



JARDINE LLOYD THOMPSON

Weathering the Storm



Insurance Market Overview

February 2005

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# 1 Introduction



This Insurance Market Overview is the seventh in a series of reports we have issued since 11 September 2001. The first four of these focused on the magnitude of the US terrorism losses and their impact on the insurance market. Since then, the report has developed into an annual review of events in insurance, an analysis of the key issues affecting the market and a look forward to what might be expected over the coming 12 months. It is written principally from a London, European and Bermudian perspective.

## Weathering the storm...

At the end of 2003 we described the market as being in a state of fragile stability. At that time rates had already started to soften, particularly on shorter-tail risks, and it was anticipated that this process would continue during 2004.

As the first eight months of 2004 edged towards another relatively benign year for losses, with insurers still generally writing very profitable business, the downward pressure on rates, including some liability classes, increased.

The third quarter of the year then saw two severe storms unleashed on the insurance world. The first of these was in the form of the worst hurricane season since records began. The second was a different genre of storm which shook the market, as New York State Attorney General Eliot Spitzer announced that his investigation into the practice of Contingent Commissions being charged by insurance brokers had uncovered instances of bid-rigging.

With four major hurricanes tearing through the Gulf of Mexico and Florida and an active typhoon season in Asia, it was frequency as well as the severity of events which made 2004 an unusual year in terms of natural catastrophes. The insurance market managed to absorb the impact of these losses surprisingly well. (Re)insurers were responding from a much higher premium base than had been the case prior to 11 September 2001 and the burden of the hurricane losses was also eased significantly as a result of over a quarter of the losses being met by two government agencies: the Florida Catastrophe Fund and Citizens Property Insurance Corp.

As the year ended, the world looked on in shock as the scale of the tragedy of the tsunami in South-East Asia unfolded. However, the impact on the insurance industry

is expected to be limited and this was an event whose legacies will be predominantly humanitarian.

## Clearer skies ahead?

The industry can perhaps take some positives from what was a difficult year. (Re)insurers emerged in many ways relatively unscathed by a year of above average catastrophe losses and also appear to be in better financial shape, with a more stable rating environment and fewer issues over prior year reserve inadequacies.

Whilst the fallout from Eliot Spitzer's investigations continues to reverberate around the industry, it is hoped that if the opportunity for reform is grasped, it will ultimately result in benefits to insurance buyers through increased transparency and greater choice of markets.

As 2005 progresses, the greater regulation being seen in the market, whether it be from Sarbanes-Oxley in the US, Solvency II in Europe, or the Financial Services Authority (FSA) and the Lloyd's Franchise Directorate in the UK, should provide a more disciplined environment for the future.

Finally, the first verdicts of the World Trade Center (WTC) insurance litigation have thrown the spotlight on contract certainty. This, including the concept of wordings agreed at inception, is clearly on the agenda of the industry and its regulators for 2005.

We expect this year to see continued pressure on rates in most sectors, with additional capacity continuing to come on-stream from conventional and non-conventional sources. This will benefit insurance buyers in the short-term, but underwriters will seek to keep discipline to ensure that the balance does not tip away from them, sending the market into another rollercoaster cycle.

The unpredictable element in all of this is, of course, losses and underwriters will be hoping that 2005 will be a year of below-average claims.

Many of these issues are examined in more detail in the second section of this report, whilst the third section analyses the market by each major class or area of business.

A PDF version of this report is available from the Jardine Lloyd Thompson website at [www.jltgroup.com](http://www.jltgroup.com).

## January

### Lloyd's managing agent capacity up

The trend for ever-larger trading units at Lloyd's continued with the average syndicate capacity size reaching £227m, up from the previous record of £203m in 2003.

According to analysis from Leadenhall Insurance Consultants, the average capacity for each Lloyd's managing agency also increased to £332m, up from £319m.

### XL reveals US\$647m charge

Bermudian insurer XL Capital Ltd unveiled a higher than expected US\$647m post-tax charge for the fourth quarter of 2003, demonstrating that insurers are continuing to battle against under-reserving. In XL's case the reserve boosts were *"primarily related to adverse development in [our] North American reinsurance operations for casualty business written during the 1997 through 2001 underwriting years"*.

### FSA warns on CIC

UK regulator, the Financial Services Authority (FSA), warned the industry about CIC Insurance Company, an unrated insurance company being offered as security by London market representatives in 2003.

This followed an investigation of CIC for issuing UK policies without being authorised to do so.

## February

### Lloyd's capacity stable at £14.9bn

Lloyd's 2004 capacity remained stable at £14.9bn. Significant reductions from St Paul, ACE and Berkshire Hathaway's Marlborough were counterbalanced by notable increases from existing operations such as Liberty Syndicates, Omega and Illium. Two managing agencies departed, GoshawK and Dex.

### Levene looks to tort reform and the 'special relationship'

Lloyd's chairman Lord Levene again focused on tort reform, US funding requirements and the 'special relationship' between the UK and US in a speech to an American audience.

*"If there were an Oscar awarded for the most talked-about issue, resulting in the least action, then tort reform would win it. But as we enter 2004, I am as convinced as ever of the need for expedient and far-reaching change."* he explained.

### Halliburton and Equitas reach asbestos settlement

US energy services group Halliburton entered into a US\$575m settlement of its asbestos exposures with Equitas, the reinsurer established by Lloyd's in 1996 as a run-off vehicle for its pre-1993 liabilities.

### Credit Lyonnais agrees settlement over Executive Life scandal

Credit Lyonnais and US regulators agreed terms to settle a long running investigation into alleged breaches of US Federal and State banking laws in relation to the French bank's acquisition of failed insurer Executive Life in the 1990s.

### Overriders overdone?

US free market think-tank the Washington Legal Foundation (WLF) attacked the practice of brokers charging off-slip fees to insurers in exchange for placing business with them as "potentially damaging". The WLF urged senior industry regulators, including New York State Attorney General Eliot Spitzer, to investigate "conflicts of interest" which arise from Placement Service Agreements (PSAs). Few at the time anticipated the chain of events that was to follow.



## March

### Obesity suits face curb

Legislation curbing the appetite of the US plaintiff bar to launch obesity class action suits took a step closer to reality after a US House of Representatives Committee recommended the proposals to a formal vote.

The "Personal Responsibility in Food Consumption Act" would prevent the food industry and their insurers from being overwhelmed by lawsuits relating to obesity.

### R&SA increases reserves

Despite warnings in 2003 that it might have to boost reserves by some £800m, Royal & SunAlliance shareholders reacted with surprise when told the UK insurer would look to increase claims reserves by £96m for the fourth quarter of 2003.

R&SA's shares dropped 15% on 11 March when the group's results were revealed (£140m operating profit for the year) suggesting that shareholders were not expecting any further reserve additions following the £500m in 2003.

## April

### Greenberg ACE promotion

Evan Greenberg was announced as the successor to Brian Duperreault at the helm of ACE. Greenberg joined ACE in 2001.

### Buffett blasts corporate America

In his annual letter to Berkshire Hathaway shareholders Warren Buffett castigated corporate America for high executive remuneration. *"In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging,"* he said.

### Madrid terrorism losses remain with pool

Despite the large loss of life, the 11 March Madrid terrorist attack had only a limited impact upon the

insurance industry because of the longstanding government backed compensation fund, the Consorcio de Compensaciones de Seguros.

### Spitzer investigation widens

Californian insurance commissioner John Garamendi confirmed he was looking into the practice of charging PSAs.

On 22 April, Aon was the first firm to reveal it had been subpoenaed by the office of New York State Attorney General Eliot Spitzer. Marsh and Willis, together with US retail broker Kaye Insurance Associates, later confirmed they had also received similar demands.

### WTC verdict – insurers victorious

Insurers the world over breathed a sigh of relief when a jury decided that several insurers of the World Trade Center would not be liable for a double payout to the building's leaseholder, Larry Silverstein.

The verdict came on 29 April with the jury's decision that eight insurers – Lloyd's syndicates, Lexington (AIG), Houston Casualty (HCC Holdings), QBE, Copenhagen Re (Alm Brand), Federal Insurance (Chubb), Great Lakes and Employers of Wausau (Liberty Mutual) – were bound under the terms of the WilProp policy wordings, which previous courts have established treat the 9/11 terrorist attack as a single event.

## May

### Chubb sells Hiscox stake

US insurer Chubb completed the disposal of its stake in Lloyd's insurer Hiscox. The sale, consisting of some 54.5m shares, was to a range of institutional investors, raising an estimated £89m for the New Jersey-based company.

### Lloyd's £1.9bn profit: Central Fund up 38%

Lloyd's announced record profits of £1,892m on the back of a benign loss environment and high premiums. The profits, recorded on a pro-forma annual accounting basis, represented a 127% increase on 2002's figure of £834m.

## Lloyd's expands European licences

Lloyd's revealed it was now authorised to trade in 72 territories worldwide following the enlargement of the EU on 1 May.

The UK regulator, the FSA, authorised Lloyd's to write business in eight of the new countries that joined the EU, in addition to fellow new members Malta and Cyprus where Lloyd's already trades.

## Citibank settles WorldCom claims as part of a US\$4.95bn charge

US banking giant Citibank announced it had reached a pre-tax US\$2.65bn settlement of class action litigation brought by WorldCom investors.

The settlement led to the group announcing a US\$4.95bn, or 95 cents a share, second quarter charge.

## Rates falling say brokers

There was growing evidence from both sides of the Atlantic of the end of the hard market. In the US, the Council of Insurance Agents and Brokers (CIAB) warned that rates had eased across most lines during the first quarter of 2004, whilst in the UK, brokers at the annual British Insurance Brokers Association (BIBA) conference heard the results of a survey in which 53% of respondents said the market was already softening.

## June

### Momart fire costs insurers £20-30m

A fire in a warehouse containing works of art from the collection of Charles Saatchi and others was estimated to cost fine art insurers more than £20-30m in claims.

The fire ripped through a storage facility on an industrial estate in Leyton, East London, destroying around 100 works of art insured by specialist insurers Ascot, Catlin, Amlin, XL, Hiscox and ACE among others.

### Goshawk defeats Atletico Madrid appeal

The fronting insurer of Spanish football club Atletico Madrid failed in its attempts to overturn a decision in the UK courts which allowed London market contingency underwriters to void coverage relating to the side's relegation in 2000.

The Court of Appeal held that reinsurers led by the Goshawk Syndicate 2021 were entitled to dispute the claim because of material misrepresentation relating to the size of the club's losses.

## Buffett takes 16% White Mountains stake

Berkshire Hathaway took a 16% stake in fast growing (re)insurance group White Mountains, whilst subsidiaries Folksamerica and recently acquired Sirius were subject to positive ratings actions from Moody's.

## July

### Capital plan falters

A radical proposal to drive Lloyd's consolidation became public after it emerged that the Warren Buffett-backed vehicle Capital Insurance Holdings was planning to acquire insurer Euclidian as a prelude to sweeping up its quoted peers in a public company. The plan faltered, however, after a lack of support from the UK investment community.

### Shell struck by D&O suit: insurers exposed?

Oil giant Royal Dutch/Shell looked set for a courtroom clash with shareholders after 27 directors and officers of the company were named in a lawsuit filed in the US by law firm Lerach Coughlin Stoia and Robbins LLP in relation to oil reserving irregularities.

The Anglo-Dutch company was badly shaken in January 2004 when it emerged it had booked higher oil reserves than were actually available.

### AT&T issues US\$139m writ over 9/11 insurance claims

Telecommunications giant AT&T filed a lawsuit against 15 insurers over allegedly unpaid Property damage and Business Interruption claims relating to 9/11, claiming US\$139m in damages.

## August

### R&SA sells UK life arm to Resolution

Royal & SunAlliance completed its exit of UK life business by selling its closed operations to Resolution Life for some £850m.

Separately, the insurer agreed to sell its Pakistan operation for £700,000, whilst raising £450m in subordinated debt. One month earlier the insurer had sold the life and pensions divisions of its Scandinavian subsidiary Codan.

### Lloyd's to impose compulsory loan

In an initiative designed to boost the Society's central assets to £2.1bn and help improve its financial strength ratings, Lloyd's announced that underwriters would have to provide an annual rolling compulsory loan of between 0.75% and 1% of capacity to the Corporation from 2005.

### Fortress Re settles 9/11 claims

Aioi Insurance, Sompo Insurance and Taisei Reinsurance settled claims against controversial US reinsurance agent Fortress Re over losses related to the 9/11 US terrorism losses.

According to the three Japanese insurers, the settlement amounted to some ¥16bn including real estate and other assets from Fortress Re.

### Converium reserve provision reignites fears on US exposures

Converium announced a US\$400m reserve deficit, pushing the reinsurer into the red for the first half with a pre-tax loss of US\$295.5m. The group's share price collapsed to less than half, whilst the rating agencies all downgraded the company's financial strength.

### Hurricane season underway

As Hurricane Charley made landfall in Florida, few could have anticipated that it signalled the start of the worst storm season on record.

## September

### Coffers buoyed as Admiral floats

UK motor insurer Admiral enjoyed a successful stock market debut, floating on the London Stock Exchange at an offer price of 275p, just above the midpoint of the indicative price range and valuing the company at £711m.

### Lloyd's begins Central Fund showdown with Swiss Re

The showdown between Lloyd's and its Swiss Re-led reinsurers over the failure to pay more than £300m of claims on the Central Fund reinsurance contract began on 31 August.

This followed Lloyd's April 2003 revelation that it had sought arbitration proceedings after the reinsurer stalled on paying £290m of claims on the grounds that they related to solvency requirements, rather than actual losses.

An initial ruling in January 2005 subsequently found that Swiss Re was *prima facie* entitled to avoid the policy. However, the arbitration also made a "first partial award" in favour of Lloyd's. The findings will be considered again after hearing Lloyd's case against the other five insurers.

### Quanta receives Irish green-light

Bermudian start-up Quanta Capital Holdings received approval from the Irish authorities to write insurance through its Dublin office, the location of its European headquarters.

### Converium closes US operations with rescue package

Two of Converium's significant business lines were sold off as the reinsurer stumbled on the eve of the Monte Carlo reinsurance *Rendez-Vous*.

Endurance acquired the Swiss reinsurer's West Coast agricultural business, whilst General Re and Munich Re agreed to front on its participation in the global aviation pool. The catalyst for the carve-up was rating agency Standard & Poor's downgrade of the company to BBB on 10 September after Converium posted a US\$400m increase in its non-life reserves.

### Insurers sued over Enron crime policy

Energy company Enron filed lawsuits against St Paul Fire & Marine, Federal Insurance and Great American Insurance over their alleged refusal to pay on a crime loss indemnity policy covering senior staff.

### Frankona name disappears as GE rebrands

Giant conglomerate General Electric (GE) announced on 7 September it would bring together all its reinsurance and commercial insurance operations under the umbrella name GE Insurance Solutions.

## October

### Spitzer intervenes

The issue of PSAs hit the world's headlines after New York State Attorney General Eliot Spitzer revealed he was suing Marsh, the world's largest insurance broker, for bid-rigging and collusion. Also named in the writ were insurers ACE and AIG among others. AIG lost around US\$20bn of its market capitalisation overnight after two of its executives pleaded guilty to criminal charges.

