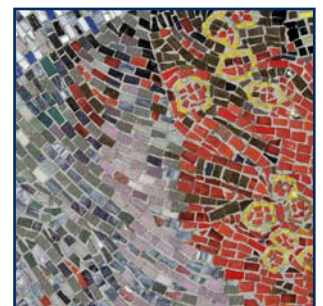
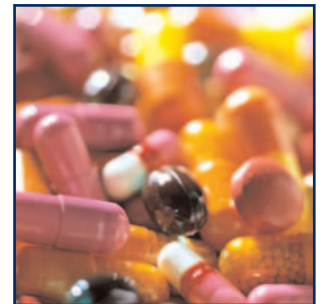


Marketplace Realities & Risk Management Solutions

2008

Risk and Risk Management –
A Timeless Mosaic
January 2008 Edition



Willis



Marketplace Realities 2008

& Risk Management Solutions

Risk and Risk Management – a Timeless Mosaic

Willis

January 2008

Contents

In this edition of *Marketplace Realities*, each of the articles is paginated separately to facilitate their use in stand-alone fashion. They appear in the following order:

- Foreword – “A Timeless Mosaic”
- Captives
- Executive Risks:
 - Directors & Officers
 - Employment Practices
 - Fidelity
 - Fiduciary
- Financial Institutions
- Life Sciences
- Medical Professional
- Property
- Real Estate
- US Workers’ Compensation
- Utilities

TRIREA Legislation

As we go to press, TRIA-related extension / expansion legislation hangs in the balance. Passage in some form before year-end is expected. We will notify our clients immediately, with a special *Alert* bulletin providing analysis of the legislation, recommendations for near-term actions, and long-term implications for insureds and the industry.



Marketplace Realities 2008

& Risk Management Solutions

Risk and Risk Management – a Timeless Mosaic

Willis

January 2008

Recommended Reading

Willis provides thought leadership throughout the year, with more than 90 Alert bulletins, research papers and marketplace reports to date in 2007. We invite readers to visit the Publications page of www.willis.com, where you will find articles and studies covering the spectrum of today's salient risk management and insurance issues.

December publications to date from Willis practice groups include:

- *The Subprime Crisis and Insurers* – The Willis Financial Institutions Practice examines the impact of the subprime crisis on insurers – from their own investment portfolios and through their insurance operations.
- *FOCUS on Benefits* – Reporting recent developments and Willis Employee Benefits Practice perspectives on nine major topics, including wellness initiatives, EEOC guidelines regarding the treatment of cancer as a disability under ADA, and ERISA reform.
- *Class Action Privacy Suits – Merchants Beware* – The Willis Executive Risks Practice reports on litigation arising out of alleged breaches of privacy and the increasing use of FACTA – the Fair and Accurate Credit Transactions Act passed by Congress in 2007 – as a basis for consumer class actions.

November publications include:

- *Shelter from the Growing Subprime Storm* – Willis Financial Institutions Practice
- *Feeling the Heat* – Willis Environmental Practice
- Indices of Market Conditions from the Willis FINEX (Financial & Executive Risk) Group
 - *Professional Indemnity*
 - *Directors' and Officers'*
 - *Financial Institutions*
 - *Environmental*
- *Change Brewing in Fiduciary Liability* – Willis Executive Risks Practice

Editorial Staff:

Gordon Prager
Jonathan Fried
Arlene Calandria
Paulette Callen



Risk and Risk Management – a Timeless Mosaic

Willis

January 2008

Foreword

“We’re in a soft market” is the message that runs through virtually every article in this edition of the Willis *Marketplace Realities* series.

Over many decades, we, our clients, industry observers, financial analysts and insurers themselves – we have all posed the question: why does insurance industry performance always seem to run in cycles of soft to hard and back again? It is a tip-of-the-iceberg query that reflects perplexity and, at times, consternation with a financial services sector that episodically exhibits significant variability and volatility in rates, capacity, product offerings and scope of coverage.

Just beneath the surface, in times of stress and uncertainty, are litanies of challenging observations and exhortations:

- Can such swings and volatility be tamed – or are they innate and unavoidable?
- Are carrier operational and financial management practices the predominant factors in fueling and driving cycles, or is it a combination of industry practices, insured events and external factors – investment earnings, the economy, legislative and regulatory developments, fresh case law, and new age uncertainties such as global warming and its putative impact on natural catastrophe risks?
- What is the anatomy of a cycle, and to what degree are the peaks and troughs predictable in their duration and quality?
- How does one optimize cost of risk and program breadth when the parameters of choice are moving targets?

Reasonable and relevant as these questions may be, they are also to a certain extent academic. On any given day, one deals with the immediate reality – and therein resides the good news, for experience demonstrates that the strategies, tools and activities employed to achieve risk management program objectives are relevant, efficient and effective in virtually every marketplace environment. The macro components of program design seldom vary: retentions, limits, sub-limits, policy wordings, carrier metrics (contract certainty, claims performance, market security), premium, cash flow and collateral requirements.

The methodologies and practices of self-knowledge, modeling, differentiation, game theory, negotiation, capital efficiency and risk funding are engaged to seek the best fit for all of the pieces. With firm-wide participation of corporate governance stakeholders and with deft execution, such science becomes art – a mosaic, a harmoniously assembled, organically responsive blanket of protection.

(continued)



Marketplace Realities 2008

& Risk Management Solutions

Risk and Risk Management – a Timeless Mosaic

Willis

January 2008

The art of risk management is timeless, and the science grows apace.

In the articles that follow, Willis Associates around the world have contributed hard facts and marketplace perspectives to provide you with in-depth segment overviews, relevant headline news, program strategies and recommendations on how to achieve positive differentiation in the marketplace. We invite you to contact our authors to delve deeper into any area that may command your attention.

Gordon H. Prager
Director of Risk Management Consulting
Willis North America
+1 212 915 7905
prager_go@willis.com



Captives

January 2008

Extracting Value in a Changing World

The following is an update of the article, "Captives and Change," that appeared in the Willis Enterprise and Risk Finance Newsletter in October 2007.

Captive industry commentators will tell you that captives should be regarded as a medium-term strategic tool and not a short-term fix in a hard market. This is because in the early stages of captive establishment and development, the costs often accrue more quickly than the benefits.

However, the pace of change in the modern international business environment is such that the prevailing circumstances at the time of establishing a captive cannot be relied upon to continue beyond the medium term. To continue generating benefits and justify the initial investment, captives need to adapt to new circumstances and respond to new challenges as they arise. That they do is borne out by the continuing commitment of captive owners over decades of captive operation – though the source of value of their captives can change significantly over time.

This article examines the changing environment in which captives operate and how captives can and do respond.

Drivers of Change

The Insurance Market

It is a common misconception that captives are most cost effective in hard markets and that interest in captives, therefore, follows the insurance market cycle, with new formations in hard markets and captives being wound up or moth-balled in soft markets. People often point to the significant number of new captives established during the hard market of 2003/2004 as evidence of this. However, a closer examination of the evidence suggests that this correlation is weak at best and that the number of captives in the world has grown fairly steadily through both hard and soft markets. Given the high front-end costs of establishment, it is perhaps not surprising that short-term market conditions (and the hard part of the cycles always seem so much shorter than the soft!) drive the formation of many new captives. Market cycles may affect the *timing* of establishment, but are not usually the captive's *raison d'être*.

However, the state of the market has a very significant impact on the way in which a captive is used and in the source of the value that its use creates. Additional sources of value arise in a hard market, such as access to reinsurance markets and the ability to fill gaps in a program where 100% cover is not available or where terms vary or cover is denied for specific risks.

Regulatory Environment

Regulatory change can shift the ground rules under which captives operate, but this is not necessarily bad. It can lead us to reevaluate the captive's purpose. As more domiciles compete and fiscal and corporate regulations change, the reevaluation process is crucial to optimizing any captive operation.



Marketplace Realities 2008

& Risk Management Solutions

In Europe, regulatory change is ongoing. The EU Reinsurance Directive was issued in late 2005, with the aim of harmonizing reinsurance regulation across 27 European countries and in the process encourage barrier-free transaction of business. This effort has led to some major companies like XL Capital and Partner Re taking full advantage of regulatory change and choosing Ireland as their European headquarters and to Swiss Re moving its European headquarters to Luxembourg. Similarly, captives are reevaluating their business models and some have relocated to competing domiciles within Europe for maximum regulatory and fiscal advantage. This competition is healthy for the market and will lead to further innovation. The establishment of Malta as a credible EU domicile has provided further beneficial competition in the EU captive market.

A greater change looms ahead with the proposed risk-based capital model known as Solvency II, which is expected to be implemented around 2010 with a three-year transition period. It has been widely stated that captives will suffer under Solvency II, but recent financial modeling of some captive programs based on current proposals has identified areas of opportunity. While it is generally accepted that minimum capital requirements are likely to increase as a result of a captive's inherent lack of diversification of risk, this may be alleviated by capitalizing existing surplus assets. By enhancing or modifying some of the captive's internal corporate governance activities, many well managed captives have already identified the key risks outlined in Solvency II and have put in place cost-effective risk mitigation solutions. The period leading up to final implementation of Solvency II will provide EU captives with the opportunity to reexamine all aspects (strategic, operational and financial) of their business models to take advantage of the stronger capital model that Solvency II will encourage and reward. Solvency II should also lead to easing of some regulatory burden, as local regulation becomes a thing of the past.

It has been noted that Solvency II will assign compliant companies (including captives) a virtual rating that would make them an attractive proposition for potential partners. This can only help captives negotiating with other carriers and European (re)insurers negotiating with the US on greater mutual recognition. The New York Insurance Department's recent announcement that it intends to reduce collateral requirements for foreign reinsurers has been universally welcomed.

Europe may well be leading the charge toward a true globalization of the world insurance market. Captives should be well placed to ride the big wave of change.

In the US the proliferation of state captive laws are now bearing fruit, as captive formations are picking up in some of the newer domiciles. The varying legislative framework and infrastructure in the growing number of state domiciles is beginning to create domicile centers of excellence. Some areas of specialization include limited liability companies, nonprofit corporations, risk retention groups, life insurance securitization structures and even terrorism covers. These are appealing differentiators in an increasingly competitive marketplace.

One of the more pervasive forces of change affecting captives is the continued evolution of corporate governance standards. Implementation of the Sarbanes-Oxley Act continues to involve all layers of operational control, with most recent revisions impacting US GAAP and related internal audit processes.



Business Environment

Perhaps the most significant source of change comes from captive owners themselves as they respond to changes in their own marketplace and business environment. Changes in core strategy, mergers and acquisitions, new management, new products and evolving markets all directly impact both the role of the captive and the risks it insures.

Captive strategy should be reevaluated in light of such changes at the shareholder level to ensure that objectives are aligned with those of shareholders. This allows shareholders to derive maximum value from captive participation. This alignment is best achieved by examining the underlying sources of captive value and identifying which are most relevant to shareholders and what changes can be effected in the captive to harness such value.

Strategic Value

- Flexibility and control over the insurance program in terms of both coverage and claims management
- Optimized program design – risk retention/risk transfer at both strategic business unit and group levels
- Supplement to conventional markets – specific or unusual covers including new risks without claims history
- An important option to consider in pursuit of optimal corporate governance

Operational Value

- Reinsurance market access
- Holistic risk management control and coordination
- Expert advice and access to specialist delivery and management information systems

Financial Value

- Market leverage as an alternative to conventional markets
- Reserving of claims, especially IBNRs & IBNEs
- Reduced administration costs through outsourcing to specialist administrators
- Cash flow / investment returns
- Efficient use of capital
- Tax deductibility of premiums
- Other fiscal benefits subject to parental CFC (controlled foreign company) restrictions

All captives generate value through some combination of these sources. Captive managers must seek the optimum combination of location, corporate structure, program, management and governance infrastructure to deliver the greatest possible value from the captive in all the prevailing circumstances – value that is in line with group priorities and objectives.

