MARKETPLACE REALITIES & RISK MANAGEMENT SOLUTIONS

A TIMELESS MOSAIC

SPRING 2008 EDITION
FOREWORD AND CONTENTS

On this page three months ago, we metaphorically described enterprise-wide risk management as a timeless mosaic. When deftly crafted by corporate governance stakeholders employing best practices in the art and science of managing risk across the organization, the mosaic becomes a harmoniously assembled, organically responsive blanket of protection.

In this edition of Marketplace Realities 2008, we present four new studies that examine diverse, vital risk management-marketplace arenas — articles that exemplify the superior value to be derived through integrated decision-making.

- **Green Economics: Climate Change Risk and Opportunity** – Willis Environmental looks at the multifaceted phenomenon of climate change — examining insurance program implications, insurance industry product development, global governmental initiatives, regulatory developments and cap-and-trade systems that provide a marketplace for buying and selling emission allotments.

- **Surety Market Update** – Willis Surety provides a comprehensive guide to Suretyship today, comprising industry financial performance, capacity, consolidation, strengths, preferences, niche segments, product offerings and anticipated trends — along with strategic advice for contractors and other clients whose operations require responsive, quality surety support.

- **The Aviation Marketplace** – Willis Aviation spotlights air transportation — a vibrant, vital sector in the global economy experiencing dramatic growth in passenger traffic, the advent of superjumbo aircraft, and proliferation of very light jets in an already crowded airspace. The authors profile aviation insurance marketplace conditions, potential coverage enhancements, and significant legal and regulatory developments.

- **Umbrella & Excess Casualty: a Marketplace in Dynamic Transition** – Willis Casualty paints a portrait of a marketplace driven by carrier efforts to differentiate and grow — through diversification of products, targeting business segments, forging strategies to increase capacity offerings and a renewed responsiveness to negotiation of ancillary coverages. Relatively favorable marketplace conditions provide further opportunity for clients to enhance program terms and pricing — through compelling articulation of one’s risk profile and risk management practices.

We also incorporate eight thought leadership publications recently posted on our website, [www.willis.com](http://www.willis.com) — articles that offer insight, analysis and advice on a wide spectrum of individual interests and organizational issues:
TRIA and Captive Insurance Programs – The Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA) enacted in December extended TRIA for another seven years. Willis Captive Consulting and the Willis Terrorism Practice conduct a thorough examination of captive formation and utilization as a funding vehicle for terrorism risk. Many companies that have experienced exorbitant rates for terrorism insurance because they are located in high-risk areas have found that a captive insurance company is a straightforward, cost-effective route to securing adequate, affordable insurance. (March 20, 2008)

Spotlight on the Tagalong – “ERISA tagalong” is the convenient shorthand for a claim commonly regarded as a D&O securities suit, except that the suit is brought on behalf of a pension plan — typically a 401(k) plan — that holds the employer’s securities. Willis Executive Risks examines three of the most significant differences between D&O securities suits and ERISA tagalong claims. While these claims arise from the same fact pattern alleged in a D&O securities claim — that is, fraud of some kind that hurts stock price — assuming that the tagalong suit will proceed just like the D&O claim can be an expensive mistake. (February 29, 2008)

Subprime D&O Claims: Early Indicators? – Willis Re describes a unique methodology and set of analytics for assessing vulnerability to subprime-related D&O lawsuits. (February 20, 2008)

Appeals Court Revives San Francisco’s Employer Healthcare Mandate – Willis Employee Benefits assesses the implications for employers of recent federal district court and appeals court rulings — along with employer reporting and recordkeeping requirements. (February 11, 2008)

It’s All About Automobiles – The Willis Private Client Group devotes an issue of its Wealthy & Wise series to a singular personal asset: the car. Featured are “Collector Car Insurance,” “Winter Driving Tips,” a special competition known as the “Concours d’Elegance,” the implications of a “DIU Citation,” and how to evaluate the “Difference between Good and Great Automobile Insurance.” (February 4, 2008)

A New Era Begins for the Brazilian Reinsurance Marketplace – Willis International provides a detailed examination of final rules and regulations adopted by the National Council for Private Insurers. The article addresses “The Impact on Multinationals Operating in Brazil” — important reading for companies with operations in Brazil. (January 31, 2008)


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

We also invite readers to visit the Publications page of www.willis.com, where you will find many other articles and studies of immediate and enduring value to risk managers, financial executives and corporate governance stewards of every stripe.
The issue of climate change has truly begun to affect the way the world thinks about the environment. People are engaged in vigorous and constructive dialogues about immediate and long-term implications, economic impact and risk management.

Whether it’s the $22 billion investment that Abu Dhabi is making in a carbon neutral city or the U.S. investors that have pledged $10 billion at a recent U.N. summit to reduce greenhouse gases, the public and private sectors around the world have recognized the urgency of the issue. They have begun to substantially fund and pursue solutions aimed at making fundamental changes in the way the world consumes energy and uses resources.

The U.S. Supreme Court recently ruled (Massachusetts et. al. v. EPA) that the EPA has the authority to regulate CO₂ and any other greenhouse gases under the Clean Air Act. By this ruling CO₂ can now be considered a pollutant. States have enacted aggressive legislation, such as the California law that aims to bring emissions to 1990 levels by 2020. The European Union (E.U.) has established emissions standards and a comprehensive trading system to manage and reduce greenhouse gas emissions. Government entities worldwide are contemplating emissions standards and embedding them in trade agreements and treaties, such as the Kyoto Protocol and the proposed successor agreements discussed at the recent U.N. conference in Bali. All of this activity points clearly in one direction: toward potentially greater liability for those responsible for greenhouse gas emissions.

Furthermore, green business practices and conservation efforts are becoming increasingly popular. Corporations are being rewarded in the court of public opinion for proactive measures that address global warming. To stay competitive, corporations with any sort of greenhouse gas emissions will soon have little choice but to integrate exposure to climate change liability into their risk management programs.

While there certainly is some coverage available in existing insurance programs, we do expect insurance carriers to, not only adjust underwriting practices to address the growing risks associated with climate change liabilities, but to also develop products that specifically cover the liability that flows from greenhouse gas emissions. The natural place for much of this coverage to surface would be the Environmental insurance market, and product development is already progressing. However, insurance risk management decisions should also contemplate the gamut of climate change risk exposures from enhanced Property exposures to new Directors & Officers (D&O) liabilities and everywhere in between.
INSURANCE PROGRAM CONSIDERATIONS

PROPERTY
First and foremost, risk managers considering climate exposures are taking a hard look at their Property programs and bolstering their Wind, Flood and Business Interruption coverage for property in regions more susceptible to catastrophic weather events. Climate change is expected to increase the frequency and severity of coastal flood and windstorm, but may also create new zones of high weather risk in interior regions as well. Additionally, Property insurers are taking a long-term view of how climate change will impact their risk profile – including the potential for rising sea levels. These factors have prompted insurance carriers to modify their catastrophe modeling and strive to better anticipate how catastrophic events may cascade as a result of secondary effects not traditionally part of their calculations – such as the levee failures in New Orleans during Hurricane Katrina.

GENERAL LIABILITY
Liability trends usually start with statistics – on illness, injuries or other measures of harm. Litigation follows. Broad complaints have been filed by environmental groups and government agencies against oil producers and automakers, alleging that they have contributed to global warming. California’s attorney general recently brought a suit against the six largest automakers, arguing that they damaged the state’s natural resources and created a public nuisance as they produced vehicles that collectively emitted massive amounts of greenhouse gases. The suit alleged that since the automakers were liable for global warming, they were also liable for the costs of the increased emergency response, health and environmental remediation services that global warming will necessitate. The District Court dismissed the case (California v. General Motors Corp, et. al.) on the grounds that causation had not been proved and that a wide variety of factors besides autos contribute to global warming. Despite this setback, environmental advocacy groups are gaining momentum. While they may not yet have the evidence to prove causation, they are working hard to make the connections necessary to succeed in such legal action.

Cases dismissed today, if presented tomorrow in a different light with better science, will likely have the traction necessary to establish that emitters of greenhouse gases are liable to a certain extent for damages to natural resources and for the effects of climate change.

Once the statistical foundation to show causation is in place, greenhouse gases may follow the pattern set by other liability lightning rod issues. Mention asbestos or mold, and corporations with demonstrable exposures are often ready to settle rather than face the ultimate consequences of paying substantial compensatory and punitive damage awards. The tobacco industry provides another bracing example. Litigation against tobacco companies produced a stream of trials and settlements that reshaped the entire industry, making it much less profitable and much more difficult for cigarette manufacturers to do business. If the statistics in the global warming arena evolve in a similar fashion, organizations involved in greenhouse gas emissions may see a drastic change in the business climate.

Huge sums – from legal fees for defense costs to final judgments – will be at stake. Businesses that emit greenhouse gases will be looking for insurance products and other risk funding mechanisms that provide coverage and financial resources for the exposures and their potential consequences.
D&O LIABILITY
Sarbanes-Oxley created a new regimen of oversight and transparency that has cascaded through all aspects of risk management. Directors and officers must now address environmental risk specifically in their annual reports and tax filings. Soon this area of reporting will likely require that companies address greenhouse gas emissions and their potential liability for resulting climate change. At all levels of planning and financial disclosure, therefore, risk managers need to contemplate the risks associated with greenhouse gasses and offer information about those risks to their shareholders. A recent article published on CNNMoney.com stated that most utilities and refiners, as expected, are reporting on greenhouse gas emissions and the anticipated impact on their business, but many other companies that perceive less of an exposure appear to be underreporting. Directors and officers of companies that could be deemed emitters want reassurance that their Executive Risks programs provide coverage for suits alleging failure to safeguard shareholder value from the impact of climate change.

REGULATORY ACTIVITY AND CAP-AND-TRADE SYSTEMS
Regulatory frameworks governing greenhouse gas emissions in California and in the E.U. are generating vigorous debate and often high praise. Global warming knows no boundaries; it is therefore probable that industrialized countries everywhere will soon enact their own emissions caps and regulations. International treaties and stipulations in trade agreements add another layer of complexity to this already confusing scenario. Taken together, these factors are prompting the development of solutions that have broad commercial implications.

One of the leading trends is toward cap-and-trade systems that work in connection with emission limits. Under these systems, companies that emit less than their permitted emission allotment can sell that allotment on an open market. Companies that struggle to meet the standards can then buy that allotment. In effect, the buyer is being fined for polluting, while the seller is being rewarded for having reduced emissions. Critics of emissions trading point to problems with monitoring, enforcement and allocation, but on the whole, the systems have been well received.

The E.U. trading system began in January 2005 and now includes the 27 E.U. member states. The program caps the amount of CO₂ that can be emitted from large installations, such as power plants and carbon intensive factories, and covers almost half of the E.U.’s CO₂ emissions. While Phase I (2005-2007) of the trading system received much criticism due to oversupply of allowances and the distribution method of allowances, the E.U.’s Commission has been tougher on member states’ plans for Phase II. Most economists and scientists agree that the first phase has in fact established a strong, viable market and compliance was high in 2006, thereby increasing confidence in the system.

Smaller trading systems have also worked. A sulfur dioxide (SO₂) trading system was developed under the framework of the Acid Rain Program of the 1990 U.S. Clean Air Act. Because SO₂ is less prevalent in the environment than CO₂, it has been easier to track and manage. The program is expected to cut SO₂ emissions to 50% of 1980 levels by 2010. Some experts argue that the trading system for SO₂ emissions reduces the cost of controlling acid
Insurers have already introduced programs that are geared toward commercial buildings that follow green standards, with rating guidelines that offer credits for green building materials and upgrades.

Commercial auto insurers are developing pay-as-you-drive (PAYD) programs aimed at reducing greenhouse gas emissions by encouraging people to drive fewer miles.

Carbon Credit Delivery Insurance is on the drawing board at a number of insurers.

Ultimately, the most comprehensive response to greenhouse gas emissions liability is likely to come from environmental insurers. Leading insurers have already issued guidance on how they plan to tailor coverage for greenhouse gas emissions liability, and some are currently developing underwriting guidelines on these issues.

Given the insurance industry track record for generally excluding emergent environmental risks such as mold and MTBE, it is possible that greenhouse gas emissions will soon become excluded in standard Property and Casualty policies. This will heighten interest in environmental products. The broad definitions of pollution in current environmental policy forms may already provide some degree of coverage, but greenhouse gas emitters will likely demand modifications and endorsements that explicitly address the issue. Coverage will likely apply to off-site remediation costs, property damage and damage to natural resources. Bodily injury and on-site remediation costs may not be as readily included. Nevertheless, all of the major coverage issues are expected to be in play. Insurers are also starting to introduce programs designed to manage Kyoto Protocol-related risk in carbon credit transactions. In the trading markets, industries will need to guarantee that they can meet certain standards with of the

Renewable energy-related insurance products are allowing companies and investors to participate in renewable energy projects as they provide risk transfer and free up capital for more investments.

Willis has developed a program that can help cover potential underproduction of power from wind farms.
implementation of available technology. They will want to cap the costs necessary to meet the standards and transfer the risk of potential implementation cost overruns. Insurers are contemplating programs that cover multiple risks related to carbon credit transactions, including:

- **Carbon Credit Delivery Coverage** – For operational, credit, political and pricing risk coverage
- **Kyoto Multi Risk Policy** – Provides coverage for clean development mechanism (CDM) projects for property, income, political risk and revenue from carbon credits
- **Global Carbon Credit Trading Coverage** – Provides coverage for the risks related to CDM project registration and the issuance of Certified Emission Reductions (CERs), including the failure or delay in the approval, certification and/or issuance of CERs from CDM projects by United Nation Framework Convention on Climate Change (UNFCCC)
- **Alternative Fuels System Performance Insurance** – Offers coverage in the event that an alternative fuel development project fails to pass specified post-construction acceptance tests due to a design deficiency in the technology, allowing the insured to service the outstanding debt shortfall that resulted from such failure or make system modifications intended to improve performance up to specified levels

**LEADING THE WAY**

The markets have already started disseminating literature on how such programs would work. As we have in response to other areas of new and complex liability, Willis is working with insurers and industry leaders to develop solutions for these new exposures.

In addition, we have formed the Willis Climate Change Task Force (WCCTF), a worldwide collaboration of all Willis Associates dealing with climate change issues, to keep pace with regulatory, scientific and marketplace developments. The WCCTF establishes a central point for monitoring, gathering and disseminating relevant climate change information both internally and to our clients. In addition to Associates from the Willis Environmental Practice, WCCTF includes the Willis Research Network (WRN), a unique group comprised of specialists from Willis Re and universities around the world. The WRN has access to the Earth Simulator Supercomputer in Yokohama, Japan, one of a few computers in world capable of modeling the number and severity of hurricanes, typhoons, flood, heat waves and global temperature change over varying scales of time and geography. Insurers will be able to use this information to anticipate future climates, which will assist in the setting of underwriting protocols and in demonstrating to their reinsurers and investors that they are making long-range business decisions based on sound data.

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1 “Who could get sued for global warming” – January 9, 2008, on CNNMoney.com by staff writer Steve Hargreaves.
SURETY MARKET UPDATE: RECORD RESULTS, REASONS FOR CAUTION

The highly vibrant construction economy of the past five years has produced record results for many construction firms and contractor balance sheets, the likes of which have not been seen in a very long time. Demand for surety bonds generated by robust construction activity, combined with improved contractor credit quality and continued underwriting discipline, also led the U.S. Surety industry to perhaps its best year ever.

As always, however, the recent past is no predictor of the future and history provides diverse examples of where market conditions may be headed. With this in mind, surety buyers should position themselves to take advantage of the easing conditions that exist today in most sectors of the surety business, while preparing themselves for sudden changes that could emerge out of today’s unsettled business and credit environment.