Spitzer hinted at widespread corruption within the industry. *"If the practices identified in our suit are as widespread as they appear to be, then the industry's major business model needs major corrective action and reform,"* he said.

### WTC trial mark II begins

The second phase of the WTC insurance trial began with nine remaining insurers arguing that they are only liable for one payout despite not relying on the "one event" WilProp form.

### Lloyd's debuts with £500m debt issue

Lloyd's capped a year of success with the news that it would make its first ever foray into the international debt markets by raising £500m of longer-term subordinated debt.

## November

### ACE Europe grows with Belgium transfer

ACE European Group became the UK's third largest insurance company by premium income following approval of the transfer of its Belgian business to the UK.

### Spitzer fallout continues

The chain of events set in motion by New York State Attorney General Eliot Spitzer showed no sign of letting up, with MMC Chief Executive Jeffrey Greenberg forced to step down and a further 3,000 Marsh employees losing their jobs.

### Garamendi to file contingent commissions lawsuits

Meanwhile California insurance commissioner John Garamendi filed civil complaints against insurance

industry participants as part of an investigation into bid-rigging and New York's superintendent of insurance, Greg Serio, revealed his department had issued citations to MMC, Marsh Global Broking and more than 10 Marsh subsidiaries as part of an investigation into alleged bid-fixing.

## December

### Euclidian goes into run-off

Euclidian, the Lloyd's insurer briefly at the centre of an ambitious consolidation bid, closed for business after its owner Berkshire Hathaway confirmed it was going into run-off in November.

### Japanese insurers expand London presence

Tokio Marine & Nichido Fire Insurance relaunched its London arm as Tokio Marine Global, a £125m capitalised insurer.

Separately, Aioi Insurance Company revealed it would launch a £40m capitalised London operation, Aioi Motor and General Insurance.

### WTC: Silverstein wins

WTC leaseholder Larry Silverstein won the second round of litigation after a jury decided that the 9/11 terrorist attacks constituted two separate events for which nine insurers should be held to a double payout. This verdict ensured that Silverstein would receive as much as an extra US\$1.1bn in addition to the US\$3.55bn he has already received.

### Glacier Re formed

A new reinsurer was born in Switzerland with the launch of Glacier Re, a niche, global specialty reinsurer backed by money from investment guru George Soros. It said it was aiming for gross written premium income of between US\$400m and US\$500m by the end of 2007.

### Tsunami tragedy unfolds

As the year closed, news broke of unimaginable tragedy across the Indian Ocean. The scale of the humanitarian disaster resulting from the tsunami touched the world, but the financial impact on the insurance industry is likely to be limited.

# 3 Price cycles

The insurance industry has historically been through a series of cycles, with wild fluctuations between periods when insurance rates are high and corresponding times when they are low. The market is, to an extent, like any other where the forces of supply and demand determine what level persists. However, other influences can also influence volatility in the market.

## Demand

The insurance market is relatively mature and despite fluctuating global economic activity is still generally growing slowly. Demand is therefore a limiting factor in the volatility of the market. Swiss Re research indicates, for example, that between 1998 and 2003, global non-life premium grew by more than 10% in only two of those 23 years. In the reinsurance markets, changes in buying patterns, with ceding insurers retaining more of the risk, have had an impact on demand, although that capacity remains in the market as a whole. To a lesser extent increased self-insured retentions may have actually taken some demand out of the direct market.

## Supply

Supply is without doubt the overriding factor behind the cyclical nature of the market. It is fair to say that the insurance industry is capacity-driven and whilst capacity remains plentiful, competition will force rates down. The supply of new or additional capacity to the market has become much more flexible in recent years, as evidenced by the ease with which the Bermudian (re)insurers set up shop after 2001. The most recent examples are the establishment of Glacier Re and the introduction of hedge funds into the reinsurance markets.

The problem is the speed in which reductions of capacity take place. Operators in the market have invested over time in their assets, both intellectual and otherwise, which cannot easily be switched off in the same fashion. In the past insurers kept writing business for premium income rather than profitability. There is no doubt that this has changed both through greater attentions from capital providers and as a result of increased regulation.

However, when profitability starts to become marginal, perhaps due to a poor loss year, there is still pressure on insurers to look at their involvement over the longer-term and to maintain market share so that they can take advantage when the market turns again.

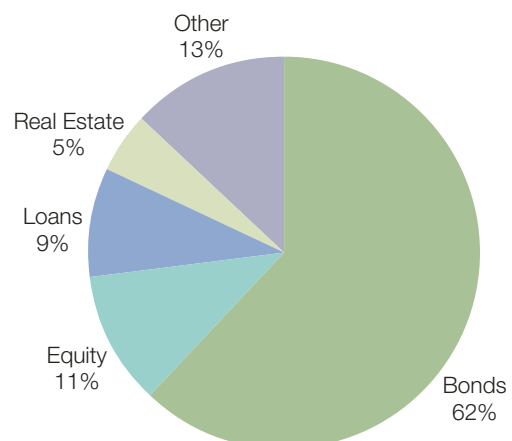
## Pricing

Pricing is not strictly a driver of the cycle; it is more a consequence. However, for most businesses, price remains a key reason why an insurance buyer chooses a provider. There are some who see the broker-driven side of the market as placing too much pressure on the rating environment, but this is simply the operation of a free and competitive market.

## Investment returns

The last market cycle saw pure underwriting results heavily subsidised by a buoyant equity market. In the clamour for premium income, which was then invested, many (re)insurers lost sight of both the fundamentals of underwriting risk and of managing their own business risk. Today's environment is markedly different, with (re)insurers holding a more conservative mix of investments which are seen as supplemental rather than central to their business earnings.

**Current asset mix of the major European (re)insurers**



Source: Fox-Pitt, Kelton

With a low interest rate environment and falling bond prices, returns from investment income are less significant.

## Claims

In a capacity-driven environment, a weakening market is most likely to be turned quickly by one or more unsustainable losses. The US terrorism losses turned the market in the most dramatic fashion and altered peoples' perception of risk. The natural catastrophes of 2004 have had a much less severe effect and underwriters have viewed 2004 in isolation: a manageable 'hit' rather than a reason to retrench.

## Rating environment

The importance to (re)insurers of maintaining adequate financial ratings cannot be overstated. An example was Converium's downgrading to BBB in September 2004, after which a number of brokers removed the reinsurer

from their security lists. There has been a significant shift in the methodology with which rating agencies look at insurers, with greater emphasis now being placed on the delivery of sustainable profitability, as opposed to purely capital adequacy. This should act as a brake on the writing of unprofitable business across the pricing cycle.

## Regulatory environment

This is perhaps the area where the greatest changes are being seen, with new solvency requirements under the FSA regime in the UK, Solvency II regulation on the horizon for the rest of Europe, the Lloyd's Franchise Board taking a greater interest in underwriting profitability at Lloyd's and the effects of the Spitzer enquiry and Sarbanes-Oxley in the US.

The table below sets out some of the key differences in the underwriting environment now compared to 1997.

### Key differences in the underwriting environment

	1997	2004
<b>Investments</b>		
Equity gearing	>100%	<30%
Equity returns	30% p.a. (1997-2000)	-1.5% p.a. (2001-2004)
Five year bond yields – Euro	5.0%	2.8%
<b>Loss reserves</b>	Releases to come from 1997 and prior	Over US\$60bn of under reserving in US alone (AM Best)
<b>Rating agencies</b>		
Absolute ratings	>Five AAA (re)insurers Numerous AA ratings	Only two AAA (re)insurers Handful of AA ratings
Key driver for upgrade	Capital adequacy	Sustainable profitability
<b>Regulation</b>	Minimal	FSA/Solvency II Lloyd's Franchise Board
<b>Underwriting controls</b>	Few classes modelled Weak processes	Significant modelling Peer review Improved information flow
<b>Underwriting remuneration</b>	Volume driven	Profitability driven

Source: Fox, Pitt Kelton.

## Cultural change

Modification of the cycle is as much about cultural change within organisations as any technical influences or controls. The section "*Underwriting discipline: fact or fiction*" examines developments in this area further.

## A reduced amplitude?

All of the building blocks are in place for the market to react in a more disciplined manner. In the event that underwriting conditions deteriorate to a position where business is being written at a loss, the rhetoric seen over the last 12 months would seem to indicate that action will be taken. We therefore expect to see the extent to which the market swings from a hard market to a soft market reduced.

Immediate evidence of this is, however, still awaited. Figures recently released by the Council of Insurance Agents & Brokers (CIAB), the trade body representing US insurers and brokers, point to an accelerating softening of the market.

Its 2004 fourth quarter rate survey revealed that average Property and Casualty rates were down some 7%, compared to 6% in the previous quarter. It added that large accounts (those generating more than US\$100,000 in commissions and fees) saw the biggest decline.

Furthermore, the insurance industry has not managed to significantly change its cyclical tendencies over a sustained period. When there is money to be made investors will wade in; when earnings become marginal there is a natural reluctance to give away that hard-earned market share. Underwriters must still strategically consider underwriting at a profit over the length of the cycle rather than at every stage of the cycle. Ultimately, human nature will have a telling influence on whether change actually happens.

# 4 Insurance market summary

## Insurers and pricing

2004 saw reductions in rates over most lines of business and the trend is expected to continue through 2005. The chart below shows a rating index for the principal lines of business within Lloyd's. This demonstrates that rates on marine, non-marine and aviation business all fell in 2004. A split between Property and Casualty lines within those classes, would have shown that Property rates peaked earlier and fell faster than Casualty business.

What is clear from the chart is that although rates are now declining, the market is still at a comparatively high level. We therefore anticipate that rates will fall further before serious resistance is encountered.

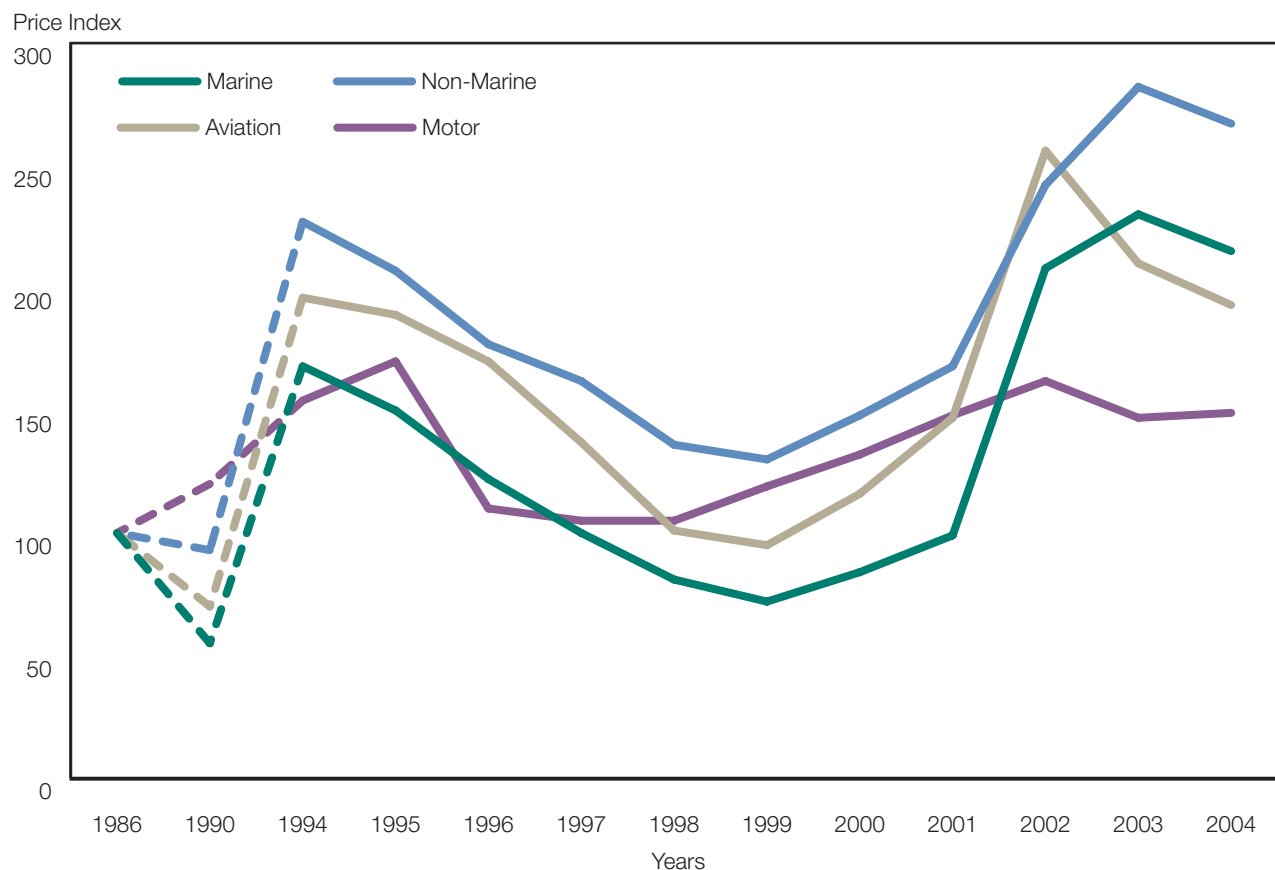
## Terms and conditions firm

Although insurers were tolerating often significant price reductions in 2004, they tended to remain firmer on terms and conditions. On a general level this is an encouraging sign because it indicates a collective will to avoid the dangerously broad conditions of the late 1990s, characterised by multi-year policies, free reinstatements and large accumulations.

However, even here there has been pressure and the year ahead is likely to be a test of the insurance industry's resolve to maintain discipline in the face of plentiful capacity and competition.

We examine the impact of the hurricane losses in greater detail at page 27. Nevertheless, there were an estimated US\$42bn of Property catastrophe insurance losses in 2004, of which the hurricane season contributed

### Insurance market cycle at Lloyd's (CBSL Index)



Source: CBS Private Capital Limited. 2004 figures are estimates.



## Top 10 most costly insurance losses 1970-2004

Insurance losses US\$bn indexed to 2004	Date	Event	Location
42.0	11 Sep 01	Terrorist attack	US
21.4	23 Aug 92	Hurricane Andrew	US, Bahamas
17.8	17 Jan 94	Northridge earthquake	US
11.0	16 Sep 04	Hurricane Ivan	US
7.8	27 Sep 91	Typhoon Mireille	Japan
7.0	13 Aug 04	Hurricane Charley	US
6.6	25 Jan 90	Winterstorm Daria	France, UK et al
6.6	25 Dec 99	Winterstorm Lothar	France, Switzerland et al
6.4	15 Sep 89	Hurricane Hugo	Puerto Rico, US et al
4.9	15 Oct 87	Storm and floods	France, UK et al

Source: Swiss Re; Insurance Information Institute updated by JLT.  
Indexed from 2002 to 2004 using IMF world average core inflation rates.

approximately 65% and accounted for two of the top 10 insurance losses since 1970. There was consequently some surprise that (re)insurance pricing has not reacted to a greater extent.

This was partly because much of the international insurance market avoided a really heavy hit from these losses. Swiss Re estimate that the hurricanes would add only about 6% to the US Property and Casualty market's second half combined ratio, which was likely to end up at 100 for the year.

