growth and welfare of their societies. Everywhere there is challenge, vision and determination.

We present portions of the country reports as "Postcards from the World" — selected highlights of their respective business and social environments that provide valuable perspective.

AUSTRALIA

Commercial Insurance Market — The Australian insurance marketplace has undergone significant consolidation in recent years, a trend driven by lack of profitability and by increasing levels of regulation. The 2003 / 2004 reporting season, however, has produced some of the best results in decades. The KPMG General Insurance Survey 2004 reports that respondent companies increased gross premium income by 12 percent; before-tax underwriting profit by 428 percent, to over $1.5 billion; and investment returns by 73 percent, to over $2 billion. Even so, KPMG cautions:

> Australia’s general insurance industry sector has reaped the benefits of a hard underwriting market and improved investment performance to announce the best results in decades. The higher profits will not necessarily translate into lower premiums, so policyholders should not expect major premium reductions. The reality is that the bumper results … are still overshadowed by the magnitude of underwriting losses incurred in previous years.

The favourable results have also emerged as a result of a year of low loss levels, particularly from catastrophes, plus the beneficial effects flowing from tort law reform. As expected, we saw a drop in rates for shorter tail classes in 2004, and long-tail risk premiums are expected to soften in 2005.

BRAZIL

Although its economy has rebounded from the recession of 2003 and is now expanding at a rate of five to six percent, Brazil still faces significant challenges to sustained and balanced growth. Consumer confidence has lagged, with semi-durable and non-durable goods expanding at a lower rate than capital, durable and intermediate goods. The unemployment rate, though improved, remains high, and inflation, though under control, is a persistent concern. The government has invested very little in infrastructure so far and will need to invest heavily in roads, railways, ports and the energy sector in order to sustain growth.

Recent news on the economy has, however, been quite positive. As reported by Bloomberg on November 30, 2004:

> Brazil’s economic growth quickened to its fastest pace in eight years in the third quarter as lower interest rates boosted demand at home and exports of soybeans and cars surged. Gross domestic product grew 6.1 percent in the July-through-September period from a year ago after expanding 5.6 percent in the second quarter. The $522 billion economy has grown every quarter this year.

President Luiz Inacio Lula da Silva said in an interview last week he is optimistic South America’s largest economy is on a path of sustainable growth. The jobless rate fell to a two-year low of 10.5 percent in October, industrial output has climbed every month this year and inflation is about half the level of a year ago.

Risk Management in an Evolving Market

Companies on the whole have learnt from the lessons of the hard market about insurers’ requirements and demands for a more robust approach to the management of insurable risks. Imposed levels of self insurance as well as risk improvement measures are now being embraced, and we predict that this will lead to less volatility in rates as and when the market may turn and begin to harden. In the past year, we have seen increased focus on captive formation and similar risk-taking vehicles for Australian based companies.
Employee Benefits: Healthcare

2004 was a year of great turbulence in the private health sector in Brazil. Due to the poor financial condition of the government-controlled plan and the state of public hospitals, a great portion of the Brazilian population either has a private health plan or participates in a company-sponsored plan – a virtually mandatory benefit for companies that want to retain and recruit employees.

The government, however, in exerting control over certain operations of the private plans, has in the past demanded that the insurers widen coverage and has limited their power to raise rates. Furthermore, the private insurance sector had not reviewed the medical fees paid to doctors and hospitals for more than five years, and many medical professional associations took public action, striking against health insurance plans and demanding that the fees paid by insurers be reviewed. Many doctors and hospitals boycotted the insurance companies and turned down some insureds that needed treatment in order to apply pressure to the insurance companies. A few of the major insurers agreed to review and increase the fees, partially stabilizing the situation. Insureds were strongly affected by this tug of war, with costs of health insurance increasing by an average of 25 percent in one year.

New Insurers and New Products

The entry requirements for foreign and domestic insurers remain high, and although there is likely to be a small increase in the number of insurers, the impact on the market will be limited geographically. Plans called for international insurers to be allowed to apply for branch licenses anywhere in China at the end of 2004, but the licenses can be costly and still retain certain geographical restrictions. In the short to medium term therefore, the market is expected to remain dominated by the four large domestic insurers that already have a significant branch network.

Although there has been a relaxation in the approval process for manuscript wordings, it has not been removed completely. Manuscript wordings need to be submitted for approval in Chinese and within 30 days of issue. Although this has not killed innovation, it does frustrate it and is a contributing factor to the restricted number of products available in the market. As a whole, the industry remains dependent on basic industry policy forms.

CHINA

State of the Market – With the exception of specialist covers and situations where international facultative reinsurance support is required, the Chinese domestic market remains largely unaffected by trends occurring outside of the country. Market conditions are extremely competitive in spite of minimal deductibles and limited attention being paid to risk management issues.

Following IPOs or with impending IPOs in mind, however, most domestic insurers are likely to try to improve overall loss experience and adopt stricter underwriting policies – although changes are expected to be limited to particular classes, with any increases being moderate and on a case-by-case basis.

Overall the insurance industry is still in its infancy, with fundamental movement unlikely until international underwriting practices are adopted, and the industry sees a general improvement in skills and technical expertise.

INDIA

India is widely perceived to have an agricultural economy, with nearly two-thirds of the 1.2 billion population working in the agricultural sector and accounting for one quarter of the GDP. Services, however, are turning out to be India’s most dynamic sector, registering impressive growth in telecommunications and information technology. With one of the fastest growing economies in the world, India has seen GDP growth rate averaging in excess of five percent over the past few years. Despite such impressive growth, the country continues to have some of the lowest human development indicators in the world, particularly in rural areas. India’s per capita GDP hovers around USD 470.
Corporate Governance — Corporations by and large do not take a proactive approach to risk management. For example, Property insurance, which generally accounts for the largest chunk of the insurance spend, is under tariff, and companies have very little incentive to invest in preventive and safety measures. Good risks and poor risks invariably attract the same rates within a given industry, and the tariff deductibles are typically USD 200 for Property business, with no commensurate discounts for those taking higher retentions.

MEXICO

Government and Special Risks — Notwithstanding the 2004 season, natural disasters seem to be on the increase in frequency and severity for Mexico. The central government, sensitive to the lack of capacity and the need for catastrophe risk protection, is in the process of creating a federal fund for CAT coverage that would be designed to work as a complement to CAT coverage purchased by each individual Mexican state government. The arrangement is intended to encourage the purchase of coverage by the individual states so they can qualify for federal help in covering part of such risks. As a result of this activity, a large market is opening for CAT coverage, and a handful of Mexico’s 31 states have already purchased or are seriously considering purchasing such coverage.

UNITED KINGDOM

FSA Regulation — The UK has enacted the EU Intermediation Directive. From 14 January 2005, the UK Financial Services Authority (FSA) will regulate all entities conducting an insurance intermediation activity “by way of business” in the UK. How does this affect risk managers? Until July 2004, it seemed that risk managers who arrange programmes for Group subsidiaries and receive internal remuneration might fall subject to the rules, a development that would have caused chaos. Fortunately the FSA has announced that intra-Group arrangements may not require FSA authorisation. However, many clients who arrange insurance covering non-Group entities (customers, joint-venture partners, etc.) will or may still fall within the net and will need legal advice. From 14 January it will be a criminal offence for a broker or insurer to do business with an entity that is carrying on a regulated activity but is not FSA authorised.
**Employers Liability** – Employers Liability insurance is compulsory coverage for workplace injury and occupational disease. Unlike US Workers’ Compensation, UK EL is a “fault-based” system, and although the employer’s duty of care is very high, issues of comparative and/or contributory negligence do factor into the equation, and workers are obliged to engage the services of a solicitor.

Eighteen months ago the Employers Liability market could justifiably have been said to be in crisis. The scale of the losses and dramatic contraction in the number of insurers who would offer stand-alone cover led to many entities (especially smaller ones) struggling to find cover at any price. This led to calls for government to step in and form something akin to an Assigned Risks Pool. Although a measure of stability has since returned to the market and cries of crisis have diminished, buyers face two continuing challenges:

(1) **Claims costs** – They are still rising at something like 10 percent per year due to a number of factors: increased propensity to claim; increased awards for pain and suffering; ability of the National Health Service to recover medical costs; contingent legal fees.

(2) **Long-tail disease claims** – A number of insureds with asbestos exposures prior to 1972 find claims uncollectible as the insurer at the time is now insolvent. (In 1975, the Policyholders Protection Board provided an industry safety net for insurer insolvency.)

The following Willis Associates contributed to the preparation of this article:

**Australia** – David W. Carter
**Brazil** – Anthony W. Harvey, Cecilia Vodopivic and Eduardo Burlamaqui
**China** – Paul Morgan
**India** – Prem Bhanu and Adam Willis
**Mexico** – David Atherton and Marco Cummings
**United Kingdom** – Terry Pey and Robert Barr
The following is an excerpt from the Willis Lloyd’s Review published in August 2004. The Introduction and Executive Summary provide a concise overview of Lloyd’s financial condition and management practices. We invite readers to download the full review from our web site, www.willis.com. Under Publications, it was posted on August 10 as Lloyd’s Review 2004.

Introduction
The Lloyd’s franchise continues to evolve as Lloyd’s moves away from its traditional role of market supervisor to be a proactive manager of a commercial franchise. Lloyd’s senior management team has driven the process with a range of initiatives in the past year centred on the ultimate goal of creating a commercial environment where the long-term return to all capital providers is maximised.

Lloyd’s strong return to profitability and the attractive underwriting conditions afford Lloyd’s management with a window of opportunity to invest time and resources in creating a disciplined marketplace of well-managed, independent businesses. Significant progress has been achieved in the past year, and the market appears well placed to continue with the momentum generated for further reform. The challenge for Lloyd’s will be to proactively manage the franchise and avoid the extremes of underwriting ill-discipline of a small number of businesses that in the past caused significant damage to Lloyd’s central resources and brand. Against a background where underwriting conditions in most classes of business are beginning to weaken, the acid-test to the Lloyd’s franchise system will be to deliver profitability over the underwriting cycle, and not micro-manage Lloyd’s independent business to the extent that Lloyd’s renowned entrepreneurial spirit, innovation and flexibility are destroyed.

This review seeks to identify and comment upon some of the key trends and developments at Lloyd’s during the past year, and to give a brief insight into the state of the market in 2004.

Executive Summary
Lloyd’s underwriting capacity for 2004 stood at a record high at £14.96 billion, albeit marginally larger than the opening figure in 2003. Lloyd’s forecasts capacity to contract in subsequent years, as it expects underwriters to focus on profit rather than maintaining market share in the next downturn in the underwriting cycle.

At £1.9 billion, Lloyd’s profit in 2003 on a pro-forma annual accounting basis represented a more than twofold increase on the figure achieved in 2002. The combined ratio for 2003 improved to 90.7 percent, down from 98.6 percent in 2002. This strong positive result was achieved in spite of a further charge for adverse loss reserve development for US casualty business for years 1997 to 2001.

On a three year accounted basis, the 2001 year closed with a loss of £2.4 billion, representing 21 percent of capacity. The result was heavily influenced by losses arising from September 11.

Underwriting conditions remain attractive, with the 2003 year seen by Lloyd’s as the peak of the underwriting cycle. Prospects for future earnings are good, and in April 2004 Lloyd’s forecast combined profits for the 2002 and 2003 years account in the region of £3.5 billion.

The Lloyd’s market financial strength market ratings were affirmed by Standard & Poor’s and A.M. Best at A (Strong) and A- (Excellent) respectively. Lloyd’s aims to achieve a one-notch upgrade in its market rating from both rating agencies by the end of 2005.

The equity markets’ positive results in 2003 contributed to a further strengthening of Lloyd’s balance sheet. Net resources (Lloyd’s measure for shareholders’ funds) rose by 35 percent in 2003 to £10.1 billion. Lloyd’s achieved its widely stated goal of increasing central net assets to in excess of USD1 billion by December 31, 2003. Lloyd’s central net assets, largely comprising Lloyd’s Central Fund, increased by 39 percent to stand at £781 million as at the 2003 year-end.
The Lloyd’s franchise continues to evolve. This was evidenced in 2003 by developments such as:

– Creation of the Franchise Performance Directorate
– A more rigorous business planning process
– Amendment to the relevant EU directive to facilitate the move to annual accounting
– Appointment of a head of business process reform

Equitas announced its results for the year ended March 31, 2004, reporting that accumulated surplus, after tax, decreased by £67 million to £460 million, driven by the need to further strengthen asbestos claims reserves. However, Equitas’ solvency ratio improved to 9.8 percent from 8.7 percent in 2003.

In 2003 the Financial Service Authority (FSA) began the process of taking a more direct approach in the regulation of the Lloyd’s market. The FSA proposed new requirements, which will be introduced from January 1, 2005, designed to ensure that senior management at both the Corporation of Lloyd’s and at managing agents focus on their responsibilities for managing risk effectively and on the level of capital needed to support the risks of the insurance businesses.
After years of carrier withdrawals, the market for international program business has finally stabilized. This does not, however, leave a large number of carriers in the field, and uncertain underwriting results, carrier mergers, and the cost of maintaining an international network make it extremely unlikely that we will see new entrants into this sector any time soon. For US domiciled insureds, carriers Royal & SunAlliance, AXA and If P&C Insurance are not a factor. (Allianz underwrites Casualty business in Europe, but not in the US.)

**Market Snapshot**

The international carriers serving multinational clients can be divided into three 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 and have the underwriting expertise to accept the most difficult classes of business. Two years ago, this tier was dominated by a greater proportion of non-US owned carriers.

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

**Tier III** – While operating on an international scale, these companies are supported by a limited geographic spread of nationally operating companies and offer a very limited product range. This category has been all but eliminated as most carriers are either in the market with stronger facilities and products or they have left the program business altogether.

**Premium Tax Payment Issues**

Premium allocation and tax payment systems in Europe have matured and are now part of common insurance business practice. A similar change is likely to follow in North America.

While premium tax rules have existed for many years in the EU, settling premium taxes was often neglected, even on Euro policies. What has changed? Over the last two years, Lloyd’s has been mandating the payment of premium taxes on non-admitted placements. Now, we are seeing more and more of the non-Lloyd’s market in Europe allocating premium taxes on non-admitted placements, and they are doing this everywhere in the world, not just in the EU. As carriers promote these efforts in Europe, it is just a matter of time before program carriers in the US adopt the same position.

We also observe that corporate governance activities focused on global compliance have led many companies to examine past years to determine whether there are any issues in regard to the payment of premium taxes on non-admitted placements.
Direct Writing Captives

With the expansion of the European Union / Europe Economic Area (EU/EEA), direct writing captives are now better able to compete with the traditional program carriers. They now represent serious competition to the markets in Tier I and Tier II categories.

Background

Insurance policies issued directly (by way of admitted paper) in the EU and EEA must be underwritten by an insurance company approved and regulated within the EU or EEA. Under the Directive on Freedom of Services, the insurance company can be incorporated and licensed in any one of the member countries and must be able to issue policies to any of the other countries. This permits direct writing captives to enter the field.

Ireland is currently the country most favored as an EU domicile for captives wishing to issue EU/EEA admitted paper, with currently over 200 captives providing this service to its insured parent and/or subsidiaries.

Benefits

Setting up an EU captive direct writer offers many benefits.

– Access to admitted writing capabilities in 28 European countries (EU/EEA) for “all risks” lines
– Reduction in the overall EU/EEA insurance cost by centralization (in the EU captive) of all insurance and service purchasing
– Unbundling embedded carrier costs and potentially eliminating or substantially reducing fronting and associated collateral costs
– Access to the reinsurance markets (including other group captives)
– Flexibility in premium allocations based on local risk management / loss history
– Creation of a centralized function for key areas of concern to local insureds (i.e., clinical trial certificate issuance for pharma groups)
– Utilization of existing double tax treaty arrangements to optimize tax positions that may also eliminate federal excise tax for US insureds
– Positioning to afford cover for further investment in the expanded EU/EEA (30 countries by 2007)

A direct writing captive has the ability to provide fully-admitted insurance policies to its operating units in any of the following countries:

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<td>Belgium</td>
<td>Hungary</td>
<td>Poland</td>
</tr>
<tr>
<td>Cyprus</td>
<td>Iceland</td>
<td>Portugal</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>Ireland</td>
<td>Slovakia</td>
</tr>
<tr>
<td>Denmark</td>
<td>Italy</td>
<td>Slovenia</td>
</tr>
<tr>
<td>Estonia</td>
<td>Latvia &amp; Lithuania</td>
<td>Spain</td>
</tr>
<tr>
<td>Finland</td>
<td>Lichtenstein &amp; Luxembourg</td>
<td>Sweden</td>
</tr>
<tr>
<td>France</td>
<td>Malta</td>
<td>UK</td>
</tr>
<tr>
<td>Germany</td>
<td>Netherlands</td>
<td></td>
</tr>
</tbody>
</table>

It may also be able to issue policies directly to (among others) the following domiciles:

– Australia
– Hong Kong
– New Zealand
– Singapore
– South Africa
– Thailand

Direct writing captives can handle payment of premium taxes, although this can also be done by a local broker or a third-party facility.

Not all multinationals will prefer direct writing captives since they do not offer the level of local service of a traditional carrier. Also, in some cases, the geographic spread of a multinational may not match the list of countries where captives operate. Others may simply be averse to owning an insurance subsidiary. Nevertheless, captives are a significant alternative to the traditional program carriers.

Local Issues

Multinationals need to be keenly aware of local developments that impact the way business is conducted in countries around the world. We have seen several such developments in the past year in Latin America.
Brazil
Always a challenging country in which to administer global programs, Brazil has recently seen changes in its Directors & Officers (D&O) environment. The traditional approach of issuing a Global D&O policy and relying on the non-admitted carrier to reimburse for claims on a non-admitted basis no longer works in Brazil. Under new legislation, directors and officers in Brazil must show evidence of a local D&O policy in the event of a claim. In the absence of a local D&O policy, the assets of a director or officer are frozen until the case is settled. While underlying coverage placements to the Global Program do not work in Brazil, more and more buyers are reverting to local policies to cover their D&O exposure in Brazil.

Mexico
In an attempt to combat money laundering, the Mexican government recently imposed on carriers the task of pre-qualifying an insured on any policy whose premium amounts to more than US$10,000. Insureds must comply with detailed reporting requirements prior to policy inception. Unless documentation is complete, premiums cannot be collected, policies cannot be issued and claims cannot be paid.

Argentina
Until recently, Employers Liability was not an issue in Argentina. If an employee was injured, the injured employee’s only remedy was Workers’ Compensation. A recent court decision declared that the Workers’ Compensation law was incompatible with the Argentine constitution, and it allowed injured employees to sue employers in local court. As of this writing, carriers in Argentina are still refusing to underwrite Employers Liability because of the unknown loss exposure.

It is likely that similar issues will arise elsewhere as societies become more litigious and social security plans continue to come under threat because of loss problems.

UK Employers Liability
Claims and awards are increasing in Employers Liability in the UK. For relatively low hazard occupations in offices, the awards are increasing due to stress claims being filed by employees. Employers are turning more and more to employee assistance programs to reduce their exposure to these losses. The UK government recently announced plans for a corporate manslaughter bill, another move that insurers have warned may drive up the cost of Employers Liability coverage. There is also a continuing concern regarding legacy issues such as asbestosis and other industrial diseases that can generate substantial claims and awards.

Property Fronting Programs
The cast of carriers offering Property fronting programs and the limits the carriers offer has not changed since last year, with the exception of Allianz, which has increased its maximum fronting limits from $200 million to $500 million. We are, however, seeing a more competitive environment for these programs.

Strategies for 2005
We continue to recommend that insureds consider a global primary program with an insurer that has the ability to issue local policies, and then build a permitted non-admitted excess program. A direct writing captive is now an option to consider, given the expanded number of countries that can be included.

Fronting Carriers as of November 23, 2004

<table>
<thead>
<tr>
<th>Carrier</th>
<th>Max. Property Fronting Limits</th>
<th>Security Requirements</th>
<th>Guaranteed Flow (Standard Terms)</th>
<th>Front for TRIA</th>
<th>No. of Owned Countries</th>
<th>No. of Affiliated Countries</th>
<th>No. of Total Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACE</td>
<td>$500 M</td>
<td>S&amp;P A Rated</td>
<td>Paid by 25th, out 15th of following month</td>
<td>Will consider</td>
<td>46</td>
<td>100</td>
<td>146</td>
</tr>
<tr>
<td>AIG</td>
<td>$500 M</td>
<td>Committee approval</td>
<td>25 days selected countries</td>
<td>Will consider</td>
<td>89</td>
<td>14</td>
<td>103</td>
</tr>
<tr>
<td>Allianz</td>
<td>$500 M</td>
<td>Specified carriers</td>
<td>None</td>
<td>Will consider</td>
<td>42</td>
<td>15</td>
<td>47</td>
</tr>
<tr>
<td>FM Global</td>
<td>$500-1,000 M</td>
<td>Committee approval</td>
<td>None</td>
<td>Will consider</td>
<td>18</td>
<td>70</td>
<td>88</td>
</tr>
<tr>
<td>XL Global</td>
<td>$500 M</td>
<td>Committee approval</td>
<td>None</td>
<td>Will consider</td>
<td>28</td>
<td>53</td>
<td>81</td>
</tr>
<tr>
<td>Zurich</td>
<td>$500 M</td>
<td>5% of carrier surplus/A rated</td>
<td>None</td>
<td>Will consider</td>
<td>36</td>
<td>47</td>
<td>83</td>
</tr>
</tbody>
</table>

Note: While this chart highlights Property fronting, Casualty fronting is available from all but FM Global and Allianz
We offer a word of caution to multinational organizations about compliance with local laws governing compulsory and non-admitted insurance. National enforcement bodies are growing less tolerant of violators, and violations can be costly. One way for risk managers to maintain global control is to be sure they are receiving timely information on regulatory changes around the world. For example, in China we are beginning to see changes in regulations that will have an impact on global programs in 2005. In today's world of rising corporate governance standards, compliance is a must on any international risk manager's to-do list.
A Postscript on the Internet

Organizations in the private and public sectors continue to turn to digital-age solutions including e-commerce, the Internet, networked storage and wireless applications to increase productivity, build competitive advantage and satisfy regulatory requirements. With increased reliance comes increased risk, and many of the resulting cyber exposures are not covered by standard insurance instruments.

So begins our Cyber Risk article (page 38), which addresses specific exposures and risks associated with the world of “e”, including first-party losses and third-party liability for misappropriation or unauthorized use of a computer network, and cyber extortion. Although cyber risk is a real and present danger, we recognize that its wellspring is the pursuit of cyber reward — through a medium that has been transformational. We offer the following as a satellite-level view of the global phenomenon of our times, the Internet, and how it affects our lives, our world and the realm of risk.

In the age of electronic media, the digital age, the wireless age, we are connected in ways only imagined a generation ago. The Internet, reigning icon of the age, has become a kind of global common — ethereal, landless, borderless, universally accessible, oblivious to time zones, boiling with information, data, news, opinion, chat, solicitations to buy, exhortations to act, and any and all other matters that anyone anywhere can stir into the mix.

With such accessibility and connectivity to the people of the world, we have come to expect the instantaneous, to expect that we can read about, see and hear events transpiring literally a moment before in a capital city or a rural hamlet, whether standing in the midst of battle or nestled in the snuggery of one’s own den. We have learned that we can fast forward from fresh history to shared experience to active participation and influence — from the “now” into the unfurling future — and all with the click of a mouse.

The Internet, the I-net, the I. It’s easy to grow effusive in praise of the multiplicity of its applications, to feel dissociated when not online, to speak anthropomorphically of it as an organic entity, an avatar of humankind cyber-pooled. Neither he nor she, the I is We.

