REAL ESTATE & HOTELS

Willis VIEWS

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PLOT TWISTS IN A CHANGING STORY

For the last 18 months, the story of the insurance industry has read like a novel with several unexpected plot twists. Insurance is not usually big on plot twists. The most we expect is a turn in the market cycle now and then or maybe some new alternative risk financing wrinkles. Lately, we've been living in a page turner.

Many of us grew up in this business during the ascension of AIG as a great global player. AIG's commercial insurance operations were nearly brought down by the actions of its holding company, once touted for its incredible financial strength. Since then, the name of the commercial insurance operations has changed from AIG to AIU Holdings and now to Chartis. Many of us are still catching our breath.

Other giants have teetered on the brink. The Hartford, which opened its doors in 1810, found its reputation and financial standing recently threatened by some of its Life products and investments. XL got off to a flying start in 1985, but its financial guaranty affiliate recently dealt the parent organization a shockingly big blow. We've seen some significant companies survive some unusual challenges and severe tests over the past year and a half.

If we extend and broaden our look back, however, we see that things were not exactly routine and stable before these latest turns in the story. Between Enron and SOX, 9/11, two wars, and hard and soft market peaks and troughs for Property insurance, many of us in insurance have seen more change during the past 10 years than in any period in our careers. Throughout this turbulent decade, owners, financial managers, general counsels and risk managers have had to remain on top of the risk issues, learning from the past while keeping their sights on the horizon so that they could manage change that was the only constant.

The mission of *Views* is to put topical issues in front of you so that you can better manage the changes that keep rolling in like the tide. In this issue, we start with an overview of the insurance marketplace, presenting the Real Estate & Hotels segment of Willis' just published *2010 Marketplace Realities & Risk Management Solutions: Careful Steps.* We then look at the status of the H1N1 pandemic and its potential impact on business continuity planning, terrorism issues in the hospitality sector, important changes in earthquake modeling and opportunities for utilizing secondary building characteristics in CAT modeling.

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We hope that you will find our views both interesting and helpful, and as always invite your comments and suggestions as to future topics of interest to you.

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MARKETPLACE REALITIES 2010 – REAL ESTATE & HOTELS

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

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

The recession is cutting demand, as companies slow production, cut back on expansion and development, reduce staff and, in some cases, simply buy less insurance to save money. Surplus, or supply, is impacted by underwriting profits and losses and investment income. In 2008 the Property and Casualty industry saw a deterioration in the combined ratio to 105.1 – up from the 95.5 mark in 2007.[1] Investment losses exceeded underwriting profits.

Despite the deteriorating results reported by many carriers, MarketScout recently reported that "the average rate for property and casualty insurance fell 5% in August compared to a decline of 10% a year ago."[2] Rate decreases continue for many clients. Why? Despite a drop of about 10% in surplus from 2007 to 2008 (due largely to investment declines), "after several years of strong surplus growth the industry can handle it," according to Andrew Colannino of A. M. Best Co.[3] While investment losses have increased significantly for Property and Casualty insurers, the industry overall "is not in trouble by any means," Colannino said.

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

Another factor is reinsurance. The hardening of the reinsurance market in 2009, which many expected to raise costs for insurers and in turn push up premiums for insurance buyers, did not materialize. Now it appears the opposite may be in the works. According to a Moody's Investors Services report, "Global reinsurers have more capacity than the demand can absorb, which could mean greater price competition in 2010."[4]

That being said, the tale of two markets continues. For risks with limited or no catastrophe exposure, the market remains soft, with year-over-year declines, albeit moderating somewhat, for virtually all lines of coverage. For those with CAT exposures, the market can be tough. Many are reporting that risks with catastrophe exposures can expect to see higher premiums. It remains to be seen what impact a relatively quiet (to this point) 2009 hurricane season will have on rates for CAT-exposed properties. Some are predicting a softening for these risks, which, up to this point, have not experienced much in the way of rate relief. Barring a significant surplus-depleting event, we expect the total cost of risk for most insurance buyers will decline when the numbers are tallied for 2009, and that the trend will continue in 2010.