With much of the risk being borne by the Florida Catastrophe Fund and Citizens Property Insurance Corporation, the toll on the commercial markets was significantly reduced. This, together with the fact that there were four separate losses, greater aggregation controls in place and larger self-insured retentions, resulted in underwriters internationally being much less exposed than they may have been a few years previously.

## Brokers

2004 was a defining year for insurance intermediaries, with the Spitzer investigation in the US not only uncovering illegal practices, but also questioning the conflicts of interest that may be created by contingent commission payments from underwriters to brokers. This has forced a step change in the industry, with all the major broking houses having undertaken not to enter into Placement Service Agreements (PSAs) going forward. We look in more detail at the impact of the Spitzer enquiry at pages 33-34.

At the same time, in the UK, whilst also feeling the impact of the investigations in the US, the focus was on preparing for the new regulatory regime under the Financial Services Authority (FSA), which came into effect on 14 January 2005. Throughout the year, insurance intermediaries were preparing the changes in systems and operations necessary to accommodate the new regime, but insurance buyers had also to determine whether they needed to obtain accreditation if they provide insurance services "by way of business" within their own organisations.

This wind of change blowing through the insurance broking industry is likely to have several consequences. The findings of Eliot Spitzer dealt a blow to the reputation of the industry. Where required, changes in practices and increased transparency will be needed to demonstrate that the potential for conflicts of interest cannot arise.

Also, with the demise of PSAs, a major income stream has been turned off for the larger broking houses. Whilst new business models are being developed which may replace some of this income, there is little doubt that their revenues will still be adversely impacted. The major broker fraternity will therefore have to reform and take a long overdue look at its cost base. The necessity of developing more efficient methods of transacting business is clear.

The loss of PSAs and similar revenue does call into question the sustainability of the current situation whereby brokers pay for the delivery of the products of insurers and virtually all the administrative stages in the process. Meanwhile, the renewed attention to quality is creating real fluidity in the employment market. The propensity for people to move between broking companies has certainly increased.

For insurance buyers this should all in theory translate into more transparency, greater value, improved levels of service and perhaps better access to markets. There is also a line of thought which suggests that those brokers immediately affected by Spitzer will, in their desire to retain business at all costs, place further pressure on the market for rate reductions. Nevertheless, there appears to be some evidence of insurance buyers considering and utilising a greater number of options in the placing of their insurance programmes.

# 5 Reinsurance market summary



## Ten largest reinsurers ranked by gross premiums

2004 Ranking	Group name	2003 Ranking	Consolidated gross premiums US\$m
1	Munich Re	1	28,650
2	Swiss Re Group	2	26,849
3	Hannover Re	4	14,551
4	Berkshire Hathaway Group	3	14,373
5	Lloyd's of London	5	11,802
6	GE Global Ins Holdings	6	11,559
7	SCOR Group	7	4,635
8	Everest Re Group	13	4,574
9	XL Capital	9	4,485
10	AXA Re Group	8	4,327

Source: AM Best

The last two years have again seen considerable change within the reinsurance industry and the coming year will see that process continue. Although the reinsurance market is discussed in more detail in the report, here we capture some of the current issues.

The table above shows the major global insurers, dominated by Munich Re and Swiss Re, who between them control perhaps 30% of the market.

## Buying trends

As primary companies have merged and reinsurance pricing has dramatically increased following the heavy losses experienced by reinsurers, many cedants have been seeking to retain more risk. This has been especially evident for those layers of reinsurance programmes subject to losses with short return periods. The pricing levels achieved in the primary insurance market have made this approach more sustainable than was previously possible. This purchasing trend has also resulted in less retrocessional cover being purchased.

## Proportional to excess

There has also been a shift in the type of cover being purchased with many reinsurers being unwilling to offer proportional coverage, especially in those areas with significant natural hazards exposure. This shift towards excess of loss coverage removes reinsurers' exposure to any declines in local insurance pricing that can occur with proportional reinsurance.

In addition, with rates having been at a high level in the primary insurance market, many cedants have chosen to retain an increased proportion of this income.

The changing regulatory regime at Lloyd's, limiting the amount ceded under Qualifying Quota Shares, has also led to decrease in the amount of ceded premium under proportional treaties.

Some of these pressures eased slightly during 2004 and the 1 January 2005 renewal season.

Reinsurer security continues to be a major area of concern for cedants. Financial security ratings of reinsurers were subject to fewer downgrades during 2004 providing cedants with a greater degree of confidence than in previous years.

## Pricing divergence

Despite sufficient capacity in the reinsurance markets and some softening in certain lines of reinsurance during the recent renewal season, the rating environment has generally held up fairly well compared to the direct markets. This has been caused, in part, by the losses experienced during 2004, in addition to the greater use of modelling techniques to more accurately determine the risk exposure.

However, with rate decreases in the direct market continuing to show no signs of slowing, this is likely to become an issue over the next year. One of the major questions facing reinsurers in 2005 will be the extent to which they are willing to hold firm in their pricing of reinsurance risk when faced with significant competition for business, some of which they will be tempted to write for market share.

Whilst it is too early to determine the true answer to that question, it may well be that any pricing reductions will continue to be selective as opposed to wholesale. Nevertheless pricing pressures for non-catastrophe affected Property risks grew at the tail end of last year, as they did for a number of Casualty lines.

## Catastrophe modelling

The ever-growing sophistication of the industry's catastrophe models and its reliance upon them were also cited as factors why reinsurance pricing appeared to be more stable than direct rates last year.

Certainly, the emphasis on monitoring aggregation exposures, a lesson cruelly learnt from the US terrorism losses, has encouraged greater reliance on the models. So has the focus by investors on examining the cost of capital employed by reinsurers. Nevertheless, in the light of 2004's natural catastrophes, the industry is also likely to look again at some of its approach to modelling. In particular, the four US hurricanes showed the damage that can be caused in terms of frequency of losses rather than the severity of a one-in-a-hundred or one-in-two hundred year event.

## Hedge funds

Last year saw the development of new reinsurance capacity as some hedge funds became active in the area of property catastrophe reinsurance.

We examine the implications of this trend later in the report. The hedge funds are not, however, strangers to the reinsurance industry. They have been both equity investors in reinsurers and capital investors as counterparties in catastrophe bonds.

## Collateralisation/downgrade triggers

Concerns over reserve adequacy have increased the pressure upon reinsurers to provide buyers with security for their exposures, most typically through providing collateral. Inevitably, it is a trend that has been fiercely resisted by the traditional markets.

Nevertheless, some reinsurers have been pressured into submission by the large buyers. AIG for instance led the way in 2003 by demanding collateral from US reinsurers (non-US reinsurers are already obliged to put up collateral; an issue which is itself still causing controversy).

Collateralisation requirements have often tended to go hand-in-hand with downgrade triggers that oblige reinsurers to put up security in the event of deteriorating financial strength grades. If they do not, or are unwilling to do so, then these provisions often enable the buyer to void the contract.

Although last year saw greater stability for financial strength ratings, buyers were also reminded of the fragility of some reinsurer's reserves.

For instance, several reinsurers have recently announced fourth quarter 2004 charges to boost their US Casualty reserves. These included GE Insurance with an estimated pre-tax charge of US\$700m (US\$1.2bn for the year) for 1997-2000 business; Hartford with a pre-tax charge of US\$40m in the fourth quarter (US\$170m for the full year) and Alea Group, who took a fourth quarter charge primarily relating to US Casualty reinsurance.

As a consequence, pressure for collateralisation will continue for some time to come.

# 6 Ratings overview: relative calm



Whilst 2004 saw storms raging through the Caribbean and across the South-East corner of the US, the climate for ratings movements was considerably calmer after the turbulence of 2002 and 2003.

During those previous two years the industry, predominantly on the reinsurance side, was hit by a number of ratings downgrades. The world's two biggest reinsurers, Munich Re and Swiss Re, saw their AAA Standard & Poor's (S&P) financial strength ratings drop to A+ and AA respectively. Their AM Best ratings both migrated from A++ to A+ over the period.

Berkshire Hathaway was the only major reinsurer not to experience a significant downgrade, maintaining its AAA and A++ ratings.

The major insurers fared slightly better, with AIG in particular maintaining an AAA rating.

By contrast, 2004 was a year of stabilisation in the ratings agencies' outlook for the industry. There were few significant actions at the company level, as balance sheets stood up to a battering by the hurricanes and the focus on financial strength shifted further towards earnings and profitability.

The most significant ratings action of the year was Swiss reinsurer Converium, who was downgraded after revealing that its liabilities had been underestimated.

In July, the company announced that the amount involved was at least US\$400m, sending its share price tumbling (it lost more than two-thirds of its value in 2004) and prompting S&P and AM Best to downgrade its financial strength ratings from A to A-. Fitch cut its long-term rating from BBB+ to BBB- and assigned an A- financial strength rating to the reinsurer. All three joined Moody's in placing the reinsurer's ratings under review for further downgrade.

On 31 August 2004 the reinsurer revealed that the results of an independent actuarial study had found the situation to be worse than at first feared and that up to an additional US\$100m might have to be added to reserves. Converium also announced a US\$420m rights issue and confirmed it would be placing its North American business into run-off.

AM Best responded by further cutting financial strength ratings to B++. S&P and Fitch followed a week later by amending the ratings from A- to BBB and A- to BB+ respectively.

The S&P action was viewed as particularly significant, in light of the increased importance the agency's ratings hold in Europe and the timing at the start of renewal negotiations at the Monte Carlo *Rendez-Vous*.

However, the agency said it would upgrade the reinsurer to BBB+ on the successful completion of its rights issue, a promise on which it duly delivered in October. Fitch also upgraded Converium to BBB- once the capital was raised.

Other ratings actions in the reinsurance market focused on changing the outlook of some of the leading players, the most significant of which was Swiss Re as S&P dealt it a negative outlook in November over pricing prospects for some of its longer-tail liability business.

## Financial strength

Sector-wide, the agencies unanimously upped their outlook on the global reinsurance industry during the course of 2004.

In September, with hurricanes Charley and Frances having already hit, S&P revised its outlook on the market from negative to stable, citing improved accident year profitability for 2003 and good earnings prospects for 2004 and 2005.

Standard & Poor's analyst Stephen Searby said:

*“The stable outlook, which indicates that the majority of insurer financial strength ratings are more likely to remain the same than to change, reflects participants’ resolve to keep prices at economic levels.”*

*This resolve has been further strengthened with the recent hurricane losses expected to slow, although not halt, declining rates across global property-catastrophe and big-ticket US property risks.”*

The agency warned that a rebound in credit ratings should not be expected, with pressures on newer players as their ability to withstand the first round of large losses is tested and pressure on the more established players from deteriorating legacy losses.

It highlighted the importance of managing the softening of the insurance cycle and welcomed the decision of some (re)insurers to reduce exposure to lines that are already showing signs of reducing.

AM Best echoed this view as it proffered that the industry's key test at the 2005 renewal season is how it reacts to pricing pressure from cedants. It warned that whilst high catastrophe losses in the second half of 2004 would slow the descent into a soft market, the trend of downward pricing would not be reversed.

It added that with established market participants only returning combined ratios in the mid 1990s at the height of the hard market, the theory of “through the cycle” underwriting profitability couldn't be supported, particularly with the potential for further adverse reserve development. They continued:

*“The fundamental issue, therefore, will be whether the industry can hold the line at rates that are still economic, or, if the market becomes truly soft, whether the soft market can be both short and shallow. Pricing behaviour over the next twelve to eighteen months from the 2005 renewal will be crucial to that.”*

In establishing its outlook on the sector, the agency drew attention to the challenge for reinsurers to balance shareholders' expectations for returns on capital with their ongoing risk-adjusted capital adequacy. It warned that a desire to return capital to shareholders and write less business in a soft market might be threatened by the need to retain capital to support the company's financial strength, which in turn might increase the pressure to use this capital to write more business.

The agency stated that it expects reinsurers to seek to maintain sufficient capital through the cycle capital to support financial strength ratings in the A+ to A- range.

This view seems to be gathering increasing support from the marketplace, as many question the need to sustain a rating at the AAA or A++ level, requiring significantly higher capital support.

Swiss Re CEO John Coomber told delegates at the International Insurance Society seminar in London last year that aspirations for a return to AAA ratings may be unnecessarily high, due to the difficulty in servicing the higher levels of capital required. He suggested that earnings are currently more closely matched with a AA rating.

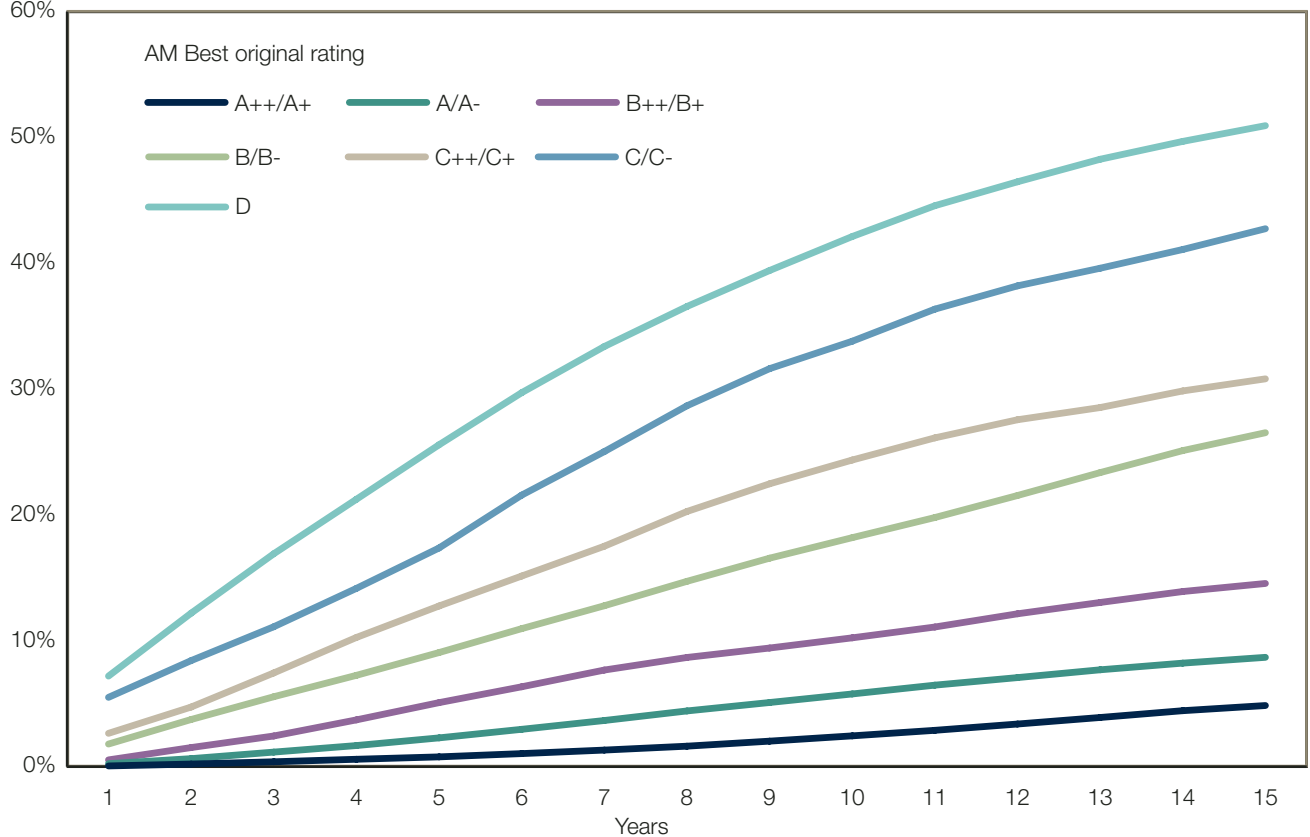
## Buyers' perspectives

Without a doubt, the security of (re)insurers is increasingly an issue with buyers, particularly on long-tail liability business. Whilst this has not created an obviously apparent pricing differential between (re)insurers with different ratings, the fact that many lines of business have been oversubscribed has meant that buyers can be more demanding in terms of minimum credit ratings for (re)insurers who participate in their programmes.