We can leave it to the pundits of the next generation to determine whether the e-glomeration of the World Wide Web fosters unifying order or unbridled anarchy. Amazingly, it seems to have given us many opposing extremes simultaneously. A fount of burgeoning knowledge with synergistic values streaming from it, and a Pandora’s Box. The apogee of proximity — one Google degree of separation — and a heavy blow to the art of analog intimacy. A grand palette for harmoniously blending the colors of thought and feeling, and a cacophonous babel of voices vying stridently for hearts and minds.

We know already that both great good and preying evil are borne by the Internet. The technology that enables a heart surgeon in Dallas to guide the hands of a colleague practicing medicine in a remote and otherwise unreachable village in time to save a life — that same medium is also home to identity theft, pornography, fraud, malice, criminal seduction, corruption, conspiracy and hate.

We are cognizant in all of this of the paradoxical affinity of risk and reward, and of the overarching element of individual choice. Regardless of how dependent one small planet becomes on the medium of the Internet for communication and commerce, it is a beauty and a beast of our own making, subject to the essence of risk management: the power of one to say yes or no.

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Willis Marketplace Realities and Risk Management Solutions 2005 19
The 2004 year has been anything but dull from a reinsurance market perspective. In this year’s review, we begin with a survey of market conditions for Property and Casualty reinsurance, followed by an examination of two overarching issues – terrorism risk management and reinsurer security. Finally, we describe specific enhancements in reinsurance industry tools, models and practices that have enabled us to deliver greater value to our clients.

Market Intelligence

Property Reinsurance Outlook
Despite the Property/Casualty industry’s worst third quarter on record — with $21.3 billion of insured Property losses — the Property reinsurance market is expected to be level for January 1, 2005 renewals. Although the reinsurance market’s share of these losses will not have a significant impact on full year results, there are several major catastrophe reinsurers who have sustained quite substantial losses. Their willingness to follow the softening market trend will be tested. Florida-domiciled insurers are expected to bear the brunt of price increases, while some small to medium-size regional carriers may experience slight premium decreases. Loss-free national insurers should renew at close to expiring rates.

Capacity for both Catastrophe and Per-Risk programs remains abundant, as many reinsurers look to maximize their capacity from a smaller group of clients. Other than special termination and funding requirements, there are no significant issues anticipated with respect to reinsurance placements for January 1, 2005 and beyond.

Casualty Reinsurance Outlook
Pricing in the general Casualty insurance market (Primary GL and Umbrella) has started to soften. Calendar year 2004 began with carriers continuing to obtain rate increases, but the momentum faded over the course of the year. Depending upon the class of business and size of account, rate levels at January 1, 2005 will probably be flat or down as much as 15 percent – and potentially more for larger accounts.

With competition focusing mostly on price, other terms and conditions have generally remained tight. However, this may change in 2005 as brokers seek to broaden coverage (e.g., professional within the umbrella, multiyear policy terms, punitive damages, etc.). Reinsurers will most likely continue to maintain exclusions such as sexual abuse, nursing homes, professional liability and silica. They may also continue to focus on adequate auto attachments for excess business, especially for trucking risks.

Capacity, while still readily available, is unlikely to be increased across the board. The standard excess capacity should remain $25 million for larger excess carriers. Many reinsurers, however, remain skeptical about the ultimate profitability of the last three years in the general Casualty market. While significant rate increases during this period have strengthened overall rate adequacy, reinsurers question whether these gains were enough to offset a decade of rate erosion, as well as to keep pace with loss trends. Given the limited universe of first-tier Casualty reinsurers, retrenchment on their part would reduce the availability of high-quality reinsurance security.
Emerging Issues

Terrorism Risk Management

The threat of terrorism is a pervasive reality in today’s world. Willis Re has studied various aspects of the peril for over two years, monitoring the development of TRIA, scrutinizing the development of sophisticated analytical tools, reviewing risk management concerns and options with client executives, building tools to assist in quantifying the risk, and working with reinsurers to develop risk transfer approaches.

In analyzing the risk that terrorism poses to a client balance sheet, we begin with our proprietary accumulation management tool, Willis CTRL (described below). We scan the client’s portfolio of locations to determine the largest zones of concentration and then perform an analysis of terrorism attack models against highly concentrated areas to determine the estimated loss potential. Next, we assess the proximity of our client’s locations to landmark properties using our proprietary terrorism landmark database Willis High Interest Properties. We augment the deterministic “attack mode” analysis by simulating attacks at landmark properties in the vicinity of our client’s locations, and we conclude the analysis by assessing the frequency of large losses through a probabilistic portfolio analysis.

The analysis provides useful information regarding exposure accumulations, loss potential from attacks on insured properties, loss potential from attacks on US landmark sites, and other key metrics. We then perform “as-if” analyses, imposing terrorism insurance sublimits on those commercial accounts subject to the greatest risk of loss, in order to estimate the potential quantum of uninsured losses.

Reinsurer Security – Managing Counterparty Credit Risk

Willis Re has developed a series of reinsurance security analysis tools designed to help insurance company clients examine reinsurance security trends in a different light. Looking beyond some of the traditional measures, these models provide an array of output metrics that focus on the retrocessional markets standing behind the ceding insurer. This analysis provides insurers with a sense of the complete exposure their policyholders’ surplus base might sustain through the failure or impairment of a single reinsurer.

Our database modeling capabilities have allowed us to put together some interesting user-friendly financial analysis packages that compare, amongst other metrics, loss development trends within a chosen group of reinsurers, historical loss trends by line(s) of business, and by type of premium cessions over a ten-year period.

Additionally, our reinsurance analysis tools look at issues such as reinsurer payment practices, not only from our client’s perspective, but also from the perspective of other carriers’ experience with reinsurer payments. The model’s output, combined with our internal client reporting practices and other analyses, can be a leading indicator of a reinsurer’s future instability.

Reinsurance Industry Practices

We are dedicated to bringing continuous improvement and innovation in client service standards, systems, tools and practices. In this article we describe three such areas:

– Contract certainty
– eCommerce initiatives
– Proprietary tools and models

Contract Certainty

Beginning with contracts effective on or after January 1, 2005, Willis Re will employ a process called Contract Certainty in the negotiation and execution of reinsurance contracts. The process contemplates using full contract wording as the basis of negotiations from beginning to end, with the goal being signed documentation by the effective date of the contract. A summary of selected terms will provide reinsurers with a concise overview of the coverage and pricing terms for purposes of
answering their initial underwriting questions. A redline version of the contract will show any proposed changes. Once negotiations are completed, reinsurers will authorize the draft and execute it promptly.

The Contract Certainty process will require cooperation and effort from the cedent, reinsurer and Willis Re. The cedent must review and agree on terms early in the process. Willis Re must deliver the product to the parties in a form that is simple to review and with sufficient lead time. The reinsurers must review the more detailed contract wording earlier in the process than they have in the past.

The process promises to be much more efficient, while also diminishing the potential for misunderstandings and disputes.

**eCommerce Initiatives – ePartner and eClient Service**
With the adoption of our secure ePartner platform in 2001, Willis Re was the first intermediary to shift to a completely electronic basis of transmitting underwriting data to reinsurers. Designed to improve the service that Willis Re provides to our clients, ePartner adds value in several ways:
- Reaching the market instantly
- Providing reinsurers with key data elements in a user-friendly format that facilitates rapid internal information sharing (e.g., between underwriting and actuarial departments)
- Tracking reinsurer activity on all program submissions

These features serve to accelerate the underwriting process and differentiate client offerings to the marketplace.

Willis Re has also leveraged the internet to afford its clients a more convenient means of administering their reinsurance programs. For each client, Willis Re creates a customized eClient web site. These protected sites serve as central repositories for all information pertinent to the reinsurance purchasing and administration processes, including contract documentation, market submissions and claims / accounting details.

**Proprietary Tools and Models**
A primary focus of our product development group is to create tools and models to assist clients in evaluating risk exposures, setting program goals and optimizing reinsurance programs. We cite two examples.

*Willis CTRL* was originally designed as a tool for determining whether insured properties were geographically clustered or dispersed. The goal was to assist underwriters in avoiding taking on additional risks in close proximity to other insured properties facing potential losses due to earthquakes, windstorms, fire, etc. Since developing the model we have found numerous additional uses for it. In one case we helped a health insurer determine the extent of its potential exposure to terrorist activities by modeling nearly 15 million residential locations.

*Willis iPMT* uses catastrophe modeling results to assist underwriters by identifying locations that have particularly high or low risk relative to premiums. Insurance company clients have found that a typical book of Property business can be significantly improved by using the tool to identify profitable changes in the type or locations of properties being sought.
### Headlines and Highlights

- Despite 2004’s remarkable hurricane season, the Property marketplace is financially robust – in substantially better condition than in 1992 after Hurricane Andrew.
- We foresee a continuing reduction in average rate levels for 2005.
- Terms and conditions require ongoing scrutiny. Examples include percentage deductibles, ingress/egress, service interruption, civil authority, demolition and increased cost of construction.
- In its post-election session last year, the US Congress did not vote to extend TRIA past December 31, 2005. The ISO has submitted a Conditional Exclusion of Terrorism endorsement that excludes or amends coverage for terrorism upon TRIA’s expiration or amendment.

### Lead Story: Storms Whip the Atlantic and Pacific
Following several quiescent years, 2004 may best be remembered in Property circles as the year of the storms. Four hurricanes tore through the Atlantic, generating an unprecedented 2+ million claims in Florida alone. Other areas significantly affected by one or more of these storms were the Bahamas, the Cayman Islands, Grenada and Haiti, where the accompanying loss of life was catastrophic. Last year was the first time in more than a century that a single state, Florida, felt the brunt of four hurricane-force storms in one season.

On the other side of the world, typhoons, the Pacific equivalent of hurricanes, took their toll. Japan was battered by a record-breaking 11 tropical storms. And hard on the heels of Nock-Ten, the last typhoon, an earthquake of magnitude 6.8 shook the northwest coast of the country, causing mudslides that brought considerable death and destruction.

In all, these natural catastrophes are thought to have caused upward of $30 billion in insured property and time element losses, a number that excludes flooding in the US. An estimated 30 to 40 percent of these losses will be borne by commercial insurers – and their reinsurers.

### The Ongoing Hurricane Impact
Through the first half of 2004, rates on Property lines showed an average decrease of 15 percent, and despite the ravages of an intense hurricane season, rates continued to decrease through the balance of the year. Why? Because the Property marketplace is financially robust – in substantially better condition than in 1992 after Hurricane Andrew. In fact, only one US carrier, a personal lines company in Florida, has been placed in rehabilitation, and there have been no rating downgrades for the remainder as a result of this year’s hurricane losses.

That being said, we believe these losses will act on the market in several ways in the months ahead. Rate reductions will slow or stop for those policyholders with substantial storm exposures, including non-coastal properties in Florida. The prevailing wisdom had been that interior areas of the state were not wind-exposed. After tracing the paths of Charley, Frances and Jeanne, carriers know better. Many have had to reinstate their reinsurance treaties at substantial cost, and they will certainly look to pass these costs back to their exposed policyholders.

Primary carriers will revisit the protection afforded to them by percentage deductibles, particularly those whose reinsurers insist on high levels of ceding insurer retentions in upcoming treaty renewals. We expect central Florida and other inland areas to be subjected to percentage deductibles, if they were not before, given the fact that Hurricane Frances alone spawned more than 100 tornadoes, many well north of Florida and inland. To the extent they are available at all, aggregate occurrence caps on percentage deductibles will be vetted to ensure they are closely aligned to a dollar value that application of the percentage itself would develop.

As occurs after every natural catastrophe, the various modeling providers (e.g., AIR, EQEcat, RMS) will make amendments to correct any previous inaccuracies. It is too early to tell how these might affect findings relevant to insurers’ portfolio.

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aggregations to loss. If they go up, insurers have two obvious alternatives: buy more reinsurance and pass on the costs, or reduce their liabilities, meaning their commitments of capacity.

The Art and Science of Risk Modeling
Sophisticated models for estimating catastrophic losses were unlikely available before or immediately after Hurricane Andrew. This capability was developed in response to that event and others in the late 1990s. Today the modeling of an insurer’s portfolio of risks, whether from earthquake, windstorm or flood, is an essential part of its treaty renewal process. It is the basis upon which reinsurers accept or decline participation and decide at what level and price to participate.

The difficulty with cat modeling is that it is still partly art and not all science. Here, for example, are the original estimates for Hurricane Frances losses (as reported by Fitch Ratings in September):

<table>
<thead>
<tr>
<th>Source</th>
<th>Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIR</td>
<td>$5 to 10 billion</td>
</tr>
<tr>
<td>EQE CAT</td>
<td>$2 to 5 billion</td>
</tr>
<tr>
<td>RMS</td>
<td>$3 to 6 billion</td>
</tr>
</tbody>
</table>

As claims became clearer, later estimates released by Property Catastrophe Services amounted to $4.4 billion. Our goal is not to compare these modeling firms. All of them strive to render as accurate a picture of damage probabilities as can be drawn. For all, we see ample motivation to undergo refinement in the wake of 2004.

Rates and Capacity in 2005
What if your portfolio of risks is not windstorm-heavy? We foresee a continuing reduction in rates for 2005, although we believe the typical decrease will be 10 percent, with fewer radical swings above and below this average. Again we might ask, how is this possible? How can there be further rate reductions when insurance company managers are espousing, in fact demanding, rate stability?

First of all, rates are still substantially above their all-time lows of the late 1990s. Even at lower rates, insurers can look to make money at current deductible levels and with continued conservatism in terms and conditions. Deductibles, terms and conditions, then, may be the wild cards for 2005.

Could we see a classic meltdown in underwriting standards in a race for market share? It’s certainly possible, but we think unlikely. Interest rates are still too low to offset underwriting losses and insurers must strive to turn a pure underwriting profit. To some extent they can explain away their storm losses, because they are after all in the business of providing catastrophic protection to their policyholders. But a sudden erosion of profits through a pattern of assuming attritional (expected) losses will be unexplainable — and unacceptable — to shareholders. In explaining rate movement, one must always return to supply and demand. Capacity breeds price competition. Here is a look at estimates of changes in capacity for some key insurers.

<table>
<thead>
<tr>
<th>Insurer</th>
<th>Status</th>
<th>Capacity (new/increase)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arch</td>
<td>Established</td>
<td>+50M</td>
</tr>
<tr>
<td>GE Insurance Solutions</td>
<td>Established</td>
<td>+75M</td>
</tr>
<tr>
<td>Max Re</td>
<td>New (to Property)</td>
<td>+10M</td>
</tr>
<tr>
<td>Quanta</td>
<td>New</td>
<td>+50M</td>
</tr>
<tr>
<td>St Paul Travelers</td>
<td>Merger</td>
<td>-125M</td>
</tr>
<tr>
<td>XL Risk Solutions</td>
<td>Established</td>
<td>+250M</td>
</tr>
</tbody>
</table>

Must Experience Be the Best Teacher?
Insurers and reinsurers aren’t the only parties with lessons to learn following the recent spate of natural catastrophe losses. Some insureds have learned the answers to the following questions the hard way:

– How are policy deductibles applied?
– What do location limits of liability really mean to our recovery?
– How can “increased cost of construction” or similar policy limitations affect our recovery, depending on market conditions for building materials?
– What happens when ordinances are tightened after a loss?
– How do Civil Authority clauses apply?
– How much Claims Preparation Expenses cover do we really need in the event of catastrophic loss?
– How do mold exclusions really operate?
– What assets do we have in a sub-limited or excluded flood zone?
  And most importantly . . .
– Do we have a vibrant business continuity plan?

As it is unlikely that the terms and limitations referenced above will be substantially improved for policyholders in 2005, the operative question becomes: what can a risk manager do?

Know your vulnerabilities to loss. Identify and quantify your risks. If you are unsure of the true quanta of your exposures, obtain an appraisal of your property values (based on the recovery you would expect and require in the event of loss), and make sure these details are written into your policy. Vet your time element values by use of an outside resource, if necessary. Consider using someone you might turn to after a loss, since this resource would then already be familiar with your operations and your books. Have your own natural catastrophe modeling done (or other loss scenarios if you are not subject to natural catastrophes). Determine your worst case scenario — and plan for it.

These comments are all made in the context of the 2004 storms. The questions and recommendations still apply to companies nowhere near a hurricane zone. Percentage deductibles and their application are important to wind, earthquake and even flood exposures. The effects of the other policy terms and conditions noted above are almost universal.

**Lead Non-Story: No Action (Yet) on TRIA**

Legislation to extend TRIA did not come to a vote in the post-election session of the US Congress. We therefore go into 2005 with no government backstop guaranteed to insurers after December 31, 2005.

The Insurance Services Office (ISO), a group representing many insurers, has submitted a Conditional Exclusion of Terrorism endorsement that has been accepted by a number of states, with Florida, Georgia and New York being the notable exceptions to date. The endorsement stipulates that upon expiration of TRIA, all previous endorsements providing terrorism coverage are replaced by an absolute terrorism exclusion. Further, if TRIA is extended with amendment(s), the exclusion would apply if the “make available” requirement is rescinded and any of the following also occurs:

– The percentage retention of the carriers is changed (from 15 percent in 2005)
– The percentage of government backstop is reduced (from 90 percent excess of the retention)
– Coverage under TRIA is expanded (e.g., to include nuclear, biological and/or chemical contamination)

At the same time, our discussions with insurers of large accounts have given us some cause for optimism. Many carriers have indicated that they will not subscribe to the ISO endorsement. Rather, they will quote risks with inceptions after January 1, 2005, with terrorism included without exception for the one-year duration of the policy term, although they may have to include an endorsement replacing TRIA (certified terrorism) coverage with something else.

In looking at the prominence of terrorism as a topic of concern, we find it hard to understand why certain policyholders would choose not to purchase terrorism coverage, either through a Property policy or on a stand-alone basis. The more thoroughly so-called trophy risks are protected, the more other locations emerge as potential soft targets. Furthermore, coverage has become relatively affordable. Weighing relatively modest premium outlays against retained material risks seems to argue for purchasing coverage in the marketplace.
Property insurance may have led the way into the soft market, but Casualty has joined in. New and existing insurers are in the market promoting competition in the primary Casualty layers. For insureds that can demonstrate solid financials and superior loss control, decreases of 10 to 15 percent are the order of the day. For those with less appealing loss records, rates are increasing more slowly or remaining flat.

In the umbrella layers, premium decreases for most insureds are larger and more common, frequently reaching 15 to 20 percent. However, for classes of business such as healthcare, pharmaceuticals and chemicals, a flat renewal may be the best that can be expected.

In Workers’ Compensation, new entrants and a renewed new business effort from existing carriers have eased what is still an unstable market in many areas. One of the most difficult exposures had been clerical concentrations in urban areas. Since 9/11, many carriers have refused to offer Workers’ Compensation to companies with hundreds of employees in a single building. Those carriers that did provide coverage collected hefty “catastrophic” surcharges, building special reserves for over three years. Coverage is more available and carriers are more willing to underwrite urban concentrations — although the charges mostly remain in place.

In excess Workers’ Compensation, there has been a resurgence of capacity to cover qualified, self-insured programs. Two new entrants, XL and Berkshire Hathaway, have added substantial capacity and ACE has recently expanded its commitment in this area. Broad terms and conditions and the ability to write statutory limits have also transformed the excess Workers’ Compensation marketplace.

Other Signs of Market Softening
Rate reductions are not the only sign of improving market conditions for insurance buyers.

Many more clients are unbundling their claims management from coverage and using third-party administrators for claims handling. This can often yield more cost-effective and focused attention on claims control.

Creative rating structures are becoming more common, particularly in excess markets and with Bermuda carriers. Multiyear single aggregate excess programs are being used to further provide insureds with previously unavailable options to manage their risks.

For those who own or utilize a captive, a positive development is more direct access to reinsurance. Major carriers have cut back on the array of reinsurers they use, leaving several reinsurance providers looking for business. The reinsurers are turning to captives, and this has presented captive managers with more capacity and more options. Another result of this is an increase in quota share arrangements, changing the way insureds retain risk.

Driving the improvement in carrier results and in market conditions for buyers is of course positive loss experience. The number of Casualty-related catastrophes in the past couple of years has been lower than expected. However, it may also be the case that actuarial estimates underlying insurer strategy have been overdeveloped. Rather than unusually low losses, perhaps the industry has been responding to somewhat exaggerated loss expectations.

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It’s Not All Soft, However
The soft market has brought rate reductions and some increased options, but the market has not changed in several key areas. The inclusion of additional coverages in policy terms is one such area. In the past, coverage for several specialty lines could frequently be attached to umbrella coverages. This was often true for Professional Liability, Errors & Omissions, Pollution, Product Recall and Aviation exposures. Now separate products are needed to address these exposures.

Another area in which conditions have not eased is in policy forms. Many forms are becoming more restrictive, particularly in the lead umbrella area.

Auto Liability
This has been the most unpredictable line over the past year. Significant umbrella losses have turned this into the least relaxed Casualty market segment. Even so, rates are mostly flat.

Industry by Industry
Each industry group has its own set of risks and its own risk profile. A well-run company with few losses in an industry with an undesirable risk profile may suffer, just as a company with high losses in an industry with a good history may benefit. Fair or not, insurers still use industry class as one criterion in judging a given company’s loss potential. Today, light manufacturing, distribution and retail, particularly food-related businesses, are being targeted as desirable classes of business by insurers. Long-haul trucking, healthcare and pharmaceutical companies are, as before, having the hardest time with carriers. The best recourse for an insured in one of these industries is to build the case that it is best in class for its industry.

Markets
In addition to XL and Berkshire Hathaway, Bermuda has contributed new capacity. Arch, Max Re, Endurance and AWAC are eager competitors, dropping down to attachment points previously dominated by US markets. US markets are competitive, though often strict on terms and conditions. They tend to use policy forms preferred by many buyers, using a traditional occurrence basis as opposed to claims-made or occurrence-reported forms preferred by Bermuda carriers. US carriers seek a competitive advantage in that regard.

The loss portfolio transfer market has seen renewed activity, although we suspect that this market segment will become much more competitive if and when long-term interest rates rise.

Looking Ahead
We expect the market to continue softening in 2005, offering decreases of five percent and perhaps into double digits. Excess Liability, above the umbrella layer, will be even softer, though perhaps no softer than it is today, offering decreases up to 20 percent.

Multiyear single aggregate excess programs are being used to further provide insureds with previously unavailable options to manage their risks.
For several years the Workers’ Compensation story has been steep price increases, as insurers struggled toward and finally achieved a return to profitability. Now, some good news has come to buyers. Most are experiencing modest increases or no increases at all, and many are seeing rates drop. Both insurer and insured are enjoying the continuing decline in frequency and decreases in severity in states where regulatory efforts have come to fruition.

A continuing burden for carriers, however, is underestimated reserves concentrated in accident years 1997 through 2001, when competition was heavy.

Florida, California, Tennessee and Vermont have recently passed major legislation revising key aspects of their Workers’ Compensation benefits provisions, and legislation is pending or being formulated in Alaska, Texas and Oklahoma.

Five issues have emerged as factors pushing up costs: new medical products, painkiller addiction, obesity, overtime and workplace violence.

The Road to Fiscal Balance
Three years of double-digit Workers’ Compensation price increases resulted in a 2002 calendar year combined ratio after dividends of 112.2. This improved to 107.8 in 2003. After investment income in excess of $4 billion, or 10.1 percent of earned premium, the Workers’ Compensation line produced a profit for the industry in 2003. Workers’ Compensation prices peaked during the first half of 2004 and began to decline thereafter. Part of the reason for the reduction was strong regulatory action to cap and reduce benefit costs in states with large volumes, most notably California and Florida, and also in Tennessee. Another reason was increased competition, with the line producing underwriting profits in accident years 2002 and 2003 and promising to do so again in 2004.