SURETY MARKETPLACE

INDUSTRY PERFORMANCE

According to early indications, the U.S. Surety industry enjoyed record premium volume and profitability in 2007. This would mark a third consecutive year of profitability for Surety underwriters, a remarkable turnaround after the tumultuous underwriting results of the early 2000s. For 2007, the industry is expected to report a loss ratio of between 18 and 20 cents for every dollar of earned premium. Premium volume is expected to top $5.1 billion. Some major Surety writers have indicated their 2007 results generated loss ratios of less than 10% — on record levels of premium. This is certainly good news for an industry that, not so long ago, was in jeopardy of losing significant support from its capital providers. As the chart below reflects, the longer-term view of volatility in the Surety business is not one that provides assurance of consistent returns, but there are factors in play that suggest the industry might maintain the positive trend of the past couple of years for just a bit longer.
Surety industry consolidation has been significant, especially compared to the marketplace of 10 years ago. The chart below illustrates the increased concentration of capacity that has occurred as the result of M&A activity and the withdrawal of some major participants.

SURETY INDUSTRY VOLATILITY

This chart includes Willis’ estimate of 2007 results based on early indications of Surety industry figures for the year. The relative inelasticity of industry pricing is evident. Most gains in premium volume have come, historically, from increased economic activity as opposed to rising price levels. Based on long-term trends, increased surety loss activity has traditionally trailed the growth trends in construction activity by 18-24 months. If this holds, some observers expect the slow-down in construction activity that may be in early stages today will yield volatility in future returns for the Surety industry.

Source: Surety & Fidelity Association of America (SFAA)

Surety industry consolidation has been significant, especially compared to the marketplace of 10 years ago. The chart below illustrates the increased concentration of capacity that has occurred as the result of M&A activity and the withdrawal of some major participants.

SURETY INDUSTRY CONSOLIDATION

The combined market share of the 10 largest writers has increased by approximately 17% since 1998. Industry results for 2007 are expected to show a marginal increase in this figure. The top four writers’ share has increased even more dramatically, from 32.5% to 43.0% (up 32%). This increased concentration — and the fact that the top four writers are co-surety participants with one another on many large contractor programs — portends sustained underwriting discipline on the large Surety programs that present severity risk to the industry and its reinsurers.

Source: Surety & Fidelity Association of America (SFAA)
Increased scrutiny from ratings agencies in light of the current turmoil in the credit markets, and the increasing requirements for large deployments of capital to remain competitive, may be a prelude to additional M&A activity in the primary and reinsurance marketplaces as carriers are subjected to non-compliance with ratings requirements or increased capital costs that result from a ratings downgrade. Ratings agency actions come with little warning and can impact the ability of a surety to deliver capacity to its clients, literally overnight. Standby surety relationships are employed by many contractors to mitigate the risk of an interruption in surety support due to factors outside their control.

UNDERWRITING & CAPACITY

The underwriting environment continues to ease with regard to placing capacity, but less so with regard to pricing and terms. Terms are becoming more competitive in the middle market sector, but Surety rates are not materially below the levels of a year ago. To date, the increased capacity has come from existing carriers’ willingness to support good credits and attempts by sureties to support clients in the midst of the recent vibrant construction market. Although there have been new entrants into the small constructor Surety sector in recent months, the longevity and patience of this capital is not tested. For the broader market, no significant new capital has entered the business since 2002. One major Surety writer recently announced, however, its entry into the large contractor marketplace and has hired underwriting staff to build that business.

The focus has shifted from expanding contractor backlogs to the flexibility of a contractor’s financial plan for dealing with potential drops in volume and/or margins in late 2008 and 2009. While many sectors of the construction marketplace remain strong, the macro-economic picture has changed and many contractors’ private clients are experiencing increased equity and underwriting requirements to obtain funding for projects that not long ago were quickly financed. Contractors have become more aware of the credit risk in private work and have taken steps to satisfy themselves on both the availability and stability of project funding. Any enhancements in such risk controls should be communicated to the surety.

The limited market choices for large contractors suggest that the underwriting environment will remain disciplined. This is an environment that favors well-managed construction firms, as increased competition for work begins to become a reality in some sectors. Underwriters are also on watch for trouble in the subcontractor marketplace, as firms that have enjoyed a pick-and-choose environment (and, for many, a growth in cost structures) are now faced with challenges to their gross margins.

RESIDENTIAL MARKETPLACE

The steep decline in the fortunes of the residential marketplace has put subdivision bond exposures in the spotlight. Historically, this line has been one of the industry’s most profitable, but sureties have begun to experience losses in this sector and underwriters are restricting capacity and significantly tightening terms — even for preferred credits. Sureties perceive significant exposures in national and regional builders’ programs. To date, even well-managed home builders, at both the national and regional levels, have recognized losses from the write-down of asset values and/or goodwill impairments, but many have sustained positive cash flow and liquidity and reduced their use of funded debt. A long slump will test the ability of most firms to manage overhead and fixed cost structures. Firms will
try to limit the impact on their balance sheets to changes in asset values, leaving tangible equity and liquidity diminished. Willis expects capacity will further constrict until there is some indication that the trough in the housing market has been reached.

**BOND FORMS**
The scrutiny of contract and bond forms by underwriters continues. Recent rulings in the courts of Florida and Virginia generated a swift reaction by sureties in regard to long-accepted industry bond forms, particularly the AIA-312 Payment Bond form and the Engineers Joint Document Committee (EJDC) form. The courts’ literal interpretation of these forms’ wordings has led the major Surety writers to require modifications that spell out grounds for making a claim. While the rulings created an opportunity for the industry to demonstrate its ability to respond to claims in a timely manner, the absence of a proof-of-loss burden on claimants and the restricted deadline for discovery imposed an obligation Surety underwriters found unacceptable. The AIA is currently considering modifications to its payment bond form and working with construction and Surety industry groups to arrive at acceptable wordings.

Other contract provisions that attract attention include clauses stipulating liquidated and/or consequential damages, extended contract duration or maintenance periods, and design or warranty exposures. Consequential or significant liquidated damages provisions are unlikely to attract surety support. Under the credit modeling employed by many of the major Surety writers, pricing for individual projects will be affected by contract duration and the extent of maintenance or warranty provisions in the contract.

**FINANCIAL PERFORMANCE**
Many contractors currently maintain levels of open work that will allow them to hit their financial targets for 2008 and perhaps even early 2009. Surety underwriters are increasingly focusing on their clients’ business plans and financial projections for 2009 and 2010, with an expectation that some sectors will see increasingly soft conditions. Overhead expense, funded debt levels and the adequacy of cash flow will receive particular scrutiny in the underwriting process. The aging of accounts receivable, particularly on private work, will be emphasized.

Contractors can expect underwriters to compare prior business plans and financial projections to actual results. Transparency in the information presented and the ease with which it can be analyzed will continue to serve users of surety well in maintaining stable and competitive surety facilities to support their business.

**INDEMNITY AND OTHER CREDIT SECURITY**
The indemnity offered in support of a surety’s bonding facility remains a critical part of the underwriting equation. Personal indemnity for closely held firms, in particular Subchapter S corporations, remains the industry norm. Sureties remain determined that the indemnity agreements in place do not put them in an inferior credit position compared to a contractor’s lender(s) or other creditors. This may even involve explicit agreements regarding the use of assets to complete bonded work or, in the case of private equity ownership, change-in-control agreements.

**CONTINUITY AND CHANGE**
Demographic trends indicate that significant portions of the privately held segment of the U.S. construction industry will be transferred, in some form, over the next 10 years. Buyers will include strategic purchasers looking to establish a presence in new market or
industry sectors, equity investors attracted by the potential for very high return on invested capital, and more traditional transitions to employees or the next generation of family ownership. The drop in the value of the U.S. dollar has also had an effect, significantly increasing the activity in the marketplace by non-U.S. based construction groups, as well as the amount of reverse flow business being considered by sureties. Conversely, the use of surety bonds is expanding in markets outside the U.S., particularly in Europe and parts of Asia.

Until very recently, private equity funds were active in financing the buy-out of owners looking to realize the wealth built up during long careers. Sureties focus on the financial impact of share purchases on a client’s balance sheet, but as importantly, are interested in the operational/management aspects of new ownership. Contractors would be well served to include their surety in preliminary conversations around continuity plans to assure that any changes that are implemented will not impact the availability of surety support to the post-transaction organization. In many cases, the availability of surety credit is a key component of the valuation exercise.

THE WAY FORWARD
For users of surety, the marketplace is more accommodating than it was three years ago. Contractors that treat their Surety underwriters as integral partners to their business will find stable support. If, however, an assumption is made that past performance is an assurance of future results — by either party — a contractor that is not proactive regarding market conditions in its business might find its surety credit has been impacted by factors beyond its or its surety’s control. Prudent planning and a modest investment of time can be the difference in maintaining a strong surety relationship in unsettled times.

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AVIATION

Air transportation is critical to the global economy. According to the International Air Transportation Association (IATA), the aviation sector accounts for $3.5 trillion in economic activity. IATA expects international passenger traffic to increase from 760 million passengers in 2006 to 980 million in 2011. Similarly, domestic passenger traffic is forecast to grow from 1.37 billion passengers in 2006 to 1.77 billion in 2011 – an increase of almost 30%. Freight traffic is expected to grow by 22% over the same period, from 29.5 million tons to 36 million tons. The world clearly needs to fly.

While the industry continues to grow, competition and fuel prices are putting tremendous pressure on profitability, thereby driving consolidation worldwide. While airlines are exploring the efficiencies of ever-larger aircraft and may eventually be flying more passengers to fewer destinations; small commercial operators are deploying very light jets (VLJs) in large numbers to fly 5-6 passengers up to 1,600 miles non-stop at costs that are expected to be the same as an airline full-fare coach ticket.

THE AVIATION INSURANCE MARKETPLACE

The aviation insurance market has been no less dynamic. Additional capacity, new entrants, personnel changes among underwriters and the absence of catastrophic claims have softened conditions overall and led to intense competition in some segments.

Meanwhile, two major technical issues have recently confronted underwriters.

- Delivery of the Airbus A380 aircraft, with seating for 525 in the standard three-class configuration or up to 850 in an all-economy configuration, presents new challenges for liability limits and insured values as well as a new level of catastrophic potential.
- The entry of VLJs into already crowded airspace has presented potential exposure problems relating to congestion and single-pilot operations.

The marketplace, with its continued resiliency and profitable backdrop, has responded to these challenges with negligible impact on buyers, although pilot qualifications for VLJ operations are rigorously scrutinized by underwriters.
MARKET SEGMENTS

AIRLINES
The premium reduction trend of the past five years continues. While the reductions go on, underwriters are continually looking for a way to stabilize or slow the decline. A number of insurers have identified the operating environment and safety record in North America as the safest in the world, and therefore are looking to maintain their market share in North America even at premium levels that are nearing expected losses. Market volatility remains unusually high, and some airlines could receive abnormally high or low pricing purely based on the overall market inconsistencies. Those airlines with larger exposure bases and larger premium volumes will likely see deeper discounts than smaller airlines.

PRODUCTS LIABILITY
Worldwide aviation Products Liability premiums in 2007 decreased about 10% from 2006 levels due to the absence of major air disasters, negligible loss deterioration on prior years’ claims, and new capacity that entered the market in recent years. Deterioration of 2002 to 2007 losses is unlikely given the dearth of major losses in those years. If a major new loss were to occur it would likely disrupt the rate reductions that have transpired through 2007 and into 2008. However, the current 10-year underwriting profit of $3 billion would likely serve to temper such reactions.

There are several new significant losses affecting the market, but none are U.S. losses, and any impact will be felt primarily outside the U.S. There is ample capacity in the market for most manufacturers. Some risks are viewed less liberally than others, particularly those with high General Aviation exposures and high loss ratios.

The opportunity to review portfolios, create marketing synergies with corporate aircraft placements and remarket programs to new entrants is very strong now, and buyers who have already done this have seen immediate benefits.

GENERAL AVIATION
Additional entrants in the market have impacted capacity and pricing, particularly for industrial-aid risks and the larger commercial/charter fleets. As a consequence, premium reductions in those sectors accelerated in 2007 and have continued into 2008. For commercial operators, the accompanying trend toward quota-share placements has continued. Loss experience and pilot training are still important differentiating factors in insurers’ risk analyses.

Premiums for other sectors, such as airports and aviation service providers, have seen moderate downward pressure on pricing and are most sensitive to individual loss experience and risk characteristics. As a consequence, pricing varies widely and will continue to do so.

IT ISN’T JUST PRICE
Soft market periods provide an opportunity to not only reduce costs, which are of course a key focus, but also to enhance coverage. It is important to review current coverage, new coverages and potential coverage enhancements that may be offered — and take advantage of the opportunity to improve the program. Many of the enhancements offered by underwriters in a soft market will remain on policies during hard market times, but they may not be available to those who had not previously incorporated them into their programs.

With the increased placement options available in the purchase of aviation insurance, it is more important than ever for...
clients to begin gathering renewal information early and analyze the options for both the short and long term. A strong marketing plan and thorough review of underwriting markets are critical elements in a successful renewal.

LEGAL AND REGULATORY

OPERATIONAL AND CONTROL DILEMMA
The entire commercial and charter industry is focused on the issue of operational control because of recent action by the Federal Aviation Administration (FAA). Regulatory drafting is in progress, as is interpretation and speculation about it. Underwriters and aircraft lienholders and lessors are concerned about potential new obligations that may be imposed by the FAA. Willis Associates sit on several industry boards and committees, and we will be monitoring these developments and advising our clients accordingly.

FAA WAR RISK INSURANCE
FAA War Risk Insurance (aka 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 of 2003. Currently there is a Presidential Determination directing the FAA to continue to provide coverage through August 31, 2008. Most U.S. airlines place war risk insurance in the federal program. The FAA is empowered, but not required, to continue the coverage past this date, but they have not as yet made a determination.

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1 IATA Press Release #37, October 24, 2007 (http://www.iata.org/pressroom/pr/2007-24-10-01)
The Umbrella & Excess Casualty marketplace is best described as one in dynamic transition, with an often accelerated state of movement as insurers aggressively seek to differentiate their offerings in order to retain accounts and win new business.

The worldwide marketplace appears to be moving away from its traditional approach of distributing its products very carefully by geography to segregate risk appetite, policy forms offered and coverage triggers. New markets are entering the arena; existing markets are shifting appetites; distribution is becoming more local; traditional offshore carriers are moving onshore; and major insurers are combining internal capacity to provide large blocks of limits in order to produce a single source solution.

The Willis concept of Glocal service — global resources, delivered locally — has never had greater application, given the ever-increasing need for immediate, relevant, comprehensive information. Communication of product developments, optimum points of access, changing risk appetites and product offerings — all are paramount to successful execution of program design and placement strategies. So is an ongoing understanding of insurer financial strength and service performance — essential considerations given the long-tail nature of Umbrella & Excess insurance.

WHAT CAN AN INSURED DO?

Establishing positive differentiation of your risk profile and operational exposures is crucial — at all times. Comprehensive, concise articulation of relevant underwriting information serves to distinguish your risk from other similar risks that compete for Umbrella & Excess marketplace capacity. Corporate governance and risk management practices, claims reporting and management protocols, and traditional underwriting data on assets, exposures and losses — all need to be conveyed in a user-friendly, compelling fashion.

The current moment in the insurance market cycle offers an opportune time to review limit adequacy and coverages. Stress testing your program through alternative loss scenarios allows you to determine coverage and limit adequacy at a time when external pressures of inflation and legal trends are shifting. Does your current program have sufficient breadth and limits to meet the exigencies of your chosen loss scenarios? This type of benchmarking and program analysis better positions you for prioritizing objectives regarding premium, policy terms and conditions, and limit adequacy.
TERM S AND CONDITIONS
Recent restrictive trends within the Umbrella & Excess marketplace segment have abated. Such trends included increasing attachment points, introduction of new exclusions and little latitude on coverage grants for ancillary exposures within such areas as Professional Liability and Pollution. Carriers by and large have a greater willingness to work with insureds to find solutions to their needs and to remain competitive. Items such as trailing SIRs — which became prevalent in the marketplace in recent years — remain intact where applicable. Their levels, however, are being significantly reduced in response to quality supporting data. The trend of new exclusions entering the marketplace seems to have slowed, with nothing on the immediate horizon. Per-occurrence attachment points are being carefully monitored; however, the upward trend of recent years is stabilizing. One area that is not changing is aggregate attachments, as carriers continue to be very conservative.