The obvious question then is: how does a captive owner go about achieving this optimal combination?

Sources of Captive Value



Generating Value

The most fundamental requirement is a clear understanding of the group strategy and objectives. These will drive the setting of captive value priorities against which performance can be assessed.

Second, it is important to have an objective means of assessing the costs and benefits generated, even where this is not measurable in financial terms. It is only by examining these together that the overall value can be determined. This assessment should be undertaken regularly to ensure the continuing value of the captive.

The parent group must constantly challenge the captive to address the risk issues the group faces. All kinds of insurable risks are potential sources of additional value, whether retained by necessity or where the captive operates in competition with conventional insurance options.

Effective consideration of potential lines of business for the captive involves a team effort on the part of the group risk manager, the broker and the captive manager. This highlights the need for all these parties to fully understand the role and value potential of the captive, and to work together openly to achieve it. Obviously it helps to have brokers experienced in working with captive programs and to have insurance managers with wide experience and expertise in captive structures, programs and domiciles.

High-quality governance infrastructure and, in particular, a strong and competent captive board will provide effective scrutiny of proposals and oversight of implementation. All too often the value of strong, knowledgeable non-executive captive directors is overlooked.

Communication is obviously critical among all parties; the more the better.

Finally, as much flexibility as possible should be designed into every aspect of the captive from inception. This should include:

- **Domicile selection.** Attention should be paid to the style and substance of regulation (including local laws regarding company migration, should a change in domicile be sought later), market access restrictions, capital requirements and the availability of potentially useful corporate structures, such as protected cell companies and incorporated cell companies.
- **Program design.** Contracts need to reflect the possibility of changes in the underlying risk, and enable early cessation through commutation and/or cancellation clauses.

Conclusion

Benjamin Franklin once said, "In this world nothing is certain but death and taxes." However, in the modern business world, change and the need to adapt should be added to this list. Like all business challenges, those most successful at dealing with change are those who plan for it and who develop the infrastructure to manage the change process.



Marketplace Realities 2008

& Risk Management Solutions

This requires:

- Environmental awareness
- Knowledge of sources of captive value
- Assessment of captive performance
- High-quality, flexible support infrastructure

Only by responding quickly and positively to change can captives reliably generate net benefits in the medium and long terms.

Contacts

Malcolm Cutts-Watson
International Captive Practice
+44 (0)1481 735 628
cuttswm@willis.com

Jim Girardin
WNA Captive Management
+1 802 264 2080
james.girardin@willis.com



The “good times” in Directors & Officers Liability (D&O) – the recent decline in securities class actions – may well be behind us. Frequency picked up in the second half of 2007, as, beginning in August, the number of first-time class action suits filed in the US returned to earlier, pre-Enron levels. While a few of these recent suits relate to the subprime mortgage and real estate fallout, the majority do not. Turbulence in the financial markets is the likely explanation for the return to historic levels of litigation activity. The likelihood of continued financial instability suggests that the frequency of litigation may actually be elevated through 2008.

If frequency has resumed, severity never left us. In 2007, we saw one of the largest D&O settlements ever with Tyco’s agreement to pay \$2.975 billion for its consolidated securities class actions, derivative and ERISA tagalong claims. We also saw the largest settlement in a stock options dating case to date: \$117.5 million in the *Mercury Interactive* litigation. Other than the *Tellabs* decision briefly discussed below, we see little to suggest that elevated claim severity will abate in 2008.

How Big is the Wave?

At the time of this writing, we are awaiting a potentially important US Supreme Court decision in *Stoneridge Investment Partners L.L.C. v. Scientific-Atlanta Inc.; Motorola Inc.* This will tell us whether defrauded investors can recover their losses not only from the company that allegedly committed the fraud but also from the company’s accountants, lawyers, bankers and other third parties. If not, then only the Securities and Exchange Commission (SEC) and the Justice Department can pursue the third parties. Smart money seems to be suggesting that the plaintiffs will be disappointed in this case, but the ultimate implications for D&O insurance remain elusive. Some are suggesting that a pro-plaintiff ruling would result in increased D&O losses and, as a consequence, upward pressure on the price of D&O insurance. Others (with whom we side) believe that while the outcome is of major concern to financial institutions and professional services firms, it has limited potential impact on the liability of executives at other companies. Only time will tell what the final outcome will be.

One Supreme Court decision that has already begun to have a meaningful impact on D&O exposures is *Tellabs v. Makor*. This pro-defense verdict on scienter (i.e., fraudulent intent) was greeted with great acclaim by D&O insurance carriers as it almost immediately began persuading judges to dismiss cases, including some in active settlement negotiations. (We will publish further analysis on the subject in our January 2008 *Executive Risks Alert*.)

The Lerach Effect

Those in the D&O world who have not been held incommunicado during the latter part of this year are manifestly aware of Bill Lerach’s guilty plea. Known as the King of D&O Litigation, Lerach and his former law firms (Milberg Weiss Bershad Hynes & Lerach and Lerach Coughlin Stoia Geller Rudman & Robbins) dominated the litigation landscape and until recently dominated the list of D&O plaintiffs’ firms. Mr. Lerach’s guilty plea to a federal conspiracy charge of obstructing justice



Marketplace Realities 2008

& Risk Management Solutions

stemmed from an alleged decades-long practice in which Milberg Weiss partners secretly recruited and illegally paid people to act as lead plaintiffs in D&O class action suits.

The impact of this fall from grace? Many observers had attributed the previous drop in D&O securities class actions in 2006 and the first half of 2007 to a slowdown in case filings by the Lerach firms alone. On the other hand, with the sword no longer hanging over the head of Lerach's old firm (now Coughlin Stoia Geller Rudman & Robbins), they, as well as their competitors, may well be reinvigorated.

The issue of law firm behavior will not go away in 2008. In at least one high-profile case (*Carpenters Health & Welfare Fund v. The Coca-Cola Co.*), the defense has alleged that the plaintiffs' law firm engaged in the same tactics that Lerach and a former partner admitted employing in their earlier cases. Lawyers for the defense argued that "a confession by the lead lawyer who brought and oversaw the prosecution of this securities case...that he suborned perjury in securities cases to enrich himself requires denial of class certification. Indeed, the circumstances here present an even more compelling case because defendants have demonstrated that plaintiffs' counsel have engaged in the same sort of tactics in this case that Mr. Bershad and Mr. Lerach have now admitted in other similar cases." If this defense strategy is successful and class action status is denied, it may well be employed in other cases. Shareholders would then have to continue their claims individually (if they pursue their claims at all). We will be closely watching the "Lerach effect" in 2008.

The Subprime Crisis

The fallout from the increased defaults and subsequent write-downs of subprime mortgage portfolios started to become clear in the third and fourth quarters of 2007. At this writing, over 100 mortgage origination companies have gone out of business and/or declared bankruptcy. Many of these are already associated with D&O claims. We are also starting to see D&O claims against the companies that held mortgage or mortgage-backed securities in their investment portfolios – portfolios which have recently fallen significantly in value. (For more information see our *Financial Institutions Alert* of October 2007, "The Subprime Crisis.") A few have also seen ERISA tagalong claims as well (see the Fiduciary Liability section of this report). If these losses spread from the financial institutions sector, the impact on D&O insurers and D&O prices is likely to be substantial.

The subprime crisis may presage significant weakness in the housing sector, and this cooling could well be an indicator that the economy itself is slowing. If consumer finance and spending is off for a prolonged period, we may see a sudden increase in classic "disappointed-expectations" cases.

Formula 404

For one D&O issue – the burden imposed by the Sarbanes-Oxley Act (SOX) – some relief is in sight. Virtually all observers, even the act's strongest supporters, seem to agree that the implementation of Section 404, which addresses internal controls, got off to an embarrassingly bad start. Thankfully, the SEC has made significant adjustments. In June, the SEC issued guidance to provide management with a risk-based, top-down, tailored approach to complying with 404's requirements. Going forward under the new standard, auditors will focus their efforts on



Marketplace Realities 2008

& Risk Management Solutions

identifying material weaknesses in internal controls without getting diverted by immaterial control issues. This news was welcomed warmly, especially by smaller and mid-size companies gearing up for their first SOX reporting cycle in 2008.

It's a Small World after All

The SEC delivered more good news recently, this time for non-US companies that make US securities filings. Recognizing the global nature of finance, the SEC recently voted to allow non-US companies to use International Financial Reporting Standards (IFRS) without reconciling to US generally accepted accounting principles (GAAP) as previously required. Reconciliation represented an additional cost for foreign private issuers registered in the US, and the reconciliations were arguably of limited use to those who look at financial statements. Investors are likely to benefit from the elimination of the costly reconciliation requirement, and businesses should be able to refocus their resources in more productive areas. What is good for the goose may well be good for the gander. For example, France's AMF recently announced that for cross-listing purposes it would accept unreconciled US financial filings as long as the filers are not undertaking a public offering in France.

In a similar vein, the SEC plans to take up the question of whether to take the additional step of permitting US companies to use either GAAP or IFRS. For US-based global companies that access international capital markets and have non-US domiciled competitors, this added flexibility is potentially quite valuable. On the **downside**, these changes could make it easier to **pursue** a global D&O claim.

Pricing and Capacity

As we enter 2008, we are enjoying a competitive D&O marketplace for the majority of risks and industry sectors other than financial institutions (see the Financial Institutions section of this report). Most underwriters agree that it will take a severe and prolonged credit crisis and/or major spread of the subprime contagion to bring this to an end before the close of 2008.

We expect 10-20% decreases for well positioned risks, and under the right circumstances, significantly higher savings. One caveat: price savings may disappear when excess layers reach minimum pricing levels. A-Side D&O carriers, typically attaching at \$100 million or more, have been especially vocal on this point. While written as high excess coverage, many of them contain drop-down and difference-in-conditions (DIC) provisions, so they may function as primary or lower capacity in certain situations. This makes their push-back more understandable.

The potential slowdown in price savings may be mitigated to some extent by the current surplus of excess capacity in the domestic and international D&O marketplace. With new companies entering the market over the past two years (Ariel, Catlin, Ironshore and Scottsdale) and others promoting their ability to write additional limits on a given risk through sister companies in different parts of the globe (US, Bermuda and Europe), capacity is abundant, especially for A-Side coverage.



Terms & Conditions: Terms of Endearment

It is a buyer's market at the moment. With more carriers looking to write or retain D&O coverage, product differentiation is critical. Whether it be a new coverage clarification (like extradition coverage) or full severability, both new and existing markets are offering improvements to the terms of insurance contracts. This means that more homework during the renewal strategy may be key to identifying the right coverage terms and options to raise in negotiations.

The definition of *application*, the breadth of severability clauses, who/what is covered as a subsidiary, the hurdle for the personal conduct exclusions – these issues should all be re-examined this year to determine the optimum for a given risk. Program architecture – who is covered on which layers and where local policies will complement a global D&O program – is another essential discussion item before your risk enters the market.

New Coverage Clarifications

In 2008, buyers should be sure to consider the D&O coverage clarifications that have evolved over the course of 2007. This includes the clarification that damages arising under Section 11 and 12 of the Securities Code (for initial public offerings and secondary offerings, respectively) will not be labeled as disgorgement by the carrier if they are not categorized as such in a court award or settlement agreement. This can be a valuable clarification, as some case law suggests that disgorgement is not a coverable loss under a D&O policy.

Another potentially valuable coverage clarification involves excess carriers. Many excess carriers will agree to respond after an underlying carrier has gone bankrupt or when some uninsured lower layer of coverage has been in-filled by another carrier or by the insured. In practice, carriers usually do not insist on prior payment from an insolvent insurer before making their own required payments, but this clarification is still useful. What may prove particularly helpful is having formal recognition that excess carriers will not resist paying until all underlying layers of coverage have been fully paid by their respective carriers, but will instead acknowledge an in-fill, including one provided by the insured.