The Latest on Frequency and Severity
Further good news for the Workers’ Compensation sector is a steady and substantial decline in the frequency of lost-time claims since 1995. Most of the credit goes to company efforts to improve safety and implement modified duty programs. Credit is also due to insurance carriers working with insured clients to reduce fraud. Another possible source is an economic climate in which employees avoid being absent from work because of concern their positions may be filled or disappear in their absence. It has also been suggested that with a more mature and experienced workforce, there are fewer serious accidents.

Worker’s Compensation Loss-Time Claim Frequency Continues to Fall

<table>
<thead>
<tr>
<th>Year</th>
<th>Percent Change</th>
</tr>
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<tbody>
<tr>
<td>1993</td>
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</tr>
<tr>
<td>1994</td>
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<tr>
<td>2002</td>
<td>8.00</td>
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<tr>
<td>2003</td>
<td>10.00</td>
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</tbody>
</table>

Source: NCCI Advisory Forum
2003p: Preliminary based on data valued as of 12/31/03.
1993-2002: Based on data through 12/31/02 developed to ultimate.
Based on the states where NCCI provides ratemaking services.
Excludes the effects of deductible policies.
Not all the news is good, however. Overall severity increases continue. The increase in indemnity severity has exceeded the increase in wages by an average of 3.4 percent each year since 1995. A major portion of this increase is likely due to a decline in the proportion of small claims as frequency declines. It may also be due to the older average age of workers and the growing prevalence of obesity in the workforce, resulting in slower recoveries.

The largest cost driver for Workers’ Compensation has been increases in medical severity. In 2003, medical costs were approximately 55 percent of all Workers’ Compensation loss costs. Medical severity for Workers’ Compensation has been growing much faster than the medical Consumer Price Index (CPI) – at more than double the rate for the past eight years. The gap is due in part to the increasing costs of medications (discussed below), but the main reason is increased utilization: the number of trips to healthcare providers, the number and expense of tests employed, and the length of time on medication or in rehabilitation. Again, there may be a strong correlation between increased cost and the rising average age and weight of the injured workers.

**States Cap Benefits and Control Costs**

Four states have recently passed major legislation revising key aspects of their Workers’ Compensation benefits provisions. In 2003, Florida changed benefits for permanent total and permanent partial injuries. These and other changes are expected to reduce total Workers’ Compensation costs in Florida by 14 percent.

In California, legislation changed the way medical care for injured workers is controlled, tying the use of medical services to utilization standards, and setting up the potential for employers and insurers to better control usage. Along with caps on temporary disability duration and changes to permanent partial disability benefits, these changes are expected to decrease costs by 15 to 21 percent.

Recent caps on permanent partial benefits in Tennessee resulted in a loss-cost filing of a 6.3 percent decrease. Implementation of a medical fee schedule in the state is expected to result in further decreases. Changes are being implemented in Vermont, and legislation is pending or being formulated in Alaska, Texas and Oklahoma. These changes may result in premium reductions in these states.

**New Concerns**

Along with the effects of an aging workforce, five issues have emerged as factors pushing up costs: new medications, painkiller addiction, obesity, overtime and workplace violence.

Medications are not a new cost for Workers’ Compensation, but new products with powerful medicinal effects come at a high cost. A recent NCCI prescription drug study indicates that the prescription drug share of total Workers’ Compensation medical costs grew from seven percent in 1997 to nearly 10 percent in 2001 and 12 percent in 2002. OxyContin is the most prescribed painkiller in Workers’ Compensation serious injury cases according to a recent NCCI study. OxyContin has caused addictions in significant numbers of Workers’ Compensation cases, resulting in long withdrawal periods and prolonged recoveries, increasing medical costs and time away from work. Another potential issue surrounds Vioxx. This anti-inflammatory was the third most prescribed drug for Workers’ Compensation cases before it was pulled off the market in 2004 because of serious side effects.

There is increasing concern regarding obesity, with some reports indicating 30 percent of Americans are obese. Obesity is causing higher Workers’ Compensation losses from increased severity of injuries, medical complications, slower healing and longer time off work. Another effect of obesity is the increasing number of back injuries to hospital and long-term care workers caused by working with obese patients.

Pressure on workers to put in overtime hours to achieve increased productivity may be increasing the frequency and severity of injuries and medical problems. It is certainly increasing stress in the workplace, which is considered a main cause of workplace violence. Violence is a particularly troubling source of injury and death in the workplace. According to one recent report, in an average work week, one employee is killed in the US and at least 25 are seriously injured in attacks by current or former coworkers.
Under-Funded Reserves
A continuing problem for insurance carriers is underestimated reserves concentrated in accident years 1997 through 2001, when competition was heavy. As mentioned above, the industry added $3 billion in 2002 and $2.3 billion in 2003 to prior-year loss reserves; however, the NCCI estimates a $15 billion reserve deficiency remains for accident years 2001 and prior. This reserve deficiency will require funding during the next five years at a rate of approximately $2 billion per year. This will keep upward pressure on Workers’ Compensation prices charged by insurance carriers who have been writing the business over the last eight years.

New Capital Enters a Concentrated Market
The largest seven carriers in 2003 wrote more than half of all Workers’ Compensation premiums countrywide: the California State Fund, AIG, Liberty Mutual, St. Paul Travelers, Zurich/Farmers, The Hartford and CNA. While such concentration may bring short-term pricing stability to the Workers’ Compensation market, these same carriers shoulder the burden of the industry’s reserve deficiencies, whether those deficiencies reside on their own books or in the form of assessments from state guarantee funds.

The profitable results for accident years 2002 and 2003 have attracted new capital even in California, where Berkshire Hathaway recently announced plans to write $1 billion in annual premium, making it the largest entrant in Workers’ Compensation in years. In addition, new carriers such as Employers Direct, with $50 million of surplus, began niche marketing to better risks. CompWest Insurance Company recently began utilizing a few selected independent agents to underwrite select California business. In the heartland, Indiana Insurance, now part of Liberty Insurance Group, is growing its Workers’ Compensation book. Other regional carriers have similar goals.

Long-time observers and customers of the Workers’ Compensation marketplace may, however, view the new entrants with caution. While they do not carry the burden of historical reserve deficiencies, they may also be less experienced. History has also shown that new entrants in this potentially volatile insurance industry segment may withdraw within a few years if losses begin to mount, as happened in the 1990s in California.
A Rare State of Balance
In the swinging pendulum of the insurance cycle, the Directors & Officers (D&O) market may be entering one its rarest states – balance. Post-Enron, post-9/11, the market swung toward higher rates and cautious underwriting; last year, new carriers, free of claims legacy, brought softer conditions. Litigation and regulatory scrutiny may still be on the rise, but even with these added pressures, both buyers and sellers may, within reason, get what they want: for buyers, predictability and stability; for sellers, profitability. We believe that insureds seeking D&O coverage in 2005 will find markets responding more prudently, offering programs that reflect stable rates, sufficient capacity and enhanced program terms. Risk differentiation, a key catalyst in the underwriting process last year, will continue to play a strong role in 2005’s more conservative marketplace.

Premiums – Stability on the Horizon
On the pricing front, we expect rates for primary layers to level off as carriers may be reaching a walk-away point after the premium adjustments in 2004. Our expectation is for flat premium levels for large market cap companies with modest premium decreases possible (in the 10 to 15 percent range) for small to medium-sized companies as well as nonprofit and privately held companies.

In excess layers, we again see stability and continuity. Clients experienced the benefits of reduced excess rating factors in 2004 as levels of 85 to 100 percent eased into the 75 to 80 percent range. These more moderate rates should continue to hold throughout 2005.

Capacity – Plenty for All
We do not anticipate any dramatic change to current capacity levels, which currently exceed $1.5 billion globally. It is possible that a few of the newer insurers may find that premium levels in this more conservative environment will not keep pace with their reinsurance costs. These carriers may ultimately drop out of the marketplace, but we do not foresee such developments reaching the point of significantly impacting capacity, pricing or terms.

We also expect a continuation of recent limits management strategies in which carriers consider carefully whether to offer their full stated capacity on any given risk. Risk differentiation will be the determining factor. Ventilation of layers, as opposed to bulk participation by a carrier on one given stratum of coverage, may be reintroduced in 2005 on a select account basis, depending upon the risk profile of the buyer’s industry and the buyer’s market capitalization, financial performance and claims history.

A Reinsurance Perspective
Unfortunately, many of the significant long-term carriers providing reinsurance for D&O are now experiencing negative cash flows on their D&O accounts. This is a fairly recent phenomenon in the history of D&O results, and will continue to influence the willingness of the reinsurance community to support D&O products. Perhaps more of a concern than current capacity is whether the reinsurance market as a whole is adequately reserved for the current inventory of D&O claims. Results in 2005 should go a long way toward answering this
critical question. And that answer may be a driving force in influencing the D&O marketplace in 2005 and beyond.

**Net Price vs Incurred Loss per $1,000 of Market Cap**

![Graph showing Net Price vs Incurred Loss over years](image)

The momentum toward broadening policies should continue well into 2005, although we do expect the pollution exclusion in the D&O policy to be tightened to address mold (reflecting the newer wording often found in today’s Property policies).

**A-Side Coverage – A Multiple Choice Question**

Increased concerns about the potential for board members’ personal liability in increasingly severe D&O claims have heightened interest in A-Side D&O policies, which protect the personal assets of directors and officers. We believe that in 2005, clients will continue to use these policies as complements to their traditional programs or convert to stand-alone A-Side programs.

While policy features vary, there are now abundant options available as new carriers introduced their own A-Side policies in 2004. Selecting the best options will still be governed by policy nuances, pricing and, most importantly, the insureds’ corporate philosophies and appetites for risk.

**2005: the Big Year for Section 404**

Much sleep has been lost and much money expended by public companies seeking to comply with the new reporting requirements under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). Under 404, public companies must include in their annual reports a section on the company’s internal control over financial reporting. This must include statements on several topics:

- Management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the company
- Management’s assessment of the effectiveness of the company’s internal control over financial reporting as of the end of the company’s most recent fiscal year
- The framework used by management to evaluate the effectiveness of the company’s internal control over financial reporting
- The requirement that the registered public accounting firm that audited the financial statements included in the company’s annual report issues an attestation report on management’s assessment of the company’s internal control over financial reporting. (Companies are required to file their accounting firm’s attestation report as part of their annual report.)
It is crucial for companies to get this right, but some, perhaps many, are struggling. We understand that each of the Big Four accounting firms is in the process of notifying a significant number of their clients that they are significantly behind schedule on their 404 work, and that unless appropriate action is taken promptly, the auditor believes management will not be able to complete its assessment before the reporting deadline, or if completed, management’s assessment will likely not be completed in sufficient time for the auditor to complete its assessment. Should companies have to delay filing their annual reports due to their inability to comply with 404, the investment marketplace and the D&O underwriting community are unlikely to respond favorably.

Events likely to complicate 404 compliance include recent mergers or acquisitions (especially if the acquired company was previously privately held and therefore not subject to SOX requirements), and the significant use of leased employees.

Say it Again Sam – More Financial Restatements?
Another cause for concern is the possibility that financial restatements may be on the rise. In August 2004, the Public Company Accounting Oversight Board (PCAOB) issued a report on the Board’s first-ever annual inspection of the four largest public accounting firms. This limited review conducted on 2003 filings satisfied SOX’s new requirement that the PCAOB conduct annual inspections of registered accounting firms that audit more than 100 public companies. Unfortunately, after its limited review, the Board identified significant audit and accounting requirements that were missed by the firms. The Board identified concerns about significant aspects of each firm’s quality control systems in performing their reviews and audits.

"As our reports state, their emphasis on criticisms does not reflect any broad negative assessment of the firms’ audit practices," said PCAOB Chairman William J. McDonough. “The Board’s inspections are unprecedented, and in this first year, our findings say more about the benefits of the robust, independent inspection process envisioned in the Sarbanes-Oxley Act of 2002 than they do about any infirmities in these firms’ audit practices."

With the broader accounting review for 2004 nearing completion, the chairman of the PCAOB warned in the fourth quarter of 2004 that more financial restatements may be coming as result of this review.

Transparency and Disclosure: Behind the 8 Ball
The goal of the new rules is not to punish; the goal is transparency and, ultimately, better communication and fewer lawsuits. The accelerated reporting of certain events required under Form 8-K may prove especially effective in deterring stakeholder actions against companies and their executives. Taking effect in late August 2004, this rule produced 150 Form 8-K filings with the Securities and Exchange Commission (SEC) during its first 10 weeks. The events that must now be part of the accelerated public notice include:

– Off-balance sheet arrangements
– Financial restatements
– The departure of directors or principal officers
– Changes in CPA
– Material modifications to the rights of security holders

These events are the stuff of D&O litigation, and bringing them to light may well go a long way to seeing that they do not in fact become the subject of legal action. As the SEC itself has said, "A vigorous disclosure review program helps prevent violations by shining a spotlight on an issuer’s business and financial condition."

Do the Numbers Lie?
For the first time in several years, the number of enforcement actions brought by the SEC may have actually declined on a year-over-year basis. For the first nine months of fiscal 2004, the SEC reportedly brought 378 actions against companies and individuals, compared to 443 for the same period in 2003. Will this trend continue through 2005?
We hesitate to conclude that the Commission is likely to be less active in enforcing the federal securities code going forward. The Commission’s Strategic Plan for 2004 to 2009 lays out a plan to maximize the use of SEC assets by, in part, “…leveraging resources with other federal, state and foreign governments, as well as domestic and international organizations, to maximize the effectiveness of regulatory, enforcement, and educational activities.” We also note that the SEC does not measure its effectiveness by the number of enforcement actions it has brought, but rather uses several different measures, including the number of criminal proceedings brought as a result of its investigations and by the extent of the monetary remedies or civil penalties it has ordered and collected.

Divide and Conquer?
Among the departments and agencies with which the SEC is working closely are the Department of Justice and the President’s Corporate Fraud Task Force. These governmental bodies, along with all US attorneys general, have been issued new rules of engagement: the Principles of Federal Prosecution of Business Organizations. Public companies and their D&O carriers should be aware of these rules, which are likely to influence government activity in 2005.

One point of concern in the new principles is the emphasis on the "benefits" of indicting corporations for criminal misconduct. In an effort to avoid being named as a defendant, corporations are likely to cooperate with prosecutors. Chillingly, prosecutors are given a list of points to consider in assessing the degree to which a company is cooperating in the investigation, including, possibly, the waiver of corporate attorney-client and work product protection; and whether the company is advancing defense expenses to its executives and employees who are being investigated (whether it is indemnifying them or not). The principles state that, “A corporation should not be able to escape liability merely by offering up its directors, officers, employees, or agents in lieu of its prosecution.”

Nor has the government lost sight of individual wrongdoers. The prosecution principles offer the direction that, "Only rarely should provable individual culpability not be pursued, even in the face of offers of corporate guilty pleas."

A Word in Closing
The importance of D&O insurance will persist for the foreseeable future, with current high claims inventories, and ongoing civil and regulatory investigations and enforcement coming from a variety of sources. The good news is that the D&O market is stabilizing and terms and conditions can be actively negotiated. The sobering news is that we can never be certain how long such an environment will continue. Stay tuned.
Fiduciary Liability

The Fiduciary Liability market suffered in 2004, and the underlying factors portend continuing difficulty:
– An influx of ERISA employer securities claims
– Continued uncertainty over cash balance plans
– Concerns about investigations into plan assumptions and the selection of mutual fund providers
– Underfunded plans

While privately held companies and small-to-mid-cap firms have a dozen or more carriers to choose from, it is our belief that for larger companies the selection of primary markets will come from a select list of insurers.

Salient features of the 2004 market will persist: firm premium levels, tie-in limit restrictions, tight capacity management and upward retention adjustments. Fiduciary insurers have significant apprehensions regarding companies with large market capitalizations, especially those marked with the scarlet “e” – pension or benefit plans tied in any way to employer securities.

Underwriting Issues and Pricing

For the niche Fiduciary Liability marketplace, the number one risk differentiator is whether a company has employer securities in any part of its employee benefit plan. If the answer to this broad question is yes, then a sizable number of carriers will decline the risk, while others will look to attach at higher levels and/or seek substantially higher premiums. This is true for both large, publicly traded companies and private companies with Employee Stock Ownership Plans (ESOPs).

Whether they include employer securities in their pension plan or not, however, companies are unlikely to see premium reductions for the 2005 underwriting year. We expect renewal rates to be flat or to increase up to 25 percent above last year’s levels. The good news is that self-insured retentions, which have at least doubled for many insureds over the past few years, should level off in 2005. Increased limits factors will continue to show underwriters’ concern over these exposures, with typical excess rates of 80 to 85 percent of primary levels and on some programs, even higher. This will be especially true when insureds hit minimum premium levels before filling out the program. Of course, carriers will be setting these terms on an individual account basis.

While the list of primary markets is a short one, we believe that the excess Fiduciary Liability marketplace will continue to be fairly robust at or above the $50 million attachment point – for a price.

In addition to the issues of employer securities and cash balance plans, Fiduciary risk profiles are largely defined by:
– Whether a company is public or private
– Plan funding levels and assumptions
– Planned reductions in benefits
– Mergers and acquisitions
– Claims history
– Investment choices

Headlines and Highlights

– Salient features of the 2004 market will persist: firm premium levels, tight capacity management and upward retention adjustments.
– The number one risk differentiator is whether a company has employer securities in any part of its employee benefit plan.
– Negotiable coverage issues include severability provisions, priority of payment endorsements, omnibus plan definitions and tailored claims triggers.
– The excess Fiduciary Liability marketplace will continue to be fairly robust at or above the $50 million attachment point – for a price.
– Issues to track include ERISA class action suits, employer securities, litigation, mutual fund investigations, employee classification cases and other high-profile developments.
Terms and Conditions
In spite of loss cost trends, we anticipate some continued flexibility in policy terms. Coverage issues that we deem negotiable include: severability provisions, priority of payment endorsements, common claims tie-ins, omnibus plan definitions and tailored claims triggers.

Terms and conditions will still need to be closely reviewed in light of the conservative underwriting environment. Of particular concern will be the wording suggested on severability provisions and pollution exclusions. At the end of 2004, an A-Side, difference-in-conditions policy was introduced in the commercial Fiduciary Liability marketplace. With many insurance buyers first grappling with the intricacies of A-Side D&O coverage for non-indemnifiable claims, A-Side for Fiduciary Liability exposures brings with it a host of additional issues to consider. We anticipate additional pressure from underwriters seeking to impose limit restrictions for common claim tie-ins, whereby carriers try to preclude a single claim from impacting both the D&O and Fiduciary policies in cases where one carrier writes both.

The Environment for ERISA Fiduciaries
The most recent data from the courts indicates that 183 ERISA class actions were pending during fiscal year 2003, while 119 cases had already commenced, for a total of 302 ERISA class actions. By comparison, in 2000, 126 cases were pending and 62 in progress. The number of individual civil suits filed under ERISA over the past five years can be seen in the graph below. All signs seem to indicate more litigation — and more expensive litigation — in this area.

ERISA Civil Suits Filed in US District Courts

The investigative arm of the Department of Labor (DOL), the Employee Benefit Security Administration (EBSA), reports that it "recovered and protected" $3.1 billion in retirement, health and other benefits in fiscal year 2004, a 121 percent increase over recoveries during the previous fiscal year. Most of that, $2.5 billion, reportedly came from the correction of prohibited transactions and protection of plan assets. (These figures do not include the money paid to participants in the Enron and WorldCom settlements.)

Employer Securities Litigation:
The Giant Has Awakened
In late 2003, the $69 million settlement of the ERISA suit against Lucent arising from the employer securities held in its pension plans served to energize the plaintiff bar. The Lucent case was followed in 2004 by several DOL settlements:
- Global Crossing at approximately $79 million
- WorldCom’s Bernie Ebbers who along with 18 ex-officials agreed to pay about $51 million
- Dynegy at $30.8 million
- Enron’s partial settlement of $85 million

Together, these highly publicized cases exhausted all available Fiduciary Liability insurance as they resulted in payouts by most of the world’s Fiduciary insurers. Ominously, they also involved payments from the individual fiduciaries themselves.

One major market with acknowledged Fiduciary reserves in the nine-figure range ($100 million+) now uses the term “Armageddon” to describe the current claims environment. Courts are refusing to grant motions to dismiss and insureds are often reluctant to forcefully raise possible ERISA defenses. It is not surprising that the number of carriers actively entertaining this market segment is small. Those that do write this coverage within the first $50 to $100 million are likely to be judiciously managing their limits between that which they offer on the Fiduciary and the D&O lines. With D&O pricing still appreciably outstripping that for Fiduciary Liability insurance, most carriers appear to prefer to extend their limits on the pricier D&O coverage.
Possible Claims Migration:
Mutual Fund Investigations
It was a great relief to 401(k) plan fiduciaries and their insurance carriers that the mutual fund investigations and settlements seen in 2003 and 2004 did not, with rare exceptions, translate into ERISA Fiduciary Liability claims. Concern was renewed when the Securities and Exchange Commission (SEC) launched an investigation into the selection and marketing of mutual funds by and to 401(k) pension plans.

Recent developments seem to indicate that charges of wrongdoing may be brought against a number of pension plan consultants who may have received financial incentives from the mutual fund companies as the consultants assisted their 401(k) clients in the mutual fund selection process. While several major pension plans were part of this initial investigation, there is no indication at this time that the plans and/or their fiduciaries will become significant targets of these examinations. But the threat alone is enough to create unease on the part of Fiduciary Liability carriers. Events will be watched closely for continuing developments.

Cash Balance Litigation and Legislation
Last year we spent some time in our Fiduciary market forecast discussing the possible implications of cash balance plan litigation. There has not been any meaningful change since then, and the uncertainty raised by these cases still remains. For instance, the final outcome in a case involving IBM is still not known, but the company recently agreed to pay $320 million to partially settle claims and to cap any additional liability at $1.4 billion should the courts later rule that its cash balance plan is age discriminatory. Fittingly, there has been a moratorium on legislation in this area. New class actions, though, are still occasionally being filed.

While we wait for events to transpire, few new plans are being created through conversion, although some new start-ups are to be seen. Fiduciary Liability underwriters continue to take cash balance plan sponsors over the same well visited ground on each renewal.

SEC Investigations into Pension Plan Assumptions
A large question mark for some of the major Fiduciary Liability underwriters is the potential impact of the recently announced SEC investigation into pension and other benefit assumptions. While the Commission has no authority or responsibility regarding ERISA plans and their fiduciaries, the SEC has expressed concerns about the impact of these assumptions on the balance sheets and income statements of publicly traded companies. In late 2004, the SEC announced it was informally investigating these issues at six major companies. Thus far, investigators have expressly alleged no wrongdoing and have clearly signaled that they are at the early investigative stage.

The possibility remains that these investigations will yield Fiduciary claims before they are through. A key question is whether they would be D&O or Fiduciary Liability claims. The initial answer would likely depend on who brought the claim and just what wrongdoing is alleged.

This SEC investigation is in some ways timely as it follows closely on the heels of the newly expanded financial reporting requirements for pension plans. For a number of years, Fiduciary Liability carriers had been raising the issue of plan assumptions in the area of defined benefit plans during insurance renewal meetings. Recent events are likely to cause them to cast an even sharper eye on these figures.

Employee Classification Cases
Although this class of ERISA claims did not see any major movement in 2004, there were two noteworthy settlements.