The graph below shows Impairment Ratings for insurers in the US over time. In this study by AM Best, companies are classed as being financially impaired when action to restrict their freedom to conduct business as normal is first taken by their State insurance department. This provides an indication of the probability, over the long-term, of differently rated insurers ultimately being in a position to respond to claims.

### Deteriorating credit: cumulative average impairment rates for US insurers

Percentage of companies 'impaired'



Source: AM Best

# 7 Reserve adequacy: in better shape at last?

## Reserves

Although 2004 may have paled alongside the previous two years in terms of the number of massive charges taken by insurers and reinsurers to bolster reserves for prior-year liabilities, there was still enough evidence of deteriorating legacy losses. This was particularly so for US Casualty business written between 1997 and 2001, suggesting that there could be more bad news to report in the year ahead.

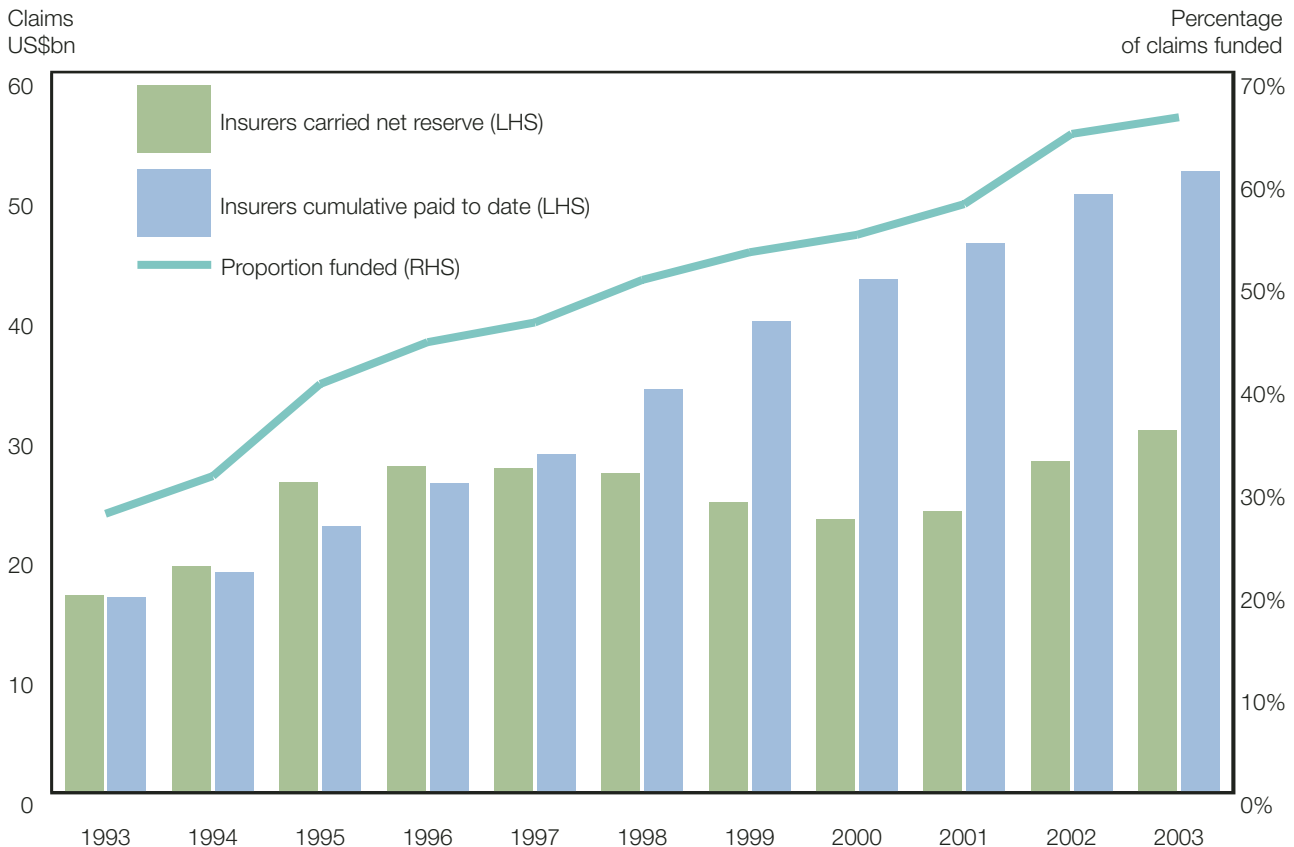
There are differing estimates as to the amount of under-reserving remaining in the industry, with some estimating upwards of US\$50bn. The chart below suggests that the industry could still be less than 70% funded for asbestos and environmental (A&E) claims. However there are signs

that the situation on reserve deficiencies has improved. Moody's estimated the reserve deficiency of the US industry, excluding A&E, in 2002 was US\$36bn, whilst their preliminary estimate for 2003 was down to US\$19bn.

The single biggest reserve charge booked in 2004 was the US\$1.6bn pre-tax boost by the newly merged US commercial insurer, St Paul Travelers. The figure, revealed prior to its first results announcement as a combined entity, was higher than expected. It targeted (almost exclusively) the specialty lines of the St Paul business, and included US\$205m for environmental liabilities.

The portion of the charge directed at environmental liabilities was seen as particularly significant, as the sector has avoided reserve strengthening in this area for a number of years.

### Development of asbestos and environmental claims



Source: HSBC

Note: Proportion funded refers to total paid and estimated claims as a percentage of the current estimated total cost of asbestos and environmental claims.



Fears of further provisions in 2005 were confirmed when the company announced the raising of asbestos reserves in the fourth quarter of 2004 by a further US\$922m.

US analysts believe that St Paul Travelers is not alone among North American insurers. Some estimates put the reserving deficit in the US primary market as high as 15-20%, equivalent to up to 30% of its free assets.

The implications for the sector's reinsurers could be just as severe.

Whilst Swiss based reinsurer Converium was reinforcing its reserves, a number of its rivals responded to allay fears that they faced a similar situation. Hannover Re denied it saw a need to increase reserves and Swiss Re argued that its reserves have historically been high.

Nonetheless, the expectation is that 2005 will see further reserving pressures for European reinsurers.

In the European primary market, Zurich Financial Services added a further US\$962m to its reserves in the first nine months of 2004, with the majority aimed at its North American business.

Whilst the more recent entrants are likely to remain immune to the threat of serious adverse development on Casualty business for a year or two yet, the longer established Bermudian (re)insurers are predicted to suffer further as a result of deteriorating prior-year losses from businesses acquired as they followed expansion paths into North America.

As we go to press ACE have announced a fourth quarter charge, net of tax, of US\$302m, most of which relates to losses from Brandywine, a run-off division it inherited with its purchase of CIGNA's Property and Casualty business in 1999.

Its compatriot and contemporary XL is also expected to face pressure on reserves at its North American reinsurance business, formally NAC Re.

The world's largest asbestos reinsurer, Equitas, announced its annual results for the year ended 31 March 2004 with a £296m increase in gross discounted reserves for asbestos claims. This was down on the £399m it added to reserves in the previous year.

The run-off vehicle, which was established by Lloyd's in 1996 to administer its pre-1993 exposures, continued its commutations policy during the year, with a number of significant settlements reached.

With legacy US Property and Casualty business the prime cause of additional reserving for the global reinsurance market, a stark warning came from ratings agencies AM Best and Fitch in recent reports on the primary sector.

In an October 2004 report, AM Best said it believed the industry's reserves to have been up to US\$67bn short as at the end of 2003, with US\$38.5bn related to unfunded A&E losses.

In December, Fitch said that its estimates for reserve deficiencies at the end of 2003 ranged from US\$43.5bn to US\$61.5bn, of which US\$15.5bn to US\$25.5bn related to asbestos exposures.

But Fitch had some good news for the reinsurance fraternity, predicting that whilst further adverse prior year reserve development is likely, it will be at a lower level than in 2003. This, said Fitch, is due to declining deficiencies in US primary reserves, and the reunderwriting of large portions of reinsurers' (and their cedants') books.

What are the implications? It simply means that despite the greater stability, the reserve risk has not gone away and (re)insurers may still need utilise earnings to boost prior year reserves. Ultimately, it is also a reminder to reinsurers why they must manage the pricing competition that is likely to continue in the year ahead.

# 8 Underwriting discipline: fact or fiction?

In this section we look at some of the rhetoric surrounding underwriting discipline (or lack of it) over the last year.

As market conditions showed signs of turning across the board, pronouncements on underwriting discipline become central to almost every earnings release from major insurers and reinsurers, as some talked the market up and others talked the market down.

Public comments from across the industry seemed to conflict, with some senior management painting a picture of sustained rates and strong discipline across the board, whilst others pointed accusing fingers at their peers for displaying ill-discipline, undercutting their competitors and putting downward pressure on prices.

In his company's 2004 interim results, the Chairman of AIG (the largest insurer in the world) Maurice "Hank" Greenberg, said that some players in the marketplace, both "foreign and domestic", were under-pricing longer-tail Casualty business.

*"These companies often lack the specialised knowledge, underwriting skills and claim management expertise that these lines require. Such pricing practices unsettle the market and add to long-term volatility,"* he said. In its results statement, AIG revealed that it had refused to renew around US\$325m of business in the second quarter alone.

Bermudian reinsurer Renaissance Re also declared its intention to turn away under-priced business, reporting in its 2004 interims: *"Our strong premium growth reflects two conflicting trends. First, Renaissance has preferred positions on various attractive reinsurance and insurance programmes as a result of our strong customer relationships and credit ratings. Second, however, we continue to see price declines, and increasingly have had to turn down business that does not meet our return requirements."*

European reinsurer Hannover Re's Chief Executive Wilhelm Zeller proclaimed his company's *"significant decline in gross premium income"* as evidence that it was managing the cycle downturn.

The biggest accusations of underpricing have been targeted at the Directors' and Officers' (D&O) market, where rate reductions were widespread. This was highlighted by actuarial firm Tillinghast in its annual review of the segment.

The firm noted that despite an increased incidence of claims and a significant number of so-called "mega" claims still unresolved, prices in US D&O dropped by an average of 10% between 2003 and 2004, the first premium decrease since 1999. Meanwhile capacity in the sector had actually risen from US\$1.35bn to US\$1.5bn in the same period.

There were some murmurings of an ill-disciplined market driven by over-supply. John Charman, the CEO of Bermudian Axis Specialty talked of *"senseless price-cutting"* by *"very, very dumb competitors"* who have become *"suicidally aggressive"*.

In an earnings conference call, Charman said:

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*"There seems to be increasing pricing pressure in some lines, particularly in our insurance segments, from a limited number of major legacy businesses whose CEOs appear to be on another planet in their understanding of what their underwriters are really up to."*

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Speaking at a Standard & Poor's conference in New York, Everest Re CEO Joseph Taranto commented:

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*"With discipline you can have a very good return in this market. That means being willing to walk away from poorly priced business."*

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Discipline also applies to resisting pressures from shareholders to chase revenue. He said:

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*“When your volumes are dropping, it’s very hard to tell your shareholders that’s a good thing, that they should be excited you’re doing less business. Having said that, it beats the alternative of writing more business and later having to pay for it.”*

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Others have talked the market up. In its 2004 interim release, insurer Alea said it was still seeing increases in Casualty lines over 2003, *“albeit at a slower pace”*. WR Berkley commented that Casualty prices, its main line of business, are *“generally increasing at rates greater than loss cost inflation”*.

Meanwhile ACE refuted allegations that it had been volume writing in its Casualty business. *“We are not growing because we are breaking underwriting discipline and we are writing business at deep discounts and cutting rates and liberalising terms to win the business,”* said the company’s President and CEO Evan Greenberg.

*“We have been increasing our physical presence and our product line capability for the last two years to such a degree that the number of submissions we are seeing, the amount of activity we are seeing, has increased substantially,”* he added.

The Lloyd’s market has displayed its commitment to encouraging disciplined underwriting with the increased influence of the Franchise Performance Directorate, which removed two syndicates – GoshawK and Dex – towards the end of 2003. 2004 has seen it tighten controls on what syndicates have included in their 2005 business

plans, leading some to rein in capacity for the year and the market as a whole to cutback to an estimated £13.7bn capacity, down 9% on 2004.

Lloyd’s CEO Nick Prettejohn said of the reduced capacity:

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*“Under the new franchise arrangements, businesses at Lloyd’s have to take a hard look at how much business they plan to write in the coming year. Given current market conditions and the focus on delivering underwriting profit, it is a positive sign that there has been a decrease, not an increase in capacity at this point in the insurance cycle.”*

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S&P said that a major factor in a stable marketplace and consequently a key ratings issue is the ability to manage the softening market.

However, it said it is encouraged *“that some reinsurers are already looking to reduce exposure to those lines that have already shown signs of softening”*.

# 9 Hedge funds: a source of new capacity

Last year witnessed the emergence of a new trend: strongly capitalised hedge funds competing with traditional reinsurers by participating on catastrophe reinsurance programmes.

Although the actual number of deals was small, it marked a significant shift in the hedge fund industry's relationship with the reinsurance markets. Since their emergence, hedge funds have traditionally been passive capital providers to the reinsurance industry. Most typically this was as counterparties on catastrophe bonds issued by (re)insurers.

The Risk Finance market also considers hedge funds as similar 'products' to catastrophe bonds. Please refer to page 66 for further details on catastrophe bonds. However, last year a number of funds, such as Citadel Investment Group, CooperNeff Advisors Inc and Nephila Capital Ltd, showed a desire to actively participate on catastrophe programmes as reinsurers.

Unlike the reinsurance capital introduced in late 2001 and 2002, these new entrants are not being formed in response to a capacity shortage as there is a significant capacity for most Property catastrophe programmes.

Instead, these funds find reinsurance an attractive proposition because it offers them a diversified investment option. After all, there is little correlation between a hurricane or earthquake and the traditional risk exposures affecting funds' investments such as the price of gold, interest rates or equity indices.

It has also been suggested that hedge fund investors do not always have the same return on equity expectations as reinsurance investors. If this is the case it may enable them to provide more competitive pricing. Whilst reinsurance investors may look for annual returns on equity of at least 10%, some funds have profit commission levels which begin at just 4% or 5% above LIBOR (London InterBank Offered Rate).

These funds have set up, or are in the process of doing so, infrastructure in offshore jurisdictions such as Bermuda that will enable them to participate on programmes. Their lean structures and limited overheads

may give them a slight cost advantage but this also means that, like many of their traditional reinsurance competitors, they prefer to underwrite a few, larger contracts rather than numerous smaller contracts.