Protection for Retired Directors

The natural turnover of board members has increased over the past couple of years. Three major reasons are new knowledge requirements set by regulators, mergers and acquisitions and the desire of companies to find board members with broad international experience. Retired directors represent a unique D&O exposure – and one that is growing.

A product innovation previously offered in Europe and Australia was introduced to the US in mid-2007 by a major North American D&O carrier. Multiyear D&O coverage, with a dedicated limit of liability solely for a given retiring director can now be offered following years of loyal service. It allows the executive to have locked-in coverage for up to six years after leaving a board on good terms. We believe that this product will receive quite a bit of attention in 2008.



Marketplace Realities 2008

& Risk Management Solutions

Contacts

Ann Longmore
Executive Vice President
Willis Executive Risks Practice
+1 212 915 7994
longmore_an@willis.com

Jenina Schiller
Senior Vice President
Willis Executive Risks Practice
+1 212 915 8087
jenina.schiller@willis.com

Anne Costello
Vice President
Willis Executive Risks Practice
+1 212 915 8144
anne.costello@willis.com



Employment Practices

January 2008

One of the most potentially influential Employment Practices Liability (EPL) decisions ever to come out of the Supreme Court was handed down in 2007: *Ledbetter v. Goodyear Tire & Rubber Co.* This pro-employer ruling may provide critical protection to employers against discrimination claims for past events. The impact of this decision will likely be tested in 2008. If it stands as is, frequency as well as severity of employment practices litigation may be reduced. (For more information on this case, see our *Executive Risks Newsletter* published May 2007.)

At the time of this writing, we are awaiting another key Supreme Court decision, this one relating to alleged age bias in *Sprint/United Co v. Mendelsohn*. Here the Court is considering whether or not to permit testimony of employees who are not parties to the case, but have allegedly experienced discrimination by other supervisors at the same company. If the Court conclusively bars "me too" allegations – which, according to some, yield irrelevant and highly prejudicial evidence – cases could be dismissed more frequently for lack of evidence, and employers across the country will have scored a major victory.

Fighting the System

In 2008, an ongoing Equal Employment Opportunity Commission (EEOC) initiative that will bear watching is the agency's Systemic Program. This involves a comprehensive nationwide program to identify and combat systemic discrimination. Each EEOC district has outlined an enforcement plan, and systemic investigators have been hired. Now, in response to every charge of employment discrimination filed with the EEOC, the investigators will consider the potential that others have been similarly harmed, thereby increasing the potential number of plaintiffs in each action. To support the initiative, the EEOC's information technology systems have been overhauled to better track multiple charges against a given company. The number of employment class- or mass-actions can be expected to rise as a result of this program.

Appealing Wal-Mart

An appeals court handed down a decision granting class certification on the largest EPL claim in US history: the million-plus member, glass-ceiling, gender discrimination suit filed against Wal-Mart. And once again, like clockwork, the decision was quickly appealed. Curiously, the majority in its decision did not reference the last crucial decision on class action status, which had come out only weeks before, *In re IPO Securities Litigation* (see our January 2007 *Executive Risks Alert*, "Top 10 Court Awards & Settlements"). The dissent certainly did, echoing the court's decision in the IPO Securities case, which overturned the largest consolidated securities class action ever. The split in the federal courts on this important issue suggests that the topic is ripe for Supreme Court consideration. Don't be surprised if this is where this case is ultimately decided, an appeal or two from now.

Retaliation

While race discrimination continues to be the number one charge brought by the EEOC, preliminary numbers for 2007 indicate that employment retaliation is poised to take over the



Marketplace Realities 2008

& Risk Management Solutions

number two spot from gender discrimination. Retaliation charges now comprise approximately 30% of the EEOC charges filed, up from 23% a decade ago. Last year's *Burlington Northern* decision (see again the "Top Ten" *ER Alert*), allowing retaliation cases to proceed even when no loss of wages or employment are involved, may have contributed to this increase.

The most recent private study of employment-related settlement data¹ provides some noteworthy figures that employers may find bracing.

- The average single plaintiff verdict in an employment suit is \$603,376.
- The average verdict for discrimination claims is \$656,072. The median is \$195,000. If the suit is brought in state court, these numbers rise to \$1,016,566 and \$235,000 respectively.
- Age discrimination has the highest median award.
- For whistleblower claims, the average verdict is \$616,039.

Defense costs are not included in these amounts.

Choices are abundant, with global capacity now exceeding \$500 million. The list of major domestic and international insurers has never been longer. The good news of 2007 was led by the entrance of a new \$100 million facility in Bermuda from an established carrier.

Small to mid-cap companies, who often purchase this coverage in combination with other Executive Risks coverages, continue to find themselves in great demand as most carriers compete to win their business. The green light is also on for large and multinational firms, who find their choices growing in the US and international marketplaces, thanks to the surge in Bermuda capacity.

Pricing

We continue to see positive news for buyers on the premium rating front. Most insureds, with the exception of a very few (those experiencing claims or major reductions in force), should continue to experience favorable rates for the remainder of the year and well into the first quarter of 2008. We expect reductions of up to 10% and possibly greater, depending on each insured's risk differentiation.

With carriers' ability to gear up their excess capacity, insureds are also experiencing reductions in excess layer pricing.

Terms & Condition Pricing

Terms and conditions for Directors & Officer (D&O) contracts are improving for buyers, and this trend is affecting EPL policies. Carriers are more amenable to broadening their terms to mirror D&O extensions, such as severability of the application. Carriers are similarly granting global extensions, amending the ADR provisions, offering identity theft extensions and providing minority and sensitivity grants. This all bodes well for most insureds.

Employment Practices Liability Capacity: Abundant



Marketplace Realities 2008

& Risk Management Solutions

Punitive damages are a key exposure in many EPL actions. However, insuring punitive damages is no sure thing in the US as each state has its own position on whether or not, and under what conditions, this form of EPL loss can be insured. To address this uncertainty, it is not unusual for US-based EPL programs to be accompanied by off-shore punitive damages wrap policies. Written outside the US, these programs are designed to fill the potential insurability gap represented by these damages. Bermuda carriers (where the majority of punitive damages wraps are written) are now requesting their own underwriting submissions in order to provide a punitive wrap quote; complying can be particularly challenging when the *primary placement* does not require an EPL application. This point is often negotiable.

There is no one-size-fits-all strategy. For example, wage and hour coverage grants are currently available from several markets, but restricted to private and small employee companies, and generally only on a sub-limited basis. The goal remains to design a program that best meets the individual needs of a given risk with the appropriate international and/or domestic markets. While coverage terms continue to evolve in a favorable direction for most insureds, the buyer may not win every negotiating point. Prioritization is key. While we continue to monitor any changes on this extension in the months ahead, no time is more favorable than the present for insureds to consider the purchase of EPL policies.

Contacts

Ann Longmore
Executive Vice President
Willis Executive Risks Practice
+1 212 915 7994
longmore_an@willis.com

Jenina Schiller
Senior Vice President
Willis Executive Risks Practice
+1 212 915 8087
jenina.schiller@willis.com

Anne Costello
Vice President
Willis Executive Risks Practice
+1 212 915 8144
anne.costello@willis.com



Fidelity

January 2008

The Fidelity market experienced another soft year in 2007. While loss results will not be made public for several months, loss frequency has not slowed, leaving some underwriters to expect another year of mixed – or worse – results. Although we do not expect a material shift in the scope of coverage available or in pricing trends, we expect 2008 may well be the final year of market softening. With prices at their lowest level in seven years and deteriorating claims experience, some underwriters have started to push back on pricing or walk away from thinly priced accounts.

Capacity

Capacity was more or less unchanged in 2007, and current levels in the US market stand at approximately \$320 million. Adding Lloyd's capacity of \$130 million yields combined capacity of \$450 million for US-based firms.

The list of carriers comprising the Fidelity market is also unchanged, and with few exceptions, they have shown a consistent risk appetite. For a product as old as Fidelity insurance, which was first written out of Lloyd's over 100 years ago, this is not surprising. The age of the product assures a long trail of actuarial data and few surprises on the loss fronts. While the manner in which property is stolen may change, the underlying motivations for stealing have not.

We anticipate neither a significant increase nor decrease in capacity in 2008. While rumors abound regarding the possibility of a strong new entry into the market next year, unless the firm is willing to lead on Fortune 500 or major financial institution (FI) accounts, their ability to materially alter the market will be minimal.

Of the 15 or so markets actively writing Fidelity, we would expect that only four to five will take a lead position on large FI or Fortune 500 accounts, leaving the balance of the market to aggressively compete for the excess layers generated by these programs. Fortune 1000 and large middle market accounts, however, will continue to enjoy a competitive Fidelity market at every level in 2008 as there are more markets competing for these risks.

Loss Results

Although 2007 Fidelity results are not yet available, it is instructive to look at 2006 numbers, posted by the Surety & Fidelity Association of America several months ago. The results were an interesting mix of poor to very good. Of the top 12 companies, three experienced net loss ratios in excess of 89%, three had ratios between 50% to 68% and the remaining six had ratios between -6.5% to 33%. A superior measure of profitability, however, is combined loss ratio. While the Surety Association results do not include this information, the usual rule of thumb can be applied: add to net loss ratios an additional 20% to 30% for acquisition costs associated with writing this business (commissions, overhead, salaries, etc.). Based on combined loss ratio, the profitability for half of the market becomes much more marginal. All the same, we do not anticipate a correction in underwriting during 2008 – though we would not be surprised to see a change soon thereafter.



Loss Trends

The types of losses sustained by underwriters have not changed significantly. The overwhelming majority of claims are caused by employee theft. While both Commercial Crime and FI Bonds offer certain coverages for non-employee theft losses, these make up a small percentage of the losses paid by underwriters. As a result, the bulk of the premium included in these policies is allocated to the employee theft (Fidelity) insuring agreement.

The recently released "2006 Report to the Nation" by the Association of Certified Fraud Examiners (CFE), which surveyed over 1,100 companies, found that vendor fraud (defined as theft resulting from an employee submitting fraudulent invoices for goods and services) made up 28% of all losses. This was followed by employee check forgery (stealing checks and forging or altering them), which made up 17% of losses, and inventory theft, which made up another 17%.

Regarding loss severity, the CFE noted that 7% of losses were the result of wire fraud (employees wiring funds from corporate to personal bank accounts), which resulted in median losses of a million dollars. Also noted were losses involving securities theft (employees transferring corporate stock to their own portfolios). While these only made up 2% of the scenarios, the resulting median losses were seven figures.

Similarly noteworthy is a 2007 fraud survey by PricewaterhouseCoopers (PwC) involving more than 5,400 companies around the world. In addition to supporting much of what was disclosed in the CFE survey, the PwC report, "Economic Crime: People, Culture and Controls," also noted a direct correlation between company size and loss frequency. Of the companies surveyed, 62% with more than 5,000 employees sustained a fraud loss while 32% of those with 201 to 1,000 employees experienced some level of fraud.

Commentary from the leading Fidelity markets further supports the data outlined in these surveys. Most notably, the markets are keenly aware of the greater loss frequency with larger accounts and the continued high frequency of vendor fraud losses. This is why we expect there will continue to be a limited number of Fidelity markets willing to take a lead position for Fortune 500 companies or large FIs.

Pricing

While the profit margins for Fidelity underwriters continue to narrow and the loss ratios for several of the leading markets are becoming quite high, we do not expect a hardening of the market, particularly for Fortune 1000 and large middle market accounts. Furthermore, coverage for excess layers will continue to draw strong competition from the entire market for most accounts, including the Fortune 500 and large FIs, which will serve to assure flat renewals or even reductions for accounts maintaining a good loss history and no material change in exposures.