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

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

[1] "U.S. P-C Industry Surplus Dropped 12%," *National Underwriter,* April 13, 2009.
[2] "Property/casualty rate declines moderate: Report," *Business Insurance,* September 10, 2009.
[3] "P&C Survives the Storm," *CFO Magazine,* April 2009.
[4] "Reinsurance rates for 2010 could be competitive: Moody's," *Business Insurance,* September 4, 2009.

HOTEL SECURITY IN AN INSECURE WORLD

Recent attacks in Mumbai, Indonesia, Pakistan and Jordan highlight the vulnerability of hotels as soft targets for terrorists. U.S. hotel operators should take heed. The methodology used to commit international terrorist attacks may foreshadow attacks on U.S. soil. In addition, terrorists continue broadening their methods of destruction to include active shooters and improvised explosive devices deployed by vehicles or humans. Fear and destruction are the ends, and violent acts against vulnerable targets are the means.

How does a hotel operator find a balance between creating and maintaining a reasonably safe environment while absorbing higher operating costs and managing the potentially negative reaction to heightened security measures? This is no easy task, and the urgency only grows.

To date, the fight against terrorism has been relatively successful, particularly in the U.S. Unfortunately, this success may not bode well for softer targets. Credible reports indicate terrorism continues to become more and more decentralized for organizations such as Al Qaeda. Working through regional or localized terrorist cells with less money and training, terrorists may be more inclined to ignore hardened targets, such as airports, sports venues, public transportation and government and military facilities, and redirect operations towards softer targets such as hotels.

Hotel targets suit terrorists for several reasons:

- A hotel is a fixed location that can be easily observed by hostile reconnaissance.
- The floor plans and security measures can be generally assessed because of their public accessibility.
- Hotels are closely tied to the travel industry, which can be significantly impacted by acts of terrorism.
- Many hotel brands are globally recognizable and have symbolic value.

The vulnerability of hotels was demonstrated by a tragedy few discuss today but that made international headlines at the time: the 1986 DuPont Plaza Hotel fire in Puerto Rico that resulted in 97 deaths. The fire was set by three disgruntled employees involved in a labor dispute at the hotel. Their intention was to create a "small" fire to frighten guests and drive down occupancy rates. The fire led to changes in security policies around the world. The litigation that followed produced something close to $2 billion in claims and was called the largest civil case to date. The event clearly showed the breadth of exposure faced by any business involved in the care, custody and control of a high concentration of people in a clearly delineated space. Are we prepared?

Here are three steps hotels can take to improve their security:

- **DEVELOP A SECURITY MANAGEMENT PLAN.** Does your organization possess a Security Management Plan (SMP) that is properly communicated to management and staff and periodically tested? An SMP should include:
  - Appointment of a security manager
  - Emergency evacuation plans
  - Access control measures
  - Due diligence procedures for staff, vendors and other relevant parties
  - Private and public sector collaboration
  - An annual general security risk assessment

- **CONDUCT SECURITY AWARENESS TRAINING.** Employees and staff are your organization's best defense. You must be sure that if they see something suspicious or unusual, they say something. This may be a simple concept but it must be continually reinforced. Employee security awareness training is a major step toward creating a culture of safety.