– New York Life settled a suit for $16 million.
– GlaxoSmithKline agreed to pay $5.2 million to settle an ERISA class action by workers who said they were improperly labeled “temporary”.

Several large ERISA class actions remain outstanding and if there are significant developments in 2005 it is possible that this may draw some of the carriers’ attention from the issue of employer securities. In employee classification cases, individuals allege that they have been wrongfully categorized (as independent contractors, leased or temporary workers) so as to deny them the benefit of the company’s pension plans. A few years back, one of these suits made the members of the plaintiffs’ class millionaires due to the retroactive effect of their phantom participation in the company’s stock purchase program.
Organizations in the private and public sectors continue to turn to digital-age solutions including e-commerce, the internet, networked storage and wireless applications to increase productivity, build competitive advantage and satisfy regulatory requirements. With increased reliance comes increased risk, and many of the resulting Cyber exposures are not covered by standard insurance instruments.

Cyber Risk policies are specialized forms designed to fill gaps where coverage has been excluded or simply not provided in traditional Property, General Liability, Crime and Errors & Omissions policies. Insuring agreements in competing Cyber Risk forms can vary greatly, but all require a failure of network security as a trigger for coverage.

Where Are the "Cyber Gaps"?

Third-Party Liability for Misappropriation or Unauthorized Use of a Computer Network

Traditional Property and Liability policies will not cover third-party claims for the misappropriation or unauthorized use of a computer system when it is used as a vehicle to perform illegal actions such as:

– Transferring malicious code, worms or viruses to others
– Launching a denial of service attack against others
– Hijacking network credentials to gain access to the network of a third party where data, software, content or services of the third party are subsequently damaged, disrupted, altered, disclosed or stolen

A traditional policy also provides no coverage for third-party claims that arise when an insured is the victim of some cyber intrusion that results in the disclosure of private information, identity theft or the destruction of data on the insured’s network.

First-Party Losses for Misappropriation or Unauthorized Use of a Computer Network

This coverage is widely excluded from traditional programs, with an occasional grant found in Property policies. The gap means that most policies will not respond with first-party coverage in cases where a failure of network security to prevent a computer attack results in loss of business income or results in data restoration expense from damage, alteration, destruction or theft of data.

Cyber Extortion

A threatened computer attack resulting in a first-party claim for cyber extortion monies is usually not covered by any traditional policy, nor will the typical policy pay indemnification for extortion monies paid to end an extortion claim. Kidnap & Ransom policies may be endorsed to provide some measure of coverage.
Other Coverage Issues

IT Outsourcing
While IT outsourcing is a growing business strategy, it does not necessarily reduce or remove Cyber Risk exposure. Outsourcing agreements can be used to reallocate some liability to the vendor, but typically these agreements provide only a limited source of recovery for losses because they generally limit liability to the value of the contract, and consequential damages are excluded. A risk transfer approach to an outsourcing model yields a more complete reallocation of risk because the Cyber Risk policy will cover liability for both the named insured and the vendor providing the outsourced services.

Patch Management
Vulnerabilities in applications and hardware are exploitable weaknesses and challenge organizations with ongoing and burdensome patch management demands. Hackers discover software vulnerabilities and software companies write software patches to fix them. Businesses must apply those patches, often across wide national or even global networks in a timely fashion.

Media Perils
Companies with information available to the public on web sites face exposures more common to media companies. Liability for web site content is an exposure that should be addressed as part of a comprehensive Cyber Risk management strategy.

The Cyber Risk Market

 Although many insurers add "cyber" or "e-risk" to the name of products, the extent of coverage varies. Insurers currently offering third-party, first-party or combined first- and third-party Cyber Risk coverage include:

- ACE
- AIG
- Arch
- Beazley
- Chubb
- CNA
- Euclid
- Gulf
- Hartford
- Hiscox
- Media Pro
- St. Paul Travelers
- Zurich

Insurer participation in the Cyber Risk marketplace is stable. There have been no recent marketplace arrivals or departures. Carriers are eager to write this line of business, and some are now specializing in coverage for specific industry groups. For example, both Chubb and Zurich focus almost exclusively on coverage for financial institutions.

Underwriting process and pricing models in the Cyber market have matured, meaning that information required on applications and for network security assessments is generally standard. Variations in pricing models do exist and are based on industry group. This is especially evident for financial institutions and healthcare businesses, which generally pay more for Cyber Risk policies because of the value, sensitivity and potential exposures related to the content of their networks.

Coverages, definitions and exclusions continue to vary between forms, making price and coverage comparisons both necessary and time consuming. Lead time for placement of Cyber Risk policies continues to be substantial due to the amount of effort required in forms analysis.

The Buyer’s Outlook

- In 2005, clients should expect the market to be aggressive in giving solid credits for insureds with well developed security policies, business continuity plans and mature technology solutions for network security. Conversely, buyers with few internal controls may be unable to obtain coverage at any price.
- In general, prices will be differentiated according to the insureds’ business services, security policies, disaster recovery planning, business continuity planning, service contracts, outsourcing approach, claims history, vetting procedures and data sensitivity.
– The 2004 CSI/FBI Computer Crime and Security Survey reports that 28 percent of businesses purchase Cyber Risk insurance. Similar surveys by Deloitte Touche Tohmatsu and Ernst & Young confirm this figure and indicate that the number of organizations purchasing Cyber Risk insurance will continue to grow.

– Transfer of risk for unauthorized disclosure and breach of privacy has increased. Financial service and healthcare providers that traditionally possess greater awareness of disclosure-based liability have made Cyber Risk coverage a key component of their risk transfer strategies.

– Liability claims against universities and schools have surfaced but their participation in the market has not yet increased.

– Heavily exposed segments where the rate of purchase of Cyber Risk insurance is lagging include retail, manufacturing and transportation.

– The trend of legislating responsibility for the security of networks and privacy will continue and eventually extend to all businesses that manage, collect or transact in consumer data. This is likely to increase the perceived need for Cyber insurance products.

– The use of the internet as a vehicle for organized crime and extortion is growing, and victims are generally unable to prosecute and recover losses.

– The exclusion of internet professional services and internet media liability on some Errors & Omissions forms is creating a demand for specialty coverages on Cyber Risk insurance forms.

– Limits will continue to be available in excess of $100 million.
For most industry sectors, we anticipate a stable market for Employment Practices Liability (EPL) insurance in 2005, with continued commitment from established markets and fresh interest from a few new entrants. For most EPL clients, 2004 proved to be a favorable year, with abundant capacity and level pricing. Despite attempts by some carriers to curtail coverage, the end results proved to be positive for most buyers. The marketplace was supported by a willing excess market. We expect more of the same in 2005. The area of greatest contention will be in policy terms, with some carriers introducing new forms that would restrict coverage, even as insureds seek more certainty and broader coverage.

Regarding EPL claims, the size and severity of suits may still be on the rise. Several major litigation themes seem to be developing:

– Glass-ceiling class actions
– Document retention
– Age discrimination
– Gender stereotyping
– Whistleblowing and other issues prompted by corporate governance legislation

**A Reasonable Market**

Over the past year, many EPL clients saw flat renewals or premium reductions of five to 15 percent. Terms and conditions held fairly stable, depending (as always) on individual risk components, expiring premiums and retention levels. Even with ongoing litigation, especially the Wal-Mart glass-ceiling case, we expect the market to stay on this course.

In 2005, we believe renewals will be flat or down five to 10 percent as the US domestic markets continue to face off against competition in Bermuda. This should hold true for all classes with retention levels at $500,000 and above, whether buyers are privately held or large international conglomerates—provided that they demonstrate good loss history and EPL controls.

Between US, Bermuda and London markets, capacity is plentiful. On an aggregate basis, tapping the US and international markets should offer buyers limits in excess of $300 million. Primary insurers for small cap and private companies are abundant. For large global firms, however, the primary carriers are limited to a strategic handful.

**Beware the New EPL Forms**

Special attention must be paid to policy terms and conditions introduced in 2004. Carriers are often looking to remove a number of standard coverage components (including third-party extensions) and add new exclusions (e.g., Alien Tort Claims Act allegations). The market is varied, however, and some carriers are still amenable to offering broad features including flexible claims triggers, defense costs coverage for WARN Act claims, and minority and sensitivity training extensions.

**Potential Glass-Ceiling Class Actions**

The EPL case to watch is still the glass-ceiling suit against Wal-Mart. If ultimately certified as a class action on appeal, the case could involve one million former and current female workers nationwide. Plaintiffs’ counsel in *Wal-Mart* has indicated they will bring a series of large state-based suits should they fail to win class action status.
While much attention has been paid to the retail sector, a wider pool of potential defendants cannot be ignored. One large defense contractor, for example, has faced several potential state-based, gender discrimination class action suits. Although the company has won a number of these cases, and successfully fought class certification, at least one case ended in a multimillion dollar settlement.

Financial institutions will also be spotlighted in 2005. The National Council of Women’s Organizations recently announced it is teaming up with a law firm to investigate gender bias on Wall Street. The group has indicated it may target a who’s who of the leading companies in the financial sector. Gender discrimination is also becoming an international issue; in one prominent case in the UK, the plaintiff is seeking individual country data on compensation practices. This has caught the attention of global insurance carriers who are realizing that EPL claims are no longer strictly US phenomena.

**Document Retention**

An important issue being raised in some EPL suits – one commonly associated with Directors & Officers (D&O) and Errors & Omissions litigation – is document retention. In one high-profile case in 2004, the judge found that the defendant had apparently taken steps to cover up research on the pay gap between its female and male employees. In another case, the judge issued a ruling blaming an employer for destroying backup email messages that were sought during an employment discrimination suit. The judge also warned that the firm’s counsel failed to properly oversee its client’s compliance with discovery obligations. Such warnings are not taken lightly, as these are the types of issues that ultimately led to the downfall of Arthur Andersen.

**Of Growing Concern: Age Discrimination**

In 2005, the US Supreme Court is set to hear a case that may set new standards for age discrimination suits, likely to become more common as the US working population ages. The court will decide how much protection older employees have against policies that may seem neutral but have adverse effects on older employees. The case, *Smith v. City of Jackson, Miss.*, revolves around a bonus policy for new police officers. The suit alleges that in attempting to attract new recruits, the city unfairly gave larger bonuses to younger employees.

Age discrimination law suits can be large. In 2004, about 2,300 former Sprint Corporation employees accused the company of engaging in a “pattern and practice of age discrimination” by lowering performance evaluations of over-40 workers or moving them into positions slated for elimination. The suit also alleged that the company used age information in making performance rankings and job assignments in advance of impending mass layoffs. Any company with a ranking system should take notice.

Severity is an issue in claims developing from age discrimination suits, as older, longer-term workers often earn higher salaries — a factor in calculating damages. Another question being addressed in the courts is whether being labeled as overqualified could be a form of age discrimination. In one case, the court ruled that overqualification was not a legitimate nondiscriminatory reason for failing to hire a worker. Although other courts have taken counter positions, prudent employers are being careful to back up their hiring decisions with more data regarding applicants’ suitability for positions they seek.

**Keep Your SOX On**

The present surge in corporate governance litigation may be felt in EPL circles. Three main areas in particular may be affected by the Sarbanes-Oxley Act (SOX), the US law aimed at improving corporate transparency:

– Internal documentation and controls
– Executive compensation
– Whistleblower protections

Internal control provisions may require human resources (HR) cooperation in providing documents related to payroll, pension and employee benefit plans, and healthcare costs and liabilities. HR departments may be called upon to help assess, review and revise internal controls under SOX section 404 (discussed further in our *Directors & Officers* article in this book). All of these activities raise EPL questions. HR personnel may also play a pivotal role in payroll issues involving CEOs and CFOs, which may be important in D&O suits.
The new securities law also touches on the employment practices related to whistleblowing. A CFO recently won damages as a whistleblower under SOX after he refused to sign a quarterly financial statement being submitted to the SEC and was subsequently terminated. The case is under appeal but still serves as a warning.

**New Protected Categories**

A recent Second Circuit Court of Appeals decision could lay the groundwork for making gender stereotyping a recognized form of gender discrimination. The case involves an elementary school teacher who was allegedly close to receiving tenure until she had a child and supervisors began questioning her commitment to her job. While the case has not yet been heard in front of a jury, the Second Circuit acknowledged that stereotyping about mothers qualifies as a form of gender discrimination. This decision could pave the way for similar cases. To date, a number of caregiver discrimination cases have reached settlement or judgment.

In a related matter, the Equal Employment Opportunity Commission (EEOC) has sued a telecom equipment maker for allegedly discriminating in its pension policy against female workers who took pregnancy leave by giving them less credit toward calculating their pensions than employees who took disability leave for reasons other than pregnancy. Such suits garner the attention of both EPL and Fiduciary Liability insurers.
Having lost their way in the late 1990s and the first years of this decade, Fidelity Bond underwriters have spent the past three years trying to chart a course back to profitability. Relying upon increased pricing and deductibles, coupled with more rigorous underwriting standards, underwriters apparently have finally found their way out of the red and into the black.

A review of 2003 underwriting results published by the Surety Association of America in 2004 this year demonstrates the point. Direct earned premiums surpassed direct losses incurred in almost every case. These results do not reflect combined loss ratios (losses coupled with underwriting expenses, i.e., commissions, salaries, rent, etc.), which average 20 to 30 percent of total premium. For most insurers, however, 2003 combined loss ratios showed substantial gains in profitability.

**Headlines and Highlights**

- Increases in pricing and deductibles, coupled with more rigorous underwriting standards, have produced a return to profitability for Fidelity insurers.
- Available capacity varies according to the insured’s industry and size.
- Fidelity sector loss records reveal that vendor fraud continues to be the most prevalent cause of loss, and that internal controls are often less carefully adhered to away from corporate center operations.
- The new Financial Institution Bond Form contains substantive changes that curtail coverage, and numerous enhancements can be made.

**Capacity**

The anticipated reduction in capacity resulting from the St. Paul and Travelers merger took full effect in mid to late 2004. The Gulf and Travelers reinsurance treaties were non-renewed, resulting in all accounts being subsequently written on St. Paul paper.

For the majority of insureds, the changeover to St. Paul was relatively seamless. The one material effect for both Gulf and Travelers clients was the changeover to the St. Paul policy form, which held subtle differences from the Surety Association contracts used by Gulf and Travelers.

For larger clients, however, particularly large financial institutions, all three companies frequently participated on the same risk, often resulting in non-renewal of the Gulf and Travelers bond due to insufficient capacity.

Outlined below is a snapshot of available capacity, by limits available and the number of insurers likely to offer terms.
Capacity and Limits

Source: Willis Executive Risks/Fidelity Practice

Fortune 500 companies and large financial institutions are afforded the least capacity. Experience has shown that the severity of loss for these larger entities is markedly greater than that for more moderate entities, limiting the number of insurers actively looking to write a primary bond for them.

Pricing

The first quarter of 2004 found many underwriters still seeking modest increases on their renewal book, even for those firms with little change in overall rating factors. It was apparent to underwriters, however, that a continued firming of the market could not be sustained, as profitable results for the 2003 year and aggressive budgets operated against them, particularly for the middle market and lower Fortune 1000 portfolio. By midyear, most insureds were obtaining flat renewals and some of the middle market and lower Fortune 1000 clients actually obtained a modest price reduction.

Although there was less movement of premium for larger insureds on their primary programs, pricing for excess placements became more aggressive. Fortune 500 companies and large financial institutions started to obtain premium relief on these placements.

Claims Experience and Notable Exposures

While employee theft loss scenarios are endless, vendor fraud continues to be the most prevalent cause of loss. Underwriters continue to drill down on this specific exposure, carefully examining the internal control mechanisms used by insureds to stem the flow of vendor fraud losses.

A significant number of Fidelity losses also continue to emanate from non-headquarters locations. Experience has demonstrated that internal controls are often less carefully adhered to away from corporate center operations. In an effort to combat these losses many underwriters are now looking for affirmation from insureds that their internal control procedures also apply to all operations around the world.

Also coming under careful scrutiny is Agents coverage, added to many crime bonds as a result of a recent and potentially major loss involving a collection agent. While collection agents are predominantly used by utility companies, the underwriters’ inability to assess and underwrite the internal controls and procedures of any agent being added to a crime bond can make the coverage precarious. While clients may be forced to rely more heavily upon the agent’s own Fidelity coverage, the agent’s policy will not respond to losses caused by an owner or partner of the agency – the very individuals that are most often responsible for causing a loss of client property.

For financial institutions, losses involving registered representatives and disclosed agents continue to be a source of loss frequency. Insurers adding coverage for this class of agents share a frustration experienced by commercial crime underwriters: the inability to underwrite the internal controls of these outside agents. Although the financial institution bond underwriters continue to add these agents to the bond, the adequacy of deductibles associated with this exposure continues to come under close scrutiny.
Coverage Issues
While several new commercial forms have been introduced into the market, each requiring numerous policy enhancements, one common theme is a change in the ownership provision. Certain policy forms are now carving out coverage for client property. While the extent to which coverage is being eliminated varies (some forms exclude property for which an insured is legally liable while others also exclude client property held by the insured), it is important to note that these forms also allow insureds to buy back the coverage under a separate insuring agreement. We believe those insureds responsible for their clients' property should always purchase client property coverage.

For financial institutions, the Surety Association of America (of which the majority of FI bond insurers are members) has rolled out the new Financial Institution Bond Form. While conversion to the new form has been slow, a careful review of it is warranted. There are substantive changes contained within the new form that curtail coverage and, for those institutions adopting it, there are numerous enhancements that can and should be made.

Outlook for 2005
Expectations for 2005 are for flat renewals and some continued modest softening. The middle market and lower Fortune 1000 clients will have the greatest potential for price reductions as there are many more insurers looking to compete on this portfolio. Compared to the risks of the largest companies, risks of this size have much lower volume of severe losses and a notably smaller exposure to non-headquarters operations, making them more appealing to Fidelity underwriters.

For the Fortune 500 and large financial institution clients, the number of competing markets willing to lead these programs is significantly smaller. Due to the greater potential for a severe loss, only underwriters with the expertise and adequate premium volume to absorb a major loss are actively looking to write a primary policy for a large organization. As a whole, these markets are looking to hold the line on pricing rather than offer significant premium reductions.

In the excess layers for these large companies and financial institutions, there is vigorous competition and we therefore anticipate modest reductions in pricing.
While losses have made the headlines, it is hard to overstate the impact of industry consolidation and attrition on the capacity and condition of the Surety marketplace. During the past year, Travelers merged with St. Paul, and over the past five years, Reliance, Frontier, Fireman's Fund, Amwest, Atlantic Mutual and Kemper exited the business. Losses and credit rating downgrades were the primary factors in these firms' decisions to withdraw from the Surety business.

On the reinsurance side, the number of professional Surety underwriters remains at around a dozen. Perhaps one-third of them, however, are relatively new entrants whose long-term commitment to the Surety line remains unproven. Change occurred recently on this front as well with the departure of Converium from the Surety business after a credit rating downgrade and XL Capital's decision to close its Surety reinsurance operation.

Loss Experience and Capacity
Even though a number of prominent sureties did manage to produce very good underwriting results in 2003, it was a loss year for the industry – the third in succession for primary writers and the sixth consecutive for their Surety reinsurers. Since 2001, the largest single Surety losses in history have been absorbed – Modern Continental, Enron and others.

In examining such losses, Surety underwriters have determined that underwriting information, indemnity, pricing and other aspects of the credit decision-making process were broadly inadequate across the full range of accounts in their books of business.

Adjustments in pricing models and a return of underwriting discipline – beginning in 2001 – have improved some sureties' return on capital, but the big picture is not getting any better. In July 2004, the Surety Association of America reported incurred Surety industry losses of more than $1.47 billion for the first six months of the year 2004. A significant portion of the figure is attributable to development on under-reserved prior-year losses. Worse yet, the half-year result did not include an additional $600 million allocated to Surety reserves announced by a leading surety in July.

Since 2002, there has been a marginal influx in new Surety reinsurance capacity, and it has not resulted in any easing of pricing or the terms under which Surety reinsurance is extended. Insurance and reinsurance companies (and sureties) have a finite supply of capital to allocate in support of their businesses. In recent years, capital allocated to the Surety line has diminished due to investor skepticism regarding the Surety industry's ability to obtain adequate pricing for risk. Capacity remains the single biggest issue facing the industry.

Alternative Solutions?
Alternative solutions in the Surety area have not yet emerged to play a major role. Letters of Credit, subcontractor default insurance, and funds control have been utilized to improve risk profiles in certain instances, particularly for individual projects. These alternatives have their place, but are not viewed as replacements for surety bonds, particularly where public projects are concerned. Surety “captives” have been explored as well, but not yet proven viable.

Underwriting Terms and Conditions
The Surety industry today consists essentially of four distinct market segments: large, middle market and small contractors, and Commercial Surety clients. There are distinct differences in the capacity, terms and conditions available to each. In this article, we examine Large Contractors and Commercial Surety.
Surety (continued)

Large Contractors – Work Programs of $250 Million or More
Surety support for large accounts remains constrained. There are currently four sureties that will support work programs of $500 million or more without co-surety support, although these companies often prefer co-surety participations on programs above the $200 million level. Co-surety participations, however, are subject to the credit rating criteria, reinsurance terms and conditions, and other factors now driving many sureties’ management of their business. The issue of co-surety credit risk was starkly highlighted in the July Surety reserve announcement referenced above. A significant portion of the reserve increase was to cover a now uncollectible share from an insolvent co-surety partner. The same factors also come into play where clients seek bonds for projects involving a joint venture partner.

Reinsurance costs and the increased risk retention on individual programs are steering some sureties to further reduce aggregate exposures on large programs. There have been recent indications of limitations being placed on single bonds above $250 million – not driven by credit quality concerns, but rather due to sureties’ portfolio requirements. A number of major projects currently underway, and many in the pipeline, will only have the benefit of a percentage bond due to industry limitations. We believe this trend may have very significant implications, over the longer term, for writers of Surety and their customers.

Contract terms and conditions are being carefully reviewed for potentially onerous provisions and levels of liquidated and/or consequential damages. Extended contract durations (beyond two years) and warranty provisions, in particular, can affect the pricing of any individual bond. Since sureties endeavor to underwrite to a client’s future financial position, underwriters are increasingly focusing on how contractors are managing the risk of material cost inflation in the current environment and the risk this presents to existing job margins.

Many contractors in this segment have or are considering work in overseas markets. The business case, allocation of resources and risk management strategies of such activities should be discussed regularly with the surety or well in advance of any new initiatives. A surety’s appetite for bonds outside the US can be limited based on the bond wordings, the provisions of the client’s contract with the owner and reinsurance terms. Questions about owner financing and potential currency exposures can be expected.

Some sureties are requiring their clients to provide indemnity agreements that are structured with an eye more toward dealing with a bankruptcy proceeding than a work-out of existing liability. For larger accounts, indemnity agreements are no longer standardized; in most cases, they are specifically crafted to address an individual client’s program. Further, some underwriters have sought to pass on the legal costs of developing such documents to the client. It is important that any requirement for new or modified indemnity documents be carefully reviewed by the client’s CFO, general counsel and broker to ensure no provisions are found to be in conflict with existing lender credit agreements.

Commercial Surety
The marketplace for Commercial Surety is more clearly defined than was the case 12 months ago. Buyers of large programs have seen the requirement for collateral increase for certain classifications of bonds, as sureties have imposed “triggers” tied to the lack of reinsurance for certain obligations. We do not see capacity returning to the market for certain types of financial guarantee bonds. In some cases, sureties are requiring annual term bonds to cover multiyear service obligations (including “non-renew” clauses to prevent a bond call). Many sureties have imposed a strict aggregate limit on Subdivision Bond exposure, regardless of the client’s creditworthiness.