Subprime Side Effects

While the financial markets continue to reel from the huge credit losses emanating from the collapse of the subprime mortgage industry, the commercial fidelity bond market has not been notably impacted to date. The FI bond markets, however, have taken a closer look at institutions



Marketplace Realities 2008

& Risk Management Solutions

with significant involvement in the mortgage industry. Some leading underwriters have taken a hard-line position on those institutions that generate a large percentage of their income from mortgage originations or that provide services associated with the mortgage industry. These institutions will likely find fewer markets competing for their business in 2008.

Contact

Stephen Leggett
Senior Vice President
Willis Executive Risks Practice
+1 212 915 7901
stephen.leggett@willis.com



Forecast

US retirement assets total \$16.6 trillion, according to a new statistical series published by the Investment Company Institute, and plan funding has reached comfortable levels for most private plan sponsors. So what in the name of ERISA (the Employee Retirement Income Security Act) could trouble fiduciaries and their insurers in 2008? How about fixed income investments that turn out to be subprime mortgages in disguise? Surprise legal decisions allowing previously barred plaintiffs to bring suit? Plan sponsors trying to transfer their liabilities and obligations to others? These were among the key Fiduciary issues that arose in 2007.

ERISA Tagalong Claims

A number of carriers reported that the number of new ERISA tagalong claims¹ fell in 2007. This would seem to be a sustainable trend for 2008 *as long as* the number of Directors & Officers (D&O) securities claims, with which they are directly correlated, continues to fall. But other fundamental forces may also be at work. Almost 70% of US employers now allow their 401(k) plan participants to immediately divest matching contributions when made in company stock.² This is a huge change from 2005 when less than one quarter of employers permitted employees to immediately move their investments out of company stock that had been contributed as part of a 401(k) matching program. This change should mitigate subsequent losses and/or litigation. Furthermore, considerably fewer employers make matching contributions in company stock, with just 23% doing so in 2007, down from 36% in 2005.³ As 2007 draws to a close, however, we see signs that D&O securities claims are on the rise again, so it may be too early to feel sanguine about the ERISA tagalong trend.

Another factor that may yield more ERISA claims is a recent series of court decisions permitting former plan participants who have cashed out of a retirement plan to bring suit under ERISA. Already, *Guidant* and its progeny are beginning to give Fiduciary Liability carriers *agita*. (For more on this topic, see our *Executive Risks Alert* published November 1, 2007 on www.willis.com.)

Fee (Fi Fo Fum) Disclosure

A looming issue for many plan fiduciaries (and an immediate concern for the 13 major employers who are currently defendants in separate legal actions filed against them and their plan fiduciaries) is the issue of 401(k) fee disclosures. Although the defense won one major case recently, when a judge determined that no violation of ERISA had occurred, it is too early for employers to feel comfortable on this topic. In addition to action in the courts, Congress has heard testimony on the potential long-term impact of plan fees that are passed on to plan participants. The General Accountability Office has also investigated fees and potential conflicts of interest, and the Department of Labor has proposed additional disclosure requirements. This issue is not going away any time soon.

Subpar or Subprime

With large institutions taking serious losses in their investment portfolios because of the subprime crisis, at least some pension plans cannot be too far behind. Already at least two suits have been



filed alleging breaches of fiduciary duties by investing plan assets in subprime mortgage products. These suits contend that the plans' investment managers invested in one or more bond funds that in turn invested in mortgage-backed securities, despite the conservative investment strategies these funds advertised. We expect that it is only a matter of time (perhaps until plan participants receive their statements) before more join the fray and sue their plan fiduciaries for subprime-related losses.

Supporting this trend is the potential for ERISA tagalong suits that might be filed against firms whose stock takes a beating due to investment losses traceable to the subprime crisis. In several instances, this potential is already being realized: suits have been filed.

Changes in the Wind

Last year saw a record number of announced plan closings or freezes. It now appears that 24% of employers with open and ongoing pension plans intend to close or freeze their plans within 18 months.⁴ Asked why they were closing or freezing their pension plan, the majority ascribed it to the nationwide trend away from pension plans in favor of 401(k) plans. Others reported shifting to hybrid or cash balance plans. Both 401(k) plans and cash balance plans, it should be noted, have been known to attract fiduciary litigation.

The shift from traditional defined benefit to defined contribution plans (including 401(k) plans) moves the risk of pension funding from employers to employees. This transfer of responsibility can result in unforeseen and often daunting legal and fiduciary complications. While ERISA Section 404(c) has a statutory exemption for plan sponsors in selecting investment options for plan participants to choose from, this safe harbor does not protect selections imprudently made, based on nonpublic information, or those improperly influenced. Similarly, while last year's Supreme Court decision on cash balance plans and the recent Pension Protection Act both provided protections to cash balance plan sponsors, these hybrid plans have continued to attract substantial litigation.

As companies sponsoring traditional pension plans continue to look for less risky solutions to long-term funding challenges, they are likely to be watching the green light that the Federal Reserve recently gave to the transfer of responsibility for a \$400 million retirement plan of a British firm. Other banking, investment and financial companies are actively exploring the idea of taking pension plans (and their billions of dollars in assets) off the hands and balance sheets of employers.

As federal agencies consider such transactions (including their basic legality and safeguards for workers), some view them as a win for both retirees and employers. These transactions allow for the retention of all the protections of current law, while putting the plans and their assets in the hands of sophisticated financial caretakers. It may also be important to note that this strategy is already being implemented on the UK side of the pond.

Fiduciary Capacity – Good News indeed

The capacity crunch of past years appears to be easing for private and public companies alike. This is good news indeed for most buyers, especially for those whose risk profiles include employer securities and cash balance conversions previously viewed as underwriting taboos.



Marketplace Realities 2008

& Risk Management Solutions

Fueling this increased capacity are the historic insurers with a penchant for rebuilding their Fiduciary Liability portfolio, new insurers and, interestingly enough, certain A-Side D&O policies where the ERISA exclusion is removed. This translates into greater choices for buyers: more primary insurers and more excess capacity as well.

Pricing

While the pricing for Fiduciary Liability is not as favorable as pricing for D&O, there is more positive news for buyers, with premium levels falling by up to 10% and greater savings possible for superior risks. Fiduciary pricing continues to be relatively inexpensive compared to D&O, EPL and E&O coverage for many companies. However, this is not the rule where substantial amounts (or all) of a company's pension and other benefit programs are invested in the company's stock.

Terms and Conditions

Most Fiduciary forms are as broad if not broader than standard D&O contracts when it comes to the basic insuring agreements, but many still lag in coverage enhancements and clarifications. This is changing, and frequently now policies can be altered to bring them closer to their D&O counterparts. Clients should be sure to seek policy bells and whistles: full severability, non-rescindable provisions, tailored claims reporting triggers, and a stock-drop clarification endorsement, to name but a few.

Contacts

Ann Longmore
Executive Vice President
Willis Executive Risks Practice
+1 212 915 7994
longmore_an@willis.com

Jenina Schiller
Senior Vice President
Willis Executive Risks Practice
+1 212 915 8087
jenina.schiller@willis.com

Anne Costello
Vice President
Willis Executive Risks Practice
+1 212 915 8144
anne.costello@willis.com

¹ Claims brought under ERISA where company securities are held as assets in the company's 401(k) or other pension plans, and claimants allege that fraudulent actions by the company or its executives lowered the value of the securities and hence the plan.

² According to a recent Hewitt Associates Inc. survey of 300 employers.

³ Ibid.

⁴ From a survey of 350 employers conducted by Wells Fargo & Company's employee benefits consulting group, BPS&M.



Financial Institutions

January 2008

Some of the major issues facing financial institutions in the past few years have diminished in importance in 2007. The capital requirements of Basel II and Basel IA are becoming clearer as institutions throughout Europe gear up to be fully compliant, and US-based institutions evaluate their own measurement options and prepare for a later inception date. The 2007 Atlantic Hurricane Season to date has been relatively benign, and aside from the devastating California wildfires, there have been no major catastrophe losses. Accordingly, investment banking losses arising out of traditional hazard risks have been negligible.

All that notwithstanding, 2007 has been a year of great turmoil and change in the financial institutions world. Recent headlines in the financial press have been dominated by the subprime mortgage crisis, breaches in network security, questions about whether the US government will extend its backing of the terrorism insurance marketplace, the growing influence of hedge funds on the financial marketplace and the threat of increased government regulation of the financial markets.

Many of these issues are interrelated. The subprime mortgage crisis has impacted hedge funds, as many have been heavy investors in subprime mortgage-backed securities. Both industries are being closely examined by Congress and federal regulators with an eye toward increased oversight.

Terms and Conditions

The combination of a slumping US housing market and increasing interest rates has led to the woes in the subprime lending market. Since much of the subprime lending was based upon adjustable interest rates, many borrowers experienced unexpected increases in their monthly mortgage payments as rates increased. Once the housing market began to cool, and home values declined while interest rates continued to climb, these loans were put under tremendous pressure.

The pressure has proved too much for many subprime borrowers, who by definition are less credit-worthy, leading to skyrocketing loan defaults. An industry tracking source, RealtyTrac, recently reported (*July 2007 U.S. Foreclosure Market Report*, August 21, 2007) that foreclosure activity in the first half of 2007 was up 55% from 2006 and that foreclosures for the month of July rose 93% from the prior July, and 115% from the prior August. At present, 43 states have reported an increase in foreclosure activity in 2007. As a result, more than 100 subprime mortgage lenders have failed or filed for bankruptcy protection, according to industry estimates.

There is a growing concern that the credit issues in the subprime marketplace will spread to other consumer credit areas, including conventional mortgages and credit card debt. Several institutions are having their credit ratings downgraded due to these fears, and securities analysts increasingly predict that the problem will spread beyond the subprime market.



For more information on this topic, see the ongoing series of Willis *Financial Institutions Alert* bulletins prepared by an international task force consisting of financial institutions specialists in the US and London. The most recent issues reviewed potentially critical insurance coverages (Mortgage Impairment, Foreclosed Property (REO) and Forced Placed) and the impact of the crisis on insurers.

[Financial Institutions Alert – The Subprime Crisis](#)

[Financial Institutions Alert – Shelter from the Growing Subprime Storm](#)

[Financial Institutions Alert – The Subprime Crisis and Insurers](#)

Network Liability and Identity Theft

Individual privacy and protection of personal data are the hot topics of the information age. Rapid changes in technology, law and the electronic recording, storage and transmission of private information have made these concerns a high priority for individuals and businesses. The pace of automation of the financial markets, along with the technology innovations that must be implemented for financial institutions to stay competitive, translate into a broad and growing technology exposure. Automation at some companies has evolved to the point where they cannot operate if their systems are not available. Security risks are inherent for any organization storing and transmitting personal information.

Risks faced by financial institutions include:

- Civil lawsuits for identity theft or personal injury as a result of disclosure of protected private information
- Defamation and breach of privacy suits due to publication of inappropriate information on a web site, internet bulletin board or online chat room
- Loss of revenue and related extra expenses as a result of a network or system failure due to unauthorized access (or unauthorized use of authorized access), virus and or malicious code, as well as denial of service attacks
- Extortion claims or threats of extortion from someone claiming to have harmful or detrimental information which, when deployed, might destroy or damage company systems

Traditional insurance policies usually do not respond to these risks. Gaps and exclusions in your Liability, Professional, Crime, Property and Media policies may mean you lack needed coverage for these and other cyber events. The insurance market has responded by offering products addressing the privacy exposures that have developed in the last few years. Policies can now cover:

- "Failure to protect confidential information" in any form or from any media
- Client credit monitoring costs
- Vicarious liability when control of information is outsourced
- Defense costs for privacy regulatory actions
- Fines and penalties for privacy violations imposed by regulatory agencies
- Client or patient privacy notification costs



Marketplace Realities 2008

& Risk Management Solutions

We recommend that financial institutions review their technical and information security policy safeguards; examine their current insurance programs for coverage gaps; review and strengthen, as appropriate, contracts with service providers and vendors (specifically organizations providing data, IT or security services); and analyze their risks and vulnerabilities and plan for funding losses. In other words, thorough and appropriate risk management.