Towards the end of the year a number of these funds were showing a willingness to underwrite layers of up to US\$100m (and in a few rare cases, even more).

## Willingness to collateralise limits

Although these new reinsurers offer no financial strength ratings (normally a prerequisite for reinsurance contracts) and there is no guarantee of their long-term commitment to the reinsurance industry, they do provide one attractive characteristic to cedants: a willingness to collateralise their exposures.

The funds compensate for their lack of financial strength, security and concerns over longevity, by providing collateral, typically in the form of a letter of credit, to the limit of their exposures. This is a compelling proposition for some cedants in an industry where concerns over security, credit control and reinsurance recoverables remain high, especially because the traditional reinsurance markets have been reluctant to collateralise.

Despite this attractive quality, some cedants were wary of considering this new form of capital because of concerns over what would arise in the event of a dispute. There are, of course, established practices to resolve disputes with reinsurance companies but the funds tend to use special purpose vehicles or "transistor" companies to facilitate their involvement. There is consequently still some wariness from buyers with regards to actual recourse against the hedge fund entity.

Other aspects of hedge funds have proven attractive. For instance, consolidation among reinsurers has also led to some cedants being concerned about aggregation of their exposures. As hedge funds remain hungry for new investment opportunities and pressure to collateralise reinsurance exposures continues among buyers, it is likely that hedge fund capacity will grow in 2005.



To date, most interest has been on the higher layers and for programmes that are peril specific (e.g. for US wind exposures) or high Excess Property catastrophe programmes. However, they have also shown interest in other risks including terrorism.

The funds are not only underwriting traditional reinsurance risks, they are employing traditional pricing techniques by analysing loss history, geographical spread and using established industry catastrophe models.

Disregarding possible cost base advantages over some traditional reinsurers, the largest differentiator is the willingness to collateralise.

## The year ahead

As noted above, 2004 saw these hedge funds begin to experiment with the notion of becoming active reinsurers, rather than their more usual role as passive investors. The amount of capital invested by hedge funds in direct underwriting is so far probably no greater than US\$2bn. However, their willingness to underwrite, coupled by the demand for reinsurance buyers to obtain security for their policies, means 2005 may see growth in this new form of capacity. In part, this will depend upon the funds' ability to reassure cedants of any concerns over dispute resolution.

At current levels, there are no immediate signs that this new capacity will have an impact upon pricing. This could change of course, but some observers expect the funds to withdraw their capacity if they find catastrophe reinsurance rates become untenable or fail to provide their required rates of return.

# 10 Insurance capital management

With sure signs of a weakening market, 2004 saw the emergence of capital management as a key challenge for (re)insurers looking to balance the needs of a growing business with those of shareholders hungry for sustained and satisfactory returns.

CEOs are being questioned over their strategies for instilling underwriting discipline and maintaining returns on equity in a sector that has seen capacity increase significantly since 2001.

Indeed, the combined capital base of the major reinsurance markets has risen by a third, to approximately US\$142bn, since 2001 as funds flooded the industry to reinforce damaged balance sheets.

## Stock buybacks

With much of the growth concentrated in Bermuda and Lloyd's, of particular interest was the strategy of some of the industry's newest players to repurchase stock from investors as well as the capital management techniques employed by Lloyd's as the market softens.

Endurance led the way in May 2004 with the buyback of two million shares from one of its founding investors, Lightyear Capital, for US\$65m. The acquisition represented 3.2% of outstanding shares and the (re)insurer has an option to buy back up to an additional two million shares before May 2006.

The company's Chairman and CEO, Kenneth LeStrange, commented, *"We are pleased to announce these capital management initiatives. Capital management has and will continue to be a cornerstone of our strategy. The repurchase of shares allows Endurance to reduce significant potential overhang from one of our initial investors at an attractive valuation. Our new share repurchase programme gives us the flexibility to enhance our return on equity through selective repurchases of our ordinary shares from time to time consistent with our capital management goals."*

Another of its founding members, broker Aon, sold off its 9.8m shares in the company in December.

Fellow islander Montpelier Re announced a similar initiative, also in May. It said that it planned to repurchase up to US\$150m, or four million of its ordinary shares, over the following 24 months, equivalent to 6.5% of the company's outstanding shares.

The reinsurer's Chairman, President and CEO Anthony Taylor remarked: *"We have always said that we will manage our capital and I am pleased to announce this initiative in addition to the significant dividend we began in the fourth quarter of 2003."*

He added that the timing followed a number of successful quarters in which the company had now *"generated excess capital, over and above the needs of our growing underlying portfolio"*.

In June last year, Montpelier Re brought its plan into action with the buyback of 1.26m shares from founding investor Vestar AIV Holdings for US\$43.6m.

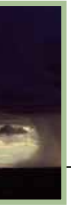
And in August, Bermuda's Platinum Re, the former reinsurance operations of St Paul, announced it too had initiated a share repurchase plan for up to US\$50m of its stock. CEO Gregory Morrison said the programme would allow the reinsurer to *"enhance shareholder return"*.

ACE, meanwhile, appears to be taking a different path in its approach to capital management. In a second quarter 2004 earnings call, the company's President and CEO Evan Greenberg said that ACE planned to use capital to support its growth plans.

*"We view ACE as a growth company. We are biased against... stock buybacks. It is a capital management tool, I agree, to be used when appropriate. We prefer to use the capital in the business... There remains in our judgment sufficient opportunity today to deploy our capital. We have adequate capital to support our business growth plans. And I'll leave it at that"*, he said.

Greenberg was keen to emphasise that this growth would not be at the expense of underwriting discipline.

Away from Bermuda, US insurer Progressive announced the biggest share repurchase plan of the year as it revealed it would spend nearly US\$2bn to buy back up to 21m of its stock, representing up to 10% of outstanding shares and 30% of equity.



Analysts from Morgan Stanley said this signalled the company's intention to avoid chasing growth for the sake of using capital and that its size may have become a limiting factor in its ability to sustain returns.

## Lloyd's and the Cycle

After plenty of proclamations over the importance of underwriting discipline and cycle management, Lloyd's announced in December that it expects the market to write £13.7bn of business in 2005, a fall of around 9% on the capacity figure for 2004. This figure was based on the 2005 business plans of the participants in the market and review of those plans under Lloyd's franchise arrangements.

The Corporation's CEO Nick Prettejohn commented:

*"Capacity is a function of planned activity. Just as important will be the amount businesses [syndicates] actually write during the year, taking account of market conditions as the year develops. We will be monitoring this closely."*

The Lloyd's Franchise Performance Directorate oversees the underwriting activities of the market's syndicates.

## Consolidation

Another option for an industry facing the challenge of sustaining returns in conditions of excess of capacity and subsequent downward movements in rates, has traditionally been consolidation.

With the profits of the hard market increasing available capital and premium rates across most lines having peaked, the incentive appeared to be there for companies to seek further growth through acquisition.

However, aside from a few significant exceptions, 2004 saw little of the mergers and acquisitions activity that some had predicted.

In the primary sector, the only really significant coming together of corporations was the merger of US commercial giants The St Paul Companies and Travelers

in a US\$17bn deal completed on 1 April. The merger created the second biggest commercial insurer in the US, bringing together total assets of US\$107bn and net written premiums of US\$20bn.

On the reinsurance side, there were no deals to compare with the emergence of St Paul Travelers, but Odyssey Re purchased Overseas Partners for US\$43m, whilst rapidly expanding Bermudian based reinsurer White Mountains acquired Sirius International for US\$425m from troubled Swiss company ABB.

The size of deals in the reinsurance sector in 2004 was historically low, at least in comparison with the US\$33.8bn that changed hands in 13 major merger and acquisition transactions between June 1995 and August 2001. Indeed 1998, the start of the last soft market, saw an astonishing 550 international deals completed.

Despite the lack of activity last year, many observers believe that merger and acquisition activity will return. However, with doubts over legacy issues, rating agency constraints on capital utilisation and the uncertainty over market conditions views on consolidation have remained cautious.

This was illustrated among the most recent Bermudian start-ups, who chose to expand with the selective buy up of portfolios of ongoing business, rather than acquiring companies and a potential for legacy baggage. However, it is interesting to note that rationalisation was a feature of the last round of Bermudian start-ups, with five of the "class of 1992" subsequently acquired.

A S&P report cast doubts over the wisdom of consolidation in the reinsurance sector, as it examined the success of acquisitions undertaken in the period up to 2001.

The agency compiled combined ratio data in the years after acquisition on a number of the significant deals closed between 1995 and 2001, including Munich Re's purchase of American Re, Employers Re's acquisition of Frankona Re and XL's takeover of NAC Re. Out of 15 examples, only one – Hannover Re's acquisition of Clarendon – has experienced an average combined ratio better than the market average since completing the deal.

S&P suggested that, in the light of its findings, reinsurers might be better off in the quest for organic growth:

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*“The question has to be asked whether the strategic objectives of a reinsurer can be achieved without resorting to acquisitions. For instance, some groups have demonstrated that new business can be accessed via existing channels.”*

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## Lloyd’s consolidation vehicle flounders

Since 1993 the Lloyd’s market has perhaps seen more consolidation than any other, with the number of syndicates shrinking from 360 to just 66 in 2004.

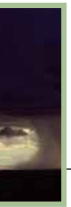
With the stocks of a number of the market’s listed corporate vehicles underperforming, rumours in the marketplace were rife that further consolidation was on the cards.

But no such activity emerged in 2004, despite the efforts of Capital Insurance Holdings (CIH) to raise funds with the purpose of acquiring some of the smaller groups.

CIH was 25% funded by Berkshire Hathaway and planned to buy Lloyd’s insurer Euclidian before making approaches to a number of its peers in the Lloyd’s market. With most Lloyd’s stocks trading at disappointing multiples of book value and some trading at discounts to net asset values the rationale behind CIH was to cut costs by creating a single, large public company, centralising administrative and accounting functions.

The increased size, it was argued, would attract more interest from the investment community, which has long viewed Lloyd’s stocks as something of a sideshow.

# 11 2004 storm losses and WTC update



## Catastrophes: an above average year

2004 has been an active year in terms of catastrophe losses, with earthquakes, hurricanes, floods, terrorist attacks and tornadoes all playing a part in one of the more expensive years for (re)insurers in recent history.

By December, more than 300 natural and man-made catastrophes had occurred around the world since the start of 2004, with estimated aggregate losses of around US\$105bn.

According to research from Swiss Re, Property insurers worldwide will bear US\$42bn of these losses. Only 1992, 1999 and 2001 have been worse in terms of insurance claims. The reinsurer estimates that around 95% of these claims were attributable to natural catastrophes.

Similar figures were released by rival reinsurer Munich Re at the Climate Change Convention in Buenos Aires on 17 December 2004. It said insured losses for the first 10 months of 2004 were US\$35bn, with US\$26bn of those coming from the US.

## Typhoons and hurricanes

The most significant natural catastrophes of the year, at least in terms of their impact on the insurance industry, occurred in the Caribbean and the South-Eastern US when hurricanes Charley, Frances, Ivan and Jeanne tore through the region in little over a month.

Figures varied as to the impact of the US storm season on insurers. The table below shows estimates from various modelling agencies and statistical organisations.

Swiss Re said that whilst the four hurricanes were responsible for US\$27bn of insurance claims, estimates of actual damages was over double that figure at US\$56bn.

Estimates from risk modelling firm Risk Management Services (RMS) suggests that the four hurricanes generated over 1.5m claims. This was more than twice the number which followed Hurricane Andrew in 1992.

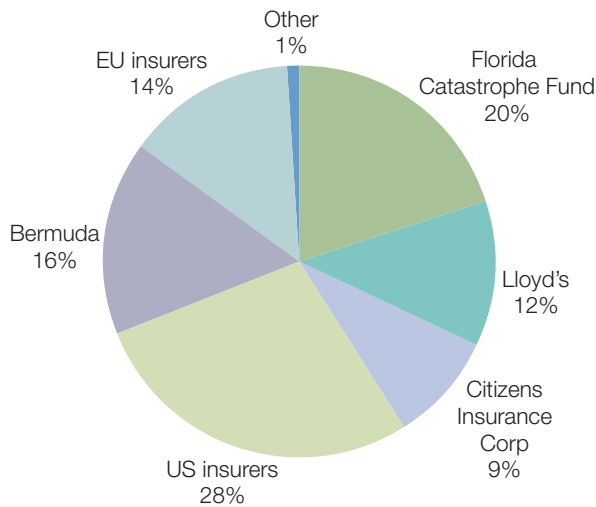
A large proportion of the hurricane losses will be borne by state-sponsored entities: the Florida Catastrophe Fund and Citizens Insurance Corp.

### Insurance loss estimates for four US hurricanes (US\$bn)

	RMS	AIR	Eqecat	PCS*	Swiss Re
Charley	6-8	6-10	6-9	6.8	7
Frances	3-6	5-10	3-6	4.4	5
Ivan	3-6	3-6	4-10	6	11
Jeanne	4-8	5-9	6-8	3.2	4
<b>Total:</b>	<b>19-28</b>	<b>19-35</b>	<b>19-33</b>	<b>20.4</b>	<b>27</b>

\*Estimate based on US claims figures only.

## 2004 hurricane losses – market split



Sources: Morgan Stanley report and JLT research.

Approximations – some insurers include typhoon and other storm losses in their figures.

Significant storm activity also took place in Asia, with Japan being hit by the highest number of typhoons for decades, with 10 major storms making landfall over the course of the season. On 30 August, Typhoon Chaba came ashore in Kagoshima Prefecture, causing estimated economic losses of US\$1.8bn and Property claims of US\$700m. On 7 September, Typhoon Songda landed in Nagasaki Prefecture, causing estimated economic losses of US\$6.2bn and Property claims of US\$2.5bn. The last major typhoon of the season to hit Japan was Tokage, which made landfall in Kochi Prefecture on 20 October, causing some US\$1.4bn of economic losses and Property damage of US\$800m.

## Earthquakes

The year's series of Japanese natural catastrophes was far from over, however, as several earthquakes followed. The most serious of these occurred in Niigata Prefecture on 23 October, killing 40 people and injuring 2,900. The earthquake was estimated to have caused economic losses of US\$19-28bn and claims of US\$600m.

## Impact on insurers

The impact of all this activity on the industry has been varied. In the immediate aftermath of the year's Florida hurricanes it appeared that (re)insurers' losses were well within manageable levels. This was certainly the message coming from Bermuda, Lloyd's and the US.

However, as third quarter results filtered through it became clear that the four US hurricanes had turned healthy hard market profits into losses for many as the severity of claims began to crystallise.

Particularly hard hit were Bermudian (re)insurers, with Renaissance Re increasing its loss estimates to US\$520m from US\$425m and PX Re reporting a loss ratio of 174%, compared with 51% in the prior year period. Also hit was Goshawk-owned Rosemont Re, which on 15 December was forced to significantly up its catastrophe loss estimates from US\$22m to US\$33m, warning that the figure was "still subject to potential upward or downward revision".

Meanwhile, Lloyd's announced its £1.3bn aggregate loss estimate for the 2004 global storm season.