Commercial Surety underwriters have been applying a cost-of-capital model to their portfolios. Even though there are new participants in the marketplace, we expect such modeling to result in pricing that remains at current levels, or perhaps somewhat higher, for the medium to long term.
Surety Strategies and Relationships
There is a direct correlation between transparency and maximizing the level of surety support a contractor can obtain. Contractors need to treat a surety as they would an investor or business partner – with unconditional openness in sharing the company’s business plan, construction risk management practices and financial information. We make the following observations and recommendations:

– Regular access to senior Surety underwriting executives is essential.
– "Underwrite" the Surety underwriter’s business model, reinsurance capacity, claims expertise and financial condition.
– Management of subcontractor performance is the essence of many contractors’ businesses. How such derivative risk is managed is of utmost importance to contractors and their sureties.
– Investigate the benefits of a co-surety structure for your bond program, with an eye toward more than just your company’s near-term business plan. Planning is required to align your interests with mutually acceptable co-surety partners and/or to determine if a shared surety facility is more advantageous.
– Standby surety relationships require similar strategic planning and management to deliver capacity and support when called upon.
– Communication is imperative. Professional Surety underwriters have dealt with bad news regarding a contractor’s performance before and respond in more predictable ways than when they deal with surprises. Does your surety have access, as needed, to your other professional advisors (CPA, lenders, outside counsel, etc.)?

This article is an excerpt from the Willis Surety Market Update of December 2004. Readers are invited to contact the author for an electronic copy of the bulletin.
The Aviation insurance sector is composed of distinct segments — and sometime sub-segments — each with its own underwriting attributes. The excellent loss experience exhibited recently by airlines, for example, does not apply to the aviation products sector. Hence we see insurance rates going in opposite directions: down for airlines and up for aviation products manufacturers. In other segments, stability reigns and is reflected in continuity in market conditions.

**Headlines and Highlights**

- Since peaking in 2001 and 2002, rates for the Airlines sector have declined by nearly 50 percent, with ample capacity being attracted by the sector’s unprecedented safety record over the past three years.
- The Aviation Products sector experienced the reverse — reduced capacity and increasing rate levels as underwriters struggled with long-term claims development in a segment they regarded as inadequately priced.
- As we go to press . . . Extension of the FAA War Risk Insurance program to Dec. 31, 2005 is still pending.

Airlines
Since peaking in 2001 and 2002, rates in this sector have steadily declined, and every year insurers have attempted to stabilize the rate reductions achieved by airlines. The total worldwide airlines premium income is down nearly 50 percent from the record high premiums of 2001 and 2002. This dramatic reduction is due to the excess available capacity that has been attracted by the unprecedented safety record of the industry. There has not been a major aviation catastrophe since November 2001, and capital providers have enjoyed large returns on this class of business. In 2004, rates fell to levels where there was little difference between expected losses and worldwide premiums. In the fourth quarter of 2004 underwriters were attempting to hold the line at modest reductions. A continued trend of rate stabilization and perhaps some capacity reduction is expected in 2005. In the absence of multiple major catastrophes or a sudden contraction of capacity, dramatic premium and rate changes are not expected. Policy conditions, however, remain the subject of negotiation.

Aviation Products
In 2004, capacity levels for aviation product risks were down slightly and there was a notable constriction in market appetite. In recent years, underwriters have struggled with the long-term claims development and viewed the segment as inadequately priced. The market imposed a wide range of price increases that depended on factors such as product mix, sales volume and deterioration in loss reserves. Risks renewing with static exposures and favorable loss records received increases of 10 to 30 percent. For those risks with deteriorating loss histories, the increases were higher. Insurers continue to differentiate accounts and use actuarial trending analyses to support increased price levels. In 2005, we expect pricing to stabilize.

General Aviation
General aviation risks in 2004 saw neither capacity changes nor any new insurers. Segmentation in the sector continues. There is plenty of competition for good industrial aid risks, resulting in premium reductions. For commercial operators, there is less capacity, and only those with excellent loss records have been able to negotiate flat renewals or marginal reductions. Others have seen increases, particularly ground handlers and fixed-base operators. High limits of liability will remain expensive. Loss experience and pilot training are critical factors in insurers’ risk analyses.

Space
It is anticipated that capacity for both launch and in-orbit risks will remain constant for 2005. Current capacity estimates are $366 million for launch risks and $217 million for in-orbit risks. Likewise, premium rates should be relatively stable at 18 to 20 percent for launch plus one year of coverage, and around three percent per annum for in-orbit risks. The greater challenge will be to improve the in-orbit product offering so that more satellite operators purchase the coverage. The cost of insurance and the exclusions often imposed by insurers have pushed potential insureds towards self insurance. Loss experience for 2004 is currently estimated at 80 percent, little changed from 2003.

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In 2004, rates fell to levels where there was little difference between expected losses and worldwide premiums.

**Legislation – FAA War Risk Insurance**

Federal Aviation Administration War Risk Insurance (Chapter 443), which was amended by the Homeland Security Act to provide first-dollar coverage for third-party and passenger liability, hull and spare parts insurance, was finalized in February 2003. As a result, most US airlines cancelled their commercial war risks insurance and entered the federal program. Additional legislation extended this program to August 2004 and subsequently to December 31, 2004. As we go to press, legislation is pending before the US Congress to further extend the program to December 31, 2005.
Construction

Headlines and Highlights

- Changes emanating from insurers, the construction industry and state legislatures have produced a complex, splintered marketplace.
- Residential projects represent more than 50 percent of total US construction — but carriers have yet to understand how to adequately address the exposures.
- Carriers have narrowed the scope of coverage available to additional insureds — a development that makes it important for general contractors and owners to revisit and redraft their construction contract requirements.
- The majority of contractors now purchase Contractors Pollution Liability policies, with limits ranging from $1 million to $50 million.

The key trends in the construction industry and construction risk management are easy to spot but they do not necessarily assemble easily into a clear, simple picture. Changes emanating from insurers, the construction industry and state legislatures have produced a complex, splintered marketplace, divided according to any number of factors: the size and market position of the insurance carrier, the geographical location of the construction company, the type of construction work involved. The results are in many ways positive, as insurers find ways to improve their stability. Insurance rates are flat or in some cases declining, and legislatures are beginning to tackle difficult problems. One thing is certain. Risk managers in the construction field have a lot to consider, and that applies as well to the full roster of participants: contractors, owners, designers and suppliers.

The trends among Construction insurers continue as they were in 2004:
- Consolidation
- New entrants into the marketplace
- tighter underwriting

As part of their effort to achieve greater predictability in loss results, carriers changed insurance standards, filing new ISO rules for additional-insured endorsements. This is having wide impact on the contractual risk transfer and risk financing for contractors. Depending on carrier history — what losses they may be confronting from previous years or how hungry they are if new to the line — appetites vary greatly.

The trends in the US construction industry are also familiar. Foremost is faster growth in residential construction than in non-residential work. At this point, residential projects represent more than 50 percent of total US construction and this percentage is growing. For non-residential projects, the trend is modest growth. In 2005, we expect street, road, sewer, water and healthcare and education projects to pick up. For both residential and non-residential efforts, price swings for materials and fuels are a major factor. Overall, however, times are good for the construction economy, and we expect this to continue.

For insurance buyers, the overall picture is positive. The market in 2004 started to flatten, led by umbrella/excess pricing. In primary Casualty lines, moderation in increases began early in 2004 and competition tended to reduce pricing later in the year.

Key Challenges and Developments

Residential Construction

Put simply, the insurance industry doesn’t like the residential side of the street. The impact of residential work and exposures has now been felt in commercial construction and it is clear that insurance carriers have yet to understand how to adequately address residential exposures in a traditional manner, specifically regarding construction defect issues (completed operations, property damage coverage). In the long run, the insurance industry will likely develop new products to help, but for now, most builders will struggle to get affordable coverage that truly addresses these risks.

The residential construction insurance problem emerged in 2003, as litigation and related loss activity caused underwriters to reduce their appetites for these exposures even when they represented a relatively small percentage of a contractor’s total work program. Many carriers only want to insure construction risks when residential work is a small part of it (25 percent or less) — and in some cases no part of it. For residential builders
with inadequate insurance the pain won’t be felt for some time, as residential construction losses at issue are typically claimed seven to 10 years after project completion.

The current alternatives to addressing these risks include project-specific policies, wrap-ups, true alternative risk treatments including captives and self insurance, and policies that extend coverage up to 10 years from date of closing.

Restrictions and Exclusions
The latest coverage changes in General Liability center on Additional Insured forms. The industry has narrowed the amount of coverage available to additional insureds, which will cause general contractors and owners to rethink how their construction contract requirements are drafted. These endorsements historically allowed owners and general contractors to pass significant amounts of risk (including in many cases sole negligence) to subcontractors’ insurance policies. The new endorsements restrict that coverage to only those instances where the subcontractor had a degree of negligence.

Insurance buyers must also confront specific exclusions. The industry has started excluding silica-related losses in General Liability in response to mounting losses from long-term silica exposure.

The industry continues to develop broad exclusions for construction delivery systems, specifically exterior insulation finishing systems (EIFS). Despite efforts by the EIFS industry to counter claims that the products themselves were problematic, carriers will generally exclude completed operations coverage. Owners, architects and contractors should know that lack of such coverage has the potential to increase the cost of the work.

Line-by-Line Considerations

Commercial General Liability
Many of the major issues in construction risk have centered on defect issues and the long-term liabilities they imply. Carriers always push to limit exposures to risks with long tails or uncertain case law surrounding them, and both apply in the case of construction defect. Another major General Liability issue is the Additional Insured wordings issue discussed above (and at length in a Willis white paper available through the Willis Construction Practice). Other topics of interest include mold exclusions and lack of support for wrap-up completed operations coverage and for joint ventures. These will remain more difficult to accommodate than in the late 1990s.

From a pricing and attachment perspective, we expect the moderation trend will continue with average increases of less than five percent. Better classes of risk may see more competitive outcomes. Deductibles are becoming more focused on specific risks such as completed operations (which is one way carriers address defect issues). Deductibles of $100,000 per occurrence and higher are common in this area.

Workers’ Compensation
This line varies widely by state but we have seen competition return especially on large programs with deductibles. California risks may see more competition thanks to reform. In general, carriers in this line may still need pricing increases to achieve good results, but competition is tempering these to single-digit percentages, with better risks seeing better outcomes.

Commercial Automobile
Coverage concerns typically don’t impact this line but major losses are common and pricing varies widely. The line remains among the most volatile, though individual premiums typically are small relative to those for General Liability or Workers’ Compensation. Pricing, however, has moderated along with other Casualty lines and we anticipate modest increases to flat pricing for 2005.

Umbrella/Excess Liability
This is the most competitive Construction line from a pricing perspective. Many accounts saw better pricing in 2004 than in 2003 and in some cases the results were significantly better. We expect this to continue in 2005, especially on larger placements, with average decreases of five to 15 percent. On a precautionary note, coverage changes in primary programs are usually matched in umbrella coverage. Exclusions for residential, subsidence, silica, wrap-up, joint ventures and professional risks are often added to higher layers.

Capacity in umbrella coverage remains high, with limits in excess of $100 million available and several carriers offering $25 million or more on a single risk.
Professional Liability
Many contractors have purchased Professional Liability in the last 10 years due to the increase in design-build activities, construction management and value engineering. The market has been very active as a result, and specialized forms are available to address contractors’ specific needs. The trends in Professional Liability mirror many in the commercial General Liability line. These include restrictions on mold, EIFS and silica. In addition, on master programs most carriers are seeking to restrict the percentage of residential work to 10 percent or less. Another trend in 2004 was reduction in appetite for project-specific professional placements if the contractor did not already have a master program in place with the carrier. Previously, project policies were often sought for longer-term jobs or those with specific needs such as true design-build. The market currently has pushed back on those, and as a result the pricing on project placements has increased substantially.

Another trend in the market is the development of Owner Protective Professional and Contractor Protective Professional policy forms, which address the true vicarious liability of the parties from professional activities and can make the adjusting process easier. From a pricing perspective master professional programs show modest rate increases of five to 10 percent. Capacity remains high for these programs with limits of $50 million being available by combining several carriers.

Pollution Liability
The biggest change in this line over the last several years has been the advent of mold buy-back endorsements to address the exclusions on GL policies. This coverage is just now being tested as the first cases are being adjusted with mixed results as carriers try to decide what indeed is related to property versus mold. The majority of contractors now purchase Contractors Pollution Liability policies, with limits varying from $1 million to as high as $50 million. Pricing remains stable and the coverage is available in both occurrence and claims-made forms.

Property, Marine, Builder’s Risk
These lines were very competitive in 2004 with price decreases being the rule. Appetites were high for a number of carriers, which caused rates to drop and coverages to expand. The impact of the recent storm season may temper this appetite in catastrophe risk areas, but in many cases those losses were under very substantial deductibles; losses may therefore not have a major impact on the line countrywide. Builder’s Risk is showing signs of additional capacity coming into the market, including London-based underwriters. Individual capacities can readily accommodate jobs in excess of $100 million. Coverage expansion into contingent areas does not appear likely (force majeure, liquidated damages, and efficacy all have little to no capacity available). On inland marine risks including equipment, we expect the market to continue to be soft as well. So called “wet marine” exposures remain stable. This line includes barges, equipment on barges or related navigable waterways.

Wrap-Ups
The wrap-up marketplace has changed in the last several years as carriers have started to become more cautious. Several carriers have shifted their focus from owner-controlled programs to contractor-controlled programs as they perceive that contractor results have shown better outcomes from a loss standpoint. However, there are many situations where owner-controlled programs are still successful. Wrap-up markets have been reduced from seven or eight to just a few (three or four). In addition, wrap-ups have morphed from major, single-site projects to entire work programs called rolling wrap-ups. These have been used for both owners and contractors, including residential home builders. In many respects the approach recalls the original goal of wrap-ups, which was to assure coverage consistency and coordinated claim handling on a site. This is particularly appealing as coverage deteriorates.

Outlook for 2005
We believe 2005 will be both more competitive from an insurance standpoint and at the same time more challenging for the construction industry. While pricing seems to be moderating and should continue to become more competitive, coverage terms will vary widely on General Liability and the entire concept of contractual risk transfer will need to be examined. New capacity will continue to impact the market, while legacy carriers attempt to both fill holes and confront the new competition. Contractors will need to take a hard look at their business strategies related to residential work and understand that long-term risk financing options may be more opportune than traditional insurance policies. Companies in the construction industry will need to spend more time understanding their coverages and how they may impact their business appetites and ultimately their bottom lines.
A Steady Rise
The 2005 marketplace is expected to be only marginally more attractive than it has been in recent years. We anticipate average price increases to continue to climb at a double-digit pace. For preferred provider organization (PPO) plans, we estimate 10 percent average increases. Price hikes for health maintenance organization (HMO) and point of service (POS) plans are expected in the vicinity of 11 to 12 percent. Prescription drug costs will remain one of the fastest growing cost components, with expected increases of 14 percent. Retiree medical plans, burdened by high prescription drug use, will likely see even greater cost increases — 14 to 15 percent — making such plans even more unpopular with employers. Dental plans, which increasingly follow the managed care model, can expect typical increases of five to six percent. Long-Term Disability rates, which tend to follow the overall economy, should hold fairly constant, assuming the economy continues to improve.

Healthcare Legislation

HIPAA Deadline
The health insurance industry is moving further into the era of HIPAA, the Health Insurance Portability and Accountability Act of 1996. Most employers have by now concluded their implementation of the basic HIPAA privacy requirements, and in 2005, they face a new deadline to comply with security requirements regarding electronic protected health information (ePHI). Ensuring that provider and employer electronic systems are secure means a new round of risk assessment and analysis. It is safe to assume that the cost of these efforts will be passed along through increased premiums or administrative fees.

MCOs and a Patients’ Bill of Rights
The long-debated Patients’ Bill of Rights is gaining new political life in Congress following recent US Supreme Court rulings. In a pair of cases, Aetna Health Inc. v. Davila and Cigna Healthcare of Texas Inc. v. Calad, the court ruled that federal limits on suing managed care organizations (MCOs) took precedence over state laws allowing suits for punitive damages. The federal Employee Retirement Income Security Act (ERISA), which deals with fiduciary as well as healthcare issues, limits plaintiffs to recovering only the financial equivalent of benefits that would have been provided, plus legal fees. In winning the judgments, the Justice Department and others argued that allowing lawsuits under the state laws would weaken fundamental ERISA protection for employers. Further, they said, Congress intended ERISA to encourage employers to offer insurance plans by creating uniform and predictable laws. The Justice Department argued, and the Supreme Court agreed, that allowing state laws to prevail would seriously jeopardize this system. Healthcare legislation observers may see a certain irony in this, as most employers would otherwise prefer to avoid ERISA requirements. The source of the conflict, furthermore, may be receding as managed care plans evolve to reduce or remove the MCO’s gatekeeping function. The loosening of such managed care restrictions is one of the reasons that medical costs have continued to increase so rapidly.

Reaction to the Court rulings has been strong, and many are calling again for passage of the Patients’ Bill of Rights.
Employee Benefits (continued)

**Mental Health Parity**
Legislation to support coverage of mental health treatment was defeated in the recent session of Congress, but proponents are expected to continue to push this issue. President Bush has indicated that he does favor some sort of mental health parity, but sees current law as sufficient. Some, however, see the possibility of movement on this issue.

Although many observers feel that consumer-directed plans are a means of shifting costs to employees, most employers maintain their overall contribution level when they shift to such plans.

**The Effects of Reform**
Medicare reform introduced by the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 is gradually taking effect and will impact benefit plans in several ways. New Medicare coverage of prescription drugs might ease burdens on retiree medical plans. Many retirees in these plans fear that the Medicare entitlement will permit their current plan provider to drop or reduce the drug coverage in their plans, which are typically more generous than the proposed Medicare coverage. A potential counter balance to this problem is a ruling that employers who can demonstrate that they provide a satisfactory level of drug coverage will receive a subsidy that partially offsets the cost of offering this benefit.

Of even greater impact could be the Medicare reform language that promotes consumer-directed health plan offerings, which have been offered by providers and selected by less cautious employers. The legislation provides for the use of health savings accounts (HSAs) as a vehicle for employees to pay for their medical costs. The rules stipulate high deductibles, tax advantages and full portability, giving employees more control over their healthcare funds and more incentive to avoid unnecessary care. Regulations and guidance were issued in several steps over the course of 2004, and while a small number of employers adopted HSAs for 2005, many more are expected to do so for the 2006 benefit year.

President Bush’s reelection was a boost for HSAs, which exemplify his idea of an “ownership society.” He is expected to propose additional legislation making HSAs more attractive.

Although many observers feel that consumer-directed plans are a means of shifting costs to employees, most employers maintain their overall contribution level when they shift to such plans. To help make sure that employees do not forgo preventative care in an effort to save costs, some companies are providing additional well-care benefits to their employees.

The president also has indicated that he favors legislation to permit association health plans. Such legislation would overturn some of the restrictions preventing smaller employers from banding together to leverage their purchasing power.

**Prescription Drug Imports**
The re-importation of low-cost prescription drugs from Canada (and elsewhere) remains a pressing political issue. There have been several proposals introduced in Congress to legalize the practice, which takes advantage of price caps in Canada. None of the legislators condone price caps in the US, but they do seek to impose an administrative and regulatory scheme to ensure that the drugs from Canada are safe and do not come from venues where controls are not as stringent.

One point rarely mentioned in the debate is that generic drugs are actually less expensive in the US than they are in Canada. As more emphasis is placed on generic drugs, the Canadian drug issue may become less pressing.

**Deferred Compensation Programs**
Health plans are not the only employee benefits receiving attention from legislators. The Enron case brought up questions about the rules regarding deferred compensation monies. The American Jobs Creation Act of 2004 changed the rules to outlaw the practices that allowed Enron executives to get the cash in their deferred compensation programs out of Enron before it entered bankruptcy.

**Regulatory Update**
– Rulings last year that permit plans to use debit cards for making payments associated with flexible spending accounts (FSAs) led to an explosion in the number of plans with such cards.
– Final regulations on what constitutes a proper COBRA notice were issued by the Department of Labor, necessitating changes to the forms issued by employers.
California, whose legislation is often emulated by other states, has been active in several employee benefits areas. In September 2004, California enacted an anti-harassment training law requiring employers of 50 or more persons to provide two hours of sexual harassment training every two years to employees with supervisory authority. In the November 2004 election, California voters narrowly overturned a mandate requiring employers with 20 or more employees in the state to subsidize 80 percent of the cost of medical coverage for workers. Larger employers were required to pay 80 percent of the cost of dependent coverage.

California’s 2002 Family Leave Act hit implementation milestones in 2004. The law allows California employees to take up to six weeks of paid leave to care for their own serious illness, the serious illness of a family member, or to bond with a newborn or newly adopted child.

Other Trends to Watch

– Changing behavior through the use of mandatory wellness and disease management programs
– Intensifying monitoring and analysis of medical costs, employee compliance with company policies and vendor relationships
– Improving communications with employees, often through internet technology
– Outsourcing administration and call centers to third parties
In this article, we present the Foreword to the October 2004 edition of the Willis Energy Market Review. The subject of the article goes well beyond the boundary lines of the Energy industry. After defining the two types of risk underwritten by the commercial insurance marketplace — single-site risk and aggregation risk — the author examines history, cycles, current events and forward-looking scenarios that add up to a provocative and instructive vision of the future.

Readers are invited to visit www.willis.com and click on "Publications" to download and read the entire publication.

Although there are many niche insurance markets for energy risks, the lion’s share of underwriting capacity resides in the commercial insurance marketplace — a marketplace that comprises two distinct types of risk: single-site and aggregation. Single-site risk virtually defines itself: value-at-risk at one location for a given insured. Aggregation risk includes:

– Concentrations of exposures (people and/or physical assets), within a defined geographical area, that may be subject to such ‘nat cat’ perils as flood, wind or earthquake, or to an act of terrorism.
– Accumulation over time of liability arising from specific perils, products or operations.

Cost, availability and terms of risk transfer for energy risks, as well as the long-term future of the marketplace, depend upon the behavior of these types of risk. To better understand the forces at work, we need to take a brief historical perspective.

Perspective
For over a generation, cyclical forces, natural catastrophes and shock losses have shaped, battered and transformed the commercial insurance marketplace. We weathered the capacity crunch and extreme premium inflation of the late 1970s for primary and excess Casualty lines. Particularly hard hit were buyers of products liability, medical malpractice and other long-tail liability risk. We recall the lack of capacity for North Sea platforms in the early 1980s, the widespread hard market of the mid-1980s, and the nat cat losses of the late 1980s and early 1990s, as Hurricanes Hugo and Andrew and the Northridge Earthquake captured the headlines. Already in 2004, the US sustained multiple punches from Hurricanes Charley, Frances, Ivan, and most recently Jeanne, midway through a predicted active hurricane season. In the energy sector, large losses occurred in clusters from the late 1980s onward. The new millennium witnessed the beginning of a string of revelations of corporate fraud and malfeasance on a grand scale. Then came 9/11.

Throughout this period of time, carriers around the world were forced to deal with enormous losses generated by products and exposures for which little or no premium had been collected — because their exposures were undervalued or they were not intended to be covered in the first place. Examples include asbestos, silicone breast implants, certain pharmaceutical products, mold and environmental claims.

Despite these daunting events and losses, the marketplace managed to right itself after each crisis, to soldier through and stabilize — although with fewer insurers and reinsurers and with notable and persistent changes. We experienced the advent and growth of large retentions, captives and other risk funding and special purpose vehicles, claims-made and occurrence-reported forms, tighter policy wordings, catastrophe risk modeling and revamped underwriting regimens.