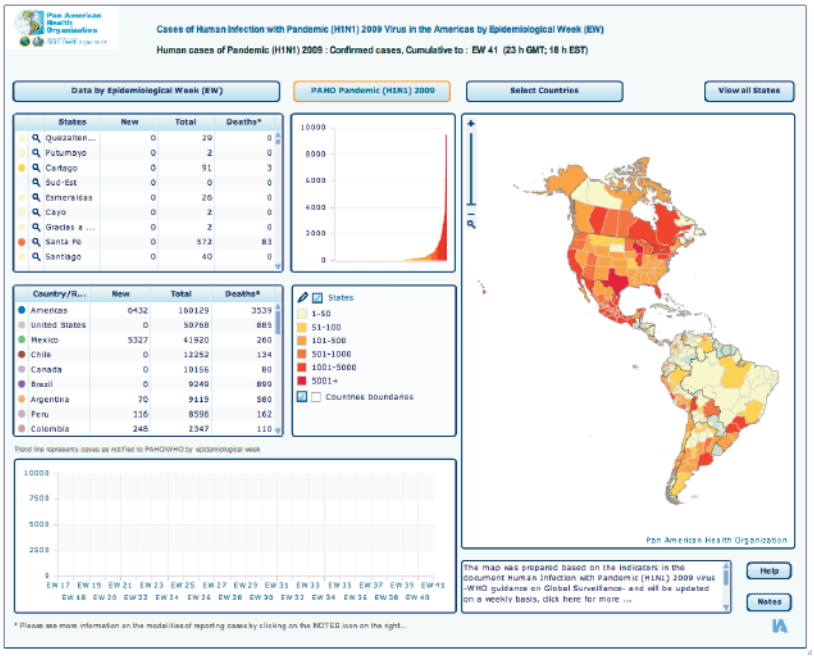
- **SEEK SAFETY ACT DESIGNATION AND CERTIFICATION.** The Department of Homeland Security certifies qualified anti-terrorism products, services and systems, which limits the liability of the users and producers of those products, services and systems. Hotels may be able to submit their anti-terrorism technology or security measures for certification. If certified, the hotels could potentially limit their own liability in the event of a terrorist act.

The security challenge for hotel operators is daunting. While the threat is very real, so are the steps hotels can take to mitigate the threat. For more information, please contact Matt Kelly, Practice Leader, Willis North America Risk Mitigation at 610 260 4339 or matt.kelly@willis.com.

INFLUENZA A (H1N1) UPDATE

As of October 5, 2009, the Pan American Health Organization (PAHO) reported 153,697 cases of influenza A(H1N1) infection in the Americas, which have resulted in 3,406 deaths. There were 50,768 reported cases in the U.S. with 833 deaths. The **PAHO Influenza A (H1N1) surveillance map** shown on right tracks reported cases. This map is interactive and allows users to obtain up-to-date statistics by individual country, state or province.

Are you doing everything you can to prepare for a pandemic outbreak? You may want to review five questions we offered in a recent ***Insights* bulletin** on the threat of pandemic flu. You may also want to make relevant modifications to your business continuity plan. For more on business continuity planning, see below. For help on your planning efforts, please contact your Willis Client Advocate® or Jeffrey Seibert, National Technical Director Casualty and Critical Incident, at 757 628 2304 or jeff.seibert@willis.com.



This map has been provided courtesy of the Pan American Health Organization

BUSINESS CONTINUITY AND THE HOSPITALITY INDUSTRY

Because the traditional approach to business continuity planning focuses on common catastrophes (earthquake, flood and fire), pandemic influenza requires special consideration. Unlike other disruptive events, a pandemic is not geographically or temporally bound and can significantly affect planning considerations. A fire usually impacts a single location. A hurricane or flood may impact a specific region. A pandemic outbreak can hit everywhere at once. If you have a business continuity management (BCM) program, it may not apply to pandemic risks – but you can readily update it. This article will review the key concepts in BCM program development to assist you in updating existing plans or initial plan development. We also recommend the American Hotel and Lodging Association's 26-page manual, ***H1N1 Influenza Management in Hotels,*** which covers prevention techniques and guidelines on how to deal with guests and employees afflicted with the flu.

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Business Continuity and the Hospitality Industry continued from page 4

BCM FUNDAMENTALS

The fundamental goals of a BCM program are to minimize the extent of disruption, establish alternative means of operation, minimize the impact of economic losses, train and educate personnel to familiarize them with emergency procedures, provide for a smooth and rapid transition of services and insure the wellbeing of guests and employees.

How can this be achieved? The answer is a tested strategy that allows you to take thorough, effective and immediate action. A current, detailed and flexible plan is the best way to protect your assets and help your organization survive a catastrophe.

In order for a BCM program to work, it must be endorsed at the highest levels in the organization, including senior management. In most cases, a project such as this will require steering committees or planning teams that will need to spend significant time working on plan development in addition to their regular day-to-day responsibilities. (This added burden is one of the major impediments to effective BCM.) Once the team is in place, performing a risk evaluation and a business impact analysis (BIA) can commence. The risk evaluation identifies the frequency and severity of perils and leads ideally to the implementation of controls. These analytic steps form the foundation of any business continuity management program.