As 2004 drew to a close, further revisions were made as the extent of the damage to Gulf of Mexico oil installations from Hurricane Ivan became clearer.

Japan's insurers felt the pain from their typhoon losses with Tokio Marine & Nichido Fire Insurance suffering a 95% drop in net profit for the period April-September. Sompo Japan and Mitsui Sumitomo followed suit with first half net profit drops of 71% and 66% respectively.

Nonetheless, despite dented profits across the board, it appears that the (re)insurance industry has weathered the year's storms reasonably well. The consequences are likely to be limited to a firming of Property catastrophe rates in affected areas.

## WTC trials focus attention on contract certainty

Losses from previous years remained in the headlines, as 2004 saw the culmination of two bouts of litigation relating to insurance for the World Trade Center.

In each case, the dispute found its way to court to consider leaseholder Larry Silverstein's contention that, when he purchased a 99-year lease on the property from the Port Authority of New York & New Jersey six weeks before 11 September 2001, the insurance policy covered all losses up to the policy limit for each event separately. He therefore alluded to be entitled to a two-event payout on his insurance.

A trial in April found that one group of insurers – Swiss Re, various Lloyd's syndicates, Lexington, Houston Casualty, QBE, Copenhagen Re, Federal Insurance, Great Lakes and Employers of Wausau – were bound under the so-called WilProp policy wordings, which had previously been ruled by the courts as determining that the attacks constituted one event only.

A second trial, held in November 2004, involved a group of insurers not bound under the WilProp wordings. According to Silverstein's legal team, this meant they were bound to pay as much as US\$1.1bn more than the US\$3.55bn face value of the insurance on the property.

Here Silverstein was more successful, with the verdict going in his favour. In a statement following the trial he described the verdict as *"a win for all New Yorkers"*, adding that the proceeds from the victory would be used to ensure *"a timely and complete rebuild of the World Trade Center"*.

Although the insurers in the second trial said they would appeal, commentators noted that the additional claims had already been reserved for and that the impact on the named insurers would be minimal as a result.

Regardless of who won or lost, however, the disputes focused a spotlight on the issue of contract certainty, as only one insurer had issued a final policy prior to the 11 September attacks. Although the sheer scale of the WTC loss meant litigation was probably inevitable, few doubt that much of the legal costs would have been avoided if the policies had been issued in a timely fashion.

# 12 Terrorism and renewal of TRIA

## Terrorism cover in 2004

Terrorist attacks continued to hit the headlines in 2004, with the Madrid train bombing one of the most significant events.

There were indications that take-up of terrorism cover by businesses was on the rise. However governments still have a large role in smoothing the economic impact of terrorist attacks by providing back-stop or pool insurance programmes where necessary.

The need for this intervention is clear. Terrorist acts are highly unpredictable and potential losses (particularly in the case of nuclear, chemical or biological attack) are almost incalculable, making traditional forms of insurance inadequate. Even a conventional attack can bring unforeseen consequences, with claims large enough to bankrupt the insurance industry. The Insurance Information Institute, for example, estimated that the US terrorism losses created the largest ever reinsurance claim (US\$32.5bn over all classes). There is little question that without the help of the US Government-backed scheme, Terrorism Risk Insurance Act (TRIA), the availability of cover following the attacks would have been severely limited.

Outside the US, governments have also adopted reinsurer-of-last-resort schemes. In Europe, the Austrian, French, German, Spanish and UK Governments have all established pool or back-stop systems to deal with terrorist threats. Australia, Israel and South Africa have taken a similar approach.

## United States

### TRIA renewal

Much debate and lobbying effort over the course of 2004 centred on the renewal of TRIA, the Act signed by President Bush on 26 November 2002 and intended as a temporary three-year solution to the problem of providing adequate insurance cover in the period immediately after the US terrorism losses.

### What it does

The Act pledges federal "backstop" funds to Property and Casualty insurers up to an aggregate limit of US\$100bn on acts of foreign terrorism that take place on US soil. It makes cover compulsory and nullifies existing exclusions for attacks occurring in the US committed by foreign terrorists. TRIA only applies to terrorist acts certified as such by the Secretary of State and the Attorney General. It only applies to losses of between US\$5m and US\$100bn with any loss in excess of that dealt with by Congress.

Each insurer covers a variable sum, based on a percentage of its direct premiums from the previous year, rising from 7% during 2003 to 10% in 2004 and 15% in 2005. Above this, 90% of losses will be covered by the Federal Government with the remaining 10% covered by insurers.

With the Act due to expire on 31 December 2005, the question over the coming months is whether TRIA will be renewed and how long any extension may be for.

### Presidential elections

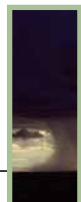
The re-election of George Bush in November was considered a boon for those in favour of TRIA renewal. The generally pro-business President had already voiced support for the measure.

Leading TRIA renewal lobbyist Charles Landgraf, of New York law firm Le Boeuf, Lamb, Greene & Macrae, said Bush's re-election could profoundly affect chances for the Act's renewal:

*"The election result does change the dynamic. Now Bush feels he has a mandate to enact a strong business reform agenda... We hope it will be possible to persuade the President to bestow his magic on TRIA"* he observed.

### Prospects for renewal

Proponents of TRIA renewal before its 31 December 2005 expiry have described the failure to renew as catastrophic. They argue that lacking any "run-off" provision, carriers would seek to impose exclusions or sublimits on terrorism coverage from 2006, severely curtailing terrorism capacity and so diminishing the ability to transfer risk in the event of an attack.



Some believe it would have consequences on the economy as companies denuded of terrorism cover adopt an increasingly cautious business approach.

However a Congress Budget Office report in January 2005 also highlighted disadvantages of renewing TRIA, both in terms of cost to taxpayers and lower incentives for policyholders to take measures to minimise the risk of terrorism incidents.

Three bills are now before Congress to prevent this outcome, although renewal appears to be contingent upon a Treasury report on TRIA due in June 2005. It may take until then for a consensus to emerge. However the longer uncertainty persists, the greater the scepticism that the Act will renew.

## Government programmes outside the US

Outside the US a number of governmental approaches have been adopted to terrorism insurance.

### United Kingdom

The UK's system of terrorism cover was set up in the wake of Irish Republican terrorist attacks in 1993 and has been used as a model by other European governments. A mutual, Pool Re, provides capacity to the UK commercial Property market with the UK Government acting as a backstop.

Its cover includes nuclear, chemical and biological terrorism acts occurring in the UK, but excluding Northern Ireland.

Deductibles are set for each insurer annually as a proportion of an industry-wide figure. The maximum industry retentions are:

Applying from	Limit per event	Aggregate limit per annum
1 Jan 2004	£50m	£100m
1 Jan 2005	£75m	£150m
1 Jan 2006	£100m	£200m

### Germany

In Germany, Extremus Versicherungs AG is a primary insurer of commercial Property and Business Interruption terrorism cover. Formed in 2002, it cedes 100% of its policies to German insurers and global (re)insurers, the latter led by Berkshire Hathaway. The programme features a €25m retention, €1.5bn pool and €1.5bn in reinsurance, with a government backstop to €13bn. It has a deductible of 1% of the maximum sum insured and there is no differentiation of risk.

### France

In France, GAREAT features a €6m retention, a €400m pool and two reinsurance layers. The government acts as a backstop on any losses above €1.75bn. The scheme offers cover on Property damage and Business Interruption for commercial, industrial and professional risks over €6m on acts of terrorism and sabotage in France.

Victims of terrorist attacks also receive direct government compensation. The fund covers bodily injury and is financed by a direct tax on all Property insurance.

### Spain

Spain's Consorcio de Compensaciones de Seguros (CCS) provides Property damage and Business Interruption cover for industrial and commercial property, excluding construction risks.

Unlike other government-backed schemes, CCS provides full coverage and an unlimited State warranty. It is not limited to a specific number of losses or loss amount.

The scheme was established in 1941 to cover terrorism/ civil war losses and was made permanent in 1954.

In 2004 it faced its largest challenge to date when it covered virtually all of the €200m losses from the Madrid train bombing.

## Australia

The Australian Reinsurance Pool Corporation came into being in July 2003 after the enactment of the Terrorism Insurance Bill.

It offers cover on any act defined as a “designated terrorist incident” by the Australian Government and covers chemical and biological attacks, although nuclear incidents are excluded.

There are four layers of cover: the first is retained; the second layer of A\$300m is premium funded over three years; the third is a A\$1bn commercial loan, with a final government backstop of A\$9bn.

Government and Commonwealth buildings are excluded.

## South Africa

The South Africa Special Risks Insurance Association (SASRIA) features a Rand 37m industry retention. A second layer of cover is provided by a Rand 2bn industry-funded pool, followed by a government backstop. The pool covers losses of up to Rand 300m a year.

Physical damage to property by terrorism, political violence, strikes, riots and civil commotion is covered, whilst war, malicious acts and nuclear contamination are excluded.

## Other developments in 2004

### OECD defines terrorism

One significant development in 2004 came in December when the Organisation for Economic Co-operation and Development (OECD) published proposals to define more clearly the concept of terrorism for the purposes of compensation. This is important because the definition of an act of terror has traditionally been difficult to pin down.

The OECD also set out criteria for risks to be insurable or eligible for other types of compensation, such as state support or non-insurance financial mechanisms including so-called “terrorism bonds”.

What the OECD failed to do was to provide a general definition of terrorism, preferring to stick to elements on which a definition can be based such as intention, means and effects of an attack. It left the job of providing a precise definition of terrorism to individual countries and insurers. The proposals are non-binding.

# 13 The Spitzer enquiry



## Calm after the storm – the challenge of transparency and equity...

2004 will be remembered for the devastation wreaked by nature, but in insurance history it will be forever linked with the actions of the campaigning New York State Attorney General Eliot Spitzer.

Spitzer's 14 October 2004 lawsuit against Marsh & McLennan Companies (MMC) was the culmination of months of investigations into the practice of insurance brokers' remuneration. In due course this action, together with other regulatory probes, complaints and class action lawsuits will be settled, but their effect will be felt for a long time to come.

### Restoring reputations

The examples of wrongdoing uncovered in the US appear to be isolated and the actual practice of charging insurers contingent commissions is not itself the cause of the illegalities alleged by Spitzer.

In his complaint of 14 October against MMC, the factual allegations Spitzer pointed to were, *inter alia*: false advocacy of acting in a client's best interest; false and misleading disclosure of contingent commission agreements; increasing contingent commission income by steering clients to favoured insurance companies; and participation with insurance companies in a bid-rigging scheme.

The potential for conflicts of interest created when contingent commissions become such a large part of a business strategy spilled over into the actions upon which Spitzer could hang his case. Nevertheless, whilst brokers immediately affected by the investigations have had to address, where appropriate, their practices and procedures, those who have not been implicated in the enquiries have also needed to reassure clients of the clarity and appropriateness of their remuneration structures and processes.

At the end of January 2005, Marsh reached an agreement with Spitzer and the New York State Insurance Department which involved a US\$850m

payment in restitution to policyholders and the adoption of a new business model designed to avoid conflicts of interest. A statement issued by Marsh Inc. "*apologize[d] for the conduct that led to the actions filed by the New York State Attorney General*" and recognised that "*certain Marsh employees unlawfully deceived their customers*".

### Transparency in process

There are several positives to come out of the regulatory scrutiny inspired by Spitzer's challenges. The first is the momentum to create transparency in the insurance industry's practices. This is something that should be welcomed.

The practices uncovered and subsequent action taken by Spitzer will not only drive more transparent business procedures in the industry, but has also put the spotlight on the transactional processes.

In a recent speech, Nick Prettejohn, CEO of Lloyd's said: "*Following the Spitzer intervention, who can possibly doubt that we need a transparent, auditable and structured record of the process of a transaction?*".

His comments tie in with the need for contract certainty, which we look at in further detail in the next chapter.

### Transparency in remuneration

Imposing transparency on remuneration structures will be painful for some, but the challenge is to create a new landscape where efficiencies and fair value dominate. Several organisations sounded fears over the extent of market practices such as contingent commissions in the late 1990s. Despite this the practice grew in recent years.

Some brokers argued, with a degree of credibility, that these arrangements were constructed to reflect the many, otherwise unrewarded, services performed by them on behalf of insurance companies. It is of course true that brokers do far more than pure transactional work. Risk consulting, claims and premium processing, modelling, wordings, marketing and underwriting support, for instance, are all services performed by brokers which, to varying extents, benefit insurers. The disparity with which Placement Service Agreements (PSAs) were applied however, ignored the fact that all brokers undertake these services.

The challenge now is to create transparency and consistency in how these services are remunerated. This should also result in efficiencies. There may, for instance, be services traditionally carried out by brokers at their expense, which insurers are better suited to perform and vice versa. Spitzer's actions have at last allowed a proper debate about what functions should be performed by whom and how they should be paid for.

Action is following from these various investigations. For instance, in the US, the National Association of Insurance Commissioners' adoption of new disclosure rules on broker commissions should encourage individual states to impose the rules this year.

### **Transparency: avoiding other potential conflicts of interest**

Transparency also enables companies to manage potential conflicts of interest. Spitzer's initial investigation into the practice of PSA has led to a series of regulatory probes into many other aspects of the industry's structures: such as the relationship between reinsurance and direct business and the issue of brokers and insurance companies having corporate, as well as commercial, relationships. Although it is not certain what the outcome of many of these investigations will be, it has provoked debate on what are the most appropriate structures for the industry and how they should be disclosed to clients.

### **The UK position**

There are concerns that Spitzer's findings should be viewed in a proper context. Whilst some investigations continue, it must be remembered that the actions pursued by the New York State Attorney General relate to what are so far isolated incidents of bid-rigging. There are also other champions of reform in the industry and regulatory scrutiny is not restricted to the US.

In Europe, as well, regulators are taking a much closer interest in insurance affairs. The Insurance Mediation Directive (IMD) came into effect on 14 January 2005 with the aim of harmonising regulation of insurance across the EU and promoting cross-border sales. In the UK this has been implemented by the FSA.

The FSA at present impose an obligation on intermediaries under Insurance Conduct of Business (ICOB) rules not to conduct business under arrangements that might give rise to conflict with their duties to customers. The FSA regime also dictates, under the

ICOB principles, that intermediaries must disclose their commissions "on request". There is however pressure on the FSA to change this stance, with Lloyd's recently urging the rules to be amended to specify mandatory disclosure.

### **A driver of efficiency**

Reduced revenues for some brokers will force the industry to look at the efficiency with which business is transacted. Cost controls will be necessary to counteract the reduction in income. This has already been seen through a reduction in the MMC workforce by at least 3,000 but it is a realisation that is dawning on the broking fraternity as a whole.

### **A level playing field?**

Transparency, disclosure and the creation of level playing fields are feasible. However, it will take a collective effort and there are already concerns that a fragmented approach is beginning to develop.

At the time of writing, MMC's new business model is yet to be announced, despite the settlement agreed with the New York State Attorney General's office. Meanwhile the UK arm of Aon has already said that it will begin charging underwriters a fee for providing additional services.

Many anticipated that the regulatory authorities would issue clear instructions and guidelines on the payment of contingent commissions, but generally these have not yet materialised.

Nevertheless, the important issue is that, whatever additional discounts or fees the market may end up paying brokers, it is in the best interests of open competition (and therefore of clients) that these are applied by the market in a consistent and transparent manner.