Anatomy of a Cycle
All parties — insurers, insurance buyers, brokers, bankers and everyday consumers of products and services — have been directly and indirectly impacted by the evolving marketplace, and their respective responses have changed the way we do business, the cost of doing business, and how we manage and finance risk.

In many ways, however, the basic behavior of the insurance business remains the same. When post-‘crisis’ returns are perceived to be attractive, fresh capital pours in to take advantage of growing and cresting premium rates, thereby rebuilding capacity. The 1980s, 1990s and 2000s have given birth to ACE, XL, Mid-Ocean, Axis, Arch, AWAC and many others. Meanwhile, many of the older, established ‘legacy’
companies enter receivership, merge, or reinvent themselves (e.g., Lloyd’s and Equitas). The cycle is reborn, and until the next crisis, it’s a new chapter of ‘business as usual’.

We see nothing on the horizon to indicate that the next 10 years will see anything different in the fundamental behavior of the life cycle of the marketplace. Yes, the names of the companies will change and the underwriters will change and the pundits will change, but the inherent nature of the process will remain the same. Forces that create financial travail for some create opportunity for others, and a new generation of capitalists will be attracted by the prospect of entrepreneurial rewards in the Property/Casualty arena. The question each time will be: can they get it right?

**Change, Challenge and the Future**

The two types of risk defined above – single-site and aggregation – are becoming ever more divergent.

Remarkably and with a few exceptions (LNG plants, silicon chip manufacturers, certain high-rise buildings, etc.), the peak single-site property exposures in real PML terms are lower today than 20 years ago. In the energy sector, clients are buying similar limits, and there is little pressure on capacity. As respects third-party liability, although limits purchased are somewhat higher, only a few companies in a few industries are pushing for more capacity. Single-site risk therefore does not pose a problem for the marketplace.

For aggregation risk, however, growth of exposures will continue to accelerate, far outpacing inflation and the ability of today’s insurers to fund for them.

If the marketplace today were to sustain a new round of catastrophe losses, would it be able to stabilize, as it has after every crisis over the last 25 years? Would it be able to continue to cover aggregation exposures on the basis it does today?

As the lines of single-site and aggregation risk exposures continue to diverge and obtaining sufficient funding for aggregation risk becomes more difficult or simply impossible for the commercial insurance marketplace, where will insurance buyers find coverage or contingent capital for their aggregation risk? Can we reasonably expect to see new generations of
The unremitting demand for greater corporate transparency has resulted in new, more stringent governance obligations and more onerous financial disclosure requirements in most jurisdictions. In the US, for example, the stakes have risen sharply with the passage of the Sarbanes-Oxley Act and its implicit demand for greater transparency in disclosure of environmental liabilities.

In addition, the high-profile focus on the adequacy of corporate disclosures has prompted increased scrutiny by shareholders, securities analysts and lenders. With environmental liabilities now more visible and pressing than ever, corporations continue to strive to better manage, contain and transfer these risks. Gains in M&A market momentum across multiple industry sectors also continue to stimulate the use of Environmental insurance to remove pollution-related deal impediments.

Overview of the Global Marketplace
The Environmental insurance market continues to experience healthy growth and has come to represent a significant line of business for many insurance companies. We estimate that worldwide Environmental premiums will exceed $2.75 billion for 2004, an increase of over 10 percent from the previous year. This estimate does not include premium flowing into the various European pollution pools and the limited pollution coverage granted in some territories under General Liability programs.

At least 90 percent of the premium flow into the specialty Environmental insurance market is generated in the US, where market conditions remain buoyant. We estimate that Europe probably accounts for around 70 percent of Environmental premium generated outside the US. We expect further growth in European business as the specialty Environmental insurers continue to demonstrate that they can offer more effective and competitive solutions than local pool schemes.

Pricing and Capacity
The Environmental market experienced neither the remarkable premium increases nor the subsequent market softening seen in some other insurance market segments in recent years. Environmental premium increases have remained fairly constant, with most product lines producing average increases in 2004 under 20 percent. We do not expect this situation to change significantly in 2005.

The Environmental market has, however, exhibited a form of hardening over the past two years as challenges have appeared in both coverage and engineering requirements. A major cause of this trend has been the stance of the limited group of reinsurers that are active in the Environmental area. In the past few years they have been seeking opportunities to restrict the terms of their treaty arrangements with primary insurers. These restrictions (not unlike price increases associated with hard market conditions) are often passed along by primary insurers. There are, however, some indications that this pressure has begun to ease.

The total market capacity available from the primary Environmental markets has reduced somewhat to around $500 million in the past few years, mainly as a result of the general hardening of reinsurance market conditions. Some Environmental insurers are able to provide limits of up to $100 million for a single placement, and since very few projects require limits in excess of this figure, the reduction in total
market capacity has not been problematic. Where higher limits are required, it is possible to build capacity by developing layered programs with different insurers. In some cases it may also be necessary to access facultative reinsurance markets.

As general insurance market conditions continue to improve, we foresee more capacity becoming available for primary Environmental insurance placements.

**Product Developments**

Environmental insurers launched an array of new product offerings in 2004. These include a new web-based tank program and a number of product line combinations designed to provide more cost-efficient solutions on a single policy form. Some of these new products are outlined in the Insurer Developments section below.

Liability Transfer and Guaranteed Fixed Price Remediation programs are playing an increasingly prominent role in the management of legacy liabilities as organizations seek to present clear and credible evidence that these liabilities are being efficiently managed, funded and transferred. A prerequisite for these programs is a Cleanup Cost Cap policy – often combined with an associated funding mechanism. Environmental insurers are expanding their presence in this specialty area in response to an upsurge in relevant opportunities, especially in relation to the increasing number of privatization initiatives.

In the spring of 2004, AIG announced its withdrawal from the Secured Creditor market. Originally introduced in the late 1990s, Secured Creditor policies address lender liability exposures. They have become a standard requirement for many financial services companies, especially those concerned about the potential impact of environmental issues on the value of real estate collateral.

Some of the Environmental insurers offering Secured Creditor policies have experienced adverse loss results from this product and have been progressively limiting coverage in past years. There are still a few carriers offering Secured Creditor products, but buyers can expect fairly rigorous underwriting protocols and increasing rates.

**Insurer Developments**

**ACE Environmental**

Now entering into its third year, ACE Environmental Risks continues to offer a range of pollution products including a new follow-form excess policy. ACE Environmental Risks continues to work closely with the traditional primary and excess casualty units of ACE USA to offer a whole-account approach to environmental risk. In the past year, ACE expanded into the Midwest region by adding an underwriting team in its Chicago office. ACE is also doing the same in the Western region by building a new environmental team in Los Angeles.

For 2005, we understand that there will be no major changes in ACE’s underwriting appetite. Capacity for its Remediation Cost Cap product will remain at $10 million, and at $25 million for other product lines. ACE launched its online underground tank underwriting platform (Tanksafe) in 2004 and will be launching its online Contractors Pollution Liability underwriting platform in the near future.

Looking further forward, ACE is developing a combined GL, CPL and Errors & Omissions policy form. ACE is expected to increase staff and focus more on international opportunities.

**AIG Environmental**

AIG remains the largest Environmental insurer, maintaining a capacity of $100 million and the ability to write a range of multiyear contracts. AIG also leads the market in the use of blended finite risk programs that support long-term, multiyear policies.

In 2005, AIG aims to increase the use of its EAGLE® product, which is a combined General Liability and Pollution Legal Liability form. AIG will also continue to offer an Eagle Umbrella product with a combined capacity of $20 million. For conventional (i.e., non-finite) programs, AIG will seek to limit policy terms to three to five years and will be selective in offering longer policy terms – up to a maximum of 10 years.
AIG will continue to provide Contractors Pollution Coverage on an occurrence basis for multiyear terms, with mold coverage provided on a claims-made basis.

Arch Insurance Group
Arch is now entering into its second year of providing Environmental products. It offers coverage on both a primary or excess basis for most products with limits up to $25 million. Product offerings include Pollution Liability, Environmental Consultants Professional and Pollution Liability, Contractors Pollution Liability and Combined Pollution Products.

An example of one of Arch’s Combined Pollution Products is its Environmental Multi-Line Policy, which provides General Liability, Contractors Pollution Liability and Professional Liability under one form. The General Liability and Contractors Pollution Liability portions of this combined form may be offered on a claims-made or occurrence basis. Arch is able to provide claims-made coverage for mold on most product offerings.

The majority of Arch’s business is written on an annual term basis; however, it will consider multiyear terms on a case-by-case basis. On multiyear terms, reinstatement of limit options can be considered and for those products with multiple coverage parts multiple aggregates can also be considered.

Chubb Environmental
The past year was one of restructuring for Chubb Environmental after the loss of a significant portion of its underwriting resources in 2003. Chubb has underscored its commitment to writing Environmental business by adding new staff and retaining much of its existing renewal book. It has added underwriting staff in Los Angeles, New York, Texas, Boston, Pittsburgh and will look to add staff shortly in Chicago. It is beginning to expand its outlook and entertain new business opportunities.

Chubb has developed very competitive mold coverage, providing first-party remediation coverage with no construction defect exclusion. Further, mold coverage is provided for third-party bodily injury and associated legal defense costs; Chubb will consider third-party property damage on a case-by-case basis.

In 2004, Chubb experienced most of its growth in transactional business including mergers, property divestitures and acquisitions. It also experienced growth with real estate portfolios, fixed-based operators, manufacturers and energy risks. With respect to its Contractors Pollution Liability Product, most placements were project specific. Chubb anticipates that these growth areas will remain consistent through 2005, with capacity remaining at $50 million.

Gulf
Gulf exited the Environmental marketplace following its purchase by St. Paul Travelers. In-force Environmental policies will be honored, with servicing to be handled out of Georgia and Texas. Further, Gulf was offering a straight rate pro-rata return on any Environmental policy cancellation even if the policy premium had been deemed 100 percent minimum earned. For those policies coming up to expiration, Zurich has purchased the renewal rights to Gulf’s Environmental book of business.

Liberty
LIU Environmental continues to be an important Environmental market for straightforward placements. Capacity remains at $25 million. LIU will continue to emphasize annually renewable business although it will consider multiyear terms on a case-by-case basis — typically on its Site Pollution Legal Liability product and project-specific Contractors Pollution programs.

In 2004, LIU experienced the most growth from its storage tank and Contractors Pollution products. LIU is also a Professional Liability market with the ability to offer a combined Contractors Pollution and Errors & Omissions coverage geared specifically for Environmental services firms. LIU expects these growth areas to remain the same for 2005.

Quanta
Established in 2003, Quanta Capital Holdings Ltd. is a Bermuda holding company providing specialty insurance, including Environmental products. In September 2004, Quanta acquired Environmental Strategies (now known as ESC), which for the previous 17 years operated as an independent, privately owned company providing Environmental management and consulting services. Quanta's goal in this acquisition is to develop technically advanced Environmental risk underwriting and assessment capabilities.
With a capacity of $50 million and the ability to provide increased capacity of up to $100 million or more on specific deals, Quanta’s Environmental product offerings include Pollution Legal Liability, Remediation Cost Cap, Contractors Pollution Legal Liability, Environmental Errors & Omissions Coverage as well as Lenders Environmental Site Protection (Secured Creditor Liability). Quanta maintains the ability to offer multiyear policy terms as well as finite and excess programs. In addition, Quanta continues to offer its liability buy-out product, Quanta Liability Transfer, through ESC.

**XL Environmental**

XL will continue its strategy of offering clients fully integrated environmental risk solutions. One of its key growth objectives is to expand its international business by developing relationships with brokers on a global basis. Domestically, XL will look to differentiate itself by maintaining a high-service posture and capitalizing on its strong internal risk control and claims management resources.

XL offers multiyear programs but is aggressively pursuing annually renewable pollution business, especially with the manufacturing sectors. XL is able to cover mold exposures, subject to a sub-limit, via a competitive mold endorsement. XL's capacity remains at $50 million.

In 2005, XL plans to increase the availability of its Remediation Cost Cap product while still focusing on those contractors and consultants that are prepared to commit to developing a long-term relationship with XL.

**Zurich North America**

Zurich North America is continuing its strategy of offering insurance products to corporations, municipalities and local governments for the full range of potential environmental liabilities — from compliance with underground storage tank regulatory requirements to complex Superfund or legacy contamination liabilities. Zurich continues to offer multiyear term options for both historical and current operational conditions. It is willing to consider up to five years on industrial exposures and up to 10 years on real estate exposures that do not include industrial exposures.

**International Markets**

AIG, XL Environmental, Quanta, Chubb and Zurich are actively underwriting Environmental insurance business in Europe. London is still the focus for much of the Environmental business written outside of North America, though some insurers have established dedicated Environmental teams in other territories and can provide local servicing and even policies in local languages. AIG for example has a local Environmental presence in a number of countries including France, Germany, Sweden and Australia. We expect some of the other Environmental insurers to expand their presence in coming years.

**A View Forward**

Continued market growth is being fueled by the increasing institutionalization of the purchase of Environmental coverages. The drivers of this growth include:

- Increased emphasis on corporate financial disclosure and corporate governance obligations
- Greater penetration of the M&A/divestiture market
- Ongoing expansion of privatization initiatives
- Greater use of fixed-price contracting within the environmental services industry
- Increased market awareness and product breadth

In the meantime, the current Environmental insurance market continues to provide competitive pricing and flexible terms and conditions. The likelihood of further market growth is considerable since overall penetration is still relatively low, particularly outside the US.
The risk profile of virtually every industry group touches the basic lines of insurance and some specialty lines as well. Because of the complexity and variety of their operations, financial institutions may face more specialty insurance exposures than any other industry sector. The following is a representative list of routine FI activities that generate a host of risk management issues:

- Owning aircraft or operating an aircraft leasing program
- Financing or owning a construction project
- Financing a marine vessel
- Rail, auto and equipment leasing
- Real estate lending (with attendant Property and Environmental exposures)
- Owning merchant banking operations
- Operating branch banking locations
- Offering online banking services

As a result, just about every article in this report can apply to financial institutions. Below we highlight trends and developments in the industry and their impact on risk management.

**A Rough Century So Far**

Financial institutions have had some very difficult issues to address over the past few years.

- Ensuring ongoing operations after Y2K
- The requirement to clear trades in fewer days
- Concentration and contingent business interruption risks that resulted from 9/11
- Insider and unauthorized trading
- Mutual fund issues
- The advent of electronic crime and network liability
- Ongoing investigations into various insurance products, including life and financial reinsurance

All of these have demanded that industry risk managers and their insurance partners be creative and focused in identifying, measuring, minimizing and/or transferring these risks.

The insurance marketplace, in both the traditional and alternative forms, has provided products, or at least possible solutions, for many of these issues.

**Cyber Insurance**

Increasingly, customers of financial institutions expect the convenience of accessing their accounts via the internet, and with it come unavoidable risks. Identity theft, online banking, "phishing" and worms/viruses are among the major exposures that result from our increasingly electronic means of conducting financial transactions. ("Phishing" is the act of using bogus emails and fraudulent web sites to deceive recipients and users, often with the aim of acquiring confidential information – passwords, account numbers, credit card information, etc.)

Traditional insurance coverages, including Property, Casualty and Crime policies, cover these risks only partially, but several Cyber insurance products are now available to fill the gaps. Recent industry surveys reveal that cyber crimes are on the rise, and that many businesses feel that their cyber protection, both in terms of digital security and insurance coverage, is adequate. Many are not aware of the gaps in coverage, but as they become aware, solutions are readily available.

**Captives**

Establishing captive insurance companies is a familiar tool for transferring risks. Recently, financial institutions began to use captives to address terrorism exposures, in connection with the Terrorism Risk Insurance Act (TRIA). Captives can function as acceptable insurers that can be used to access the coverage afforded under TRIA.

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Financial institutions can also consider participation in certain industry association captives. ICI Mutual, for example, is geared to providing Mutual Fund D&O/E&O and Bond cover for its insureds. It has been in place for over 15 years. Another was created by a consortium of securities industry firms to provide Excess SIPC to its members. Its genesis will be discussed below.

Reacting to Basel II
On June 26, 2004, the Basel Committee on Banking Supervision published its "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," familiarly known as Basel II. Its enactment will give Basel II the force of law within the EU. In the US, many institutions are dealing with the question of whether or not to adopt the capital requirements of Basel II.

While only the largest institutions are required to fully comply in 2007, many others are now deciding if they will voluntarily adopt Basel II’s Advanced Measurement Approaches or opt out. Those that are required to comply are aggressively determining precisely what their operational risks are and whether the insurance policies they currently purchase are responsive to these risks. Mapping their risks to their insurance policies is a critical piece of their reviews.

Many databases have been created to assist these institutions, as they must use not only their own data but that of the industry as a whole. These databases combine many publicly known matters with proprietary losses, and also track insured and uninsured losses. These subscriber-based databases represent a considerable opportunity for FI risk managers to expand their ability to analyze the risk profile of their industry and tie it back to their own risk transfer purchases — a mechanism that will also enable them to maximize the credit they will be able to take against their operational risk capital charges.

Consolidation Marches On
In 2004, consolidation continued in the financial sector. Many of the largest money center banks have now merged to form some of the world’s largest diversified financial institutions. In addition, solid regional banks are merging with larger banks that are seeking to fill in niche markets with significant partners. Insurers and securities firms are not immune to the merger bug. The recent combination of the St. Paul and Travelers is a dramatic example.

Excess SIPC
For over 30 years, Aetna and its successor companies offered coverage to sit in excess of the protection provided by the Securities Investor Protection Corporation (SIPC) and the Act that created it. This coverage continued, essentially without loss, until late in 2003, when Travelers and other domestic insurers decided that they no longer wanted to offer the cover.

In the face of this loss of capacity, a large group of FI risk managers, each with significant securities operations, banded together to create an association insurer offering Excess SIPC coverage to its membership. Many of the largest firms now purchase the cover from this insurer. Many others purchased protection from London, modifying a form that has been available for many years. One Bermuda-based carrier offered a form of the coverage late last year. Taking a different approach, several large-name firms decided to stop buying the coverage entirely, confident of their ability to address the concerns of their investing clientele without the protection.

Markets Serving Financial Institutions
There are many insurers offering dedicated financial institutions capabilities. Those that have fully integrated FI departments offering a broad spectrum of coverage include:

– Chubb
– St. Paul Travelers
– Zurich

Others carriers with product-specific teams of highly skilled specialists are:

– AIG
– ACE
– The Hartford
– CNA
– AXIS
– XL
– Lloyd’s and the London companies
Cautious optimism was the byword for Healthcare Professional Liability (HPL) in 2004. A number of insurers saw improvement in their results, based on stringent underwriting, rate adequacy, flat claim frequency trends and an improvement in claim severity trends (although the issue of improvement in severity is a subject of debate). With an influx of new capital, pricing has stabilized in most segments. Many think that the market is now in balance between buyers and sellers, with underwriters enjoying rate adequacy for the first time in years.

The market continues to be relatively disciplined; no companies appear to be underpricing their products to gain market share or meet growth expectations, as they did in the 1990s. The moderation of pricing increases is good news for healthcare buyers who have always desired stability and predictability for what has become one of their largest budget items. The market competition for good healthcare business that began in 2003 continued in 2004, with some exceptions for territory and industry segment.

Other notable trends include:
- Moderate success in the enactment of malpractice reform legislation. With the US presidential candidates both having promised reforms, the degree of political and media focus on the problem has been unprecedented. Malpractice reform initiatives proceed in many states.
- More healthcare buyers, particularly institutional accounts and large physician groups, are examining self-insurance vehicles in an effort to control costs. The vehicles include alternative risk financing strategies ranging from increased deductibles, self-insured retentions at various levels and the creation of captives and risk retention groups.
- There were a number of carriers that experienced ratings downgrades in 2004, but fewer than in recent years. Carriers receiving downgrades included AP Capital, GE Medical Protective, The Doctors Company, MLMIC (now unrated, along with subsidiaries OHIC and Princeton), HANYS, PPIC and Converium. Converium’s downgrade affected many reinsureds and closely followed the exits of PMA Re, CNA Re, and ERC from the medical malpractice treaty reinsurance segment of the marketplace.

**Underwriting Focus**
Malpractice carriers continue to be careful and discerning in their underwriting analysis, with special focus on territory, attachment points, limits and account-specific experience. Underwriters are more comfortable with the higher attachment points of recent years, and they prefer that no aggregate attachment be offered. Thus most institutional retentions are on an each-and-every basis. In all industry segments, there is heightened scrutiny of clinical risk management programs and protocols, patient safety initiatives and technology, and quality improvement programs. Staffing levels, particularly for nurses, are also key factors in the underwriting of the institutional segment. Typical coverage restrictions or exclusions include punitive damages, terrorism (available on a buy-back basis), mold and sexual abuse claims.

The most desirable classes of business continue to be miscellaneous healthcare facilities and community hospitals. The most distressed segment is physicians and surgeons with continuing issues of affordability in almost all states, and availability problems in some states and territories.
HPL Segments

Primary HPL
This market segment has become more competitive with the entry of new carriers in recent years. These include Darwin, Hudson Insurance Group, Arch, and ACE USA. The newest entrant in Primary HPL is OneBeacon. Provider-owned (both physician- and hospital-sponsored) companies control major market share in this segment but are being challenged by newer and older entrants. Commercial carriers such as AIG, Chubb, CNA, GE ERC, and Zurich will write Primary HPL within their own guidelines, subject to such considerations as account size, territory and loss history. First-dollar coverage is difficult but not impossible to find for this line, with most carriers requiring a minimum deductible of $25,000. Pricing has stabilized. Buyers should expect 2005 rates to remain flat or rise moderately (up to low double-digit percentages).

HPL Excess and Reinsurance
The HPL excess and reinsurance segment softened in 2004 after a period of extreme hardening. There has been more competition in this segment as more capacity has become available, especially in the domestic and Bermuda markets. The London market is still a vital player as well. Competition has led to more underwriting creativity in the form of swing programs, inner aggregates, buffer layers, finite risk and a limited return of integrated risk programs.

ERC, long-committed to occurrence coverage, has stated that the coverage will no longer be offered on new business. There is some occurrence coverage available in the marketplace, but it is very limited and pricey.

Significant markets include AIG, Am Re, Arch, AWAC, Berkley Medical Excess, Catlin, Chubb, CNA, Darwin Professional Underwriters, Endurance Specialty, GE ERC, Hanover Re, Max Re, OneBeacon, Renaissance Re, XL and Zurich.

Pricing at renewal will be mostly flat to single-digit as underwriters strive to obtain rate increases to at least match loss trends. Slight decreases in this segment may be possible for accounts with good experience.

Physicians & Surgeons
This remains the most distressed of all HPL segments. While most of the segment experienced single to high double-digit increases, some states and territories and some specialty classes saw triple-digit increases in 2004.

Organized medicine has never been more focused on malpractice reform and lobbying has helped produce favorable legislation in more than 20 states over the last three years. However, the long tail of medical malpractice means limited price relief so far for physicians and groups. While the main issue in this segment is affordability, availability is a question in certain states and territories. There are no longer any physician carriers truly willing to write on a national basis. Few companies are willing to serve as fronting carriers. This segment continues to be dominated by provider-owned carriers, particularly those members of the Physician Insurers Association of America (PIAA).

The most troubled specialties appear to be radiology, obstetrics/gynecology, neurosurgery and emergency medicine. All four of these specialties have experienced very adverse aggregate loss experience in recent years along with dramatic premium increases, and fewer carriers are willing to write them.