In conjunction with the risk evaluation, a business impact analysis (BIA) helps quantify potential business interruption and financial loss as well as help determine recovery priorities so recovery time objectives can be set. The recovery time objective is the maximum amount of time before the lack of a business function severely impacts the business entity. The recovery time objective is comprised of two components; the time before a disaster is declared and the time it takes to perform the tasks, as documented in the BCM, that will allow business resumption.

A BIA should include:

- On-site review of all operations and their interdependencies
- Critical systems needed to perform key business functions
- Input required to perform key business functions
- Staffing requirements
- Key suppliers
- Identification of critical operations and their components
- Assignment of a risk factor or class to each event to help set priorities
- A review of any existing business continuity plans, including recommendations for risk mitigation, additional response procedures or insurance needs

Some specific points to keep in mind when performing the BIA:

- Diagramming your workflow may help you visualize all the dependencies and components of a particular function and assess the impact of losing one of the interdependent components.
- As the duration of an interruption increases, the potential impact may worsen.
- As interruption time increases, a function or service that may have been deemed a low priority may become a higher priority.
- Business interruption can mean tangible losses, such as loss of revenue, customers and potential fines. It can also result in intangible losses, such as loss of reputation.
- Impact evolves over time. Some functions or services may be adversely impacted within minutes, while others may be affected hours or days later.

A BCM program should outline regular exercises to ensure all personnel are familiar with their assigned roles and responsibilities, public relations and crisis communication procedures (both internal and external) and information for coordination with other agencies. You should implement a formal change procedure for making plan updates and changes. For example, you could require people to sign a sheet or return their old plan documents when a new plan is released. Be prepared to update your business continuity plans whenever changes are made in the organization.

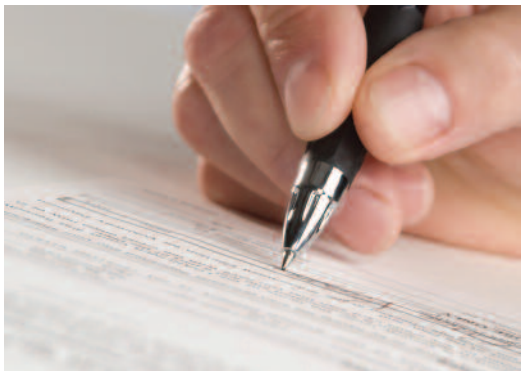
If done right, a BCM program can be an advanced strategic plan and an integral component of your organization's corporate culture. A strong plan can enhance the bottom line by protecting share value and an organization's competitiveness. The process of looking closely at the availability, integrity, quality and the strength of every major business process can be invaluable and lead to operational and strategic improvements. Good BCM will improve the design and development of critical business processes so that minor mistakes, and possibly even major ones, can be eliminated and disruptions and breakdowns can be reduced or mitigated.

For more information, please contact David H. Gluckman, ARM, CBCP, CFPS, SVP – Senior Risk Control Consultant, Strategic Outcomes Practice, at 973 829 2920 or david.gluckman@willis.com.

ASSURELEASE™ – THE ALTERNATIVE TO TRADITIONAL TENANT SECURITY DEPOSITS

AssureLease is an insurance product that replaces tenant security deposits. Tenants pay an insurance premium that is added to the monthly rent, either directly or through inclusion in common area maintenance (CAM) charges. This product can be used by owners or managers of residential, retail and student housing properties. Here are features of AssureLease.

- A new tenant does not put up any security deposit.
- Existing tenants can be given the option of having their deposits returned to them.
- Participating tenants pay approximately 1½-2½% of their monthly rent as an insurance charge.
- There is no cost to the owner – none.
- Given an expected 20% loss ratio, the owner keeps 55% of the premium paid by the tenants.
- This option removes the danger of a bankruptcy trustee seizing security deposits.
- Instead of holding a one-, two- or three-month security deposit, the commercial owner now has as much as 12 months of rent loss covered by AssureLease. Some of this can also be used to pay for eviction costs and excess damage.