# 14 Industry regulation and market reforms



## Capital Adequacy

The EU is currently in the midst of a major review of solvency requirements relating to the life and non-life insurance industries. The project is working towards the production of a framework directive by mid 2006, which is likely to result in new legislation being adopted perhaps in 2008.

Solvency II, whilst still in a consultation stage, is likely to be broadly based on the three pillar system adopted by the financial institutions sector under Basle II. It is expected to therefore address minimum solvency requirements for (re)insurers, the review of their risk management practices and disclosure issues.

Whilst Solvency II is still being debated and drafted, in the UK the FSA is one step ahead with requirements already in place from 1 January 2005 for UK insurance companies. The new system requires non-life insurers to calculate their solvency requirements according to a factor-based ECR (Enhanced Capital Requirements) model. In addition, firms must demonstrate the work they have done under Individual Capital Assessments (ICA) and prove to the FSA that all potential business risks have been recognised and treated in a sound manner. Actuarial consultants have estimated that the UK (re)insurance industry may require up to £2.5bn additional capital to meet these new requirements, although in practice it may be that the less strong companies simply underwrite less business to comply with these new capital adequacy rules.

## Corporate Governance

The Sarbanes-Oxley Act of 2004 (SOX) was introduced in the US in the wake of the high-profile scandals that dogged corporate America at the turn of the century. SOX has done much to raise awareness of governance and the responsibilities of directors. It is designed to protect shareholders *"by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes"*.

The law also requires publicly traded firms, including insurers, to document and test their internal financial controls, and report within 48 hours any "material" events

or weaknesses that may affect their earnings.

And it is not only US regulators that have influenced the shift in global corporate culture. Taking the lead from SOX, regulators in other countries have implemented change and this trend continues to grow.

New standards of transparency and governance are being set; from the broadening approach of the UK Financial Services Authority (FSA), to the Australian Stock Exchange adopting all 28 Principles of Good Corporate Governance and Best Practice Recommendations issued by its own Corporate Governance Council.

## Financial Services Authority

On 14 January 2005 a new FSA regime came into force which will regulate general insurance mediation for UK companies pursuant to the EU Insurance Mediation Directive (IMD). Throughout the year insurance intermediaries were gearing up to the new regulation, which covers issues such as business principles, conduct of business, accounting of client monies, assessment and review of employee competence, together with senior management controls and systems.

During 2004, there was some concern amongst risk managers as to whether they would need to seek authorisation from the FSA, on account of providing insurance services to other companies within their group. Various organisations lobbied to have the rules clarified, which led the FSA to issue guidance on the 'by way of business' test.

The need for regulation in the broking industry was clear and the new regime provides the environment to achieve the FSA's aims of providing greater protection for the customer.

## Lloyd's Franchise Directorate

Established on 1 January 2003, the Franchise Directorate's aim is to create an *"efficient, transparent and profitable Lloyd's insurance market"*.

The focus is on ensuring that standards and underwriting competencies remain high among the Managing

Agencies operating in the Lloyd's market, with advanced benchmarking, peer review and business planning techniques being introduced into the marketplace.

Guidelines are laid out to encourage disciplined underwriting with the Directorate responsible for approving business plans and setting parameters governing the level and lines of business syndicates can devote capital to.

Following the high-profile departure of hull underwriting facility Dex from the market in late 2003, actions from the Directorate have been largely conducted behind the scenes. However, after a loss heavy year in the marine and energy sector, more public action may be taken in the future for those segments which are unable to reverse historically poor underwriting results.

## London Market reforms

Last year saw further strides taken in the quest to modernise and transform London's archaic back-office functions, which come under such criticism for their inefficiency in settling premiums and claims together with high frictional costs.

The London Market Principles (LMP) reforms were first set in motion back in 1999, in an effort to abolish London's so-called "Victorian pipework".

Key projects driving the LMP reform process are mandatory use of the LMP slip, development of the Electronic Claims file, the Accounting and Settlement project and the Wordings drive, designed to deal with the problem of contract certainty.

Speaking in New York late last year, Lloyd's Chairman Lord Levene highlighted the need for change. He pledged:

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*"The insurance industry owes it to its customers as well as itself to ensure that cover is fully agreed and clearly documented right from the start. It is a core objective at Lloyd's."*

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## Contract Certainty/LMP Wordings

If the events surrounding the Silverstein trial over the WTC coverage built pressure on improving the quality of policy wordings, then fresh impetus from UK regulator the FSA placed the onus firmly on the market to increase contract certainty, or face regulatory action.

The FSA Chief Executive John Tiner has already put improved contract certainty high up the agenda.

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*"We challenge the London Market – the underwriters, the brokers, the infrastructure providers and the clients – to develop and execute as rapidly as is possible a market-based solution to this issue of contract certainty. Consistent with our philosophy of working with the grain of the market, the FSA wants to see the insurance industry grasping this nettle and moving to a business and operating model which is transparent and efficient."*

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Tiner has stated that one of the FSA's roles will be to accelerate the pace of change already being driven through the London Market Reforms.

The process commenced last year with the proposal whereby the prudential policy review (currently carried out by London market bureau Xchanging) could be shortcut so it becomes part of the placing process.

During the year the Contract Certainty Steering Group (CCSG) was formed to progress this proposal with the aim of bringing together the firm order, wording agreement and policy review processes. A pilot scheme is expected to be rolled out in the first half of 2005.

Although there is much to do before contract certainty can be achieved, the commitment of the market and the force of the FSA should see real progress in 2005.

## LMP Slip

LMP slips have been in the marketplace for four years, but initial resistance to change limited the level of uptake.

Building upon the progress made in 2003, Lloyd's mandated the use of LMP slips in the market with effect from 1 January 2004 and released a number of progress reports throughout the year, detailing the improving quality of slips.

The LMP slip structure is now universally accepted across the market.

## LMP Accounting & Settlement

The Accounting & Settlement project remains a cornerstone of the LMP reform process. Once complete, it will replace the existing paper interface between brokers and underwriters with electronic messaging that will communicate with the market's systems.

Roll-out of the initial phase is expected to take place this year, with a high volume of transactions passing through during 2006.

Successful implementation should considerably reduce errors and re-keying inefficiencies, as well as allowing queries to be resolved earlier.

Whilst many challenges lie ahead, the International Underwriting Association and Lloyd's have thrown their weight behind the project. We look forward to seeing Accounting & Settlement become a reality.

## Electronic Claims File

The market reached a consensus during 2004 between the London Market Insurance Brokers' Committee (LMBC) and the Lloyd's Market Association (LMA) on the Electronic Claims File.

A market repository is being developed with Xchanging Ins-sure Services, which brokers will be able to access taking away the need for them to transport the paper claim file from one underwriter to another in order to obtain agreement.

The project has moved from the conceptual to implementation phase and whilst some disappointment has been expressed about the pace at which it has developed (like Accounting & Settlement it depends on collaboration and resources) it is expected to be up and running for 2006 and widely used by 2007.

# 15 Tort reforms

## The impact of the growing costs of Liability claims

According to Swiss Re, the 10 largest non-life insurance markets worldwide sustained liability claims totalling US\$84bn in 2002, of which US\$67bn was attributable to the US. The rise in tort claims in excess of economic growth is an issue of great concern for (re)insurers and has had no small part to play in the adverse reserve developments experienced in recent years.

Of concern is the apparent inefficiency of the tort system in the US, where most awards are made at state level and forum shopping for the most plaintiff-friendly venues is widespread. The result is that an estimated 54% of the total cost of US personal illness and injury claims is made up of administration costs. This compares against just 17% for claims under Workers' Compensation regimes.

## Tort reform: closer than ever before?

As 2005 dawned it appeared momentum was building to reform US tort law. The US Presidential election in November 2004, which returned the pro-business George W Bush to the White House for a second term, also returned a Republican majority to both the Senate and the House of Representatives.

Since then, pressure for tort reform has increased at both the federal and state level, with most commentators agreeing that legislation of some kind will be passed in both arenas in 2005.

That there is a need for reform was underlined early in 2005 in a report released by Towers Perrin Tillinghast in which the actuarial consultants considered the costs of the current US tort landscape. It found that although the rate of inflation was slowing, the US tort system still cost US\$246bn in 2003. Clearly something has to give.

The problem has become so acute that in 2004 AIG chief Maurice Greenberg was moved to call the US plaintiff bar a group of "terrorists" – a comment that provoked a predictably outraged response by various lawyers' organisations.

### Growth of US tort cost

Years	Annual average increase in tort system costs
1951-1960	11.6%
1961-1970	9.8%
1971-1980	11.9%
1981-1990	11.8%
1991-2000	3.2%
2001	14.7%
2002	13.4%
2003	5.4%
<b>52 years (1951-2003)</b>	<b>9.7%</b>

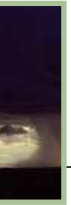
Source: Towers Perrin

Early in January 2005, emboldened by a post-election mandate for a pro-business agenda, President Bush responded to these pressures by laying out his stall for tort reform.

He launched a three-day campaign on 5 January 2005 when he visited plaintiff-orientated southern Illinois' Madison County. His target was the soaring cost of medical liability insurance which, he said, was preventing doctors, especially those in high-risk specialties such as obstetrics, from working.

At an address at the Gateway Convention Center he was quoted as saying: *"What I'm here to do is say as clearly as I can – the United States Congress needs to pass real medical liability reform this year."*

On 7 January, he followed up with a visit to the town of Clinton in Michigan State, calling on Congress to pass legislation that would end litigation by asbestos victims that he said has bankrupted 70 US companies.



## Bush's pitch

President Bush's tort reform agenda has three main strands.

First, he aims to limit the amount of money victims of medical malpractice can win for such "non-economic" damages as pain and suffering. A suggested cap is US\$250,000.

Secondly, he hopes to restrict the degree to which lawyers can corral large groups of people to sue a company over a harmful product in class action lawsuits. His solution, laid out in the Class Action Fairness Act, S.1751, is to move more cases into the Federal Court where rules are tighter.

Thirdly, he is pushing for curbs on lawsuits against makers and sellers of asbestos-filled products. Under the Fairness in Asbestos Injury Resolution Act (FAIR), the proposed alternative is for asbestos compensation to be handled not in litigation but through a trust fund established by Congress and funded by the industries facing lawsuits.

## Background to tort reform

This is not the first time that reform has been on the agenda. Over the past two years both Republicans and Democrats have been searching for a compromise, particularly with regard to the setting up of an asbestos trust fund.

A new measure tabled by Senator Arlen Specter, the incoming chairman of the Senate Judiciary Committee, is introducing a draft bill to set up a US\$140bn fund. It is hoped that this may finally be adopted, when voted upon in 2005.

Nevertheless, there are concerns over this approach from some quarters. The insurance industry may have to contribute up to US\$46bn to the fund and Equitas in particular is concerned over the amount of its potential contribution and the different treatment it may receive under the bill to US domestic insurers.

The Class Action Fairness Act, meanwhile, will also be voted on by Congress during 2005. In 2004, the same bill had significant support, but disputes over procedural matters kept it from reaching the Senate floor for a vote.

## The Australian example

Whilst the US still struggles to come to terms with its tort burden, Australian (re)insurers are already in line to benefit from changes made to tort law in 2004.

The changes came on 24 June 2004, when the Federal Senate passed three relevant pieces of legislation.

Following an increase in premiums over the past five years, the Treasury Legislation Amendment (Professional Standards) Bill 2003 aims to provide professionals with access to affordable Professional Indemnity insurance. It caps liability under federal legislation for professionals who subscribe to Professional Standards Schemes.

The Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill introduced proportionate liability legislation for economic loss and property damage claims arising from misleading or deceptive conduct. Under the terms of this Act, corporations (and their insurers) are only responsible in law for the loss caused by their negligence and are not required to compensate other unprotected or insolvent parties on a joint and several liability basis.

The last initiative, the Trade Practices Amendment (Personal Injuries and Death) Bill N° 2 2004, limits access to compensation for personal injury or death. It prevents State or Territory tort law reform from being undermined by access to a Federal statute on identical causes of action.

US legislators are likely to follow with interest developments on the other side of the Pacific.

# 16 Sector analysis: Insurance

## Accident and Health

At the time of writing, the full impact of the Asian tsunami tragedy on the Accident and Health market is still being established. Most of the activity to date has been on the assistance side, with evacuation and repatriation claims.

There is little impact on pure medical expenses cover, with most of the injured treated locally under emergency measures, without the need for private medical cover.

The volume of death and disability claims under Personal Accident Policies is unknown, with the final amount dependent on a great number of factors at the individual level, and determining limits of cover.

### Pricing

Although the market for Accident and Health insurance has a history of stability, rate increases of 20% in the wake of the US terrorism losses were not uncommon.

Rates were flattening out by 2003/2004, with insurers imposing rises of around 5-10%.

By 1 January 2005 renewals, rates were declining, as the increased capacity entering in 2004 put downward pressure on pricing. Buyers sought reductions through 2004 and, whilst sellers at first attempted to hold their expiring rates, weakening emerged as the year wore on. Policy terms and conditions remained stable, however.

### Capacity

The new capacity arrived primarily from Bermuda and the US, with the most recent entrant, Bermudian Zon Re, writing London market business through Reykjavik 1.

Any additional entrants in the market, particularly on the reinsurance side, are expected to push rates down further.

### Coverage

There is continued demand for catastrophic Personal Accident cover linked to pension fund protection. In recent months a number of life insurers have started putting aggregate limits on 'death in service' payouts related to company pension funds, to limit liability in the case of a catastrophic incident in a major financial centre.

Companies with a high concentration of exposures are looking to the market to provide cover to bridge the gap between the aggregate limit and the obligation of the fund. The capacity is available for this, but pricing is an issue.

Conventional terrorism is offered under most reinsurance covers. Nuclear, Chemical or Biological (NCB) terrorism cover is available on a restricted basis, where a reinsurer will seek assurances over accumulation exposure at any given location.

NCB cover can also be obtained on direct business, subject to price and accumulation information.

## Sub-classes

### Medical expenses

The market softened considerably for US Medical Stop Loss cover and although the 2004 underwriting year is yet to develop, an overall industry net loss ratio of 95%, or even slightly worse, would not be a surprise. However, a slow down in medical "inflation" (both treatment and the costs of medicine) may come to the rescue, as there seems to be some evidence that this may turn out to be lower than the sector priced for.

The international medical market remains tight, with a few key lead markets able to be selective both on products and territories. The withdrawal of Employers Re Corporation (now GE Insurance Solutions) in late 2003 from certain international medical markets contributed to this contraction. Nevertheless, there were reinsurers prepared to support a disappointing medical portfolio to maintain a broader trading relationship with the buyer.

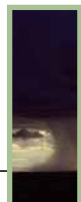
### Special contingency

WTC and subsequent incidents, particularly in Saudi Arabia and Iraq, focused attention onto the security of corporate personnel. Nevertheless, conditions in the Kidnap & Ransom market remain neutral.

Restrictions on Political Evacuation cover bundled with Kidnap & Ransom continue to apply, with some insurers completely excluding the product and others offering limited cover. This often excludes the countries where the product is most in demand.

### Travel

Coverage remains restricted for high risk destinations such as Iraq, Iran, Afghanistan and Pakistan.