Hedge Funds

The hedge fund industry is one of the fastest growing financial sectors in the world, but until recently hedge funds have suffered very few significant financial losses. As a result the industry has avoided both the regulatory and media spotlights.

However, as the attraction of hedge funds continues to grow, and hedge fund-related headlines appear regularly, regulators and tax authorities are now showing more interest. The expansion of regulatory requirements, external auditing and media coverage has led to an increase in the likelihood of litigation from fund investors.

Investment managers have recently recognized that the costs of defending an action, even a spurious action, can be substantial, and these costs can impact their bottom line. The hedge fund industry is catching up to other financial segments in terms of making Management Liability insurance a part of the standard conduct of business. Regulated investors such as pension funds have started to insist that their investment managers hold Professional Liability insurance, and more and more investment management agreements are making this a contractual requirement. Most municipal investors will require proof of insurance as part of their request for proposal process.

Risk management for hedge funds and fund managers is becoming its own subspecialty, requiring identification of key risk exposures and negotiation of specialized policies to ensure that the required level of protection is provided. This kind of dedicated focus is now crucial to obtaining comprehensive coverage at a competitive price.

Government Oversight and Regulation

The financial services industry is coming under increasing scrutiny from many sides. Congress is considering several pieces of legislation, covering such issues as mortgage reform, revision of the bankruptcy code, resetting adjustable rate mortgages and setting standards for securitizing loans. The House Financial Services Committee, under Rep. Barney Frank, has been exceptionally active in advancing many of these proposed reforms.

In addition, the Federal Reserve Board, the Federal Deposit Insurance Corp., the Office of Federal Housing Enterprise Oversight, the US Office of the Comptroller of the Currency (OCC), the US Treasury Department and various state attorneys general have all promulgated or stated their intention to promulgate their own restrictions.

The mutual fund industry is preparing for added oversight from the Securities and Exchange Commission. Of particular interest are the compliance programs of these investment managing companies and the manner in which they manage their securities lending transactions.



Marketplace Realities 2008

& Risk Management Solutions

While many institutions and industry trade groups are discussing self-regulation, the tide of increased governmental oversight is fast approaching.

Similar questions surrounding Basel II requirements, which, while not the source of worry they were a year ago, are again taking on urgency as some important dates approach. At the end of October, the OCC said that federal banking regulators had reached an agreement on the best way to implement the advanced measurement approach for Basel II and were planning to release a final rule in November. The largest banks in the US are moving toward implementing Basel II in January of 2008. The agreement between the OCC, Office of Thrift Supervision, Federal Reserve and Federal Deposit Insurance Corp. would allow smaller banks to remain under the requirements of Basel I.

Terrorism

Due to their involvement in development projects as lenders, owners and operators, financial institutions remain dependent upon coverages afforded under TRIA (and its subsequent extensions), as well as stand-alone insurance products, to protect assets and investments globally from the peril of terrorism. By providing companies with the ability to rebuild after an event and the cash flow required to meet their existing commitments while doing so, terrorism insurance enables many companies to access the capital required to strengthen and expand their businesses. From real estate developers to mining operations, terrorism insurance is a vital component of an overall insurance program that protects not only the company's interests, but also those of their investors.

The current Terrorism Risk Insurance Extension Act is set to expire on December 31, 2007. On September 19, the House of Representatives passed a 15-year extension of the current legislation, significantly expanding the scope of the original act to include elimination of the distinction between domestic and foreign acts of terrorism, backstopping Group Life insurance, and coverage for nuclear, chemical, biological and radiological attacks (NBCR). On October 17, the Senate Banking Committee passed a pared-down version of the proposed extension, reducing the extension period to seven years and eliminating the mandatory provisions for NBCR and Group Life.

While it is reported that the Bush administration does not favor another extension, Treasury Secretary Paulson indicated that a bill in line with the Senate version could be acceptable.

Contact

John Bayeux
Executive Vice President
Willis Financial Institutions Practice Leader
+1 212 915 7945
john.bayeux@willis.com



Life Sciences

January 2008

The life sciences industry encompasses a variety of organizations, from large pharmaceutical companies to emerging biotech firms, from contract drug manufacturers to medical device companies. All these sectors are for the most part subject to the same mega trends.

Big Pharma in the Commercial Marketplace

Some years ago, most large pharmaceutical companies decided to stop paying what they regarded as disproportionately large premiums for excess capacity above huge retentions that they believed would never be exceeded anyway. Even if they did have a big loss, they determined that company earnings would be sufficient to absorb it. Buying expensive insurance as balance sheet protection for low probability tail risk was therefore no longer an attractive concept, and they began withdrawing from the commercial marketplace.

Now there are rumblings of a return by big pharma to the commercial market. What's going on? A few big hits that did affect earnings, combined with widespread softening in the marketplace, have inspired some to reevaluate the purchase of excess insurance. Big pharma is in the process of testing the marketplace to determine whether select carriers will respond with pricing and terms that make financial sense.

A Soft Market for Life Sciences?

For many marketplace segments and client industry sectors, the soft market is here, and many life sciences companies are looking to reduce premium costs and negotiate enhanced coverage terms from their insurers. However, the life sciences industry in general is not seeing the same drop in rates and premiums as other industries that underwriters deem to have lower potential for volatility and severity of loss. Life sciences companies are still viewed by underwriters as having the potential for enormous losses in the form of batch claims or mass tort claims.

For Directors & Officers and Products / Professional Liability lines of insurance, we are seeing modest 5% to 10% reductions in late 2007, with the possibility of further reductions in the year ahead.

New insurers have entered and committed some underwriting capacity to the Products / Professional Liability marketplace – One Beacon, Travelers and Darwin. Medmarc, a longtime insurer in the medical device market, has entered the therapeutic arena as well. Furthermore, we expect that the London and Bermuda marketplaces will continue to emerge as sources of capacity for life sciences companies.

Mid-Layer Excess

We see a potential gap in markets and capacity in the mid-layer excess area. Many markets want to be either primary or to participate in the high excess layers of a Products / Professional Liability



Marketplace Realities 2008

& Risk Management Solutions

placement. Carriers thin out in the mid-range layers – a potential problem as some of the late-phase clinical trials products gain approval and move into commercialization. Companies vending such products will be looking for higher limits, and the market may be somewhat restricted.

Product / Professional Liability for Mid-Size Companies

Products / Professional Liability policy terms and conditions for clients in the middle market arena have shown a high degree of variation, so comparing coverages can be problematic. It is also challenging to layer a program when each carrier uses its own form. Continuity of coverage will continue to be an issue for middle market layered programs where “follow form” isn’t really available for these lines of coverage.

The Next Blockbuster

Many blockbuster drugs will come off patent in the next few years. Where will the next generation of such mega-revenue drugs come from? Big pharma will continue looking to acquire smaller life sciences companies that have R&D programs compatible with the acquiring company’s strategy. This trend is particularly important as baby boomers seek new treatments that will allow them to continue their active lifestyles well into retirement. Merger and acquisition activities will therefore focus increasingly on the evaluation of assumed risks, as merging companies attempt to identify and deal with issues such as Directors & Officers continuity, potential liabilities created during clinical trial activity, and possible Errors & Omissions exposures that often go unrecognized and uninsured.

The Global Equation

The trend for life sciences companies to position themselves as global enterprises even at very early stages of development will continue. Many, if not most, US-headquartered life sciences companies are conducting clinical trials in other countries. From a corporate governance and insurance perspective, complying with local country laws and regulatory requirements can be like navigating a maze. The European community issued a code in an attempt to gain some degree of uniformity in EU countries – a good idea that fell short when most countries issued laws that interpret the EU code and apply their own specific requirements. Some countries have compulsory insurance requirements for clinical trials. Many countries require locally admitted and locally issued policies that comply with local laws.

Compliance can be a time-consuming administrative challenge for life sciences companies planning or conducting trials in multiple countries. Allow for plenty of lead time in the planning process and partner with a contract research organization and a global insurance broker to work through the issues

Contact

David Shuey
WNA Life Sciences Practice Leader
+1 410 527 7244
david.shuey@willis.com



Marketplace Realities 2008

& Risk Management Solutions

Medical Professional January 2008

The Healthcare Professional Liability insurance marketplace was more competitive in the first half of 2007 than any time since the late 1990s. With rate adequacy and stability in all major global marketplace venues, industry conditions for insurance buyers may be the best since the 1970s, and the near-term outlook is equally positive. Competitive conditions in the reinsurance marketplace have benefited the commercial Healthcare Professional Liability markets as well as healthcare industry reinsurance buyers.

The Healthcare Professional market segment has benefited from downward trends in loss experience as well. While conditions vary by state and jurisdiction, claim severity appears to have leveled off, and claim frequency is markedly reduced. These improvements result primarily from widespread state enactment of malpractice reform laws, rate adequacy and greater commitment to risk management, patient safety and quality initiatives.

High single-digit to 20% premium reductions, and on occasion reductions near 25 - 30%, have been the norm for renewals across most facility segments, with decreases of at least 5 - 10%, and often more, for physicians.

In such a competitive environment, insurance carriers are looking for ways to differentiate themselves. Multiyear programs, innovative program structures and enhanced coverage terms are available and negotiable.

The National Medical Malpractice Environment

The national medical malpractice environment in 2007 may be the best in the last 10 years. Frequency is down markedly, while severity has moderated, albeit from historic highs. Clearly, the successful push for malpractice reform legislation in 30-plus states since 2000, especially the enactment of non-economic damage caps in many jurisdictions, has impacted the malpractice environment. One often overlooked factor is the media focus on the malpractice problem, which has affected the general public's attitude towards litigation. There are fewer patients engaging plaintiffs' attorneys, and the jury pool is looking more favorably on defendants in many jurisdictions. Organized medicine and state hospital association initiatives to pass tort reform measures often included media campaigns that successfully drew the link between the malpractice problem and healthcare access. The question remains whether such salutary sensitization and educational effects will erode over time.

Recognizing that they have been losing the battle for public opinion as to the malpractice problem's effect on healthcare access, the trial bar has reacted in a number of ways. First they are attempting to fund attempts to overturn damage caps and other malpractice reform laws, raising questions about their constitutionality. As part of the strategy, (called judicial nullification) the trial bar focuses on malpractice cases that elicit maximum sympathy and high damages.





Second, they are being more selective about the types of malpractice cases they are willing to accept and take to trial. Cases of clear negligence and/or high economic damages are preferred, as defense is more difficult. The result is higher demands, often unreasonable demands, for resolution prior to trial. The trial bar is still willing to gamble that juries will make large awards for the badly injured or deceased plaintiff at trial. The perfect case for them is a relatively young victim with dependent children or an injured child, as in a case involving obstetrics or pediatrics, and a life-care plan that the plaintiff's economists will often inflate to above \$10 million. This strategy totally avoids the non-economic damage caps limitation and makes certain high-damage malpractice cases potentially extremely volatile.

Physicians and Surgeons

This segment has improved dramatically over the last two years after lagging in improvement behind other market segments of Healthcare Professional Liability. Physicians in most states are experiencing rate decreases ranging from low single digits to low double digits, typically 5 - 10%.

The number of start-up physician insurers, including risk retention groups and captives, has leveled off, but concern remains over the adequacy of the capitalization and thus long-term viability of some entrants. There has been a dramatic rise in the number of physician risk retention groups created over the last five years, and the numbers continue to grow, albeit at a much slower rate. Many are specialty focused.

Leading markets are MLMIC, Medical Protective, ProAssurance, The Doctors Company, NorCal, ISMIE, MAG Mutual, ProMutual and FPIC. Hudson and Darwin seek group business. AIG and CNA have sought to increase their writings in the physician market, with both seeking large group business. There are few remaining national carriers for physicians, with Medical Protective as the company closest to filling that niche for both individual physicians and groups. There has been continued consolidation in this segment, with ProAssurance purchasing PIC Wisconsin and The Doctors Company purchasing OHIC in 2006. The Doctors Company announced plans to acquire SCPIE in late 2007.