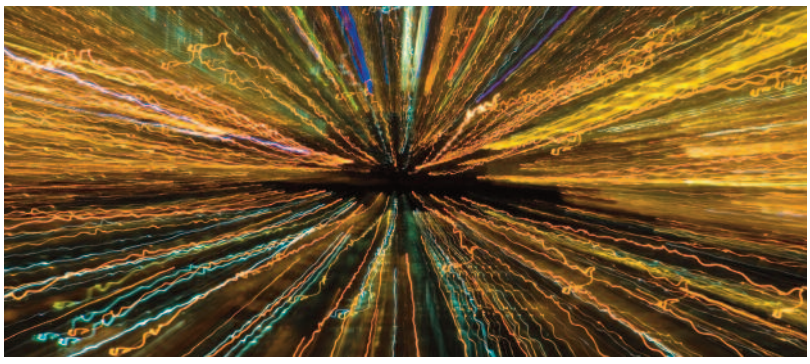
- The policy has other features, such as providing coverage for unamortized tenants' improvements at an additional premium.

For further information about the program, contact your Willis Client Advocate® or John Lepire, President and CEO, AssureLease LLC, 949 574 5868 or J.Lepire@assurelease.com.

A NEW VIEW OF U.S. EARTHQUAKE RISK

The risk of earthquakes may never decline, but the estimates of earthquake damage are lower than they used to be. Risk modelers recently changed their earthquake models following the release of new government earthquake risk maps that showed decreases in loss estimates ranging from 10-35%.

The United States Geological Survey (USGS) released the latest version of its National Seismic Hazard Maps in April 2008. The maps, previously updated in 2002, incorporate the best available science on fault slip rates, paleoseismic data, earthquake catalogs and strong motion recordings from global earthquakes. These maps define the latest scientific view of earthquake hazard at varying probability levels across the U.S. The new hazard maps are significantly different from the old maps, showing a 10% decrease in hazard for small residential buildings and 35% decrease in hazard for tall buildings in California. The significant reduction in the estimates of the earthquake risk in California and other parts of Western U.S. is largely due to the new science related to the calculation of ground shaking at a location from the earthquake epicenter (ground-motion attenuation equations).



Commercial catastrophe risk modelers updated their earthquake models following the latest USGS' hazard maps and the models now show decreases in loss results. In an article titled ***"Preparing for a New View of U.S. Earthquake Risk,"*** published in the Society of Actuaries' *Joint Risk Management* newsletter early this year (March 2009), Prasad Gunturi and Kyle Beatty of Willis Re's Catastrophe Management Services observed that, "...model changes will affect underwriting guidelines, capital requirements and portfolio management strategies."

For further information on CAT modeling, contact Bruce Norris, Director of Willis North America RMS Catastrophe Services at 650 453 1809 or bruce.norris@willis.com.

GOOD DATA MAKES GOOD CATASTROPHE MODELING

"Garbage in, garbage out." This aphorism of the information age may in fact trace its roots to Charles Babbage, inventor of the first programmable device, who said, "On two occasions I have been asked, 'Pray, Mr. Babbage, if you put into the machine wrong figures, will the right answers come out?' ...I am not able rightly to apprehend the kind of confusion of ideas that could provoke such a question." (Charles Babbage, *Passages from the Life of a Philosopher,* 1864)

Effective catastrophe modeling depends on accurate property underwriting data. Gathering accurate property data starts with identifying what the data is being used for. Here are three reasons organizations gather data:

1. Evaluating a portfolio's exposure to natural catastrophes (hurricane, flood, earthquake, terrorism, etc.)
2. Evaluating a portfolio's exposure to All Risk exposures (fire, theft, etc.)
3. Obtaining capacity and the best pricing from underwriters

Each of the above has different data needs. A hurricane PML analysis does not hinge on whether a building is sprinklered or not. An earthquake PML does not rely on roof age or geometry.

Once you have considered the purpose of the data, you will need to focus on what data is most important – and why.

PRIMARY CHARACTERISTICS

For natural catastrophes the most important data describes a property's primary characteristics:

- Address
- Values
- Construction
- Occupancy
- Year built
- Number of stories

The first two items, address and values, are often given short shrift. These two factors can have a bigger impact on the loss estimates than the other items.