RATES, PREMIUMS AND CAPACITY
The greatest opportunity for rate/premium reduction exists in the mid Excess area directly above the lead Umbrella layer and below the capacity blocks of limits typically obtained via the Bermuda marketplace. Capacity is abundant in the mid Excess layers, thereby creating the greatest savings opportunity. For select industry classes, competition and capacity remains abundant on lead Umbrellas as well; however, depending on the risk profile and class of risk, this field is more limited — with fewer options and smaller rate reductions. On average, recent renewals have resulted in rate reductions in the 15% to 20% range, with standard caveats applying for more hazardous classes of risk. Capacity remains plentiful, with theoretical limits of approximately $1.75 billion. The actual available capacity, however, is more in the neighborhood of $1.2 billion when accounting for such factors as the pyramiding of reinsurance, insurer limitations due to class or industry, and insurer preferences on layer placement within a tower of limits.

As in many other marketplace segments, global Umbrella & Excess market conditions are of course sensitive to major natural catastrophe losses and acts of terrorism. Classes of business underwritten, capacity allocations, scope of coverage, and insurance and reinsurance premiums are all immediately susceptible to change if the marketplace experiences a significant loss of capacity due to such occurrences.

THE PLAYING FIELD
Carriers have expanded their efforts to retain existing accounts and write new business through a variety of distinct and creative ways.

- Some insurers (Swiss Re, Allied World, Endurance) have established local access points in cities across North America.
- Certain insurers, who have traditionally been associated with large blocks of capacity dedicated exclusively for difficult/complex risks, are beginning to consider standard commercial risk business.
- AIG is a prime example with the creation of their mid Excess facility — which complements its already dominant share of lead Umbrella and high-capacity business.
- Allianz is methodically re-entering the North American liability marketplace.
- Insurers are pooling internal capacity to create greater single-source policies, with limits of up to $100 million on a lead basis for certain classes of risk.
Bermuda-based insurers are lowering historic high attachment points and coverage triggers in order to compete with domestic and European insurers.

Finally, enactment of the Terrorism Risk Insurance Program Reauthorization Act of 2007 (TRIPRA) will likely require many insureds to amend their current policy if it was placed prior to early December 2007. Most major Umbrella & Excess insurers have addressed TRIPRA’s passage by issuing amendatory endorsements to update their policies as necessary.

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Captive insurance programs provide a form of self insurance, offering companies an alternative method of funding for risk. One of the most obvious benefits is accumulation of investment income. A captive, which is a subsidiary of the company that creates it, can retain the premium and pay its parent dividends, net of reinsurance, if there are no losses during the policy period. Other immediate benefits of a captive insurance company can include:

- Tailored, expanded coverage
- Pricing stability in an unstable marketplace
- Direct access to reinsurance
- Greater claims control
- Access to increased insurance capacity

When extension of the Terrorism Risk Insurance Act of 2002 (TRIA) came down to the wire at the end of last year, companies with terrorism exposures were preparing to scramble for coverage. The TRIA extension passed with days to spare, but the need and opportunity to consider coverage options has not gone away. One increasingly popular option is an insurance captive.
Companies that have been penalized by exorbitant rates for terrorism insurance because they are located in high-risk areas are frequently finding the creation of a captive insurance vehicle as a simple, cost-effective route to securing adequate insurance.

**TRIA COVERS CAPTIVES**

TRIA and its subsequent extensions serve as reinsurance for commercial Property and Casualty policies covering losses due to acts of terrorism in the U.S.\(^1\) In exchange for federal support, insurers are required to offer terrorism coverage. Captives are expressly included — captives domiciled in the U.S. providing Property and Casualty coverage on a direct basis are eligible for TRIA support. They are obligated to offer terrorism coverage and comply with the act’s reporting provisions. Currently, domestic captives are direct writing certified terrorism coverage most commonly for Property exposures.

According to the recent seven-year program extension (the Terrorism Risk Insurance Program Reauthorization Act or TRIPRA) TRIA support is available for losses resulting from acts certified by the Secretary of Treasury as eligible for the TRIA backstop. The criteria for certification are:

- A violent act or an act dangerous to human life, property or infrastructure
- Damage within the U.S. or to a U.S. aircraft or water vessel, or to a U.S. mission abroad
- Losses exceeding $5 million in the aggregate.

Once an act is certified, insurers providing TRIA coverage would be subject to a deductible equivalent to a percentage of their annual direct earned premiums (20% in 2007) and would subsequently be eligible for an 85% quota share reinsurance reimbursement from the federal government for certified terrorism losses in excess of the deductible.

A captive providing terrorism coverage under TRIA offers several advantages over a commercial insurance carrier, in addition to the typical advantages of a captive program.

- Because the typical aggregate earned premium for a captive insurer is minimal compared to that of commercial insurers, the deductible amount is often quite low.
- Department of the Treasury guidelines indicate that TRIA will respond to certified losses resulting from nuclear, biological and chemical perils — typically excluded in commercial terrorism policies.
- Captives are not required to pay funds to their policyholders in advance of receiving reimbursement from the federal government, alleviating cash flow issues.

On the whole, corporations accessing TRIA directly through their captive subsidiaries generally have broader coverage, and, in the event of no loss, may recoup premiums.

TRIA coverage has its limitations. In addition to the 15% quota share, the TRIA program includes a coverage trigger that requires aggregate insured losses to exceed $100 million before government participation is available. Captives will be under pressure to consider commercial reinsurance to cover these retained losses.

\(^1\) Information on TRIA and subsequent extensions thereto may change depending on the terms and conditions of the regulations to be established by the Secretary of Treasury.
HYPOTHETICAL TRIA CAPTIVE SCENARIO

Premium and Loss Scenario (in Millions)

Captive Limits: 1,000

- Premium Rate: 0.0020
- Annual Gross Direct Premium: 2
- Certified Terrorism Loss: 250

**TRIA Deductible Calculation**

- Captive’s TRIA Deductible: 0.4 (20% of Annual Premium)
- Excess Loss: 249.6

**TRIA Reimbursement**

- TRIA 85% Q/S: 212.2
- Captive 15% Q/S: 37.4

**Captive Reinsurance Program**

- Losses subject to Reinsurance: 37.4 (does not include TRIA Deductible)
- 100% reinsurance: 37.4
- Retained Loss: 0.4

Capital and Expense Calculation

- Minimum statutory capital: 250,000 (Cash / Cash Equivalent)
- Minimum additional surplus based on premiums (if any): tbd

**Required Surplus and Capitalization** 250,000

- Feasibility study: 30,000
- Actuarial analysis: 10,000
- Domicile implementation: 5,000
- Misc. fees (legal, tax, etc.): 25,000

**Total Captive Creation Costs** 70,000

- Captive Management: 50,000
- Annual Audit: 25,000
- Misc. fees (actuarial, taxes, etc.): 18,000 tbd

**Ongoing Annual Captive Operating Costs** 93,000
Forming a captive takes several steps once a feasibility study points the way forward. One of the first steps is choosing a domicile. Several states are available as domiciles for terrorism captives, including Vermont, South Carolina, New York and Washington DC. Only domestic captives qualify for TRIA support. A detailed matrix comparing some U.S. domiciles appears below. Each domicile has its own process for setting up a captive. As an example, we outline the steps to licensing a captive in New York.

- Arrange a preliminary meeting with the New York Insurance Department (NYID) Captive Group to discuss the proposed captive and to review the licensing and incorporation process
- Obtain approval for the name of the captive
- Prepare and submit four completed captive insurance company license application forms with all required attachments, to the NYID Captive Group including:
  - A copy of the charter and bylaws or other similar documents
  - A financial statement certified by two officers
  - A plan of operation

The submitted application should also include:

- Biographical affidavits for directors and executive officers of the proposed captive insurer
- Pro forma financials for the next five years
- Actuarial analysis
- Loan agreement
- An independent valuation (if required)

The content for the plan of operation is set forth in the application form. It must include an actuarial report or feasibility study prepared by a qualified independent actuary. Any proposed changes to the plan of operation subsequent to licensing must be submitted to the New York superintendent of insurance 30 days before becoming effective.

Letters of credit can be used to meet capital and surplus requirements.

INCORPORATION

After review of the proposed charter and by-laws by the NYID, the applicant submits an executed copy of the charter. For stock insurers, an incorporation tax of one-twentieth of one percent of the par value of capital stock must be submitted to the NYID (New York Tax Law Section 180) at this time. The executed copy of the charter is forwarded by NYID to the New York State attorney general for recording and the NYID issues a certificate of incorporation to the captive company.

After incorporation, the applicant must submit a certified, notarized copy of the by-laws and proof of funding. In addition, the captive insurance company must designate power of attorney to the superintendent as agent for service of process. This submission is accompanied by a certificate of designation naming the person to whom the superintendent can forward any process served upon him. A certified copy of these resolutions by the board of directors authorizing both the appointment and the designation is also required.
# Captive Domicile Comparison

<table>
<thead>
<tr>
<th></th>
<th>Vermont</th>
<th>New York</th>
<th>Washington DC</th>
<th>South Carolina</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Minimum equity value of parent/affiliates</strong></td>
<td>N/A</td>
<td>$100M</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Minimum captive capitalization</strong></td>
<td>Pure - $250,000</td>
<td>Pure - $250,000</td>
<td>Pure - $250,000</td>
<td>Pure - $250,000</td>
</tr>
<tr>
<td></td>
<td>Sponsored (protected cell) - $500,000</td>
<td>Protected cell structures disallowed</td>
<td>Rental (protected cell) - $400,000</td>
<td>Sponsored (protected cell) - $1,000,000</td>
</tr>
<tr>
<td><strong>Implementation/Feasibility Fees</strong></td>
<td>$30,000</td>
<td>$30,000</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>Surplus options</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Cash</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>LOC</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Receivables</td>
<td>Possible</td>
<td>Possible</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Intangibles</td>
<td>Possible</td>
<td>Possible</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Other assets</td>
<td>Possible</td>
<td>Possible</td>
<td>No</td>
<td>Sponsored captive not assuming risk upon approval</td>
</tr>
<tr>
<td><strong>Premium to surplus ratio</strong></td>
<td>None Specified</td>
<td>None Specified</td>
<td>None Specified</td>
<td>Free surplus must be the greater of $300 million or 10% of reserves.</td>
</tr>
<tr>
<td><strong>Provision for loan-backs to parent/affiliates</strong></td>
<td>Yes, prior approval, demand note basis</td>
<td>Yes, prior approval, demand note basis</td>
<td>Upon Approval</td>
<td>Limited to pure captives at the discretion of the regulatory body</td>
</tr>
<tr>
<td><strong>Taxes &amp; Assessments - Direct Written Premium</strong></td>
<td>$0-$20M Premium</td>
<td>0.38%</td>
<td>0.40%</td>
<td>Minimum for all others - $7,500</td>
</tr>
<tr>
<td></td>
<td>$20M-$40M Premium</td>
<td>0.29%</td>
<td>0.30%</td>
<td>$25M to $50M-0.150%</td>
</tr>
<tr>
<td></td>
<td>$40M-$60M Premium</td>
<td>0.19%</td>
<td>0.20%</td>
<td>Over $50M - 0.050%</td>
</tr>
<tr>
<td></td>
<td>$60M+ Premium</td>
<td>0.07%</td>
<td>0.08%</td>
<td>-</td>
</tr>
<tr>
<td>Premium Tax Cap</td>
<td>$200,000</td>
<td>minimum $5,000</td>
<td>$100,000 for all companies</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Assessments/License Fees</strong></td>
<td>$300 License Renewal Fee</td>
<td>0.25% of gross premium written on NY-based risk</td>
<td>Application review fee - $500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$5,000 annual tax payable by captive reinsurance company only</td>
<td>Certificate of authority - $300</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Annual renewal - $500</td>
<td>License renewal - $300</td>
<td>Application fee - $200</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Initial license fee - $300</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Taxes &amp; Assessments - Assumed Written Premium</strong></td>
<td>$0-$20M Premium</td>
<td>0.214%</td>
<td>0.225%</td>
<td>0.225%</td>
</tr>
<tr>
<td></td>
<td>$20M-$40M Premium</td>
<td>0.143%</td>
<td>0.15%</td>
<td>First $25M - 0.2250%</td>
</tr>
<tr>
<td></td>
<td>$40M-$60M Premium</td>
<td>0.048%</td>
<td>0.05%</td>
<td>$25M to $50M - 0.150%</td>
</tr>
<tr>
<td></td>
<td>$60M+ Premium</td>
<td>0.024%</td>
<td>0.025%</td>
<td>Over $50M - 0.025%</td>
</tr>
<tr>
<td>Premium Tax Cap</td>
<td>$200,000 max, $7,500 min</td>
<td>minimum $5,000</td>
<td>$100,000 for all companies</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
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SPOTLIGHT ON THE TAGALONG

ERISA (the Employee Retirement Income Security Act of 1974) remains a mystery to most of us – a situation that can lead to costly mistakes and misunderstandings, as ERISA is now commonly used as a basis for lawsuits against public companies. ERISA tagalong is the convenient shorthand for a claim we would typically think of as a D&O securities suit, except that the suit is brought on behalf of a pension plan (typically a 401(k) plan) that holds the employer's securities.

The litigants typically opt out of the initial securities claim to bring a separate legal action – hence the term tagalong (although today, ERISA suits sometimes precede the D&O action). Private companies with ESOPs (employee stock ownership plans) have long been aware of their employees as potential litigants. Public companies had their eyes opened in 2000-2001 when the first of the ERISA tagalong claims were brought against companies and their executives.

While these claims arise from the same fact pattern alleged in a D&O securities claim – that is, fraud of some kind that hurts stock price – assuming that the tagalong suit will proceed just like the D&O claim can be an expensive mistake. We examine three of the most significant differences between D&O securities suits and ERISA tagalong claims.

1. NO SRA BOUNCE-BACK PROTECTION

Those of us involved in federal D&O securities claims have gotten so accustomed to the procedures and protections set out in the Private Securities Litigation Reform Act of 1995 (SRA) we can easily forget how explosive and unpredictable claims can be when the SRA doesn’t apply. The SRA does not apply to ERISA tagalong claims because they are not federal securities claims. They are federal claims, but they are not brought under any securities code.

One of the most significant differences here — and there are several key distinctions — is that the SRA’s bounce-back period does not apply. The bounce-back period refers to the 90 days following a stock drop. If the stock recovers (or bounces back) during this period, then potential damages in a federal securities claim are reduced or entirely eliminated. There is no such protection built into ERISA, so damages under an ERISA tagalong claim may continue unabated.

Confusing the matter further is the fact that ERISA tagalong suits may be combined with a federal D&O securities claim, in which case the SRA might apply to part (the non-ERISA part) of a given claim.
2. KNOW WHEN TO HOLD ‘EM

D&O security stock-drop claims are not brought on behalf of all shareholders. They are brought on behalf of only those shareholders who first bought shares while an alleged fraud was taking place and then sold their stock after the bad news hit the market. Those who continue to hold onto their shares — who have not suffered any monetary loss except on paper — are not eligible to participate in a D&O securities class action.

The reverse is true with ERISA tagalong claims. These suits are brought on behalf of the plan and/or all plan participants who bought or were assigned the company’s shares during the alleged fraud — whether or not the participants ever sold their holdings. Many, if not most, will still hold their shares at the time that the claim is brought, and it is precisely for their paper loss that they seek redress.