The London and Bermuda markets provide reinsurance and excess cover for physician captives and risk retention groups.

Hospitals

This segment continues to be one of the most competitive within Healthcare Professional Liability. Improved underwriting results due to tort reform and patient safety and quality initiatives, along with new capital over the last five years – especially for excess business – have contributed to this trend. There is an abundance of capacity for both primary and excess coverage placements. July 1, 2007 renewals saw marked reductions, not infrequently in the neighborhood of 25 - 30%, and occasionally more. High excess layer pricing has softened, especially above \$10 million.

Attachment points for excess coverage are falling, and carriers are vying to be the lead layers in response to the improving environment and restored profitability. Primary Hospital Professional Liability carriers include ACE USA, Arch, Darwin, CNA, Zurich, AIG, Hudson Insurance, OneBeacon,



Medical Protective, Catlin London, and several physician-owned insurers. AWAC US is a new entrant to the domestic primary market. Endurance Specialty has created a US underwriting facility targeting medium to small hospitals excess of a \$1 million retention. Domestic excess writers include AIG, AWAC US, CNA, Zurich, Am Re, Berkley Medical Excess, Arch, OneBeacon and ACE USA. London / European markets are Beazley, Catlin, Chaucer, Lexington, Liberty, Starr Excess, Aspen Re, Swiss Re, Hannover Re, Faraday, Hiscox, Starr, ACE and Amlin. Bermuda markets include Endurance Specialty Insurance Ltd., XL, Allied World (AWAC), Renaissance Re, Starr, ACE, Arch and Max Re.

Long-Term Care

The long-term care segment continues its dramatic improvement over the last few years. Availability and affordability are no longer an issue for most buyers. Large chains usually retain a significant layer of risk but can build capacity in London and Bermuda or buy down large retentions using alternative risk structures. On the other hand, small- to mid-sized insurance buyers may find it more difficult to buy high excess layers of coverage. AIG and CNA are major underwriters. Others include ACE USA, OneBeacon, Old Colony, James River, Uni-Ter, Bunker Hill, Lighthouse Underwriters and Shand Morahan. London and Bermuda are important markets for long-term care business – London for primary and excess/reinsurance capacity and Bermuda for reinsurance. Participation will vary by attachment level and risk profile.

Managed Care

This segment remains stable but with fewer markets than any other segment. Only four underwriters offer primary coverage: Darwin, Lexington, Travelers and OneBeacon. Excess underwriters include the London market (Beazley, Lexington, Starr Excess, Liberty and Hiscox) and Bermuda markets (ACE, AWAC, Endurance, Starr Excess, Max Re and XL). Domestic excess underwriters include Darwin, OneBeacon, National Union and Travelers.

Retentions are flat, but insurers are imposing sub-retentions/sub-limits for class action and antitrust claims. Coverage for claims alleging release of confidential medical information has liberalized. The scope of regulatory agency exclusions has expanded. Single-plaintiff claim (i.e., denial of benefits) frequency and severity are down, but those types of claims are being supplanted by antitrust actions, business dispute claims (from providers, employers and regulators) and vicarious liability litigation.

Contacts

Paul Greve
ExecutiveVice President / Senior Consultant
Willis Healthcare Practice
+1 615 872 3320
greve_pa@willis.com

Kevin Downs
ExecutiveVice President
Willis Healthcare Practice
+1 312 621 4812
kevin.downs@willis.com



Marketplace Realities 2008

& Risk Management Solutions

Property January 2008

In line with our expectations, non-catastrophe-exposed business continued to experience universal competition in 2007. The rate reductions seen – generally 5 - 20% – were in a narrower range than those of the previous year. The 2006 reductions ran from 20 - 40%, demonstrating the need for underwriters to shed catastrophe business while continuing to maintain or grow their top lines.

As we entered the most active hurricane months (August through October), we expected to see a temporary retirement of some of the new coastal wind capacity that appeared in the second quarter of 2007, but this did not occur. It became clear that what was arguably an over-correction in 2006 was giving way to a more reasoned approach by underwriters. More capacity from both new operations such as Ironshore in Bermuda and from established US markets now able to realign their catastrophe portfolios led to more competition and consistently better renewal terms for all but a few policyholders.

According to the third-quarter market survey undertaken by the Council of Insurance Agents & Brokers (CIAB), every region of the US is now seeing downward trends in Property pricing.

3rd Quarter 2007 Commercial Property Premium Changes

Source: CIAB, October 2007

	Down 30-40%	Down 20-30%	Down 10-20%	Down 1-10%	No Change	Up 1- 10%	Up 10- 20%	Up 20- 30%	Up 30- 50%	Up 50- 100%	N/A
Midwest		20%	40%	32%	4%						4%
Northeast		22%	37%	33%	7%						
Pacific NW		10%	40%	40%	10%						
Southeast		29%	58%	13%							
Southwest	6%	12%	59%	12%	12%						

Meanwhile, third-quarter 2007 underwriting results poured in, with stellar earnings almost uniformly reported. In many cases, loss ratios were down slightly from 2006 levels, attributable to the benign storm season now wrapping up. US third-quarter catastrophe losses reached just \$1.13 billion, below the 2006 level of \$1.25 billion and a fraction of the 2005 level of \$48.4 billion (which included \$41.4 billion for Katrina alone). For the first nine months of 2007, US cat losses totaled \$4.7 billion, significantly lower than \$7.8 billion for the same period in 2006.

Clearly, fourth-quarter 2007 results will be impacted by ultimate insured losses arising from the fires that raged through Southern California last month. But most of these losses are attributable to personal lines and should not have a significant impact on commercial market appetite for risk going forward. Barring an unforeseen catastrophic event, 2007 will be another good year for US insurers, if not as robust as 2006.

Price is not the only measure of the softening of the market. Improvements in coverage, increases





in sub-limits and decreases in deductibles are broadly available. This trend may be more disturbing to insurer management teams and shareholders and to rating agencies than the fall in premium volume, and its financial effects may not be registered in loss ratios until 2008 or beyond.

The Exception (There Always is One)

More than two years after Katrina, those along the Gulf Coast in Louisiana and Mississippi are still struggling for adequate capacity, with rates and deductibles also continuing to pose major hurdles for reconstruction efforts in the areas hardest hit by that storm. We can understand insurers' caution, but encourage them to consider dedicating greater capacity than they have to date to these areas where it is arguably most needed. Many policyholders are willing to incorporate measures that would make their projects and the resulting finished operations "more insurable" and are waiting for insurers to step forward and indicate what those measures should be.

2008 US Treaty Renewals

Throughout 2007, analysts have commented on the apparent disconnect between the softness in the primary market and the relative discipline of reinsurers – this even in the face of initial concerns about pressure on reinsurers to find ways of deploying capital replaced by the expansion of Florida's Hurricane Catastrophe Fund (FHCF).

As it turned out, primary insurers used some of the premium savings generated by the FHCF to purchase higher levels of protection or additional event coverage for Florida wind through traditional reinsurers.

Reinsurance capacity no longer required for Florida exposures was in some cases diverted to other geographical areas of the country, allowing primary carriers to buy more protection for these areas and to write more catastrophe-exposed business.

Throughout the year, insurers and reinsurers turned to capital markets to reduce volatility in their portfolios, resulting in a sharp increase in issuance of cat bond and other hedging instruments. A.M. Best Co. Inc. estimates "total cat bond volume for 2007 will likely reach \$6 billion,"¹ up from about \$4.7 billion in all of 2006.

The January 2008 treaty renewal season will give us a preview of how committed to discipline reinsurers are after what seems to be the second consecutive year of above average profits. (Note: they may not view above average as stellar.) Posing a question that Brian O'Hara of XL Capital might ask, based on remarks he made earlier this year,² "Will reinsurers put fear or greed in the driver's seat in 2008?"

The Storm Sages Strike Out – Again

In a vignette reminiscent of 2006, forecasters at Colorado State University in October continued to predict "October and November [hurricane] activity ... well above average."³ This was accompanied by an admission in the same report that the September forecast "did not verify particularly well," given the number of actual hurricane days (3.5), the lowest number for this month since 1994.



Marketplace Realities 2008

& Risk Management Solutions

So much for storm sages – and what is an average hurricane season anyway? We have no answer other than to say we'll know it when we don't see it.

Quake Quants Come Calling

Not to be overshadowed by storm sages, a seismologist for the US Geological Survey reported on the eve of the 139th anniversary of the October 21, 1868 Hayward, CA earthquake that "the Hayward fault is the single most dangerous fault in the entire Bay Area because it is ready to pop and because nearly 2 million people live directly on top of it."⁴ As if on cue, on October 31, the ground shook in the San Francisco Bay area but not as a result of activity on the Hayward fault. The seism occurred on the Calaveras Fault and resulted in no serious damage or injuries.

Despite both the warning and the quake, and counter to a third-quarter survey by Advisen indicating that Property premiums were rising, "driven almost entirely by rising West Coast prices," our internal benchmarking showed a different reality. Earthquake pricing on our placements was down between 10% and 40%. This is another market that was clearly over-corrected in 2006 and where new or realigned capacity is driving results.

The Rest of World Has Its Share of Woes

The sheer size of the US insurance market means that only a colossal event will dislocate insurers operating here. Katrina was such an event, and the resulting dislocation was clear in 2006. So far, so good since then.

Things have not been so placid in other parts of the world in 2007. Windstorm Kyrill produced insured losses across Europe of 4.5 billion ⁵ and significant flooding events occurred around the world – in Australia, China, India, Pakistan and the UK – some insured and some not. This followed 2006 flooding in areas as far flung as Algeria, Ethiopia, Nepal, the Philippines and Zambia (a veritable A to Z).

A note to readers with global operations: while the US has FEMA flood maps that can be used with greater or lesser degrees of reliability to assist in identifying areas prone to flooding, many other areas of the world do not. In an effort to shield themselves from the unknown, underwriters of US Global property programs may resort to exclusion language that begins like this:

Outside the US, property located in areas subject to a flood frequency of between 100 and 500 years as shown in the most recent flood maps or equivalent information, **including but not limited to** [emphasis added] information regarding the maximum flood on record, available from or prepared by the locally recognized authority for flood information...

When surveying our network on the applicability / intelligibility of such wording in their local circumstances, a colleague in Willis Australia noted: "'Between 100 and 500 years' information would be limited given our relative age [as a country]." A telling and *en pointe* comment.

Beware of contract wording that is certain but whose meaning / application is not.



Speaking of FEMA Flood Maps

In the May 2007 *Marketplace Realities* "Special Report on the Property Marketplace", we warned of FEMA's efforts, prodded by Congress and others, to update flood insurance rate maps (FIRMs). On June 18 of this year one of the first major updates took effect, for Harris County, TX. As you may recall, on June 5, 2001, Tropical Storm Allison made landfall in the US and began a destructive march that ended 13 days later. Harris County was particularly hard hit and its FIRMs were found to be out of date given the considerable development that had taken place there in that area – development that exposed it to elevated flooding risks and led to many areas being redesignated.

We can expect such updates to be made on an on-going basis, although normally with some period of public review and comment before they become official zone redesignations. We urge you to take these updates seriously and advise your broker as you become aware of them. There are ways to seek re-designations from FEMA for properties that would otherwise be listed as flood-prone, but this process takes time.