Larger physician practices have created or are considering such self-insurance vehicles as captives and risk retention groups. New physician carriers have been created in many states. Both the newly created physician self-insurance vehicles and carriers face the hurdles of adequate initial capitalization and long-term viability. Hospitals continue to be pressured by medical staff to assist key physicians with the cost of liability insurance in order to support physician recruitment, retention and on-call coverage.

Rate increases for physicians and surgeons are leveling off. This segment should see rate increases ranging from a low of five percent to 25 percent with some states, territories and specialties experiencing even higher increases in 2005. Even with modest increases, premium prices remain at all-time highs. The issue of affordability continues to directly affect the delivery of healthcare nationally as doctors curtail certain services in response to insurance-driven financial considerations.
Healthcare Professional (continued)

**Long-Term Care (LTC) Facilities**
The long-term care facility segment was the most distressed a mere two years ago, but stability returned in 2004. A few new entrants and increased competition have helped here, as have moderating loss trends. Nonprofits, especially those with religious affiliations, are viewed by underwriters more favorably than for-profits. Assisted-living facilities remain an underwriting challenge because of that industry’s lack of uniformity in the levels of care and service provided by its members. Certain states and territories are difficult to place. Abuse and sexual abuse claims are often excluded or sub-limited.

The number of carriers underwriting this segment remains small but there have been new entrants in recent years. One notable trend is the entry of a number of small regional carriers that confine their underwriting to a state or region. AIG is a major insurer. CNA prefers nonprofits but is reentering certain states with favorable tort reform legislation. Other carriers include James River, American Empire, Old Colony, Evanston and OneBeacon. Evanston and OneBeacon were new entrants in 2004. The London market is an important and active alternative to the domestic carriers. Most carriers have their own niches and do not necessarily write all risks in all territories. Insureds with poor loss experience are difficult or impossible to place. Many large operators of long-term care facilities have either created or are continuing to examine alternative risk transfer vehicles.

**Managed Care Organizations (MCOs)**
This HPL segment continues to have fewer markets entrants than any other. Currently there are four participants: AIG, Chubb, Darwin and, new in 2004, OneBeacon. There are also a handful of excess markets for MCOs, including London and Bermuda. The entry of Darwin in 2002 provided additional capacity and injected some much needed competition. OneBeacon’s entry should serve to do the same.

The US Supreme Court decision in *Aetna Health Inc. v. Davila* was an important victory for MCOs because it upheld the ERISA preemption. Member coverage disputes must be brought in federal courts where remedies are far more limited than in state courts. However, underwriters have reacted cautiously to the decision as it does not preclude liability for other types of litigation such as class action litigation initiated by providers. Accordingly, *Davila* will not measurably impact rates in this segment. MCO underwriters are concerned that the success of tort reform legislation may leave them as the deep pocket in litigation since they are rarely protected under the new laws enacted over the last three years.

As in other segments, new entrants and more competition have softened rates for MCOs. Most saw flat renewals or single-digit increases in 2004. In 2005, MCO buyers can expect the same, and the possibility exists for single-digit decreases on accounts with good experience. Attachment points have remained unchanged. Carriers are more open to manuscript wording to accommodate coverage needs than they have been in recent years.

**The Major Trends**

**Claims Severity and Frequency**
For the first time in many years, we have seen conclusive evidence that medical malpractice claim severity has leveled off. Jury Verdict Research’s annual Verdict Survey released in April 2004 showed that the verdicts for medical malpractice cases rose only fractionally in 2002 after climbing dramatically in the late 1990s. On the other hand, verdicts have not decreased and, in fact, have leveled off at historically high levels.

Frequency appears to be flat nationally. In fact the National Practitioner Data Bank (NPDB) data for the first half of 2004 indicated a potentially significant drop.

**Tort Reform**
The industry has had moderate success in obtaining tort reform in more than 20 states since 2002. The most dramatic example was in Texas, which also successfully passed a constitutional amendment that effectively prevents the appellate courts from overturning malpractice reform laws. However, malpractice reform legislation varies greatly by jurisdiction, and almost all
efforts fell short of the benchmark set by the MICRA laws enacted in California in the 1970s, particularly the cap on non-economic damages of $250,000.

In the recent US election, four states voted on reform measures primarily focused on limiting damages. In Nevada and Florida, measures passed, while in Wyoming and Oregon they were narrowly defeated.

Meanwhile, in 2004, Massachusetts joined the list of states considered to be in crisis by the American Medical Association due to their poor malpractice liability climate. Others are: Pennsylvania, Texas, Florida, Mississippi, Nevada, Ohio, New York, New Jersey, Oregon, Washington, Georgia, Missouri, Arkansas, Kentucky, Connecticut, Wyoming and Illinois.

ART Strategies
Over the past five years, many healthcare buyers have adopted alternative risk transfer (ART) strategies – either voluntarily or not. Mandatory minimum deductibles and higher attachment points have driven healthcare buyers to examine the full range of alternative risk transfer vehicles. These include deductibles, self-insurance trusts (nonprofits only), captives, risk purchasing groups and risk retention groups. The number of healthcare captives has exploded in recent years as has the number of risk retention groups formed by healthcare buyers, especially physicians.

Continued turmoil in the physicians and surgeons segment is one of the main drivers of interest in ART options. Large groups, especially those with good experience, have been examining and adopting ART vehicles. Many hospitals and integrated delivery systems have created sponsored malpractice insurance programs for their medical staff, particularly in the most distressed states. Hospital captives have been successful in providing affordable coverage. These programs are costly but in many cases have become essential in ensuring that vital physician services and on-call coverage remain intact.

The moderation of pricing increases is good news for healthcare buyers who have always desired stability and predictability for what has become one of their largest budget items.
Marine

The Marine market breathed a collective sigh of relief following the trouble-free 2004 Olympic Games. Vessels valued in excess of $2 billion — many with a more valuable passenger load — were amassed around Athens, presumably all fully protected against War perils, including terrorist attacks. As the Olympic Games finished, however, the hurricane and typhoon season was about to begin, and it delivered a reminder of how exposed the direct and reinsurance markets are to Marine shock losses.

With the losses from Hurricane Ivan still mounting, the Marine market is currently navigating an uneasy passage between underwriting results, market conditions and the requirements of capital providers. So far, most Marine lines are fairly stable.

       — Hull & Machinery rates have seen successive rises over the past three or four years, and while not quite enough to ensure a comfort factor for insurers, the increases are tailing off.
       — Hull Increased Value rates are not at rock bottom, but they are low; capacity is still available.
       — Cargo is stable and providing modest profits to carriers.

       — Hull War rates are off their post-9/11 peaks and declining.
       — Cargo War rates are no longer dependent on the recommendations of the Cargo War Risks Rating Committee; this may signal a decline in prices.
       — The Building Risk line has suffered some severe blows in the past three years and rates have hardened.
       — Energy rates are finding a lower plateau after the massive increases of recent years.
       — Protection and Indemnity (P&I) needs to generate more money into its unique system, and rates are likely to rise.
       — The Marine Liability market is stable.

Before the recent spate of hurricanes and typhoons in the Florida area and Japan, the Marine reinsurance market was facing pressure to reduce rates in 2005. Now rates are likely to remain stable. Not all of the natural catastrophes will in the end have a major financial impact on the Marine reinsurance accounts, but they are almost certain to hit the wider reinsurance market. The losses from Hurricane Ivan are still accumulating: Offshore Energy claims at the time of this writing amount to approximately $1.5 billion. This number is likely to climb due to claims under additional covers, such as business interruption and undersea pipelines, which await survey. Ivan now qualifies as the largest Marine and Energy loss ever, surpassing Piper Alpha. The Ivan loss will test the catastrophe monitoring capabilities of underwriters. Lloyd’s, for example, has set store by its realistic disaster scenario studies (RDS), which are kept current by all syndicates; the industry will be waiting to see if the final loss figure corresponds to expectations. Only time will tell what the market’s present state of shock will mean for upcoming renewals.

Losses in 2004

Hurricanes were not the only source of Marine claims in 2004.

       — The Pride of America sank while under construction in the Lloyd Werft Yard in Germany.
       — The Hull line was hit early in 2004 by the Rocknes sinking off Bergen.
       — In Onshore Energy, which impacts Marine and Energy reinsurers, there were over $900 million in losses (arising from six separate claims) in the first two months of 2004 alone.

Headlines and Highlights

       — Hurricane Ivan now qualifies as the largest Marine and Energy loss ever, surpassing Piper Alpha.
       — P&I Clubs are looking to bolster free reserves by raising rates at the forthcoming February 2005 renewals, with increases likely to range from five to 20 percent.
       — Building Risk losses over the past two years approached $650 million — a major hit to a line of business with annual premium income ranging from $500 million to $750 million.
       — The administrative burden and expense of meeting Solvency 2 requirements has caused two reinsurers to cease writing Marine business. Others may follow.

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Marine Lines

Hull & Machinery
Direct Hull & Machinery insurers are looking for rate rises, but good quality fleets with good claims records will renew largely as before, and some buyers may be able to win small reductions. Deductibles are not expected to change. Increased Value and/or Disbursements coverages remain competitive, but have risen from recent lows.

War (Hull and Cargo)
The Hull War market is generally seeing reductions as the market adjusts to a more competitive post-9/11 environment. Some markets are still trying to apply a rate of 0.04 percent but this is being broadly reduced by slip deductions, concessions on hotspot additional premiums or straightforward rate cutting. The Cargo War market has been compelled by the terms of the Enterprise Act of 2002 to abandon the Cargo War Committee’s recommended rating schedule, which published recommended premiums for cargoes being transported to various political hotspots. Again, insurers are hoping to maintain post-9/11 pricing for Cargo War, fixed at 0.05 percent, but this is under pressure. The demise of the recommended rating schedule may precipitate a drastic change in approach to War and Strikes insurance, which customarily covers terrorism.

Protection and Indemnity
Protection and Indemnity (P&I) offers liability and ship owner’s interest cover to ship owners up to a potential limit of around $4.5 billion. The vast majority of vessels are covered within mutual clubs that operate under an association, which facilitates the coverage of the larger, more volatile vessels (tankers and passenger vessels, for example) through the practical expediency of a combined reinsurance program.

P&I Clubs are looking to raise rates at the forthcoming February 2005 renewals. Increases will likely range from five to 20 percent, as P&I Clubs attempt to bolster their free reserves. P&I underwriters are also governed by the looming threat of Solvency 2, updated insurance industry regulations for the European Union, which is likely to have a bearing on the market and put particular pressure on the smaller Clubs. The number of P&I claims remains stable, but the quantum of these claims is going steadily upwards. The P&I market must also brace itself for an increase in the limitations on passenger vessels, which may go into effect in mid-2006.

The collective reinsurance of the P&I Clubs – the International Group of P&I Clubs’ protection – is likely to remain stable for 2005, barring any major changes in reported claims or exposures between now and February 2005. The International Group’s pooled retention is to be increased to $6 million from $5 million.

Building Risk
Building Risk business has been the focus of much recent attention for two principal reasons: high building activity and the large losses of the past three years. Orders for new ships will keep builders busy for years. China’s seemingly insatiable demand for commodities to fuel its rapid growth has filled the order books of shipyards across Asia. China itself is planning to develop the world’s largest shipyard within the next 10 years.

The recent string of losses began in October 2002 with the Diamond Princess fire in the Mitsubishi Yard ($230 million). The following year saw two major losses in the Fincantieri Shipyards ($110 million) with Typhoon Maemi striking at the heart of the Korean shipbuilding industry in October 2003. In January 2004 the Pride of America sank in a storm in the Lloyd Werft shipyard, costing over $200 million. In the same month a yacht owned by Latsis was badly damaged. Together, these losses amounted to approximately $650 million. For a line of business that has an annual premium income in the region of $500 million to $750 million, these losses are indeed major. The market has hardened in response and markets are now enjoying some strategic pricing leverage, particularly on larger projects.

Market Notes
Much attention has been paid to the struggling Converium as it endeavors to win back the support of the financial markets and secure a credible renewal book of business in 2005. Euclidean Syndicate1243 has failed to raise the requisite support to go.
forward into 2005 and the Syndicate’s liabilities are to close into the BRM Syndicate 1861. In 2004, we saw the successful integration of the Gard Services Hull and Machinery account (previously underwritten on behalf of If P&C) under the control of Gard P&I Club.

One of the new entrants into the market is Endurance, which is focusing on Marine reinsurance in the US and UK. Arch is repositioning its Marine insurance entities into London and will provide meaningful capacity. Limit Underwriting has closed down Stephen Gargrave’s Syndicate and aims to renew the combined business in Colin O’Farrell’s Syndicate. The Fund American Reinsurance Company’s Stockholm branch has taken over the Sirius International, but has largely merged into the Sirius structure. Gothaer Re and Tryg Baltica have ceased writing reinsurance in light of the mounting bureaucracy and expense involved in fulfilling the needs of Solvency 2. In time, other insurers may also find these demands unsustainable.
The real estate and hospitality industries have three main factors in common: location, location, location. In risk management terms, both must cover hard assets and both are concerned with the safety and security of the people in their buildings. The differences between them may be equally obvious – hotels are labor-intensive businesses and real estate companies usually are not. The Willis Real Estate & Hospitality Practice serves both and so will this report.

Not only have the softening market conditions of the current insurance cycle brought good news on rates for much of the real estate and hospitality sector, but some carriers now see this sector as a growth area. Insurers are hiring dedicated underwriters for these risks, and some excess programs seem particularly responsive.

Given the recent demise of several carriers, real estate and hospitality organizations are concerned with the financial stability of the carriers in the field. This situation is more acute for assets in the CMBS (Commercial Mortgage Back Securities) marketplace. CMBS loans must be protected, according to regulations, by AA-rated insurers. This limits the field of choices for insureds and can also increase costs.

**Points of Concern in 2005**

Several perils have risen to the top of risk managers’ lists of concerns. The continued activity in first- and third-party mold claims has become a huge issue for hotels and real estate owners. Coverage can be difficult to come by and expensive.

Security and the peril of terrorism are of concern, especially to properties in central business districts (CBDs). Security requirements often involve increased hiring of personnel or the comparable expense of hiring a security company, either of which increases operating costs. In terms of insurance coverage this sector joins the chorus of many who are hoping for the extension of TRIA (the Terrorism Risk Reinsurance Act) in the US beyond its current expiration date of December 31, 2005. Without TRIA, many fear significant disruptions in coverage for acts of terrorism, which would be a potentially serious problem for property owners with assets located in CBDs.

With responsibility for protecting their employees, tenants are also concerned about terrorism, and frequently ask for details regarding the safety and security programs that their building owners put in place.

The labor-intensive hotel industry – along with any real estate company that has many employees – is concerned with Workers’ Compensation and Employee Benefits costs. A recent survey of hoteliers indicated that after energy costs, their number one financial concern is insurance-related labor costs. Four years ago, Workers’ Compensation was barely registering on radar screens for these risk managers. Now, climbing rates, legislative action and increasing numbers of coverage options demand attention.

**Cyber risks** – those related to the use and transfer of information via computers and computer networks – are rising for all businesses but are especially troubling for hotels. Hotels face exposures on several fronts. First is their reliance on computers for everything from reservations to property management. Another is the use of computers by hotel guests connecting to the internet through hotel systems, especially...
Several exposures exist: cyber crimes committed by guests against other guests or the hotel; crimes committed by outsiders directly against guests; and crimes committed by outsiders, or insiders, by hacking into hotel or guest computers. Liability issues abound.

Most standard Property and Casualty policies cover some form of cyber crime, and most have serious gaps in that coverage. Cyber products are more and more frequently being used to fill those gaps.

The cost of building materials is a major issue for any company involved in construction. The fast-growing economies of China and India are driving up the demand for steel and concrete, and with it the prices. The effect on insurance has to do with replacement values that may be written into insurance programs. If the costs have risen since the values were determined, then the policies may not cover true replacement costs. Risk managers must keep on top of both the construction marketplace and their own coverage details.

Hurricanes and the Marketplace

Like the many stricken communities in Florida and the Gulf Coast of the US, the insurance marketplace survived the terrible series of hurricanes of late summer 2004. Property underwriters were hit hard, of course, and are now concerned with concentration of risk in catastrophe areas such as Florida, the Gulf Coast and California. As a result, catastrophe modeling has become increasingly important to the optimal placement of risk. Sophisticated modeling tools are available for the task.

Another perhaps even more desirable service needed by risk managers is benchmarking. Since the hard market of the early part of the decade, risk managers have had to look closely at their costs, and in explaining the sometimes eye-popping increases of recent years, have needed to point to the fact that their competition is likely facing similar burdens. Now, as market conditions evolve, benchmarking remains something that insurance buyers expect before they commit to a risk transfer strategy.

Benchmarking is especially important for hotels in the area of Workers’ Compensation and Employee Benefits. Hotels are high turnover businesses, and being located in clusters, hotels often face fierce and direct competition for labor. Moving from one hotel to another is a simple matter for the service industry workers at hotels, and if one property offers an even nominally better compensation and benefits package, the labor force will often follow.
Areas of Conflict
The proliferation of kidnappings in Iraq in 2004 has garnered media attention and prompted nations and other entities to reassess their presence in that country. Islamic militants regard kidnapping as an effective weapon against Western-leaning governments throughout the Middle East and Islamic East Asia. Not only has it proven to generate strong public reaction, but it is nearly impossible to defend against by traditional military means and costs little to accomplish. In several cases, kidnappings in Iraq have been resolved by return of a hostage in exchange for an organization removing itself from the country. Given these incentives, kidnapping may spread from these conflict zones to Saudi Arabia, Indonesia, the Philippines, Malaysia, Northern Africa and other areas of potential Islamic militancy.

Most organizations with operations in these areas purchase Kidnap & Ransom (K&R) coverage. The premium can be significant, but this is understood to be part of the cost of doing business in active conflict zones. Companies with exposures in Iraq and Afghanistan who renewed their programs in the first and second quarters of 2004 saw premium increases approaching 100 percent.

Headlines and Highlights
- Kidnapping, on the rise as a political weapon, is spreading from immediate conflict zones to other areas of potential Islamic militancy.
- Latin America remains the region with the most K&R incidents.
- The cost of coverage is understandably high, but available.
- ACE rejoined the K&R marketplace, teaming up with response consultant Neil Young Associates.
- K&R coverage addresses a number of the financial consequences of piracy – a crime that is on the rise.

Current conditions have also resulted in restricted terms and conditions. Requirements for underwriting information are extensive, although much of the information is typically generated in the process of securing Defense Base Act (DBA) coverage. Most K&R policies exclude Personal Accident (PA) exposures in areas such as Iraq and Afghanistan, but separate War Risk PA policies can be obtained to cover these risks.

Incident preventative activities can help limit premium increases and coverage restrictions. These activities include:
- Travel security seminars
- Hostile environment training
- Site security audits
- Crisis management planning

Some carriers are automatically offering K&R coverage within their DBA programs with an embedded cost. However, stand-alone coverage has several important and valuable advantages:
- More comprehensive
- Easier to benchmark limits
- The most appropriate carrier / response consultant combination can be selected
- Strict confidentiality

Long-Standing High-Risk Zones
Kidnapping for ransom and extortion is also steadily increasing worldwide outside of the regions mentioned above, particularly in Latin America – which remains the location of the most K&R incidents – and to a lesser extent Africa. Incidents in Mexico City have increased at an alarming rate. Pricing, however, remains mostly stable for these risks and renewals are likely to remain flat or incur minimal increases, barring any significant increase in exposure. Capacity remains widely available in the market and has actually increased since 2003, with the addition of ACE to the marketplace.

Corporate Governance
Another factor promoting the use of K&R products is the rising standard for providing safe work environments for employees. When organizations send workers overseas, K&R coverage and incident prevention efforts can go a long way toward mitigating liability questions that may arise.
Special Contingency Risks (continued)

Carriers
ACE joined the K&R market in mid-2004 after a hiatus of several years. The Hiscox Syndicate at Lloyd’s remains the largest underwriter of K&R and related coverage, representing approximately 60 percent of premium volume worldwide. Great American Insurance Company replaced Gulf Insurance Company as the fronting company for Hiscox capacity, which doubled to $50 million in the US in October 2004. Other stable, long-term providers of the coverage include AIG, St. Paul and Chubb. PIA, acting as an intermediary, is also a significant supporter, providing capacity through Lloyd’s or Liberty Insurance Underwriters.

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Note: carriers are able to provide further capacity on a facultative basis.

Response Consultants
The deterioration of the international security environment has inspired many ex-soldiers and law enforcement personnel to offer their services as security consultants. Many assert that they can provide assistance in kidnapping and extortion cases. Few, however, are qualified to handle the complex and sensitive nature of these threats, and the way these threats are handled can mean the difference between life and death. The same cautionary note applies to many of the established response consultants in terms of geographic focus. A company with experience in the patterns, habits and goals of kidnappers in Latin America will probably not be the best suited to management of an incident in the Middle East. Determining which provider offers the right response expertise is crucial. The choice can have a direct impact on whether or not an incident is successfully resolved and can also influence subsequent litigation potential.

Gathering information about response consultants is not always a simple matter. Due to the nature of K&R incidents, those involved either as target companies or response companies tend to keep a low profile. The outcome of incidents is often unknown outside of this small and confidential industry, so objectively evaluating consultants’ work is understandably difficult.

When evaluating the qualifications and appropriateness of a response consultant, we consider the following factors:

- The number of cases where consultants are actively engaged
- Country-specific expertise and local language capability
- The number of responders and their employment relationship (i.e., salaried employee, retained consultant or subcontractor)
- Overall depth of experience of response team members
- Wrongful death history including any threatened or actual litigation
- Operating procedures and philosophy as well as ongoing training
- Financial and operational independence from associated insurance entities
- Exclusivity of relationship: those responders that have signed exclusive relationships with a specific carrier contractually cannot deploy their staff for a company covered by a different carrier — regardless of whether or not this is stated in the insured’s policy.

Response Partnerships in 2004
Response partnerships remained largely intact last year, with a few exceptions. Kroll Associates replaced Pinkerton BRI as preferred responder under the St. Paul program. Kroll reconstituted its response staff last year after briefly leaving the K&R response business following the end of an exclusive partnership with AIG in 2002. ACE, having reemerged as a K&R carrier, has retained Neil Young Associates as its incident response consultant.

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A Potential New K&R Peril
Piracy is on the rise. Taking advantage of the many countries without navies to protect territorial waters, let alone the open seas, criminals and terrorists are unfortunately finding success on the water. Incidents are concentrated in Southeast Asia, but are on the increase in waters around Africa, South Asia and Latin America as well. The number of incidents reported in
2003 doubled those of 2002. In 2003, there were 445 piracy attacks, resulting in 359 hostage takings, 92 deaths and 19 hijackings. The total annual damage from piracy is now estimated at $16 billion.

Typically using speedboats and handheld weapons, pirates take several approaches. Some seize hostages and leave the ships alone. Some hijack ships, change the ship names and flags of registry and steal the cargo. Some incidents are thought to have had a terrorist intent.

K&R coverage addresses a number of the financial consequences of piracy crimes, i.e., detaining or kidnapping crew members and hijacking of a waterborne vessel. We suggest that organizations facing piracy exposures should talk with their broker to consider possible applications of K&R insurance.

When organizations send workers into areas of conflict, K&R coverage and incident prevention efforts can go a long way toward mitigating liability questions that may arise.
Low-scoring games may be disappointing to fans, but low volatility in the Sports & Entertainment (S&E) insurance marketplace was a welcome change in 2004 for most of those seeking coverage for events, athletes and special promotions. The status quo remained in most S&E lines this past year, after several years of high-profile losses and market upheaval. The coming year, so far, appears to be headed in the same "uneventful" direction, but as the New York Yankees and the Boston Red Sox can attest, nothing is guaranteed.