It may be important to note that when 401(k) plans provide a company’s matching contribution in company stock (a “forced” purchase in the minds of the plaintiffs’ counsel), the potential for an ERISA tagalong claim may have increased. But even where employees elect to purchase company shares on a voluntary basis, the risk does not completely disappear. Tagalong claims in such cases will usually allege that the employees’ decision to purchase company shares was founded on the same alleged fraud that misled shareholders in the public marketplace.

3. DIFFERING STANDARDS OF CARE

Most of us are well acquainted with the business judgment rule as it applies to the actions of corporate executives; few are familiar or comfortable with the ERISA prudent-expert standard.

In D&O suits:

The business judgment rule... specifies that the court will not review the business decisions of directors who performed their duties (1) in good faith; (2) with the care that an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner the directors reasonably believe to be in the best interests of the corporation... The business judgment rule is very difficult to overcome and courts will not interfere with directors unless it is clear that they are guilty of fraud or misappropriation of the corporate funds, etc. In effect, the business judgment rule creates a strong presumption in favor of the Board of Directors of a corporation, freeing its members from possible liability for decisions that result in harm to the corporation. [Wikipedia]

ERISA sets out a potentially much higher standard of care for fiduciaries (who may be these same company executives). ERISA states that a fiduciary shall discharge his or her duties with respect to a plan “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” [Section 404(a)(1) of ERISA]

This standard for ERISA fiduciaries has been described as “the highest known to the law” other than strict liability [Donovan v. Bierwirth, 680 F.2d 263, 272 (2d Cit. 1982)].

CONCLUSION

It may be time to consider ERISA’s fiduciary liability as more than the afterthought that the tagalong name implies. The same is true of the insurance that protects fiduciaries. The plaintiffs’ bar is paying close attention to this exposure. So should those potentially exposed.
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Willis Re Analytics

SUBPRIME D&O CLAIMS: EARLY INDICATORS?
Over the past several years, misaligned incentive structures, failures in underwriting, and poorly designed products set the stage for a crisis in subprime mortgage lending. This in turn has led to a broader credit crunch.

The situation presents a significant risk to writers of professional liability insurance and reinsurance, especially Directors and Officers (D&O).

Willis Re’s Professional Liability Practice group is developing an approach, based on financial markets data, to assist our clients in understanding and managing this risk as well as future securities class-action hot spots.

INTRODUCTION

The collapse of the subprime mortgage market has caused considerable turmoil in the financial markets. Initial discussion of the effect this may have on the property and casualty insurance and reinsurance industry focused on (re)insurers’ investment portfolios. For example, Fitch Ratings has stated that the crisis is likely to have little effect on the industry as most of the P&C companies they follow “do not have a lot of [subprime mortgage] exposure.”

However, underwriters of professional liability – both D&O and E&O – may face increased claims in the present environment. In this report, we focus on the possibility of shareholder class-action lawsuits, which could present significant exposure under D&O policies.

THE SUBPRIME CRISIS

Insurers and reinsurers face risk in both their investment and underwriting portfolios

---

1 Business Insurance, December 3, 2007

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2 Willis Re Subprime D&O Claims: Early Indicators?
Of the 175 shareholder class-action lawsuits filed during 2007, a total of 35 are related to the subprime collapse, as listed in Table 1.

### Table 1: Impact of the Subprime Crisis on 2007 Securities Class-Action Filings

<table>
<thead>
<tr>
<th>Litigation Name</th>
<th>Date</th>
<th>Court</th>
</tr>
</thead>
<tbody>
<tr>
<td>NovaStar Financial, Inc.</td>
<td>2/23/2007</td>
<td>W.D. Missouri</td>
</tr>
<tr>
<td>IndyMac Bancorp Inc.</td>
<td>3/12/2007</td>
<td>C.D. California</td>
</tr>
<tr>
<td>Accredited Home Lenders Holding Company</td>
<td>3/16/2007</td>
<td>S.D. California</td>
</tr>
<tr>
<td>Coast Financial Holdings, Inc.</td>
<td>3/20/2007</td>
<td>M.D. Florida</td>
</tr>
<tr>
<td>Beazer Homes USA, Inc.</td>
<td>3/29/2007</td>
<td>N.D. Georgia</td>
</tr>
<tr>
<td>Toll Brothers, Inc.</td>
<td>4/17/2007</td>
<td>E.D. Pennsylvania</td>
</tr>
<tr>
<td>First Home Builders of Florida</td>
<td>5/30/2007</td>
<td>M.D. Florida</td>
</tr>
<tr>
<td>Fremont General Corporation</td>
<td>6/15/2007</td>
<td>C.D. California</td>
</tr>
<tr>
<td>Moody’s Corporation</td>
<td>7/19/2007</td>
<td>N.D. Illinois</td>
</tr>
<tr>
<td>RAIT Financial Trust</td>
<td>8/1/2007</td>
<td>E.D. Pennsylvania</td>
</tr>
<tr>
<td>Luminent Mortgage Capital, Inc.</td>
<td>8/8/2007</td>
<td>N.D. California</td>
</tr>
<tr>
<td>Countrywide Financial Corporation</td>
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<td>C.D. California</td>
</tr>
<tr>
<td>Radian Group Inc.</td>
<td>8/15/2007</td>
<td>E.D. Pennsylvania</td>
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<tr>
<td>Impac Mortgage Holdings, Inc.</td>
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<td>C.D. California</td>
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<tr>
<td>Thornburg Mortgage, Inc.</td>
<td>8/21/2007</td>
<td>D. New Mexico</td>
</tr>
<tr>
<td>The McGraw-Hill Companies, Inc.</td>
<td>8/28/2007</td>
<td>D. District of Columbia</td>
</tr>
<tr>
<td>Care Investment Trust Inc.</td>
<td>9/18/2007</td>
<td>S.D. New York</td>
</tr>
<tr>
<td>NetBank, Inc.</td>
<td>9/19/2007</td>
<td>N.D. Georgia</td>
</tr>
<tr>
<td>Opteum, Inc.</td>
<td>9/19/2007</td>
<td>S.D. Florida</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co., Inc.</td>
<td>10/30/2007</td>
<td>S.D. New York</td>
</tr>
<tr>
<td>HomeBanc Corporation</td>
<td>11/30/2007</td>
<td>S.D. Florida</td>
</tr>
<tr>
<td>Morgan Asset Management, Inc.: Regions Morgan Keegan Select Funds</td>
<td>12/6/2007</td>
<td>W.D. Tennessee</td>
</tr>
<tr>
<td>Huntington Bancshares Incorporated</td>
<td>12/19/2007</td>
<td>S.D. Ohio</td>
</tr>
</tbody>
</table>

Source: Securities Class Action Clearing House (Stanford Law School in cooperation with Cornerstone Research)
Understandably, writers of D&O are trying to get a handle on this risk: both to quantify the potential exposure already on their books, and to guide their future underwriting.

**WILLIS RE SUBPRIME HAZARD GROUPS BY INDUSTRY SECTOR**

To assist our clients in this process, Willis Re reviewed the North American Industry Classification System (NAICS) codes to identify those segments with the greatest degree of exposure to subprime risk.

NAICS codes have a hierarchical structure. For those industry segments judged to have greater exposure to subprime risk, we drilled down to a more refined level of detail. An excerpt from our hazard grouping is shown in Table 2.

<table>
<thead>
<tr>
<th>NAICS CODE</th>
<th>2007 NAICS TITLE</th>
<th>D&amp;O SUBPRIME HAZARD</th>
</tr>
</thead>
<tbody>
<tr>
<td>48</td>
<td>Transportation and Warehousing</td>
<td>L</td>
</tr>
<tr>
<td>51</td>
<td>Information</td>
<td>L</td>
</tr>
<tr>
<td>52</td>
<td>Finance and Insurance</td>
<td>H</td>
</tr>
<tr>
<td>521</td>
<td>Monetary Authorities - Central Bank</td>
<td>H</td>
</tr>
<tr>
<td>522</td>
<td>Credit Intermediation and Related Activities</td>
<td>H</td>
</tr>
<tr>
<td>523</td>
<td>Securities, Commodity Contracts, and Other Financial Investments and Related Activities</td>
<td>H</td>
</tr>
<tr>
<td>524</td>
<td>Insurance Carriers and Related Activities</td>
<td>M</td>
</tr>
<tr>
<td>525</td>
<td>Funds, Trusts, and Other Financial Vehicles</td>
<td>H</td>
</tr>
<tr>
<td>53</td>
<td>Real Estate and Rental and Leasing</td>
<td>H</td>
</tr>
<tr>
<td>531</td>
<td>Real Estate</td>
<td>H</td>
</tr>
<tr>
<td>53111</td>
<td>Lessors of Residential Buildings and Dwellings</td>
<td>H</td>
</tr>
<tr>
<td>53112</td>
<td>Lessors of Nonresidential Buildings (except Miniwarehouses)</td>
<td>H</td>
</tr>
<tr>
<td>53113</td>
<td>Lessors of Miniwarehouses and Self-Storage Units</td>
<td>H</td>
</tr>
<tr>
<td>53119</td>
<td>Lessors of Other Real Estate Property</td>
<td>H</td>
</tr>
<tr>
<td>5312</td>
<td>Offices of Real Estate Agents and Brokers</td>
<td>H</td>
</tr>
<tr>
<td>531311</td>
<td>Residential Property Managers</td>
<td>H</td>
</tr>
<tr>
<td>531312</td>
<td>Nonresidential Property Managers</td>
<td>H</td>
</tr>
<tr>
<td>53132</td>
<td>Offices of Real Estate Appraisers</td>
<td>H</td>
</tr>
<tr>
<td>53139</td>
<td>Other Activities Related to Real Estate</td>
<td>M</td>
</tr>
<tr>
<td>532</td>
<td>Rental and Leasing Services</td>
<td>H</td>
</tr>
<tr>
<td>533</td>
<td>Lessors of Nonfinancial Intangible Assets (except Copyrighted Works)</td>
<td>L</td>
</tr>
</tbody>
</table>

Source: Willis Re Professional Liability Practice Group
It is worth noting that highly exposed enterprises may still be coded to an apparently innocuous industry group. For example, both the A.M. Best rating agency and McGraw-Hill, the parent of Standard & Poor’s, fall into 511 (Publishing).

While the industry hazard groups are a helpful guide, we wanted to establish further distinctions among the companies in each category. As noted in “D&O Reinsurance Pricing – A Financial Market Approach,” credit ratings, credit spreads, and movements in these metrics can provide valuable information about the market’s assessment of a company’s real-time condition. This financial markets perspective is the basis for Willis Re’s proprietary D&O model, eSCAPESM, described in detail in a separate Willis Re briefing.

APPLYING FINANCIAL MARKETS DATA
Credit ratings provided by the major ratings agencies provide valuable guidance on firms’ financial health. However, by their nature, such ratings are slow to move. More responsive indicators can be obtained by analyzing the credit risk implied by bond, equity, and credit default swap data. Moody’s Market Implied Ratings (MIR®) offer a convenient source for such information.

To investigate what financial markets data might reveal, we began with the companies listed in the 2007 Fortune 1000. We eliminated privately held firms and those for which a history of Moody’s senior debt ratings from December 2006 to present was not available, leaving 664 companies in our sample. Of these, the “High” hazard group comprised 78 companies, or approximately 12% of the total. While as of January 2008, companies in the Fortune 1000 are more likely than the average public company to be involved in a subprime related securities class action, the filings-per-firm ratio observed in our test sample was similar to that of the Fortune 1000 as a whole.

<table>
<thead>
<tr>
<th>TABLE 3: TEST SAMPLE IS REPRESENTATIVE OF FORTUNE 1000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GROUP DESCRIPTION</strong></td>
</tr>
<tr>
<td>All Public Companies</td>
</tr>
<tr>
<td>Fortune 1000</td>
</tr>
<tr>
<td>Test Sample</td>
</tr>
</tbody>
</table>

Source: Securities Class Action Clearing House (Stanford Law School in cooperation with Cornerstone Research)

As of December 2006, the average senior debt rating for companies in the “High” subprime hazard grouping was Baa1, while the average rating for companies in the “Medium” subprime hazard rating was Baa3, and the average “Low” subprime hazard rating was Ba1. (See Table 4 for a listing of Moody’s rating categories.) It is perhaps not surprising that before the credit crisis manifested itself, those companies most exposed to subprime mortgage risk enjoyed the

3 “Willis Re eSCAPESM: A Paradigm Shift in D&O Risk Analysis,” Willis Re, October 2006.
strongest credit ratings, because this group included financial institutions. But over the course of 2007, while average ratings for the “Medium” and “Low” subprime hazard groupings remained unchanged, the average rating for companies in the “High” subprime hazard grouping fell to Baa3.

TABLE 4: MOODY’S RATING CATEGORIES

<table>
<thead>
<tr>
<th>Moody’s Rating</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>Highest quality, minimal credit risk.</td>
</tr>
<tr>
<td>Aa1, Aa2, Aa3</td>
<td>High quality, very low credit risk.</td>
</tr>
<tr>
<td>A1, A2, A3</td>
<td>Upper-medium grade; low credit risk.</td>
</tr>
<tr>
<td>Baa1, Baa2, Baa3</td>
<td>Medium grade; may possess certain speculative characteristics; moderate credit risk.</td>
</tr>
<tr>
<td>Ba1, Ba2, Ba3</td>
<td>Speculative; substantial credit risk.</td>
</tr>
<tr>
<td>B1, B2, B3</td>
<td>Speculative; high credit risk.</td>
</tr>
<tr>
<td>Caa1, Caa2, Caa3</td>
<td>Poor standing; very high credit risk.</td>
</tr>
<tr>
<td>Ca</td>
<td>Highly speculative; likely in, or very near, default; some prospect of recovery.</td>
</tr>
<tr>
<td>C</td>
<td>Lowest rated class; typically in default; little prospect for recovery.</td>
</tr>
</tbody>
</table>

Source: Moody’s

We next analyzed the gap between the senior debt rating and the credit ratings implied by bond, equity, and credit default swap pricing. The MIR® gap at any point in time is defined as the number of levels between the senior debt rating and the lowest of these Market Implied Ratings, with a negative number representing an implied downgrade and a positive number representing an implied upgrade.

EXHIBIT 1: UNFAVORABLE MIR® GAPS MORE PREVALENT IN HIGH SUBPRIME HAZARD GROUP

Source: Moody’s MIR® Service and Willis Re Professional Liability Practice Group
As seen in Exhibit 1, there is a strong correspondence between the “High” subprime hazard category and unfavorable MIR® gaps. This leads to the question of how far in advance the financial markets might have signaled problems in the “High” hazard industry group. While problems at subprime lenders became public in February and March 2007, the impact of the broader credit crunch was not felt until August. When did the MIR® gaps appear and widen?

**EXHIBIT 2: HIGH SUBPRIME HAZARD GROUP SHOWS WIDENING MIR® GAPS**

![Graph showing widening MIR® gaps](image)

Source: Moody’s MIR® Service and Willis Re Professional Liability Practice Group

While, as Exhibit 2 illustrates, there is little difference between the behavior of MIR® gaps of the “Low” and “Medium” categories as compared to the entire sample, the “High” hazard category declined markedly in March and again between June and September. It is also interesting to note that the “High” category already had a worse than average MIR® gap as of December 2006.

**CONCLUSIONS**

How useful is this information as a predictor of potential securities class-action vulnerability? The “High” hazard grouping comprises 12% of our sample (78 out of 664 companies); those firms with an indicated downgrade MIR® gap of -4 or worse made up about 17% of the total as of March (110 out of 664), and about 22% as of December (148 of the 664). Those firms in the “High” subprime hazard group that have large downgrade MIR® gaps (highlighted in Table 5) are likely the companies at greatest risk.
Of the 664 companies in our sample, twelve are named in subprime related filings. All but one of these fall into the “High” subprime hazard category, the single exception being McGraw-Hill. Eleven of the twelve companies had MIR® gaps of -4 or worse as of 12/4/07, and as of 3/5/07 already nine of the twelve had MIR® gaps of -4 or worse.