Excerpting from our report, "the biggest danger is in beginning a policy year with properties designated in certain zones and ending it with these zones having been updated mid-policy year. It is the norm for underwriters to put exclusions and/or limitations and higher deductibles on the most vulnerable flood zones, sometimes referred to as Special Flood Hazard Areas (SFHA – within the 100-year flood plain) and at other times as zones with prefixes A and V. It is not the norm for underwriters to identify in their policies which locations on a schedule are subject to such special conditions; rather, they will say these apply based on the flood zone designation in effect *at the time of the loss.*"

TRIA/TRIEA/TRIREA (No, Not *Veni, Vidi, Vici*)

On October 17, the Senate Banking Committee approved a compromise (TRIREA) reached by Senators Dodd and Shelby to extend the Terrorism Risk Insurance Act (TRIA) once more. This compromise would:

- Extend TRIA for an additional seven years from 12/31/07 to 12/31/14
- Eliminate the distinction between foreign-related and domestic terrorism
- Maintain "qualified insurer" deductibles at 20% of the prior year's net written premiums for "qualified lines" and coinsurance at 15% of losses above the deductible
- Maintain the trigger for an event to be certifiable at \$100 million

The White House quickly announced its acceptance of the terms of this proposal – somewhat of a surprise given its previous position on ensuring the short-term nature of TRIA and reducing the government's involvement in terrorism risk.

In terms of lead time, we are ahead of where we were in 2005 when the original extension (TRIEA) was agreed, but there is much work still to be done. The full Senate must approve the measure (no current date set for this), after which the Senate and the House of Representatives must reconcile their proposals and take final votes, and then the president must sign the final bill approved by both chambers.



Marketplace Realities 2008

& Risk Management Solutions

It is hard to say at this point what the House may insist on during reconciliation. Unlike the Senate proposal, its version of TRIREA would:

- Extend TRIA for an additional *15 years* from 12/31/07 to 12/31/22
- Include group life insurance
- Mandate “make available” provisions for nuclear, biological, chemical and radiological (NBCR) events beginning 1/1/08 and set lower “qualified insurer” deductibles for same
- Reduce the trigger for an event to be certifiable to \$50 million
- Reset “qualified insurer” deductibles for risks in areas that had suffered previous terrorist attacks

The White House immediately announced its opposition to the House proposal, which is deemed too expansive.

A fly in the ointment for both the Senate Banking Committee and the House measure is the Congressional Budget Office, which has pegged the cost of the Senate measure at \$5.1 billion and of the House measure at \$8 billion over 10 years. Under “pay as you go” measures adopted by the Democratic leadership of both chambers, they must find a way to offset any such incremental costs by either revenue enhancements or budgetary cuts. The preliminary solution proposed by the House was that no funds could be authorized by the Treasury without a post-event act of Congress. That would leave insurers and rating agencies without certainty of the availability of the backstop – a non-starter when certainty was the reason for TRIA to begin with.

Regardless of the uncertain politics, there is little doubt TRIA will be renewed and, barring last minute surprises in the Senate, it will be a superior insurance arrangement for dealing with the continuing threat of terrorism in the US.

Perspectives on a Soft Market

As the market continues to soften, it may be tempting to relax the level of diligence applied to risk identification and differentiation as part of the underwriting submission. If underwriters don't seem outwardly concerned with the details of your risk, so the reasoning might go, why should you? The answer is simple. Regardless of how accommodating, enthusiastic or nonchalant an individual underwriter may appear, all reputable insurers now have underwriting systems in place that keep tabs on what is being underwritten, as well as where and how. This is particularly true for catastrophe modeling where there will continue to be significant pressure from rating agencies, reinsurers (and their rating agencies) and others for reliable, hard data to measure how your risks affect insurers' overall portfolios in terms of loss probabilities, tail risks and aggregation risks.

It is probably true that certain buyers could get “everything but the kitchen sink” if they insisted on it. There is nothing necessarily wrong with that approach. The more buyers take in a soft market the more they have to give back in a hard market. Buyers should be aware, however, of the effect this approach has on long-term market relationships. This may or many not be a major concern. The most important point is to make sure your strategy is right for you – and transparent to all parties.



Marketplace Realities 2008

& Risk Management Solutions

In a softening market, incumbent insurers may be at a disadvantage over prospective insurers. Incumbents have to relinquish an existing harder-market underwriting position while prospective insurers have the luxury of developing one without year-over-year comparisons. Nonetheless, if you have money in the incumbent's bank, it is worthwhile trying to reach an agreement to continue the relationship, all other things being equal.

Finally, as the market softens, it is often the case that insurers who were nowhere to be found when you needed them in 2006 (or whenever times were hard) become today's white knights – eager to step in with lower rates and better terms and conditions. Equally, it may be tempting to regard the insurers who were there when you needed them – and charged what the market would bear – as the bad guys. We advise caution in making this type of comparison.

Contact

Suzanne Douglass
North America Property Practice Leader
+1 212 915 7739
suzanne.douglass@willis.com

¹ *Business Insurance*, November 2, 2007.

² *Best's Review*, September 29, 2007.

³ Statement by Philip J. Klotzbach, Department of Atmospheric Science, October 2, 2007.

⁴ *Insurance Journal*, October 19, 2007.

⁵ Munich Reinsurance Company.



Marketplace Realities 2008

& Risk Management Solutions

Real Estate

January 2008

At the risk of stating the obvious, it's a buyer's market. Regardless of risk characteristics, insurance rates and premiums on a macro level are down. The extent of the decline experienced by each buyer of insurance will as always depend on exposures, location, industry, loss history – the usual underwriting criteria – but the general marketplace is soft and likely to stay that way in the near term.

How soft? According to statistics published by *The Risk Report* for Q3 2007, the average decline was 13.3%. This included an average decline on the Property side of 15% and on Liability side of 12%. Insurer profits, the ultimate driver of marketplace conditions, were \$63.7 billion for 2006, up \$19 billion over the 2005 mark. All indications are that figures for the current year will follow suit.

How long will the market remain soft? There is of course no way to be sure, but current conditions point to a continuation of the trend. Insurer surplus for the US Property / Casualty marketplace mid-year 2007, before the quiet hurricane season, was up \$68 billion, topping the \$500 billion mark. Another factor is the changing perception of insurance companies in the investment world. Long known for modest return on investment numbers, insurance stocks are now closing the gap with the Dow Jones Industrial Average in terms of ROI. Investors are taking note, and as a result, the market cap of insurance companies has been rising. This further increases the capital that insurers can offer as capacity.

What will change the current market direction? One way that insurer finances may change is by choice: they may reduce capital by offering large dividends to investors or by buying back shares of their own stock. Another way is the traditional factor that causes the market to turn: an increase in losses due to catastrophic events of wind, flood, earthquake or terrorism.

One additional note on the macro forces at work in the industry: the picture for reinsurance has changed in recent years. Consolidation has vested 60% of the world's reinsurance business in a handful of companies, a development that typically reduces competitive pressure and yields increases in prices. However, insurers are so flush with cash that many are choosing to simply retain more risk and buy less reinsurance, which may ultimately put downward pressure on reinsurance rates.

Workers' Compensation

Workers' Compensation is the largest line in commercial insurance in terms of premium and as such has a broad impact on most companies' total cost of risk.

Largely because of legislative reform at the state level, Workers' Compensation carrier results in 2006 were among the best ever. California led the way in this movement – as California often does. Marketplace conditions can change rapidly of course, and the steady increase in medical costs may quickly undo recent gains. Still, as other states follow California's lead or continue down their own paths of reform, improvements in carrier results may continue to exert downward



pressure on rates. Workers' Compensation reforms have been successful in reducing costly litigation that often accompanies both of the major aspects of the coverage: medical costs and indemnity for lost wages.

Replacement Costs

A major coverage issue for real estate companies is the changing value of replacement costs. If a structure is destroyed, and insurance pays to have it rebuilt, will the claim settlement provide enough money? Costs of labor and materials have gone up, and in some cases dramatically (i.e., copper). Another question has recently taken on new relevance: *what* is being rebuilt? Not only do costs go up, but standards and building codes change, and rising standards can yield rising replacement costs.

Following the LEED

Because of the energy required to control building temperatures, real estate companies are one of the largest emitters of carbon dioxide. The industry is looking hard at ways to reduce its carbon footprint and incorporate sustainable energy practices. Much of the focus of this effort is on LEED, which is short for the Leadership in Energy & Environmental Design Green Rating System developed by the US Green Building Council. First released in 1998, LEED certification has become a benchmark for the industry in terms of environmentally focused building.

There are many reasons developers are turning toward LEED certification. LEED buildings consume less energy, reducing costs. LEED buildings are considered safer by many – fewer potential pollutants are used in the construction process. Carriers are now beginning to offer preferred treatment for LEED buildings, bringing another source of savings. This trend is expected to pick up speed, and some observers can see a day some five to ten years in the future when LEED certification may be so engrained that buildings that do not have it will be seen as obsolete and may struggle to attract tenants. Those employing LEED standards now will be ahead of the game. The same may hold true if large-scale emitters of carbon dioxide are at some point held liable for the effects of climate change. Lawsuits based on such allegations are now underway, and while there are no indications they will have any success, companies with LEED certification will almost certainly be in a better position.

If building owners want their insurance to cover the cost of rebuilding under LEED standards, they will have to work closely with their insurers. Underwriting, always part art and part science, requires more preparation and forethought in the face of such issues. Insurance buyers will need to deliver more information and partner effectively with their insurance intermediary and their carriers if they want to achieve the best results and successfully differentiate themselves in the marketplace.

TRIA

Terrorism remains one of the most difficult dangers to handle in an insurance context. The enormous potential for catastrophe and the difficulty in modeling potential losses has led to continued government involvement. The Terrorism Risk Insurance Act (TRIA) and its subsequent extensions are again up for debate in Congress. It appears that a renewal is likely for at least seven



Marketplace Realities 2008

& Risk Management Solutions

years. The answer to the question of whether NBCR (nuclear, biological, chemical and radiological events) coverage will be included is less certain.

Regardless of the ultimate decision, the peril of terrorism is on the table for every real estate risk manager. Whatever insurance solutions are involved, the need for and expectation of effective business continuity planning only continues to grow. Whether business interruptions come from weather-driven events, avian flu viruses, other acts of nature or human activity, real estate and hospitality businesses will be expected to be prepared – as much as one can be prepared for the unexpected.

Contact

Brian Ruane
Director, National Real Estate and Hotel Practice Group
+1 212 915 7971
briane.ruane@willis.com



US Workers' Compensation January 2008

Workers' Compensation (Work Comp) accident year loss experience has seen five straight years of improvement, leading to a favorable market and lower average rates. The calendar year (CY) net combined ratio for Work Comp is now producing underwriting profits comparable to those of other P&C lines, leading to a relatively soft market for Work Comp in most states. The lower rate structure reflects improved loss experience, driven primarily by continuing declines in loss frequency. Preliminary data from the National Council on Compensation Insurance (NCCI) indicates a decrease in net written Work Comp premium for the first time since the end of 1990s.

California, with the largest Work Comp market of any state, is a significant contributor to most statistics measuring countrywide experience. California's premium (gross of deductible credits) decreased by almost \$5 billion between 2005 and 2006. Based on projections made by the California Workers' Compensation Insurance Rating Bureau (WCIRB), using data as of December 31, 2006, the CY combined ratio, which hit 145% in 1999, has steadily decreased since the reforms of 2003 and 2004. The figure hit 66% in CY 2006. Data compiled by Best's Aggregates and Averages indicates that the 2006 countrywide combined ratio is 95.0%, the first combined ratio below 100% in 10 years. The improved Work Comp results have had a positive impact on the financial condition of the Work Comp insurance industry. NCCI's projection for the Work Comp reserve deficiency has decreased from over \$20 billion for CY 2001 to about \$4 billion for CY 2006.

Declining Frequency, Growing Severity

Not all the news is positive. The WCIRB projects the first increase in California accident year (AY) combined ratio since 1999. The WCIRB filing for pure premiums effective January 1, 2008 is the first filing since 2003 to propose a pure premium increase.