**Event Cancellation Coverage**

The first Summer Olympic Games after 9/11 inspired much concern and worry about terrorism activity and the possibility that some or even all of the Athens games might be cancelled. The International Olympic Committee (IOC) purchased event cancellation coverage for the first time at limits of about $170 million. No disruptions occurred, and apart from the hurricane zone in North America, few large-scale cancellations occurred for any reason this past year.

Headlines and Highlights

- After several years of high-profile losses, the market for most sports and entertainment lines has stabilized – thanks to a year with few major losses.
- Although new carriers did not enter the marketplace, established ones were ready to commit more capacity. For smaller scale risks, such as trade shows and conventions, there is healthy competition to underwrite event cancellation risk.
- Prize and redemption programs remain a powerful and popular marketing tool, and companies are turning increasingly to insurance products to back them up with contingent capital.

New participants did not enter the marketplace, but those in it already were prepared to commit more capacity. For smaller scale risks, such as trade shows and conventions, competition rose enough to turn event cancellation insurance into a commodity business. For the smaller events, for which modest limits are sought, a single insurer can cover the entire exposure, making it easier for buyers to compare the deals offered by competing carriers.

Coverage for large-scale events can also be obtained at limits ranging from $150 to $200 million.

**Weather Coverage**

There’s nothing like a string of four hurricanes making landfall in one season to pique interest in cancellation coverage for weather. Carriers are looking hard at natural catastrophe zones in the aftermath of the seemingly endless stream of major hurricanes that battered the Southeast US during the 2004 season. Typhoons and earthquakes struck Japan not long afterward and contributed to the unease. Coverage is available, but depending on the location, it is more of a seller’s market. In places prone to natural catastrophes, the force of nature replaced terrorism as the hottest topic of conversation in S&E in 2004.

Weather policies come in several types, offering broad flexibility. More expensive, and potentially more valuable, are those programs with specific triggers according to time and place of inclement weather. An event promoter can protect against the possibility that rain will fall during a set time before the event when the most tickets are sold. Such a policy may be triggered even if the sun comes out at game time and the event is sold out.

**Star Performer**

A year ago, sports pages were abuzz with injuries to big stars with big guaranteed contracts, such as basketball star Jayson Williams ($65 million) and baseball player Albert Belle ($35 million). Insurers were stung by the resulting claims, and the market sector hardened accordingly. This year, a lack of major disability claims has calmed the waters. For entertainers far removed from the physical risks of athletics, there is lots of capacity – a single person can be insured readily for limits of $50 to $60 million. More caution remains for star athletes,
with limits down around $30 million for what most team owners consider reasonable premiums. Higher limits are available, but relative costs are higher.

Carriers are still holding to three-year policies in most cases, and that remains the contract length that most teams commonly offer, even if a player seeks a longer deal. This seems to be the case even if teams do not seek insurance to cover their financial liability. The past year has perhaps seen a slight reduction in the number of disability policies bought to cover contracts, but insurance professionals remain key to the business side of the sports and entertainment industry.

Protection for the financial liability that follows the loss of a key performer is available not only with regard to athletes or entertainers who are household names. A key salesperson, representative or executive may be so crucial to the success of an organization that insurance coverage may be appropriate.

**Prize Indemnity and Over-Redemption Insurance**
Prize and redemption programs remain a powerful and popular marketing tool. What’s new this year is a noted increase in the interest shown in backing up these programs with insurance. We have seen this from not only US businesses but their counterparts in Europe as well.

Prize indemnity insurance does more than allow promotional events to offer large, attention-grabbing prizes. Since the policies offer a guarantee on the cost of the event, promoters can use creativity in budgeting and financing the programs. For example, a co-sponsor can be brought in to share in the limelight — and share in the premium payments. The co-sponsors do not face any risk of paying out part of a large jackpot should a lucky contestant make a half-court shot on a basketball court, or kick a ball through the goal posts on a football field.

Similar flexibility is offered by over-redemption policies, which are used to cap the cost of price reduction or give-away programs through coupons, rebates and the like. If companies considering such a program can be assured of a maximum cost, they can budget more accurately, and promote the program without worry that the response might be greater — and more costly — than expected.

**Contract Bonus Insurance**
Another contractual aspect of the sports business world is the incentive bonus. Certain statistical milestones (running for a thousand yards in a football season) and achievement of certain awards (most valuable player awards) can trigger cash bonuses, which can be covered by contract bonus policies. The market for these products has also stabilized.

Team owners and sponsors can insure losses of $1 to $1.5 million in the marketplace. After something of a retrenchment on the part of carriers last year, there is more interest again this year. Insurers are looking closely at how programs are structured and at the levels of self-insurance in the form of deductibles that team owners are willing to take on.

**A Niche Marketplace**
S&E products fall under the broad heading of contingency coverage, and most of the S&E market ends up with Lloyd’s of London. Specialty carriers and MGAs are important parts of the market, though for the most part they are ultimately backed by Lloyd’s paper. In several cases, specific products are dominated by certain specialty carriers, which translates into potential for volatility.

There’s nothing like a string of four hurricanes making landfall in one season to pique interest in cancellation coverage for weather.
Utilities

Heavily regulated until the mid 1990s, most utilities simply passed along insurance costs to consumers via their rate base, obviating the need to struggle with the many risk management options available. With deregulation, all that changed, and in the early years of this new century, risk management in the utilities sector has taken on a new importance. Accelerating the effects of the hardening market of 2001 were many large Property losses by regulated utilities and a number of losses involving new technology in the non-regulated sector. Problems were compounded by the California power crisis of 2001, which launched a period of close examination of the business practices of the industry. The collapse of Enron led to industry changes, including reorganization and restructuring of several large companies, as well as shareholder suits and subsequent losses in the D&O/Fiduciary lines. The Casualty market was next to stiffen, following deterioration in Workers’ Compensation. During this period, utilities also faced the issues of asbestosis and other historical exposures that required bolstering of insurers’ reserves.

The result was drastic movement in rates, deductibles and policy restrictions across all lines of coverage purchased by utilities.

The last few years have seen not only easing of market conditions, but many new products for utilities in response to their now sophisticated risk financing needs.

- Nuclear decommissioning cost cap programs
- Multiyear weather insurance deals
- Counterparty credit insurance
- Alternatives to financial and performance bonds
- Generation spot price volatility covers
- Environmental liability products

Current Market Conditions

Property
Utilities are seeing rate decreases in the range of 15 to 20 percent on standard accounts. Greater decreases can be found for utilities using new technology that is past the prototype stage and is more reliable. While policy terms and pricing seem to be easing, the market in general has been trying to maintain deductibles at levels that help carriers avoid attritional loss experience. We are, however, now beginning to see some movement in retentions as well.

Casualty
Casualty is a very different story. Workers’ Compensation rates continue to rise in certain states and the issue of aggregation of workers can still be a problem for some utilities, particularly in the nuclear sector. For General Liability coverage, most large utilities self insure the primary layer and then purchase Excess Liability programs. The pricing for Excess Liability programs started to level off in late 2003, and in 2004 there has been some evidence of modest reductions in the range of five to 10 percent for good accounts.

The majority of the excess programs incorporate two industry mutuals, American Electric & Gas Insurance Services (AEGIS) and Energy Insurance Mutual (EIM). These companies seem to be trying to hold rates for existing members where possible, but will seek market rates on new business. Competing markets for the first excess Casualty business are AIG, Chubb and Zurich; with the Bermuda markets coming into play on the higher excess layers. For new business these carriers can be competitive with AEGIS and EIM, often putting up rates which

Headlines and Highlights

- Capacity for utility risks continues to grow as markets look for new areas of revenue and recognize the general profitability of the sector.
- Industry mutual insurers provide substantial capacity, and in many cases form the core of a utility’s insurance program.
- Transmission and distribution (T&D) assets, being extremely susceptible to damage from catastrophe perils, have been an excluded class under most Property insurance programs, impelling utilities to look at alternative risk transfer and funding methods — e.g., captives, securitization and pooling arrangements.

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are on the low side of their normal rate plans. However, the continuity credits offered by the industry mutuals usually make the net price offered by AEGIS and EIM fairly competitive.

**Executive Risks**
The Executive Risks market has seen massive rate increases during the last three years across all industry sectors. As in the Casualty market, AEGIS and EIM have dominant positions in the D&O and Fiduciary placements for the utility industry, which has suffered not only from a large number of energy-related losses but also from reinsurance increases brought on by Executive Risks losses across other industries.

During the last six months, however, we have seen AEGIS offering modest rate reductions on primary layers for better performing insureds. Even more promising is the introduction of new capacity for the excess layers, which is beginning to bring down pricing quite significantly in some cases. At the zenith of the hard market, excess insurers were pricing their layers at 90 percent to 95 percent of the underlying layer. We are now seeing the excess pricing in the region of 75 percent to 80 percent of the underlying layer.

Because the excess pricing has been driven in large part by the entry of new insurers into the marketplace, the current pricing is expected to stay fairly flat for the near term. There is concern that pending claims could saddle the markets with excessive cash payments and a rebound in premium pricing could follow. The short-term prognosis is a stable rating base, but that could change if insured losses increase.

**Global Capacity**
The available capacity for utility risks continues to grow as markets look for new areas of revenue and recognize the general profitability of the utility sector. The industry mutual insurers provide substantial capacity for utility risks, and in many cases form the core of a utility’s insurance programs. Between AEGIS and EIM a total of $270 million of capacity is available for Property insurance programs, $135 million for excess Casualty programs and $85 million for Executive Risks.

In the Property sector the median limit of insurance purchased is $500 million, and with available capacity for utility risks of over $2.5 billion (not including FM Global), there is sufficient capacity to cover most limits requirements of utilities. FM Global can do full blanket limit programs and if used in conjunction with other markets, a total of $4.5 billion of capacity is achievable.

The median Casualty limit purchased is $160 million, with some utilities buying limits as high as $350 million. Total available capacity is in excess of $500 million. For Executive Risks placements the median limit is $125 million with some buyers taking up to $350 million. Total capacity currently stands at over $375 million — sufficient to meet the needs of the industry in this line as well.

With a few exceptions the mutuals alone are not able to meet the capacity needs of the utility sector and additional capacity is readily available from a substantial number of insurance carriers actively courting utility prospects.

**Transmission and Distribution Assets**
In recent years, overhead transmission and distribution (T&D) assets have been an excluded class under most Property insurance programs. T&D assets are extremely susceptible to damage from catastrophe perils such as windstorm and icing, and insurers have yet to find a way to provide coverage for the T&D assets at a reasonable pricing level. Risk transfer coverage can be purchased in the market, but it is very heavily rated with prices ranging from 20 to 40 percent rate on line depending on where the assets are located geographically. Most utilities do not see compelling value in these programs. They have self insured the exposure in regulated areas and sought recovery for losses under the rate base via regulatory commissions. Many state regulators allow utilities to build up storm funds over a period of time. State or municipally owned utilities can claim recovery from the Federal Emergency Management Agency for up to 75 percent of their losses, although these payments are often slow in coming.
The available capacity for utility risks continues to grow as markets look for new areas of revenue and recognize the general profitability of the utility sector.

The recent hurricane losses will no doubt put these current T&D schemes to the test. Renewed interest in alternative risk methods is likely, especially given the possibility that regulators will not provide full recovery in the future. Utilities may look again at group captives, which have failed so far mainly due to the lack of significant numbers of insureds to provide sufficient spread of risk. More recently, companies with significant risk exposure have looked to the financial markets for securitization, and this may be an option for larger utilities, or more likely, groups of utilities pooling their exposures.

**Terrorism Coverage**

There has been a marked increase in the percentage of utility companies taking terrorism coverage – doubling to over 46 percent in the past year. This is due in part to rate reductions, but also due to the fact that the Sarbanes-Oxley Act is making utilities look at their overall risk profile and make sure that their risk mitigation strategy cannot be second-guessed.
Economy and Strategy

Even as hard market incentives for forming captives faded during the recent softening turn in the insurance market cycle, captives continued to expand as a risk management option, proving that captives have a strategic value that goes beyond price. Cost, of course, remains a factor. The still-elevated cost of excess limits and aggregate coverage has impelled captive owners to expand the lines they write and take on more risk, and has prompted formation of new pure and group captive companies. The rate of formation remains at an all-time high in the US. Year-over-year written premium growth hovers around 20 percent.

New captive formations are most common in stressed risk classes: e.g., Construction and Healthcare. Healthcare entities, including hospitals, integrated delivery systems, nursing homes, and physicians, continue to be the single most significant source of new captive formations, especially in the arena of risk retention groups (RRGs). "RRGs in the Healthcare sector now constitute more than half of all operating RRGs (55 percent), representing the fastest growing segment of the RRG marketplace," according to Risk Retention Reporter. The steep rate of increases in 2003 (20 to 50 percent) eased last year. By the fourth quarter, many healthcare delivery systems were receiving premium quotes with single-digit rate increases and some saw reductions. Expanded capacity and additional markets are opening up on the reinsurance side of the equation and this has led to a more stabilized environment.

Corporate Governance and Regulation

The Sarbanes-Oxley Act of 2002 is beginning to affect captive governance, as more public company captive owners are now turning attention to captive control structures and reporting matters. At a minimum, captives (as well as any large self-insured companies) will now need to have accredited actuaries sign-off on their loss reserves.

Domiciles

Bermuda – Still the world leader in number and premium volume.

Grand Cayman – Second to Bermuda in number of captives, Cayman is still growing at a brisk pace.

Vermont – The largest US domicile, with over 700 licenses issued, added 45 new captives in 2004, another very good year. Pure captives continue to make up 75 percent of Vermont’s captive businesses; the remaining are group captives mainly in the form of risk retention groups. With approximately 525 active captives, Vermont ranks third in the world; however, premium volume of $8.5 billion is second only to that of Bermuda.

Vermont earned further bragging rights in 2004 by offering the first formalized captive training course through the International Center for Captive Insurance Education (ICCIIE), affiliated with the University of Vermont. Risk managers and other captive industry members are signing up to earn a formal captive insurance professional designation. Courses cover every domicile in the world.

South Carolina – Issuing its 100th license last year, this domicile is expecting continued growth in 2005. RRG formations have driven much of the new growth but the domicile is now starting to attract some of the household name

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parent companies that have historically been associated with Vermont. South Carolina has geographic appeal to Southeast-based companies.

**Hawaii** – More captive licenses were issued in Hawaii in 2004 than in any other year since the state became a domicile in the late 1980s. Expansion continues to be predominantly US-based, but there is growing interest from Japan. Hawaii is now home to eight captives owned by Japanese companies.

**New York** continues pressing for New York-based companies to place their captive business in their home state. The state has aggressively promoted business preservation and taken measures to sweeten the pot for local owners in an effort to continue its solid expansion. New York has issued more than 30 licenses; four years ago the number stood at five. Many of the recent New York captives are TRIA-driven formations.

**Europe and Asia** – Growth remains strong. Expansion of the EU in 2004, when 10 countries joined, made a direct writing captive in either Ireland or Gibraltar increasingly attractive. Malta has recognized this opportunity and is now geared to offer a similar offering at competitive pricing.

**Other domiciles in the US** – Existing domiciles continue searching for a differentiating marketplace niche. Washington DC broke new ground in 2004 by allowing RRGs to form as protected cell companies, although some say the concept of segregating risks with cell walls is incongruent with the risk retention and risk sharing principles of an RRG. Washington DC has issued 30 licenses. Arizona is establishing itself as a low-cost option by assessing no premium taxes for direct writing. Arizona is at or near the 30 licensed captives mark, and Nevada will have 36 by the end of 2004.

**Looking at RRGs**

RRG formations in 2004 continued at the same frenzied pace they did in 2003. There are in excess of 175 RRGs in operation in the US, and they now write in excess of $2 billion in annual premium, having doubled their volume since 2001. For the second time since passage of the law allowing the formation of RRGs, the US Government Accounting Office (GAO) is assessing and analyzing the law’s impact. A report is expected in February 2005.

State-level scrutiny is underway as well. Continuing its long tradition of not quite understanding how to fit US RRGs into the existing regulatory framework, the National Association of Insurance Commissioners (NAIC) has appointed a working group to explore how state insurance departments can get a better handle on the activities of RRGs outside of their home state.

Current options being considered by the NAIC include:

– Providing better education about the federal law among insurance departments
– Expanding NAIC financial review of RRGs writing in five or more states
– Subjecting domiciliary states to expanded accreditation standards by imposing financial standards reviews

What does this all mean to RRG owners and members? RRG owners should expect, in the coming years, greater pressure from home domicile regulators. The NAIC is a quasi-lawmaking body with insurance department sanctioning powers regarding state accreditation. States may acquiesce to greater NAIC regulation pressures and sacrifice some of their traditional business-friendly approach if accreditation is put in jeopardy.

In perhaps more positive news for captives, the NAIC is considering an industry-supported expansion of risk retention groups beyond Liability risks into Property coverage.

**Protected Cell Companies**

The number of jurisdictions with protected cell company (PCC) legislation on their books continues growing. The Isle of Man enacted a PCC law in mid-2004. Other locations are expected to follow, as fencing of assets into cells becomes an established corporate technique.
The number of PCCs licensed to act as insurers and reinsurers continues to grow apace as do the uses of the PCC structure. In addition to traditional risk financing programs, PCC technology is being used in ART arrangements, Life business and structured financial transactions.

The number of cells now exceeds the number of captives, truly a reflection of the success of this innovative structure. Regulators will have to grapple with the most appropriate way to regulate these voluminous but typically low-value transactions.

**Issues and Opportunities**

**TRIA Sunsets in 2005**


Since captives are subject to TRIA, owners of captives need to plan accordingly for any insurance policies and reinsurance programs that extend into 2005. Captive owners are considering conditional endorsement options that hinge on the ultimate fate of TRIA.

**Accounting Issues**

Release of International Financial Reporting Standard (IFRS) 4 has launched phase one of the new international accounting standard framework for (re)insurance accounting and takes effect on or after January 1, 2005. More fundamental changes are expected in phase two but this will not be effective for several years, allowing the industry time to absorb the impact of phase one. The ultimate goal is consistent accountancy treatment of (re)insurance transactions across the world, aiding readers’ comprehension and increasing transparency. Adoption of phase one may lead to increased volatility of earnings as opportunities to reserve conservatively are eliminated. Captive managers should ensure their accounting platform is International Accounting Standards (IAS) compliant and adequate reporting systems are in place.

**Migration**

As new captive domiciles emerge and the conditions in domiciles evolve, captive migration becomes an issue. The reasons for locating a captive in a particular domicile ten years ago may no longer be valid. Domiciles have responded to this marketplace reality by enacting migration or redomiciliation legislation that allows a captive to change domiciles as if it were changing its business address. The onshore locations stand to be the big gainers in captive migrations, as reputation and familiarity command boardroom acceptance.

**Leveraging the Value of EU-Based Captives**

As the EU continues to expand its membership, multinational companies recognize the opportunity to leverage the value of self-insuring risk through an EU-based captive that can write directly into all 25 EU countries plus three EEA member countries. The potential benefits of setting up such an arrangement include:

- Admitted underwriting capabilities for all risks, all lines
- Reducing overall EU/EEA administrative, fronting and collateral costs
- Direct access to reinsurance markets
- Flexibility in designing premium allocations that reflect local risk management preferences, loss history, etc.
- Centralization of certain functions that are key concerns to local insureds – e.g., clinical trial certificate issuance for pharmaceutical companies
In 2005, the marketplace for alternative risk transfer (ART) will be in a state of transition. There are several competing trends developing now that could have considerable impact. On one hand, we are seeing an increasing amount of activity in ART products, reversing a soft market trend toward traditional products that began two years ago. However, as this outlook is being written, there are inquiries being made by various regulatory bodies into certain alternative risk transactions—inquiries that could transform the way some products are structured.

Reversing a Trend
In 2003, the insurance market experienced a reallocation of capital as capacity flowed from ART solutions to traditional insurance products and the number of markets actively writing ART programs declined. The abatement of ART capital was largely due to two factors:

— Increasing returns from the hardening market for traditional products created a natural movement of capital to traditional products where expected returns were greater.

— Several markets sustained underwriting losses on ART programs or mark-to-market losses on credit derivatives. These losses forced some insurers to abandon or significantly reduce their ART offerings.

With hindsight, many markets realized that some ART products were simply not managed profitably. The entrance of insurers into credit enhancement products, for example, generally proved to be disappointing. This time around, however, we expect insurers to be more cautious in how they grow their ART business. As such, we expect underwriting activity to follow traditional insurance risk patterns, with minor exceptions in such areas as weather and volumetric covers.

The general softening of the insurance market in 2004 is creating downward pressure on returns. In market conditions such as these, insurers often launch aggressive campaigns to grow market share, without (they hope) sacrificing profitability. Alternative risk transfer products have historically proven to be a way for insurers to achieve this goal and protect incumbent positions on accounts. We expect this strategy to be active in 2005. The challenge will be to avoid the underwriting problems that contributed to the retrenchment of 2003.

Regulatory Scrutiny
A note of caution must be sounded amidst these growth predictions in light of the regulatory attention suddenly being focused on certain ART offerings. Accounting regulations and corporate governance issues are at hand. Certain transactions are now under investigation because they were organized under the ART banner but allegedly did not actually contain risk transfer or sufficient risk transfer.

We expect to see more accounting guidelines regarding ART programs—such as a clarification on the application of FAS 113, one of the more relevant regulations affecting the accounting for ART programs.

Complex Solutions
In 2005, we expect to see more attention paid to two types of programs: multiyear integrated / integrated finite programs and loss portfolio transfer programs.
Multiyear Integrated & Integrated Finite Programs
An integrated program is a multiyear risk financing alternative that combines various insurance coverages in a layer of risk transfer that attaches directly above traditional retained risk layers (e.g., $25 million to $50 million excess of loss retentions).

With an integrated program, the insured can choose to take significantly larger loss retentions, cap its additional retained loss exposure on an annual basis, and structure integrated coverage above the higher retentions. Significant savings may be created by assuming higher retentions and restructuring risk transfer into an integrated program. Alternatively, some companies may wish to avoid the additional volatility associated with higher retentions and create a risk financing program that blends a structured funding approach for the traditional first layer of risk transfer with the integrated excess coverage.

Loss Portfolio Transfer
Loss portfolio transfer (LPT) programs are insurance programs that transfer existing liabilities and the risk that those liabilities might be greater than expected. Although interest rates are relatively low, we are seeing increased attention paid to LPT programs. Three major factors are driving these programs, and we expect all three to continue into 2005.

– The need to contain adverse loss development on retained losses for old accident years. Many companies are experiencing adverse loss development on loss reserves accrued on the balance sheet. This loss development creates unexpected charges to earnings. By transferring liabilities associated with expired policy years, a company can avoid or substantially eliminate the impact of future loss development on earnings.

– The need to increase the efficiency of collateral posted to secure retained losses under deductible and self-insured programs. Many companies are facing a squeeze on the letter of credit capacity available to collateralize unpaid losses associated with deductible and self-insured programs. The squeeze is created as letter of credit obligations for other purposes are increasing, and banks are growing increasingly rigid about pricing and the amount of capacity they will provide in a credit line. In some cases, an LPT can be structured whereby the insurer will provide a trust agreement or other form of security to the legacy insurance companies requiring collateral. Consequently, existing collateral can be released, hence maximizing the value of the cash paid to the LPT insurer as premium.

A note of caution must be sounded amidst these growth predictions in light of the regulatory attention suddenly being focused on certain ART offerings.