As the impact of the credit crisis continues to make itself felt, insurance and reinsurance companies will need to remain vigilant. We believe that the Willis Re hazard classification, combined with analysis of the market implied credit ratings gaps, may prove very helpful to companies seeking to quantify their exposures and/or re-underwrite their portfolios. And more generally speaking, financial markets data, as implemented in our proprietary eSCAPE® model, may also help to offer a leading indicator of new issues confronting Directors & Officers business in the future.

- The subprime mortgage situation presents a significant risk to writers of professional liability insurance and reinsurance.
- To assist our clients in managing this risk, Willis Re has developed a D&O hazard grouping system, reflecting vulnerability to subprime related lawsuits by industry sector.
- Willis Re’s hazard grouping is strongly correlated with MIR® gaps.
- Moody’s Market Implied Ratings may offer early indication of problems that could lead to securities class-action lawsuits.
Employers breathed a sigh of relief when, days before the January 1, 2008 effective date of the San Francisco Health Care Security Ordinance (HCSO), a federal district court held that ERISA preempts the HCSO’s minimum employer contribution requirement. The relief was short-lived, however. On January 9, 2008, a federal appeals court ruled that San Francisco can enforce the employer contribution requirement while the city appeals the district court’s ruling. The appeals court’s action leaves employers with some difficult decisions in the next few months.

Although the appeals court’s ruling allows immediate enforcement of the employer contribution mandate, the ruling did not reverse the district court’s holding that ERISA preempts the minimum contribution requirement. The appeals court will decide separately on the district court’s preemption holding. In its January 9 decision, however, the appeals court signaled that it is likely to reverse the district court’s holding. In fact, the appeals court found that the city had shown a “strong likelihood” of success in arguing that ERISA does not preempt the contribution requirement. This decision is not expected before summer of 2008.

So what now for employers? Compliance is required, but if the appeals court holds that the requirements are preempted, then employer compliance will have been unnecessary. Even if the appeals court holds that the contribution requirement is not preempted, that decision may eventually be reversed. A decision against preemption would create a split in the circuit courts because another federal appeals court held that ERISA preempts a Maryland law that had a contribution requirement similar to the HCSO’s. A split in the circuits would increase the likelihood that this case would end up before the U.S. Supreme Court. If the Supreme Court were to accept this case for review, no final decision would be likely before 2009. This leaves many employers asking whether they should amend their plans to extend coverage to all of the employees covered by the contribution requirement – or take a wait-and-see approach.
CONFLICTING CONSIDERATIONS

Most employers have benefit plans for their full-time employees that meet the HCSO requirements. The difficult issue for them under the HCSO is covering part-time employees who work as few as 10 hours per week. As reluctant as employers may be to add these benefits, many would probably prefer adding benefits (that can after all help them attract qualified employees) to HCSO’s alternative – paying into the city’s program. At the same time, employers may believe that the appeals court’s decision is an aberration and that the contribution requirement will ultimately be found preempted. Many employers will also consider the fact that once expanded benefits are announced, it can be difficult to withdraw them.

As for timing, the rules are in effect as of January 9, but employers’ first real compliance obligations will be due on April 30, 2008. This is the first deadline for an employer to meet the minimum contribution requirement, and also when the first annual report from employers is due. This first report need not reflect compliance with the contribution requirement because it will refer to 2007, before compliance was required. If an employer plans to meet the minimum contribution requirement by providing benefits, however, it must implement necessary plan changes very soon.

For the employer wanting to take the wait-and-see approach, there is one option that provides flexibility and compliance: contributing the minimum amount to the public program established by the HCSO. If the courts ultimately uphold the law, employers can then decide in a more stable environment how they wish to comply. Willis strongly recommends that employers discuss their response to the HCSO with their legal counsel and weigh the various risks carefully before proceeding.

HCSO BACKGROUND

In addition to establishing a healthcare program, San Francisco’s HCSO requires that medium-sized and large businesses make certain minimum contributions toward their San Francisco employees’ healthcare. Under the minimum contribution provision, an employer may either contribute to a medical plan (or other health benefits) or pay into the public program established by the HCSO. As written, the law was scheduled to take effect January 1, 2008. (See Willis’ Employee Benefits Alert, Issue 112 for information on the HCSO’s effective date provisions.) The effective date was moved to January 9, 2008, the date of the appeals court ruling. A business is covered by the mandate if it engages in business within the city of San Francisco, is required to obtain a San Francisco business registration certificate, and employs 20 or more employees per week. The HCSO does not apply to nonprofit organizations with fewer than 50 employees or to for-profit employers with fewer than 20 employees. To arrive at an official employee count, all employees must be counted regardless of location. If the number of employees fluctuates, employer size is based on the weekly average number of persons performing work for compensation.
EMPLOYEES COVERED

The HCSO covers employees who have been employed for at least 90 calendar days (not necessarily continuously or even in the same calendar year) and who work at least 10 hours per week in San Francisco. This requirement drops to eight hours on January 1, 2009.

Employers are not required to make expenditures for employees who qualify for certain exemptions. The categories of exempt employees are:

- Employees who voluntarily complete an official form waiving the right to have the employer make expenditures on their behalf because they are receiving healthcare from another employer
- Managers, supervisors and confidential employees earning more than $76,851 during 2008 (this amount is indexed)
- Employees covered by Medicare or TRICARE/CHAMPUS
- Employees who are employed by a nonprofit corporation for up to one year as trainees in a bona fide training program consistent with federal law
- Employees who receive healthcare benefits pursuant to the San Francisco Health Care Accountability Ordinance (e.g., employees of city contractors)

THE MINIMUM CONTRIBUTION

The ordinance requires that employers make a quarterly healthcare expenditure to, or on behalf of, each of its qualifying San Francisco employees. A healthcare expenditure is any amount paid by the employer to its San Francisco employees or to a third party on behalf of its employees for the purpose of providing healthcare services or reimbursing the cost of such services.

Healthcare services include medical, dental and vision-care services or goods that, if unreimbursed, would qualify as tax-deductible medical care expenses under Section 213 of the Internal Revenue Code. They also include services or goods having substantially the same purpose or effect as such deductible expenses.

The employer determines how it will make the required expenditures and may utilize a variety of different ways to comply. Examples of healthcare expenditures that meet the requirements are:

- Payment of premiums for health insurance coverage for the covered employee
- Payments to the city to fund membership for the covered employee in Healthy San Francisco, the public program established by the HCSO
- Payments to a city-sponsored medical reimbursement account for the employee
- Expenditures made by self-funded plans (including administrative costs paid to a third party)
- Contributions on behalf of the covered employee to a health spending account, such as a health reimbursement arrangement, a flexible spending account or a health savings account
- Cash reimbursements to the covered employee for expenses incurred in the purchase of healthcare services, such as pharmacy bills

Payments made on behalf of an employee for dependents, such as a spouse, domestic partner or child, are included.
CALCULATING THE MINIMUM

The minimum required healthcare expenditure is calculated on a quarterly basis for each employee by multiplying the total number of hours paid to the employee by the applicable healthcare expenditure rate. *Hours paid* is defined as the hours during a quarter for which a person is paid wages for work performed within San Francisco or for which a person is entitled to be paid wages, including paid vacation hours, paid time off, and paid sick leave hours (but not exceeding 172 hours in a single month or 516 hours in a single quarter).

### Employer Health Care Expenditure Rate Schedule (all rates per hour)

<table>
<thead>
<tr>
<th>BUSINESS SIZE</th>
<th>JANUARY 9, 2008</th>
<th>APRIL 1, 2008</th>
<th>JANUARY 1, 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>100+ Employees</td>
<td>$1.76</td>
<td>$1.85</td>
<td></td>
</tr>
<tr>
<td>50-99 Employees</td>
<td>$1.17</td>
<td>$1.23</td>
<td></td>
</tr>
<tr>
<td>20-49 Employees</td>
<td>Not Applicable</td>
<td>$1.17</td>
<td></td>
</tr>
<tr>
<td>1-19 Employees</td>
<td>Not Applicable</td>
<td>Not Applicable</td>
<td></td>
</tr>
<tr>
<td>Non-Profit Organizations</td>
<td>Not Applicable</td>
<td>Not Applicable</td>
<td></td>
</tr>
<tr>
<td>with &lt; 50 Employees</td>
<td>Not Applicable</td>
<td>Not Applicable</td>
<td></td>
</tr>
</tbody>
</table>

Starting January 1, 2010, rates will be determined on an annual basis. The Office of Labor Standards Enforcement (OLSE) will publish rates for each calendar year by March 1 of the preceding year.

Employers must make a minimum quarterly healthcare expenditure on behalf of each covered employee. Payments for one employee that exceed the minimum requirement cannot be used to meet the minimum requirement for another employee. In addition, expenditures made for an employee in one quarter that exceed the minimum required cannot be applied to reduce the minimum required expenditure for the employee in any other quarter. There are limited exceptions to these rules for employers that offer employees uniform or self-insured coverage.

### Uniform Coverage

One exception is intended to cancel out the effect of an employer making lower contributions toward individual coverage than it makes toward family coverage. An employer providing uniform health coverage to a group of covered employees complies with the expenditure requirement for those employees if the average expenditure rate per employee meets or exceeds the employer’s applicable expenditure rate. To calculate the average hourly expenditure rate, divide the total amount of healthcare expenditures made for the group of covered employees during a quarter by the total number of hours paid to those employees during that quarter.

The employer has the option of including in its calculation only those employees having the uniform coverage who are also covered by the ordinance or including all covered employees who have the uniform coverage. The ability of an employer to aggregate expenditures under this exception is limited to those employees with the same type of coverage (e.g., an employer can aggregate the expenditures for those covered by an HMO but cannot aggregate the expenditures for those covered by an HMO with the expenditures of those covered by a PPO).

### Self-Funded Plans

If the employer’s plan is self-funded, the employer is excused from making the minimum expenditure for each employee as long as the preceding year’s average hourly expenditure rate per employee meets or exceeds the required expenditure rate. To calculate the average hourly expenditure rate, divide the total amount of healthcare expenditures made for employees by the total number of hours paid to employees during the year. The employer has the option of including in its calculation only those employees covered by both the self-funded plan and the ordinance or including all employees participating in the self-funded plan (provided that all employees receive the same coverage). If the employer’s expenditure rate in the previous year does not meet or exceed the current year’s required expenditure rate, the employer must make expenditures in the current year to close the gap.

The city has created a **flow chart** that explains how to calculate the minimum healthcare expenditure.

The expenditure may be spread out, but must be made no later than 30 days after the end of each calendar quarter. By that time, the minimum expenditure for the preceding quarter must be made in full. Details about making payments to the city, if that is the option the employer chooses, can be found on the Healthy San Francisco website.
REPORTING REQUIREMENTS

Employers are required to annually report their healthcare expenditures to the city, which expects to have the forms for reporting 2007 information mailed by the end of January. The filing deadline has been extended from February 29 to April 30. The city will include the new compliance dates with its mailing. A sample of the form can be found online. **NOTE: because the data on the form will be electronically scanned, employers cannot use downloaded or photocopied forms.** As the employer mandate did not go into effect until 2008, the initial annual report will reflect the employer’s voluntary 2007 businesses practice.

If the employer chooses to satisfy its obligation under the law by making payments to the city, then it must provide employees with **notice** that informs them when a deposit to the city has been made on their behalf. The city has not specified the time or manner for providing this notice.

In order to treat an employee as exempt due to their receiving healthcare benefits through another employer (e.g., through another job or the spouse’s employer), the employer must collect a signed form from the employee waiving his or her rights to the healthcare expenditure. The employee has the right to cancel or revoke the waiver at any time, and an employer is prohibited from forcing or coercing the employee to sign the form. The employer must receive a signed form from the employee each year in order for the employee to remain exempt.

RECORDKEEPING

Employers must maintain records going back four years for each employee. Upon request, the employer must provide the OLSE reasonable access to those records. The required records include:

- Itemized pay statements that provide such information as gross wages earned, total hours worked (unless salaried), the employer’s name and address, and the name and social security number of the employee
- The employee’s address, telephone number and first day of work
- Records of healthcare expenditures made, including how the expenditures were calculated and proof that the expenditures were made
- A signed voluntary waiver form for each employee for whom the employer is claiming an exemption due to other coverage
- A copy of the Notice to Employee of Payment to the City with respect to employees for whom the employer made such contributions

San Francisco has a variety of resources available to employers with questions regarding their obligations under the ordinance. In addition to the materials (forms, Q/A, etc.) available on its [website](#), the OLSE is available to answer questions by phone at 415.554.7892 or by email at HCSO@sfgov.org.
## US BENEFITS OFFICE LOCATIONS

<table>
<thead>
<tr>
<th>City</th>
<th>Office Location</th>
<th>Phone Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlanta, GA</td>
<td>Florham Park, NJ</td>
<td>973 410 1022</td>
</tr>
<tr>
<td>Austin, TX</td>
<td>Ft. Worth, TX</td>
<td>817 335 2115</td>
</tr>
<tr>
<td>Baltimore, MD</td>
<td>Grand Rapids, MI</td>
<td>616 954 7829</td>
</tr>
<tr>
<td>Birmingham, AL</td>
<td>Greenville, SC</td>
<td>864 232 9999</td>
</tr>
<tr>
<td>Boston, MA</td>
<td>Houston, TX</td>
<td>713 961 3800</td>
</tr>
<tr>
<td>Cary, NC</td>
<td>Jacksonville, FL</td>
<td>904 355 4600</td>
</tr>
<tr>
<td>Charlotte, NC</td>
<td>Knoxville, TN</td>
<td>865 588 8101</td>
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<tr>
<td>Chicago, IL</td>
<td>Las Vegas, NV</td>
<td>702 432 7100</td>
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<tr>
<td>Cincinnati, OH</td>
<td>Long Island, NY</td>
<td>516 941 0260</td>
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<tr>
<td>Cleveland, OH</td>
<td>Los Angeles, CA</td>
<td>213 607 6300</td>
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<td>Memphis, TN</td>
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<td>Denver, CO</td>
<td>Milwaukee, WI</td>
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<td>Detroit, MI</td>
<td>Minneapolis, MN</td>
<td>763 302 7100</td>
</tr>
<tr>
<td>Farmington, CT</td>
<td>Mobile, AL</td>
<td>251 433 0441</td>
</tr>
</tbody>
</table>

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IT’S ALL ABOUT AUTOMOBILES

This issue of Wealthy & Wise is devoted to automobiles. Americans have had a love affair with cars since Henry Ford turned out his first Model T and for most of us, our lives are inextricably linked with our cars – for work, for play, for the sake of collecting them or as an investment.

Whether you’re an everyday driver or an aficionado, you’ll find useful information on topics from insurance to dashboard lights to auto shows. We also offer sobering information on driving under the influence. So buckle up, put ‘er in drive and enjoy the ride.

COLLECTOR CAR INSURANCE

Do you own a collector automobile or an exotic vehicle? What about a fire truck? Antique commercial vehicle? Military? Modern classics or muscle car? Perhaps a replica? Custom street rod? Antique tractor, truck or trailer?

Despite their differences, all types of collector automobiles are eligible for coverage under a collector automobile policy, which differs from a standard automobile policy in the following areas.

- **Agreed value.** Most collector policies have an agreed value for the vehicle that is based on either the insurance company estimate or a verified written appraisal rather than the more standard “actual cash value” basis of conventional automobile policies.

- **Low to no deductible.** This depends on age/type/model.