ADDRESS: If you do not have an accurate physical address, it is not possible to accurately geo-code the property (assign latitude and longitude). This can have a huge impact on loss results. Let's say the address provided only yields a geo-code match at the zip code level of 94044 in the San Francisco Bay area. The San Andreas Fault cuts through this zip code, but the zip code is 13 miles across at its greatest width. The location within the zip code could mean the difference between being on top of the epicenter and being miles away from it! Alaska has an average zip code size of 2120 square miles. A zip code location in this case is nearly useless. The exact street address is also important. In San Francisco, for example, a building on one side of a street may be on land fill, while on the other side you may be on bedrock.

VALUES: If your values (current replacement cost) are off by 10%, your loss estimates will be off by 10%; if they are off by 20%, your loss estimates will be off by 20%. A very simple correlation, but one that can have an enormous effect on loss estimations.

The remaining primary characteristics have varying effects depending on which inputs are chosen and which modeler you use.

CONSTRUCTION: The crucial point is the wall structure (super structure), not the fire code or the exterior treatment.

OCCUPANCY: What is the intended use of the structure? Is it a warehouse, an office building, a single family home, an apartment complex, etc?

YEAR BUILT: Building codes and permit standards in effect at the time of construction can impact the expected losses of a property. Over time, building technologies have improved, and code requirements have increased. A 1902 masonry building and a 2006 masonry building in San Francisco will respond entirely differently to the same quake intensity. New codes for roof attachments in Florida have a considerable impact on hurricane damage.

NUMBER OF STORIES: The number of stories affects losses in different ways for different exposures. In seismic zones, buildings are generally classified into three groups by height: low (three stories and under), medium (four to seven stories) and high (eight stories and over). For wind exposures, the number of stories determines the building's aerodynamic profile and its exposure to severe hurricanes and storm surges. Lower buildings, for example, are more exposed to surge losses, since the majority of their values are low to the ground.

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SECONDARY CHARACTERISTICS

Also known as secondary modifiers, secondary characteristics can have an impact on overall loss assessment, but analyzing them depends on all primary building characteristics being known and accurate. "Unless all of the fundamental information is provided, the model will ignore any additional modifiers. For example, secondary modifiers, such as whether the windows are wind-resistant and roof is anchored, will be ignored if the building's height and age are unknown." So says AIR Worldwide, a leading provider of catastrophe risk modeling services.

Secondary characteristics typically yield a 5-20% change in estimated losses – up or down. Many mistakenly believe secondary characteristics can produce extreme differences in loss estimation. If you apply the worst case secondary characteristics and then the best case secondary characteristics, the most a loss estimate will usually change is 60%.

Results vary among modelers. In recent internal tests, RMS loss estimates had larger variations than AIR for the same portfolios when including secondary characteristics. Also noteworthy: In one case, RMS estimates decreased while AIR's increased. The point is, do not assume you will have huge decreases in loss estimates by including secondary characteristics.

AIR recommends populating these fields for your location records whenever possible.

For hurricane analyses:

- Roof geometry
- Roof covering
- Roof anchorage
- Glass type
- Window protection

For earthquake analyses:

- Soft story
- Foundation type
- Building shape

SUMMARY

- Define why you need certain underwriting data before you begin gathering it.
- Primary information not only includes construction, number of stories, occupancy and year built, but also accurate addresses and values.
- Accurate primary information is essential. Secondary information can be helpful, but only when the primary data is accurate.
- Secondary characteristics do not guarantee huge loss estimate reductions.

Secondary characteristics, however, have impact beyond catastrophe modeling. Underwriters may give credit for certain characteristics regardless of how the models treat those characteristics. Gathering secondary characteristics is not only crucial to accuracy, but can provide value by:

- Allowing for more focused rating and underwriting
- Allowing a carrier to participate in a program when otherwise they may not be able to due to loss estimates delivered by models
- Providing a standardized, multidimensional measure of a building's vulnerability
- Reducing uncertainty in loss estimates

Effective data gathering enables property owners to quantify differences in risk among buildings. It also helps improve efforts to mitigate losses.

For further information, contact Bruce Norris, Director of Willis North America RMS Catastrophe Services at 650 453 1809 or bruce.norris@willis.com.

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