Nationally, the improved Work Comp experience has been primarily driven by a 15-year decline in injury frequency rates. NCCI data indicates that between 1991 and 2005, cumulative frequency of injuries for lost-time claims (i.e., not medical-only claims) dropped by nearly 50%. During this period, only two years (1994 and 1997) saw increasing frequencies (+0.3% and +0.5% respectively). AY 2006 preliminary data indicates an additional 6.8% decrease in frequency. WCIRB data reflects an even more dramatic cumulative decrease for the same period in California. This has been reflected in the California pure premiums, which have decreased by approximately 50% since 2003.

The significantly lower frequency of injuries has helped offset the impact of increasing indemnity and medical severity. Indemnity severity, which was growing at about a 10% annual rate for the 1999-2001 AYs, has been growing at rates in the low to mid single digits since then. For most of the last 10 years, the annual increase in indemnity severity for lost-time claims has been higher than the change in wages (in the late 1990s the increase in indemnity severity was almost double that of wages). Medical severity, which was growing at about an 8-10% annual rate in the late 1990s, has continued growing at a cooler but still steady rate since then as well. For most of the last 10 years, the annual increase in medical severity for lost-time claims has been about two to three times that of the change in the medical CPI. The preliminary 2006 NCCI projection (7.5%)



Marketplace Realities 2008

& Risk Management Solutions

indicates an improvement in the rate of change in medical severity compared to the 11.7% increase during 2005. From 2005 to 2006 medical CPI change decreased from 4.2% to 4%. According to NCCI, the significant increase in Work Comp medical costs over the last two decades has pushed the medical component of Work Comp losses to almost 60% of total (indemnity and medical) losses.

Demographics Drive Claim Frequency

Frequency (the ratio of the number of claims to payroll) has been dropping dramatically since the 1990s. While the shift in the US from a manufacturing to a service economy has been considered a prime cause, research indicates that it is not a primary driver of the trend and that there are many other contributing factors and considerations. The latest NCCI research on lost-time claim frequency, which compared policies that expired in 2005 to those that expired in 2001, indicates that:

- The decline in claim frequency is now also impacting large claims (incurred value more than \$50,000).
- All injury types have dramatically declined in frequency.
- In recent years all geographic regions have experienced significant frequency decreases.
- All major industry groups (manufacturing, contracting, office and clerical, goods and services, miscellaneous) and almost all occupations experienced decreasing frequency of injuries.
- The shift in occupational mix is a minor contributor to the decline in claim frequency.

What then is the cause of the decline in frequency? Studies by NCCI have now shown that frequency reductions over the last 10 years are directly related to the demographics of the workforce. With the increase in the portion of workers in the 45 to 64 age group over the last 15 years, frequencies have continued to decrease. As baby boomers retire, however, the mixture of age groups in the workforce is expected to stabilize, and injury frequency is expected to stabilize as well.

Other factors driving the decrease in frequency include increased use of robotics, cordless tools, power-assisted processes, modular design and construction techniques. An NCCI review of injury rates in major industrial nations indicates that the decline in nonfatal injuries occurred in all countries studied.

Work Comp System Changes

California Assembly Bill (AB) 338 changed the statutory language impacting temporary disability payments effective January 1, 2008. Prior language stated that an injured worker's eligibility for temporary disability benefits was capped at 104 weeks. Unintended consequences of this reform were eliminated by AB 337, which changed the statutory language by stipulating that aggregate disability payments shall not extend for more than 104 weeks within a period of five years from the date of injury. The WCIRB estimates the overall benefit costs will rise approximately 1% as a result.

The 2003 reforms in **Florida** have had a dramatic impact on the cost of Work Comp. The rate decrease of 18.4% effective January 1, 2008 is the fifth consecutive drop in rates since the reforms took effect. Overall statewide average rates have decreased by more than 50% since 2003.



Marketplace Realities 2008

& Risk Management Solutions

New York Senate Bill 3322, which is expected to lower overall Work Comp costs, was signed into law in March. The significant components of the statutory changes are:

- Increasing maximum and minimum weekly benefits
- Limiting the maximum number of weeks for permanent partial benefits
- Eliminating the Special Disability Fund
- Establishing a fee schedule for pharmaceuticals, diagnostic tests and medical equipment

In September, New York's insurance commissioner recommended to the governor and legislature a form of competitive rating for Work Comp. The change would require the rate-making agency to produce loss costs instead of the current system of proposing manual rates. As in most other jurisdictions, insurance carriers would then have to determine a multiplier to account for expenses and profits.

After two years of significant rate increases in **South Carolina**, Senate Bill 332 was signed into law in July, bringing about major changes to the South Carolina Work Comp statutes. The main components of the changes, which in the aggregate are expected to lower system costs, are:

- *Repetitive trauma injuries* – These must now be awarded based on medical evidence of a direct, causal connection between the injury and the claimant's repetitive, regular job activities.
- *Second Injury Fund elimination* – The fund will be phased out gradually by 2013, and will not accept reimbursement claims for injuries that occur after July 1, 2008.
- *Stress, mental illnesses and mental injury claims compensability* – Employees must show that an injury was caused by extraordinary and unusual conditions, and this must be demonstrated with expert medical evidence, including expert testimony and/or medical documents.
- *New rules for claims involving impairments of the back* – Previously, back impairments affecting over 50% of body functionality were presumed to be permanent total disabilities. Under the new law, such impairments create a "rebuttable presumption" of permanent total disability.

In **West Virginia**, privatization of the Work Comp system has been phased in. The monopolistic state fund was transformed into a private mutual insurance company in 2005. In 2008, the market will become competitive and opened up to private carriers. Self-insureds should note that third-party administrators (TPAs) are allowed to use out-of-state adjusters with non-resident adjuster licenses.

Concerns and Considerations

NCCI data (for policies effective 2003 and 2004) indicates that the total Work Comp benefit cost per employee is highest in Alaska, followed by Montana and California. The lowest cost is in Indiana, followed by District of Columbia and Arizona. Employment mix may have a significant impact on these figures. For instance, even though DC average salaries are relatively high, a significant portion of employment is in the Office and Clerical industry category, which has a relatively low frequency of injuries.



Marketplace Realities 2008

& Risk Management Solutions

In recent years, one significant ongoing concern has been Work Comp medical cost inflation, which has historically been above the medical CPI and for some recent periods more than twice the medical CPI. The significant drop in frequency has helped offset the increasing indemnity and medical severity. A flattening of frequency or an increase in frequency has the potential to bring about a significant increase in Work Comp costs as indemnity and medical severity continue to increase.

For more information, see the NCCI web site, <https://www.ncci.com>, and the WICRB web site, <https://wcirbonline.org>.

Contact

Norman Niami
Senior Vice President and Actuary
+1 212 915 8095
norman.niami@willis.com



Renewable Source Generation

In the utility industry, interest in renewable source generation projects continues to grow, fueled by both the regulatory mandates in most states for a sizeable percentage of power to be provided by renewable source generation, and by the tax incentives granted by both federal and state governments. There is also proposed federal legislation currently under consideration that would require renewable source generation to represent at least 20% of all generation by 2020.

Renewable source generation ranges from hydroelectric facilities to methane recovery projects on landfill sites. However, the area that has seen the most activity in recent years has been wind generation – a source of power that has been in common use in Europe for decades. Power generation by wind has also been widely embraced by many people in North America as a viable alternate energy source.

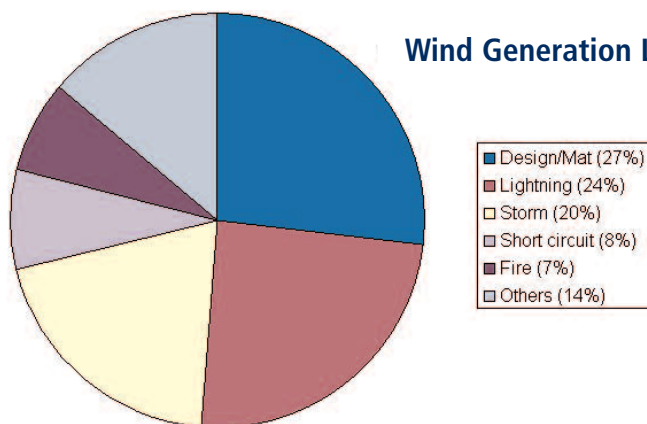
The availability of wind generation equipment is widespread, and the construction of wind farms is relatively straightforward once the required permits are obtained. More importantly, the federal Production Tax Credit, currently 1.9¢ per kWh produced during the first 10 years of operation, provides a major incentive for the development of wind generation capabilities.

Wind Generation Risk Transfer

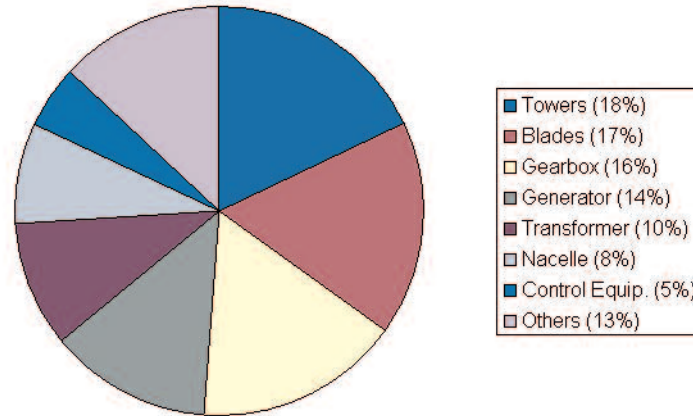
During the initial development of wind generation in North America, the loss experience was poor, and the availability of insurance became a major concern for companies looking to develop wind farms. However, the technology has come a long way and is now considered well developed, with a large number of options available to the project developer, both in terms of manufacturer and in size of wind turbine output capability.

The key risks to a wind project range from start-up delays during the construction phase through wind disruption to physical damage during operation. Although the physical damage losses can be quite large, the real exposure is that of business interruption, should a large number of units go off line at the same time.

The following charts, provided by the International Association of Engineering Insurers, show historical loss causes and components damaged.



Wind Generation Losses by Component



It was originally thought, given the discrete values of individual towers, that absent a catastrophe peril event such as earthquake, flood or windstorm, Probable Maximum Loss would be relatively low. However, losses can be complex and range from lightning strikes that cause significant damage to electrical components and cabling (taking several towers off line), to extended storm water intrusion, which can cause significant damage to the foundations of the towers. Understanding the various loss triggers and their potential impact on a wind project or facility is essential to the design of a sufficiently broad, responsive insurance program.

For a standard wind farm project, the typical needs are for an Engineering All Risks program with an associated Delay-in-Start-up program to indemnify for consequential losses arising from events that impact the construction schedule. During the course of construction of a wind farm, it is not unusual for pods of towers to be taken operational as they pass the testing and commissioning phases. At this point an Operational program with Business Interruption will be required. During the construction phase a great deal of the equipment is often sourced overseas, thereby requiring a Marine Cargo program with associated Delay-in-Startup coverage. Because of the interrelationship between these three areas of loss exposure, the insurance market is now prepared to offer programs that cover them under one package – ensuring continuity in coverage from phase to phase.

Capacity for wind farm projects has grown substantially over the last three years, prior to which there was limited capacity and very little room for customization. Today some insurers can provide up to \$500 million of capacity and have the professional staff to provide customized programs that meet the individual needs of the buyer and, importantly, the lenders who may be financing the project.

In addition to the standard coverages of Marine Cargo, Engineering All Risks and Operational insurance, there are other coverages available to protect owners of wind farm projects. These include Loss of Production Tax Credits, Loss of Wind protection, Environmental Impairment protection and Professional Indemnity for contractors and consultants. In Europe, there is an active Carbon Credit plan, and we expect that in due course something similar will take shape in North America.



Marketplace Realities 2008

& Risk Management Solutions

Willis expects the renewable source generation industry to continue to grow. Our global Utility Practice includes a dedicated group of technical professionals who provide expertise in wind generation and other renewable source generation technologies.

Contact

David Scott
Utility Practice Leader
Willis Risk Solutions NA
+1 610 254 7451
david.scott@willis.com