- **Lower premiums.** Since collector cars are not driven on a daily basis, their reduced usage can result in lower premiums.
When shopping for collector car coverage, it's important to find a policy that offers:

- **Repair shop of your choice.** This is important because collector cars are often either unique or unusually rare and require not only hard-to-find parts, but also the expertise to install them and make repairs.

- **No Attendance Clause.** Many collector car policies have an attendance clause that requires you or an attendant to watch your car at all times when it is outside your garage. You want a policy that has a no attendance clause so when you take your car out for an occasional jaunt you’ll be able to stop for dinner without worrying about it.

- **Annual Mileage:** You've spent money restoring or purchasing a collector car; you should be able to show it off occasionally on the road. It's best to find a policy that will allow you to drive up to 2500 miles per year.

- **Immediate Purchase Coverage:** If you already insure one or more collector automobiles and wish to purchase another, you want a policy that will afford immediate coverage up to a specified dollar amount, so you can drive your new wheels home knowing you are covered.

WINTER DRIVING TIPS

No matter where you are around the country, winter driving presents its own special set of challenges. Whether in heavy rain, snow, sleet or ice, paying attention to driving conditions and using good old common sense will help keep you safe on winter roads.

SNOW, SLEET AND ICE

When driving in snow, sleet and ice remember these two words: *slow and easy.* Even if you have snow tires on a four-wheel drive vehicle with anti-lock brakes, remember that most tires barely grab the road, and you must be doubly alert to everyone around you. Here are some easy-to-remember tips.

1. For every 10 miles per hour of speed, keep two car lengths between you and the car ahead. This is the minimum distance calculated for safe stopping in winter conditions.

2. If your car is covered in snow and/or ice, clear the *entire* car, not just a patch large enough to see through on your windshield. A quick stop can send snow flying down your roof onto your windshield or in some cases, onto the car behind you, increasing the chances of a rear-end collision. In most states, clearing your entire car is required by law.

3. To prevent skidding, pump your brakes (gently) when slowing down for a stop – even if you have anti-lock brakes.

4. If you find yourself skidding, turn *into* the direction your car is skidding. For instance, if you are skidding to the right, pump your brakes and turn the wheels to the right.

Remember, drive slowly and gently.

ADDITIONAL TIPS

- Before winter begins, have your car inspected and repaired if needed. This inspection should include the battery and its charging system, the cooling system, and don’t forget to replace the wiper blades each winter driving season.

- If you live in an area where the temperature frequently drops below freezing, you may want to consider purchasing an engine
block heater. This will help you start your engine even in the coldest weather.

- If your state allows studded snow tires, follow the state laws regarding when tires may be installed and by when they must be removed. If your state allows regular snow tires, install these prior to the first forecasted snowstorm and remove when warmer weather arrives. Again, many states regulate the dates snow tires are allowed. *Tip: Mount each snow tire on its own rim for easy installation and removal.*

- When traveling in areas that require tire chains, refer to your owner’s manual to select the most suitable tire chains for your vehicle. Many of today’s high-profile tires will not accommodate traditional tire chains. There are several alternatives, including cable chains and molded chains. Talk to your automobile dealer for further information.

- Stay off your cellphone and keep distractions, such as radios and unnecessary conversation, to a minimum so that it is easy for you to focus solely on your driving, the road conditions and other cars around you.

- It is a good idea to keep an emergency supply kit in your car. In the winter months, it should include a shovel, snow brush, ice scraper, extra windshield washer fluid, additional warm clothing, a blanket, waterproof boots and a flashlight. It’s also an excellent idea to carry a can or two of sand in the trunk if you live in an area where there are hills.

- Make sure your front and rear window defrosters are in perfect working order, as is required by law in many states.

- Make sure your cell phone is fully charged before leaving home in winter, as this may be your best lifeline in case of an emergency.

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**THE CONCOURS D’ELEGANCE**

What is a Concours d’Elegance? The best description is courtesy of Wikipedia, the online encyclopedia:

*A Concours d’Elegance (from French meaning a competition of elegance) is a competition between automobile owners to be judged on the appearance of their automobiles. These are commonly held at auto shows or after racing competition.*

Numerous local organizations sponsor Concours’ events; traditionally vehicle judging at a Concours d’Elegance is much more demanding than that of a neighborhood or general car show. Trained judges examine the vehicle thoroughly and in its entirety and rate each and every component. Only those vehicles that are judged perfect (or very nearly so) in every way are considered trophy class.

Often the competitiveness of a Concours d’Elegance forces restoration of a vehicle to surpass ‘mint’ condition. Mint condition would be the state of the vehicle when it originally left the factory. Concours-quality cars are often given upholstery, paint, chrome (or nickel) plating and mechanical restoration far exceeding that of the car when new.

All too frequently Concours d’Elegance quality cars are not driven, except for short distances from their trailers to the show fields. They are not intended to be used as daily drivers and are often not seen outside of museums or private collections. Even after driving only the short distance to the show field, the car is ‘staged’; errant bits of dirt or pebbles removed from the tire treads, bits of grass or mud wiped from the under-carriage, and the vehicle is constantly maintained, and frequently dusted to keep the absolutely flawless appearance while on display.

For car enthusiasts, a Concours d’Elegance is guaranteed to bring out the best of rare and beautiful automobiles from around the world. Some Concours shows are world-renowned, while others have a strong local following. Many of these shows benefit charities, and all
of them provide a wonderful time for both novice and experienced automobile enthusiasts.

Following is a sampling of fine automobile shows and their web addresses where you can find show dates and further information. You may also consider conducting your own online search for your specific needs, interests or location.

**ARIZONA**
Phoenix Concours d’Elegance: www.elegantcars.com

**CALIFORNIA**
Pebble Beach Concours d’Elegance: www.pebblebeachconcours.net
Hillsborough Concours d’Elegance: www.hsf.org/index.html
Palo Alto Concours d’Elegance: www.paconcours.com
Los Angeles Concours d’Elegance: www.laconcours.com
Newport Beach Concours d’Elegance: www.nbcconcours.com
Palos Verdes Concours d’Elegance: http://www.pvconcours.com/

**CONNECTICUT**
Greenwich Concours d’Elegance: www.greenwichconcours.com

**NEW YORK**
New York City Concours d’Elegance: www.newyorkcityconcoursdelegance.com
Scarsdale Concours: www.scarsdaleconcours.com

**WASHINGTON STATE**
Kirkland: www.kirklandconcours.com
Seattle Italian: www.italianconcours.com

**MARYLAND**
St. Michaels Concours: www.stmichaelsconcours.com

**PENNSYLVANIA**
Radnor Hunt Concours d’Elegance: www.radnorconcours.org

**FLORIDA**
Amelia Island Concours d’Elegance: www.ameliaconcours.com
Winter Park Concours: www.winterparkconcours.com
Palm Beach International Concours d’Elegance: www.palmbeachconcours.com
Festivals of Speed, St. Petersburg: www.festivalsofspeed.com

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**THE DRUNK DRIVER - THE DUI CITATION IS JUST THE BEGINNING**

We have all heard about someone getting charged with DUI (driving under the influence), but do you know what happens once you get that DUI? Laws vary by state, but the laws in almost every state have become more onerous and costly in terms of money and the impact a DUI will have on your driving record. In this article, we will site California's law, as it is the most stringent.

**TO DRINK OR NOT**

Before you order and consume an alcoholic beverage, remember these helpful tips and sobering laws.

**Transportation:** Designate a driver, call a cab, walk, stay home or call a friend or family member to drive you.

**Implied Consent:** Anyone who is granted a driver's license is “presumed to have given consent to law enforcement to conduct chemical testing of the motorist’s blood or breath.”

**0.08%:** Driving a vehicle under the influence of alcohol or drugs is in violation of the law, as is anyone driving with a blood alcohol reading of over 0.08% or higher. Under the age of 21, the level is 0.01%.
BLOOD ALCOHOL LEVELS

How many drinks does it take for the blood alcohol level to reach 0.08%?


<table>
<thead>
<tr>
<th>Your Weight</th>
<th>Number of Drinks (over a two-hour period) 1.25 oz. 80-proof liquor, 12 oz. of beer or 4 oz. of wine</th>
</tr>
</thead>
<tbody>
<tr>
<td>99 to 109</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>110 to 129</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>130 to 149</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>150 to 169</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>170 to 189</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>190 to 209</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>210 to 229</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
<tr>
<td>230 &amp; UP</td>
<td>1 2 3 4 5 6 7 8</td>
</tr>
</tbody>
</table>

(Courtesy of the California Highway Patrol)

- **(.01% – .04%) May be DUI:** Anyone, after one drink during a two-hour period, and people weighing 170 pounds or more, after two drinks.
- **(.05% – .07%) Likely DUI:** People weighing less than 170 pounds, after two drinks – people weighing 150 pounds or more, after three drinks – and people weighing 190 pounds or more, after four drinks.
- **(.08% – UP) Definitely DUI:** People weighing less than 150 pounds, after three drinks – people weighing less than 190 pounds, after four drinks – and anyone, after five drinks.

YOU'RE CITED FOR DRIVING UNDER THE INFLUENCE

When an officer stops a car for a code violation, the officer will approach the car and observe the driver. If the officer smells alcohol on the driver's breath, or if the driver appears to be intoxicated, a Field Sobriety Test (FST) will be administered. The FST comprises four different tests. (If you refuse to take this test, your license will automatically be suspended for one year.) If the driver fails any one of the tests, they are then transported to the nearest law enforcement station where they will be asked to blow into a breathalyzer. A person is considered legally drunk if their blood alcohol level is 0.08% or higher. Depending on the vehicle code violation and the breathalyzer analysis, the charges will be either a misdemeanor or a felony. You will then spend the night in jail. Don’t think your time in jail will be spent in an individual cell. You’ll be placed in a holding cell with people in all conditions from all walks of life. You will have no privacy and no bed to sleep on. If you are arrested anywhere between a Thursday night and Monday morning, you will spend the weekend in jail, because judges are not on call.

The next day you will be escorted to court where a judge will read your charges and determine your bail amount.

Once you are released from jail, your life will have changed. Period. First, the arresting officer will confiscate your license and issue you a 30-day temporary license that allows time for administration and appeal before your license suspension. A DUI conviction can cost you $10,000 or more in storage fees, jail costs, fines, penalties, attorney’s fees and vehicle insurance increases. On your first conviction you will serve 96 hours to six months in jail. When released, you will serve three to five years probation. Your license will be suspended for a period determined by the court. The court will require you to take and pass a drunk driver course.

Once you have passed the course, paid your fees and your suspension period has ended, you will qualify for a Restricted Driver’s License. This license will allow you to drive to and from work only. In order to get this license, you will need to file a form called an SR22, Financial Responsibility. This form is sent to your insurance carrier, and that is when you will find out if your insurance company will continue to insure you as a risk or drop you from your policy. Your insurance company can refuse to insure you for as long as 10 years following your DUI conviction. In the meantime, it is up to you to find proper car insurance. Should you find a company that will insure you, be prepared to pay extremely high rates for quite a long time.
GETTING BEHIND THE WHEEL “UNDER THE INFLUENCE” – IS IT WORTH IT?

Think about the consequences.
- A DUI on your driving record – which in California will stay there for 10 years
- A charge of a felony or misdemeanor on your criminal record
- Exorbitant auto insurance premiums – if you can find coverage at all
- Lawsuits related to accidents occurring while under the influence

The above items are expensive and inconvenient, but for most people these problems can be managed. What could not be managed would be the worst case scenario in a DUI situation: seriously injuring yourself and possibly killing innocent passengers and other drivers, leaving innocent families shattered and lives changed forever.

THE DIFFERENCE BETWEEN GOOD AND GREAT AUTOMOBILE INSURANCE

You’ve heard the ads on the radio, read them in the newspaper, perhaps even discussed them with friends – many companies are touting reduced automobile insurance premiums.

While it’s true that some carriers have reduced their premiums, the old adage: “you get what you pay for” is often applicable. The key factor is always the best value – not necessarily the best price – and if you own or lease an automobile with a purchase price of $30,000 or more, you owe it to yourself to obtain coverage that provides the breadth of coverage that more expensive cars require.

Compare your present policy to the better policies in the marketplace. continued on page 7

TIMELY TIP: TURN YOUR LIGHTS ON!

Many automobiles have illuminated dashboard instruments that light up whether your headlights are on or not. While this feature provides a driver with a clear view of the various gauges, it also effectively removes a handy reminder to turn your lights on. Obviously, if other drivers can’t see you, they can run into you. Furthermore, whether you crash or not, in most states driving without your lights on in the dark (and in some states, even in the rain) is against the law.

If your car has this feature, keep your headlight switch in the “auto” position so that your headlights automatically turn on as daylight running lights during daylight hours and full head and tail lamps at night.
### Feature Comparison

<table>
<thead>
<tr>
<th>Feature</th>
<th>Standard Auto Insurance</th>
<th>Better Auto Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreed value for your automobile should it be totaled in an accident</td>
<td>No. Most insurance carriers will pay the actual cash value, less depreciation.</td>
<td>Yes. The value is determined each renewal period and applies throughout the policy year, regardless of depreciation.</td>
</tr>
<tr>
<td>Substitute auto coverage. This applies when you need to rent an automobile while yours is being repaired due to an accident.</td>
<td>A per dollar per day for 30 days</td>
<td>A fixed dollar amount allowing you to rent the same type of car you presently drive</td>
</tr>
<tr>
<td>Full window glass coverage (cracked and/or broken glass)</td>
<td>No. Your comprehensive deductible applies.</td>
<td>Yes, and no deductible</td>
</tr>
<tr>
<td>Claims are settled without depreciation for wear and tear on parts</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Your choice of repair facility</td>
<td>Not always</td>
<td>Yes</td>
</tr>
<tr>
<td>Loss of use to a damaged rental car</td>
<td>No coverage</td>
<td>Yes. Amounts vary by carrier.</td>
</tr>
<tr>
<td>Key lock replacement coverage: lose your electronic key fob? You could be in for a nasty surprise when you find out what it costs to replace the locking system not only for your doors but for the ignition as well!</td>
<td>No coverage</td>
<td>Yes. Most carriers offer this coverage; some with a specified dollar amount. In most cases there is no deductible.</td>
</tr>
<tr>
<td>Excellent claims paying ability</td>
<td>Not always. You may find that you are being 'nickle-and-dimed' on repair monies.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Automobile premium estimates are based on many of the following criteria.
- Year, make and model of your automobile
- Garage location
- Horsepower of the engine
- Estimated yearly mileage
- The individual driving record(s) of you and your household and/or family member(s).

Be aware that insuring new drivers (also known as youthful drivers) is very expensive. This is because so many young drivers have less experience and are more prone to accidents. Many states have instituted new laws that require a certain number of hours of driving education and practice behind the wheel. Many insurers offer small discounts for good students with high grade point averages.

Some insurers also offer a discount if you insure your home and auto together. Again, this varies by state.

*Happy Motoring!*
## For Further Information, Please Contact:

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Areas/Regions</th>
<th>Contact Information</th>
</tr>
</thead>
<tbody>
<tr>
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<td>Chief Executive Officer / Practice Leader</td>
<td>212 915 8019</td>
<td><a href="mailto:sandra.bravo@willis.com">sandra.bravo@willis.com</a></td>
</tr>
<tr>
<td>Jim Jameson</td>
<td>Executive Vice President</td>
<td>New York, NY</td>
<td>New York Region</td>
</tr>
<tr>
<td>Joseph Clark</td>
<td>Vice President</td>
<td>Radnor, PA</td>
<td>Pennsylvania, New Jersey, Delaware</td>
</tr>
<tr>
<td>Lynn Killeen</td>
<td>Senior Vice President</td>
<td>Bethesda, MD</td>
<td>Chesapeake Region</td>
</tr>
<tr>
<td>Janet Rosin</td>
<td>Senior Vice President</td>
<td>Phoenix, AZ</td>
<td>Arizona, Nevada</td>
</tr>
<tr>
<td>Lori Caldwell</td>
<td>Assistant Vice President</td>
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<td>Tennessee, Kentucky</td>
</tr>
<tr>
<td>Mark Battat</td>
<td>Vice President</td>
<td>San Francisco, CA</td>
<td>Northern California</td>
</tr>
<tr>
<td>Brian Olive</td>
<td>Vice President</td>
<td>Seattle, WA</td>
<td>Washington, Oregon</td>
</tr>
<tr>
<td>Alan Chang</td>
<td>Vice President / Business Development</td>
<td>Los Angeles, CA</td>
<td>Southern California</td>
</tr>
<tr>
<td>Lesa Blaser</td>
<td>Vice President</td>
<td>Dallas, TX</td>
<td>Texas, Colorado, Louisiana, Alabama</td>
</tr>
<tr>
<td>Robert J. Clark</td>
<td>Assistant Vice President</td>
<td>Tampa, FL</td>
<td>Florida</td>
</tr>
<tr>
<td>Irene Dick</td>
<td>Senior Vice President</td>
<td>Toronto, ON</td>
<td></td>
</tr>
<tr>
<td>Trish McClintick</td>
<td>Vice President</td>
<td>Vancouver, BC</td>
<td></td>
</tr>
<tr>
<td></td>
<td>CANADA OPERATIONS</td>
<td></td>
<td>Wealthy &amp; Wise provides a general overview and discussion on a wide range of topics. It is not intended, and should not be used, as a substitute for professional advice in any specific situation.</td>
</tr>
</tbody>
</table>

## Wealthy & Wise

Wealthy & Wise provides a general overview and discussion on a wide range of topics. It is not intended, and should not be used, as a substitute for professional advice in any specific situation.
A NEW ERA BEGINS FOR THE BRAZILIAN REINSURANCE MARKETPLACE

After Brazil enacted the law establishing the general rules of the new reinsurance market in December 2006 (see Willis’ January 2007 International Alert), local market officials were aware that further amendments and clarifications would be required. The local authority for insurance and reinsurance, Superintendência de Seguros Privados (SUSEP), presented suggestions to the National Council for Private Insurers CNSP, which incorporated these in creating the final rules.

On 17 December 2007, CNSP issued the final rules and regulations, to come into effect 120 days from their publication.

Three categories of reinsurers will be recognized in the new reinsurance market.

- **LOCAL REINSURER** – A reinsurer domiciled in Brazil, organized as a stock company to exclusively carry out reinsurance and retrocession transactions

- **ADMITTED REINSURER** – A reinsurer domiciled in a foreign country, with a representative office in Brazil

- **EVENTUAL REINSURER** – A reinsurer domiciled in a foreign country with no representative office in Brazil (previously called occasional reinsurers)

Local reinsurers, which include the former government reinsurance monopoly, IRB Brasil Resseguros SA (IRB), will have preference over companies in the two other categories. All insurers will have to offer to reinsure at least 60% of their reinsurable business with local reinsurers. This limit will fall to 40% after three years.

If the local reinsurers decline 60% of the business or a part, the insurers can look to two other categories of reinsurers, admitted and eventual.

**CONTACTS**

For further details on the opening of the Brazilian market or a copy of the complete regulations, please contact:

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  Tel: +55 11 2161 6010
  Fax: +55 11 5181 9377
  harveyaw@willis.com

- **Alison Spooner**
  Willis Consultoria em Resseguros Ltda
  Tel: +55 21 2122 6790
  Fax: +55 21 2517 3141
  spoonera@willis.com
LOCAL REINSURERS

Reinsurers wanting to register as local reinsurers must:
• Have a fixed local base capital in Brazil above R$60 million (approximately US$33 million)
• Comply with local reporting and claims reserving rules issued by the CNSP

Local reinsurers will compete on the same grounds as the IRB for the preferential 60% of the Brazilian reinsurable business. They will not be permitted to work with non-reinsurance products and will have to exclusively explore reinsurance. They will also not be allowed to write direct business. IRB will have 180 days from publication of the final rules to adapt to the new reserve and reporting requirements.

ADMITTED REINSURERS

Reinsurers wanting to register as admitted reinsurers must:
• Open up a representative office in Brazil
• Be allowed to reinsure business and must have been compliant with regulations in its country of origin for at least five consecutive years
• Have minimum global net assets of US$100 million
• Achieve minimum ratings according to the chart below

<table>
<thead>
<tr>
<th>Rating Agency</th>
<th>Minimum Rating Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard &amp; Poors</td>
<td>BBB</td>
</tr>
<tr>
<td>Fitch</td>
<td>BBB</td>
</tr>
<tr>
<td>Moody´s</td>
<td>Baa3</td>
</tr>
<tr>
<td>AM Best</td>
<td>B+</td>
</tr>
</tbody>
</table>

- Set up a local bank account linked to SUSEP with a minimum deposit of US$1 million for Life reinsurance and US$5 million for all other lines
- Maintain financial collateral in Brazil to back up reserves linked to premium income and claims (the higher the rating of the admitted reinsurer, the lower the local reserves required)

Lloyd’s of London will be able to register as a single admitted reinsurer, with access granted to any syndicate willing to reinsure business in Brazil.

EVENTUAL REINSURERS

Reinsurers wishing to register as eventual reinsurers must:
• Be allowed to reinsure business and must have been compliant with regulations in its country of origin for at least five consecutive years
• Have minimum global net assets of US$150 million.
• Achieve minimum ratings according to the chart below

<table>
<thead>
<tr>
<th>Rating Agency</th>
<th>Minimum Rating Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard &amp; Poors</td>
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<td>Baa2</td>
</tr>
<tr>
<td>AM Best</td>
<td>B++</td>
</tr>
</tbody>
</table>

- Not have its head office located in a tax haven nor in any country that is subject to less than 20% income tax
- Appoint a power of attorney in Brazil

HOW WILL THE MARKETPLACE WORK?

To do business in Brazil, reinsurers must register as local, admitted or eventual reinsurers, and they are now starting (or should be) this process with the authorities. Currently, IRB is the only local reinsurer; it is as yet unknown which other companies will register as local reinsurers. Once SUSEP issues the list of reinsurers accepted under each of the three categories and the 120-day waiting period has lapsed, insurers can obtain full reinsurance terms from any of the local, admitted or eventual reinsurers. These terms will then need to be offered to one or more
THE IMPACT ON MULTINATIONALS OPERATING IN BRAZIL

For small and medium-sized operations, most of the multinational insurers operating in Brazil will likely have treaty reinsurance in place with local, admitted and/or eventual reinsurers. As a result, neither much premium nor many risks should be ceded to global programs. Looking for more involvement, global treaty reinsurers are likely to compete with the local markets, generating price reductions.

For large operations in Brazil, the quote for the Brazilian exposure under the global program can be used as a facultative quote. The quote must be offered to local reinsurers, who will decide if they will take a share or not. If one local reinsurer declines or only partially accepts, then the risk must be offered to the other local reinsurers. If the local reinsurers decline all or part of the 60% that must be offered locally, then the risk can be placed freely with admitted and eventual reinsurers. If a local reinsurer accepts, it must follow the terms and conditions offered. This, in our view, will have a positive impact in pricing and in terms and conditions in the local policies.

The regulations issued in December also state that in the new system, premiums and claims will have to be settled in Brazil through either reinsurance brokers or reinsurers.

Willis holds leading positions in both retail and reinsurance operations in Brazil and, through our technical and highly qualified specialists and knowledge of the Brazilian and international markets, we are fully prepared to assist clients wanting to take advantage of these changes.

SUSEP can authorize larger cessions under certain circumstances.

local reinsurers who will decide whether they will exert their right to reinsure up to 60% of the risk (facultative or treaty) at the same terms and conditions offered, or will decline to reinsure them and let the international markets (either admitted or eventual) write it in full. Life and pensions reinsurance are to be exclusively placed with local reinsurers. Insurance companies and local reinsurers cannot cede in reinsurance or retrocession more than 50% of issued premiums in any one year. This however, does not include:

- Bonds
- Export credit insurance
- Agricultural insurance
- Internal credit insurance

SU SEP can authorize larger cessions under certain circumstances.
The cost of providing healthcare benefits continues to outpace the general inflation rate. How should employers respond? This special edition of Executive Signal examines the current state of healthcare costs in the U.S. From regulatory and market-driven issues to new cost control strategies, such as consumerism and wellness incentives, we present readers with a comprehensive look at healthcare trends, highlighting proven strategies that employers sponsoring group and retiree health programs may wish to consider.

HEALTHCARE TRENDS

Willis closely monitors an array of academic and industry studies of healthcare-related employee benefit trends. Some of the most interesting revelations of 2007 include:

- According to the Kaiser Family Foundation, last year the average annual total insurance premium in employer plans was $4,479 for single coverage and $12,106 for family coverage.

- The Kaiser Family Foundation reports that between spring 2006 and spring 2007, premiums increased an average of 6.1% for employer-sponsored health insurance plans, greatly outpacing the growth in workers’ earnings (3.7%) and more than doubling the underlying inflation rate (2.6%).

ARE YOU PREPARED FOR HEALTHCARE IN 2008 AND BEYOND?

Willis has evaluated a number of initiatives employed by clients to drive success in their healthcare benefits programs. Each client is unique and must evaluate what is most effective for its specific situation. Even so, the following checklist summarizing some of the most critical opportunities and key questions that should be addressed may be helpful in determining your own preparedness for the future.

1. HEALTHCARE BENEFITS STRATEGY

- What are the business requirements (cost structure, staffing requirements, etc.) of your organization?
- How does your culture and mission impact benefits?
- What are the baseline costs of medical, pharmacy, disability and related benefits programs?

continued on page 2
Employers are beginning to gravitate to consumer-based strategies, where employees take on more responsibility for costs, lifestyle choices and treatment decisions. (Some consumerism critics decry consumer-directed health plans (CDHP) as just a reflexive cost shift; however, when properly structured, a CDHP is more accurately characterized as a means of shifting consumer responsibility and mindset to one where individuals more attentively scrutinize their personal healthcare expenses.) Many employers have adopted this approach by establishing health reimbursement arrangements (HRAs) and health savings accounts (HSAs). (Movement to consumerism is consistent with a general trend away from employer paternalism, similar to the now widely accepted switch from defined benefit pension plans to 401(k) plans on the retirement side.) This shift was accompanied by a jump in employer expectation that consumers would assume more risk and responsibility for their health and healthcare. Some employers expressed high expectations for immediate financial relief, but the move to the consumer-directed approach will, in reality, be most effective over the long haul.

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

There has been significant growth in employer-based prevention and wellness strategies to reduce healthcare costs, lost productivity and absenteeism. Statistical evidence demonstrating tangible returns on investment for these efforts is also becoming more widely available.

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*Estimate is statistically different from the previous year shown at p<0.05.

Note: Data on premium increases reflect the cost of health insurance premiums for a family of four.

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

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

**LEGISLATIVE DEVELOPMENTS**

Healthcare, along with war and national security, continues to dominate the national legislative agenda. The healthcare debate and the current structure of employment-based healthcare benefits in particular make employee benefits a hot legislative topic. Many key employee benefits issues – Medicare, executive compensation, minimum wage, paid family leave, mental health parity – remain alive and kicking, as does the most problematic issue of all: providing health coverage for the uninsured.

Although the issue has been a political hot button for many years, interest spiked in 2007. This may be due, in part, to actions at the state level. Governors in California, Pennsylvania and Illinois, to name a few key states, have proposed sweeping healthcare reform legislation. The push to do something about delivering health coverage at the state level has been fueled by the increasing drain on limited state resources by the uninsured, the successful passage of similar legislation in Massachusetts and Vermont, and the lack of progress by the federal government in finding a solution. Some proposals even include mandates on employers to provide Internal Revenue Code Section 125 programs (often referred to as cafeteria plans) for all workers, so that an employee can find his or her own insurance coverage but pay for it on a pre-tax basis as part of an overall strategy to make benefit coverages more affordable.

In addition to state legislative activity, several national proposals have been set forth by various coalition groups, federal legislators and 2008 presidential candidates. Many ideas are similar to earlier initiatives introduced in recent years, ranging from building on the current healthcare coverage system to completely overhauling it. Sample proposals include:

• **TAX-BASED SOLUTIONS**

  This concept centers on providing tax incentives (both federal and payroll taxes) for all individuals with health coverage. Individuals would receive a standard deduction of $7,500 for single coverage and $15,000 for family coverage, regardless of the actual cost of coverage. Employers could continue to take a full deduction for health insurance expenses, including for any additional payroll tax expense resulting from the payment of the employer share of FICA tax on the cost of health insurance above the standard deduction limits. Employees would no longer be permitted to pay for health insurance coverage on a pre-tax basis under Section 125 cafeteria plans. Projected to increase coverage by three to five million individuals, this proposal would benefit those who do not currently receive a tax deduction on the cost of their health coverage.
• **BUILDING ON THE EMPLOYER-BASED SYSTEM**

Employers not providing health insurance coverage or contributing to the cost for coverage would be taxed (6% in Democratic presidential candidate John Edwards’ campaign proposal). Of course, this “pay or play” scheme has been a centerpiece in several state so-called “reform” proposals. Massachusetts’ law includes that requirement as did Maryland’s “Wal-Mart law” (so-called because only Wal-Mart would have been affected). Even city (San Francisco) and county (Suffolk on New York’s Long Island) government proposals have included such provisions.

So far, the federal courts have determined (when the laws are actually challenged) that such state and local laws are preempted by the Employee Retirement Income Security Act of 1974 (ERISA). Although the Massachusetts law has not yet been challenged, federal courts have already overturned Maryland’s and Suffolk County’s laws. The San Francisco ordinance went into effect on January 9, 2008, but the ERISA preemption issue will be reviewed by a federal court later this spring. ERISA preemption remains an important barrier to the states, keeping them from enacting legislation that would force employers to comply with 50 different state laws (not to mention the thousands of county and municipal laws that could be enacted). Willis is working diligently as a member of a national coalition to strengthen the preemption concept and defeat any attempts to wear that legal concept down piecemeal.

In addition to imposing a tax on employers, those needing to purchase coverage would be given access to regional health markets, which are pooled arrangements run by the government that would offer a choice of different insurance plans. Insurance carriers could not deny coverage, nor could they charge more, to insure an unhealthy individual. Medicaid and the State Children’s Health Insurance Program (SCHIP) would also be expanded. Financing for the program would come from raising taxes on upper income individuals and reducing the tax gap (the difference between what the federal government is owed and what it collects).

• **UNIVERSAL COVERAGE MANDATE**

Individuals would purchase coverage directly from insurers rather than obtaining coverage through employers. Employers currently providing coverage would initially be required to pay their workers the amount they had been spending on their health insurance, and eventually all employers would be making “Employer Shared Responsibility Payments” to help employees buy their own insurance. The health coverage that would be available is said to be similar to what members of Congress currently receive and would feature special wellness and disease prevention incentives. The program would be financed through a new tax on employers.

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**SUMMARY**

Healthcare reform and coverage for the uninsured have been debated for many years (even before Hillary Clinton's failed attempt during President Bill Clinton’s first term). Without bipartisan support, broad Congressional changes are unlikely.

Although there has been a significant increase in state legislative activity to tackle the problem, and several proposals have been made on the national level, the outcome remains uncertain. Moreover, without significant federal financial support, state efforts to enact broad reforms will be hindered by numerous obstacles – particularly in terms of financing. Some healthcare experts are concerned that with all the attention centered on health coverage access, presidential candidates and legislators may miss another fundamental issue – healthcare cost. Although millions do not have health insurance, a majority of voters do, and numerous surveys reveal that voters with health insurance are most concerned about curbing skyrocketing medical costs.

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Prepared for Healthcare? continued from page 1

- What is the value of the benefits programs to the organization?
- How does this vary by business unit and employee class?
- What timely, actionable management information is needed?
- How do results compare to industry benchmarks?
- If you don’t make any changes, what are the projected results?
- What are the alternative strategies, goals and action plans?
If changes are made, what is the impact on the employer and the employee?
How will changes in the regulatory arena and Congress affect you?
How does the size of your organization impact your ability to take risk, use multiple vendors, structure the program?

2. WELLNESS
- What is the Return on Investment?
- How can members be identified as early as possible as having – or at risk for getting – cancer, diabetes, cardiac and other high cost diseases?
- How can this information be used to mitigate risk and address prevention?
- What legal, cultural, behavioral and other issues must be addressed?
- What barriers are in place? Are there silos that need to be integrated to promote sharing of information and collaboration?
- What motivation and incentives are needed to drive changes in lifestyle and behavior?
- What can be done internally; what should be outsourced?
- What vendors should be considered as partners?
- Should one wellness program apply to all locations and health plans?
- What are the key success factors, and how will these be monitored?

3. ABSENTEEISM AND PRESENTEEISM?
- What is the level and cost?
- How can this be measured?
- What is the correlation between the health of the work force and their absenteeism and “presenteeism” (lack of productivity)?
- Studies show that total costs, including absenteeism and presenteeism, are generally highest for back/neck pain, fatigue and depression. How does this impact your strategies and priorities?

4. COMMUNICATION STRATEGY
- What have you done in the past?
- What has worked well? What should be done differently?
- How do employees feel about the organization?
- What benefits do they value the most?
- What is their perception of the total cost and their share?
- What are the major issues of the C-Suite/HR/employees? Cost? Fairness? Trust?
- How do employees like to get information?
- Do they have internet access?
- How do you drive change? In general? From entitlement to engagement?

5. CONSUMERISM
- Is your work force ready for it?
- Are Health Reimbursement Accounts and Health Savings Accounts effective?
- What design is cost-effective and fair to employees?
- How do you drive high participation?
- What tools and training are needed?
6. PROVIDER NETWORK
- What network has the best access?
- What network has the best cost?
- What network has the best quality? Why is it important?
- How do you measure and balance access, cost and quality?

7. DEPENDENT ELIGIBILITY AUDITS
- What are the issues (including legal issues)?
- How do you make this as palatable as possible?
- How do you make this as simple and unobtrusive as possible?
- What are the savings in dollars and ROI?
- What approaches are available and what works best?

8. CARE MANAGEMENT (DISEASE MANAGEMENT)
- What are you doing now?
- How do you identify gaps in care and close these gaps?
- What are the numbers: eligible...enrolled?...in clinical compliance?
- What is the ROI?
- Should you reach out to only those who are diagnosed or those at risk?
- Should the program cover only the major diseases or take a broader approach?
- How do the approaches vary by vendor?
- Does it make sense to carve out care management from the carrier?

9. VOLUNTARY BENEFITS
- Is this appropriate for your industry and situation?
- Individual or group policy approach?
- What coverage?
- What type of enrollment: meetings, individual, web-based?
- How does this impact your ability to attract and retain employees?
- Is this a one-time, annual or more regular event?
- Does VB enrollment include core benefits enrollment?

10. TECHNOLOGY AND OUTSOURCING
- How can these be used to increase efficiency and take work off your desk?
- Which services?
- Do you buy, build or rent?
- Should you outsource clinical services to a call center that provides high quality assistance related to claims, identifying the highest quality physicians on complex cases, or other services?
SUBPRIME UPDATE: THE GLOBAL FINANCIAL CONTAGION

It has been generally accepted wisdom that the spreading of risk is a good thing. With the recent problems stemming from subprime mortgages, mortgage-backed securities and the resulting credit crunch, this article of faith is being called into question. In this Alert, the fourth in our series on the subprime crisis, we will examine the global financial contagion that has been instigated by the crisis.

The U.S. was the first to contract the bug, but due to the global flow of capital and dispersal of innovative mortgage products with underlying subprime risks, parts of the rest of the world are now experiencing distressing symptoms. Signs include significant losses with write-downs in the hundreds of millions to the tens of billions of dollars, credit distress and, in some terminal cases, bankruptcy. The widespread U.S. housing slow-down is also being mirrored in other previously hot spots. For example, property prices are now falling in Madrid, Barcelona, Valencia and Seville, ending a spectacular boom that had made Spain the hottest property market in Western Europe for roughly a decade. Now, with an estimated 98% of Spanish home loans on adjustable rates, local banks are tightening credit and raising rates so quickly that Spain’s prime minister begged national lenders not to pull back too quickly and send the economy into a tailspin. Further warnings have come from the Organization for Economic Cooperation and Development (OECD), which recently predicted that Ireland and Denmark would experience “a further large fall in housing investment as a share of GDP.” As housing is a key economic driver, a falling housing market suggests more economic indigestion to come.

Generally, the lower the barriers to entry into the local financial markets, the more common interactions with complex financial instruments will be and the greater the spread of the subprime contagion. When banks’ assets are hit, their ability to lend is hurt, causing contractions in credit. These follow-on interruptions in the flow of funds can be even more deadly than the initial illness.
WELCOME TO THE WORLD OF STRUCTURED FINANCIAL INSTRUMENTS

In our first subprime Alert, we described how asset-backed securities (ABSs), including mortgage-backed securities, may be issued by special purpose vehicles (SPVs) set up by investment banks. Investment banks have also bought ABSs and bundled these for the purposes of selling other instruments known as collateralized debt obligations (CDOs). Alternatively, investment banks sell instruments through structured investment vehicles (SIVs) which issue short-term commercial paper, leveraging the spread in yields between long-term investments and short-term borrowing. More recently, the “SIV Lite” was introduced, combining aspects of SIVs and CDOs. In the subprime crisis, many of these investment instruments have turned into NPAs (nonperforming assets).

Large numbers, very large numbers, are at stake. The total value of all outstanding U.S. mortgage-backed securities in early 2006 was reported to be $6.1 trillion. Over the course of 2006, the value of new ABS-backed CDOs issued was another $200 billion. According to Moody’s, SIVs account collectively for approximately $400 billion worth of assets. To put this in perspective, when Credit Suisse and Deutsche Bank reported significant write-downs of $1 billion and $1.5 billion respectively, they were viewed as having “relative low” exposure to this class of losses.

Of course, only a small percentage of mortgages are subprime and not all subprime mortgages are in grave shape. According to the U.S. Mortgage Bankers Association, as of March 2007, the subprime market was 13% or $1.27 trillion (that’s trillion with a t) of the total $9.8 trillion outstanding in the U.S. residential mortgage debt market.

Unfortunately, subprime mortgages, and real estate generally, is not the only category of credit experiencing defaults; now credit card companies, as well as the auto and school loan sectors, are anticipating payment problems.

THE DANGEROUS CREDIT CRUNCH

One of the harshest results of the subprime crisis has been the current, severe credit crunch. After years of mainlining cheap credit, companies are seeing their strategies overturned and their very survival endangered as the in-flow of capital is curtailed. The leading victim of the credit crisis may be Northern Rock, the British mortgage lender. The firm’s strategy of lending long and borrowing short led to a run on the bank, which had to be bailed out by the Bank of England. The company is currently struggling to survive as a viable entity but may end up selling off pieces of its business.

Credit crunch (from Wikipedia)
A credit crunch is a sudden reduction in the availability of loans (or "credit"), a sudden increase in the cost of loans (the interest rate), which may be due to increased perception of risk, a change in monetary conditions, or even an imposition of credit controls. It is often caused by lax and inappropriate lending, which results in losses for lending institutions and investors in debt when the loans turn sour and the full extent of bad debts becomes known. These institutions may then reduce the availability of credit, and increase the cost of accessing credit by raising interest rates. In some cases lenders may be unable to lend further, even if they wish, as a result of earlier losses restraining their ability to lend.

(www.wikipedia.org)
A SAMPLING OF THE GLOBAL IMPACT

As mentioned above, the more open the financial market, the greater the potential exposure to the subprime malaise. In Europe, the malady initially spread quickly across the continent. In Asia, the relative containment of many of the financial markets largely blunted the spread of the contagion.

AUSTRALIA

The country’s second-largest shopping center owner, Centro Properties, may, in the worst case, struggle to remain operational after disclosing that its assets are collateral for almost $5 billion in bonds. The proceeds of the bonds were used to purchase hundreds of U.S. properties. When the company’s chief executive officer announced that certain mall properties might need to be sold to meet its coming payment obligations, asset holders became concerned. In a week, the company lost $3.3 billion in market capitalization, 80% of its value, worsening the potential problem.

BERMUDA

Another symptom of the subprime crisis and credit crunch has been the pressure on credit ratings (which can, in turn, put further pressure on credit and profitability). Merely having one’s rating put on review, can itself cause discomfort. As a global insurance capital, Bermuda is not immune. Moody’s Investor Services placed the senior debt rating of XL Capital Ltd. and XL’s operating subsidiaries on review for possible downgrade. The concern is apparently focused on XL’s sizable equity stake in Security Capital Assurance Ltd. (SCA) and to a lesser extent on XL’s $1.3 billion direct investment in subprime mortgage assets. The warning followed an announcement of a loss of $145 million in SCA’s credit derivative portfolio. The ratings of the Bermuda-based provider of financial guaranty insurance and credit enhancement products was itself placed on alert for possible downgrading and the firm received at least one shareholder suit. Two transactions that it had insured, valued at $792 million, were downgraded. If the guarantors of complex financial instruments backed by deteriorating mortgages themselves go under, the value of these investment vehicles will suffer additional shocks, shocks from which they may not be able to recover.

CANADA

North of the U.S. border, there are few barriers to stop the flow of investments and spread of the subprime contagion. The Canadian Imperial Bank of Commerce (CIBC) announced $9.8 billion in subprime debt. More than a third ($3.5 billion) of this had been insured by a secure guarantor. When the guarantor was downgraded from investment grade to junk, the bank’s band aid had to be considered a failure. Canada’s Bank of Commerce also announced write-downs of almost $3 billion of subprime mortgage debt.
CHINA
The China Banking Regulatory Commission has indicated that domestic banks have only a “limited” exposure to subprime problems. Still, China Construction Bank is left with roughly $1 billion in U.S. subprime mortgage-backed securities and state-lender Bank of China with almost $10 billion in subprime mortgage-related assets in the U.S., plus another $1.6 billion of exposure in its Hong Kong arm.

FRANCE
Credit Agricole, France’s largest retail bank, took a €3.3 billion hit to cover possible subprime consequences. Société Générale, the country’s second biggest bank announced that it was going to bring back onto its balance sheet SFr 4.2 billion in assets previously in a structured investment vehicle (SIV) after a decision by Moody’s to put the fund on negative watch. BNP Paribas suspended redemptions from three investment funds worth $2 billion, citing problems in the U.S. subprime mortgage sector. After third-quarter earnings were hurt by write downs and subprime-related trading losses, France’s fourth largest bank by market value, Natixis SA, will reportedly reorganize its corporate and investment banking division.

GERMANY
Germany’s financial sector has exhibited few symptoms because homeownership rates are relatively low, and there is no subprime mortgage market to speak of. It has not, however, remained totally immune from the credit crisis. IKB, one of the first banks to fall victim to the credit crunch, looks likely to need more than the €3.5 billion rescue package put together by a number of banks. Sachsen LB, another small German bank, also had to be resuscitated this past summer. Both banks had diversified into areas outside their usual core competences to make up for falling earnings at home, a function of the Germany’s fragmented three-pillar banking structure, according to critics of the system. Market consolidation is thought to be on the horizon. On the investment side, Union Investment, Germany’s third biggest mutual fund manager, stopped redemptions from one of its funds after investors pulled out about 10% of its assets.

INDIA
According to the World Bank’s lead economist, the economies of developing countries are unlikely to be directly affected by the U.S. subprime mortgage crisis. None of the major Indian banks have direct investment in U.S. subprime debt, but some fear the indirect effect of reduced capital flows. The initial aftermath of the subprime blowout saw some $2 billion of foreign investments being withdrawn from Indian stock markets. This equates to 25% of the $8 billion invested in Indian stock exchanges in the first seven months of 2007.

IRELAND
While not uniform across the sector, domestic pension funds were hit hard in the fourth quarter of last year, largely attributable to exposure to local equities. The Irish stock market has a relatively high percentage of financial and housing-related investments which suffered reduced demand and the effects of the global credit crunch. This wiped out expected returns for the year and left them, as a group, with a loss of roughly €4 billion.

JAPAN
While a recent poll of Japan’s regional banks and financial institutions on their exposure to U.S. subprime mortgages revealed that 23 of the 109 institutions may be impacted, only two Japanese banks have reported $10 billion or more in potential subprime losses. San-in Goedo Bank reported subprime exposure of roughly ¥13 billion, equivalent to about 1% of its securities holdings. Joyo Bank reported a potential exposure of ¥10 billion and said it expects to write off about ¥1.5 billion in losses. While numbers keep coming in, in part due to the difficulty in pricing securities for which there is a limited or evaporating market, Japanese mega bank Mitsubishi UFJ Financial Group (MUFG) said that its losses on U.S. subprime loans soared by as much as six-fold over two months, bringing losses to a grand total of $263 million. Still later, it raised its estimate to $470 million in potential losses.

NETHERLANDS
Dutch investment bank NIBC Holding NV announced losses of $188.6 million from asset-backed securities in the first half of 2007.

NORWAY
Many were stunned by the announcement that four small Norwegian towns near the Arctic Circle had taken serious subprime losses. Collectively, their approximately $64 million in subprime-related investment had fallen to less than 55% of its original value. Norway’s main financial regulator opined that the firm that sold them the securities had violated the “good code of conduct” by failing to adequately inform them of the possible
risks related to the complex investment securities that it had sold them. This firm revealed that it would file for bankruptcy protection after losing its license as a result of these events.

**SINGAPORE**
While Singapore banks have invested in debt instruments such as collateralized debt obligations (CDOs), because most of their business is concentrated locally, they have invested less in CDOs as a percentage of assets than some western banks. DBS has revealed the largest exposure at $1.7 billion. However, stakeholders remain jittery because the bank had initially released a lower estimate of its CDO exposure. Some have suggested that the firm has still only accounted for 5% of its total CDO exposure.

**SWITZERLAND**
The Swiss lender UBS AG took a serious hit from the subprime crisis with a $10 billion write down. The Swiss banking regulator has indicated that it intends to investigate the matter once the current crisis has passed. Credit Suisse revealed a $1 billion write-down on bad debts. In the insurance sector, Swiss Re announced $1 billion of losses related to the subprime crisis.

**UNITED KINGDOM**
The Royal Bank of Scotland expects to have subprime losses of £950 million. Barclays announced potential losses in the region of £1.3 billion. Following similar moves by institutional funds, Friends Provident’s U.K. commercial property fund froze withdrawals by its retail investors for up to six months due to cash liquidity issues. Naturally, with property values falling, redemption requests increase. The Financial Services Authority (FSA), probing the U.K.’s own domestic subprime mortgage market, found defaults in this segment running at 20 times those on prime mortgages. The FSA has identified the subprime mortgage market as a priority area for supervision. Domestic subprime mortgages now account for 8% of the overall U.K. market and are estimated at £15-£16 billion.

**CONCLUSION**
The spreading of risk is paradoxical: it makes the global financial markets both stronger and more vulnerable. In the case of the subprime contagion, not all countries and institutions have been struck to the same degree. In addition, the body financial has its defenses – for most countries, their central bank – and those defenses have been responding. On the whole, the spreading of risk in this case remains an effective force for stability.

This is an evolving story. The global financial markets suffered large losses on January 21 and January 22. The U.S. Federal Reserve Bank cut the Fed Funds rate by three quarters of a point, the largest decrease in 26 years.

Willis will continue to monitor developments and will issue future *Alerts* as the story unfolds.

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