## Aviation

The Aviation industry has had to evolve in 2004. Passenger traffic has rebounded, but airlines have been hit by higher fuel costs and this, together with continued competition from the low-cost sector, is forcing the established airlines to rethink their cost bases further. Consequently the environment continues to be difficult, as evidenced by many of the larger, established airlines, especially in the US, continuing to produce trading deficits.

The insurance industry has had to relate to these changes.

### Pricing

In a record low year for Aviation losses, it was inevitable that 2004 would see further downward pressure on rates in the sector. Pricing was down by around 12% for hull and 14% for liability, although the industry's premium base fell less markedly due to increased fleet values and traffic.

To an extent, this reduction signals a continuation of the post 11 September 2001 fallout, as the market searches for equilibrium. Before 9/11 rates were completely out of balance, with US\$800m of premium against US\$2bn in losses. Prices had already started to adjust upwards and the US terrorism losses accelerated the process, sending rates through the roof.

In the absence of losses, it becomes a challenge for underwriters to maintain the Aviation insurance industry's premium base. Total premiums were US\$2.3bn in 2004.

### Worldwide aviation premium

Years	Premium
2002	US\$3.3bn
2003	US\$2.6bn
2004	US\$2.3bn
2005 (estimated)	US\$2.1bn

If the loss environment remains benign in 2005, there will be further downward pressure on rates. This will be resisted to the extent that underwriters are themselves under increased pressure from capital providers to maintain discipline, or risk losing the support of their capital.

Aviation underwriters will take into account increased passenger numbers, the growth of the individual airline, improved safety and modernisation of the fleet before deciding on the discounts on offer to buyers. However, whilst the emphasis will be on writing risks on an individual basis, average falls of 15% are predicted over the year ahead.

The sector's pricing conditions are never far from fragile, however, with the potential for a single incident to wipe out the premium base for a year, in addition to the US\$300-400m attritional losses expected annually.

### Capacity

There were no significant entrants or exits from the Aviation insurance market in 2004, apart from Markel International exiting the London market.

The market maintains a surplus of capacity, with up to 150% available for a good quality risks.

### Coverage

Successful pressure has resulted in more third party terrorism coverage being brought back into the hull and liability insurance programme. In the immediate aftermath of 11 September 2001, third party terrorism was restricted to US\$50m on the hull and liability placement, with the likes of AIG and Berkshire Hathaway entering the market to provide specialist (and expensive) stand-alone cover in excess of this.

In the recent renewal process, in order to pass on a gain to clients, brokers succeeded in persuading underwriters to increase these limits to US\$150-250m. This process is likely to continue in 2005, as buyers attempt to claw back more terrorism coverage.

The overall cost is cheaper than buying stand-alone cover and airlines feel that premiums paid for terrorism cover as part of a hull and liability policy represent a benefit against future claims, as opposed to paying premiums into a potentially short-term, stand-alone market.

US airlines continue to benefit from the US Homelands Act, which negates the need to buy terrorism cover.

There has been talk of extending the nuclear exclusion clause to deal with the issue of a 'dirty' bomb being detonated near to an airport, but to date this idea has not moved beyond the draft stage.

### Improved safety or good fortune?

When it comes to pricing insurance in the Aviation market, underwriters are tasked with the near impossible mission of judging to what extent the absence of major catastrophic losses in the last three years is a matter of luck or tangible evidence of improved standards in aviation safety.

The consensus is that it's a combination of the two. Often accidents are caused by an unlikely coincidence of a number of individually insignificant events. The geographical location of an incident is usually crucial to the eventual size of losses.

Security measures implemented at airports, as well as in-flight, have drastically cut the probability of terrorism incidents occurring – a key factor in the sector's willingness to bring terror cover back into hull and liability policies.

New (and larger) aircraft with increased hull values and carrying more passengers represents a challenge for insurers for the future. The imminent Airbus 380 is expected to carry typically 500 passengers and potentially 800, with a consequent increase in catastrophe risk.

Nonetheless even with a relatively settled premium base, underwriters know that they could be just one loss away from the market becoming destabilised.

## Sub-classes

### Products Liability

Products Liability, purchased by the aviation manufacturing and components industry, has seen providers being hit in recent years for almost US\$1bn of loss/reserve deterioration from prior years. Therefore despite current business being profitable, 2004 saw average rate increases of over 20%. The risks continue to be more technically underwritten than the airline sector and the very nature of this long-tail account mean that insurers are determined to safeguard their portfolio of business against ever rising risk exposures. Increases are almost certain to continue in 2005.

### Airports Liability

This is a relatively stable market with similar levels of cover available and rate increases in 2004 in single digit territory, following the more significant increases seen in 2003. Capacity is most plentiful on the non-US side and this has been augmented during the year with the entry of Aspen Re into the market. A similar pricing environment is expected during 2005.

### General Aviation

Despite underwriters' desire to keep rates up, plenty of capacity has been available and insurers are competing to increase their participations on programmes. Therefore 2004 saw small decreases obtained of up to 10%, dependent on loss record.

With no changes in capacity expected, it is likely that these conditions will remain in 2005.

## Cargo

2004 saw a reinforcement of London's position as a specialist market in the eyes of buyers. It is increasingly a niche market in which expertise and understanding of the sector are key selling points.

This was evidenced at the RIMS conference in San Diego in April 2004 when, for the first time, a significant number of cargo underwriters from the London market attended. RIMS was hitherto viewed as a Property and Casualty conference in which marine underwriters were unlikely to play a part.

### Pricing

Over the past 12 months, the cargo market has softened. This is largely because major corporate business has had to react to the more significant reductions seen in the Property market.

Stock throughput policies, on which Property underwriters compete with the cargo market to an extent, have witnessed the largest degree of rate reductions.

The result has been that cargo insurers have been willing to reward selected clients by reducing premiums for longevity, a good record or loss prevention.

Rates decreases in 2005 are likely to be partially fuelled by the fact that the cargo sector experienced few significant losses from the US hurricanes or Asian

### Selection of large cargo losses notified to Lloyd's during 2004

Loss	Date	Location	Estimated claim
Damage to vanilla pods due to Cyclone Galifilo	7 Mar 2004	Madagascar	US\$30m
Loss of generator following grounding of vessel	16 Oct 2004	Durban, South Africa	US\$16.5m
Damage to a consignment of insulin	20 Dec 2004	France-US	US\$12m
Damage to cargo of copper concentrate	16 Aug 2004	India	US\$8m
Flood damage to data processing goods due to Hurricane Ivan	18 Sep 2004	Pennsylvania, US	US\$7.2m

typhoons. Nor were there any significant losses from the tsunami in South-East Asia.

2004's benign loss environment indicates that the market has been much more selective and mindful of aggregation issues in relation to its windstorm and earthquake exposures.

### Capacity

2004 witnessed the withdrawal of Euclidian from the cargo market as well as the amalgamation of the QBE/Limit syndicates. This caused some concern that the options available to brokers may be reduced, but recruitment by other Managing Agencies has subsequently allayed such fears.

Cargo capacity in Bermuda remained limited and is likely to remain so in 2005, whilst elsewhere capacity is expected to be broadly stable through 2005.

### Coverage

Terrorism exclusions still have an impact on the industry. Otherwise, there is little change from 2003/4.

### Domestic markets

The domestic markets appear to be experiencing rapid reductions and in some cases are easing generally accepted coverage restrictions. In the US, Latin America and Europe there is strong competition, so it appears likely that London will continue to lose interest in competing for straightforward business which is underwritten in other international markets.

### Prognosis for 2005

Rate decreases of 10-15% on existing business are expected.

New business may see greater reductions, this being a function of the volume of business changing hands as rates soften in the Property market.

## Casualty

2004 was an eventful year for both US and international Casualty business lines. Whilst the year began with most classes strong, as the months progressed pricing pressures mounted and underwriters became increasingly unsure of completing their annual business targets.

Major corporate Casualty programmes, which saw increases of 25% in 2003, generally experienced reductions of perhaps 10% in the first half of 2004, rising to 15% in the second half. The exceptions to this were industry sectors where capacity remains tight, especially at the lower end of programmes, such as energy and petrochemical risks.

Inevitably, causing this volatility was the significant increase in capacity which flowed into the sector following the shortages experienced in 2002/2003. For US business, for instance, domestic insurers increased their capacity as did the Bermudian carriers, who have grown their presence in the sector. Plentiful Bermudian capacity was also felt in international lines, competing against both London and European capacity.

Contributing to this price weakening were underwriters' 2004 budgets that, with hindsight, often proved to be too optimistic. As a consequence, some insurers found themselves providing larger limits simply to write their targeted income or agreeing to reductions to win new

accounts. It was all a far cry from 12 months earlier when the sector had experienced two years of capacity shortages and price rises.

What were insurance buyers doing with these (unexpected) cost savings? For some risk managers it was an opportunity to buy further insurance cover; for most it was a chance to book a budget saving after several years of what they believed was overspending.

One encouraging sign for insurers of US business, however, were signs of a decline in the rampant claims inflation of recent years. This was demonstrated by statistics from Towers Perrin's actuarial unit Tillinghast. In a study (*US Tort Costs: 2004 Update*) they noted that US tort costs had only increased by 5.4% to an estimated US\$246bn in 2003, against leaps of 13.4% in 2002 and 14.7% in 2001. They predicted this moderation might continue.

There is also renewed optimism that 2005 may be the year when meaningful US Federal tort reform occurs. There have been many false dawns in this regard but the re-election of President Bush in November 2004 has restored momentum for reform. Reform at State levels in jurisdictions such as California and Texas in recent years, particularly in the healthcare area, has already encouraged insurers and possibly contributed to the decline in tort inflation noted above.

Nor was progress restricted to the US. Insurers of Australian business are beginning to reap rewards following tort reform in 2004, which saw the introduction of limits on damage awards in cases of professional liability or personal injury.

Insurers also continued to show discipline on terms and conditions. Major pharmaceutical accounts, for instance, continue to face a wall of exclusion clauses (some of which are imposed on the primary writers by their reinsurers). Nonetheless, the year ahead is likely to see underwriters being hard-pressed to justify exclusion clauses which have been imposed in a blanket fashion on accounts which may have excellent loss records. Indeed, it is difficult to avoid the conclusion that in 2005 insurers will be under pressure to relax some terms. Against this, however, capacity for major pharmaceutical accounts, which all have US exposures, remains tight. AIG, for example, have reduced significantly their overall group capacity for pharmaceutical risks.

The telecommunications industry also continues to face coverage issues. The fall of Pender Mutual has served to highlight the difficulties telecommunications companies face in finding comprehensive coverage to match their needs. There are signs, however, that some insurers are beginning to introduce more capacity to reflect the breadth of cover necessary. There is still a lack of consistency in approach across the market to coverage issues such as EMFs (Electro Magnetic Fields) and Intellectual Property.

On pricing, the year ahead is likely to be marked by a general downward trend. Indeed, there are also some signs that the rating relativity between the different layers (the primary/first excess layers and the higher catastrophe covers) is beginning to break down, a sign of increased competition among insurers. Even heavy industry is facing flat renewals, whilst so-called "vanilla" (lighter industry) accounts are in high demand by insurers.

This is not, however, to suggest that insurers have been struck with complacency. Underwriters are continuing to value and encourage risk management. Good management, loss records, safety procedures and risk awareness are all being used by insurers to differentiate on pricing. One of the challenges in the year ahead will be to ensure this differentiation continues to take place.

## Pricing

Currently flat but with downward pressure. Heavier industry, including oil and gas, is likely to be more stable in 2005. Other accounts could see declines of up to 20%, dependent upon risk profile.

## Capacity

Since the beginning of 2004, market capacity has continued to increase. With the exception of major pharmaceutical risks, most companies can now build a programme of the size they desire and experience competition at all levels.

## Coverage

Exclusions continue to remain commonplace for "alarm-bell" hazards such as toxic mould and asbestos. EMFs are also excluded by some, allowed to remain silent by others or covered on a claims-made basis still.

Terrorism cover continues to be largely provided by State schemes but cover is also available in markets such as London and also by some Bermudian carriers, though

most insurers remain silent rather than specify this cover. Nuclear, Chemical and Biological exposures continue to be routinely excluded.

As noted above, pharmaceutical companies remain faced with a raft of exclusions although there are likely to be attempts in 2005 to reduce these to a more reasonable level.

Multi-year cover is rarely available.

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## Construction

Construction comprises a wide collection of classes of insurance, principally Contract Works Material Damage, Delay in Start Up (Advance Consequential Loss), Employers' Public Liability and Professional Indemnity products.

The London Market tends to see the very large or distressed risks, particularly when there is a requirement for Delay in Start Up (DSU) cover.

### Pricing

Despite the limited capacity in the construction market, rates for renewable business have dropped by an average of 5-15%. Deductibles have remained constant.

With the majority of the market chasing the same business, further falls in rates are expected on Power construction projects in 2005, with the market for annual projects and small to medium sized Public Private Partnership (PPP) projects becoming increasingly competitive.

Clients who didn't see a reduction in 2004 are likely to this year, dependent on claims history.

### Capacity

The London market has seen four additional insurers writing construction business in 2004. These newcomers are mainly focusing on erection business, as opposed to heavy civil engineering business.

Several other existing underwriters have raised their participation in construction, particularly PPP business.

Supply shortages persist for the writing of US construction business in London and Europe, with the newcomers currently unable to write higher risk

catastrophe territories in the US. They also struggle to write business in Taiwan, due to the unwillingness of treaty reinsurers to cover them in areas in which they are themselves already heavily exposed.

There has also been a trend in the last couple of years for construction companies to self-insure larger amounts through the use of captives. It is fairly common for contractors to assume risk for attritional losses in this way.

Although capacity was fairly static in 2004, a number of underwriters were willing to write a broader range of exposures, adding to the pressure on rates. Both Zurich and ACE are widening their scope in the marketplace.

Additionally, some of the smaller Lloyd's syndicates, including Newline and Illium, are looking to move up from the mid-market they have traditionally targeted to some of the major risk areas.

### Coverage

Restrictions imposed at the end of the last soft market continue to be a common feature in coverage.

Design cover for prototypical business remains difficult to find. The market was stung by heavy losses in the last soft market and significant offers of premium and retention do not tempt a re-evaluation at this time.

As last year, limits are on a downward path for policy clauses including Removal of Debris and Professional Fees.

Expediting Expenses, a traditional extension of cover has come under the microscope recently. Its intended purpose is to provide additional indemnity to assist with getting the project back on track following loss or damage. However, with the increased sophistication of buyers, there has become a thin dividing line between the clause responding as a genuine provision to mitigate potential future costs and it being used purely to avoid onerous contractual obligations associated with timely completion. Insurers are questioning whether the clause should be excluded or fall under another section of cover.

### Contract Works Material Damage

This sector has suffered in recent years as a result of both inadequate pricing and deductibles. Despite significant increases in price, deductibles and restrictions in coverage since 2001, losses have continued and there is no sign of the market easing.

Last Autumn's heavy hurricane season and the recent tsunami tragedy appear to date to have had little impact on the international marketplace. Nevertheless, there are concerns over the levels of accumulation in areas susceptible to catastrophic risk, most notably the US and Asia.

Loss prevention and mitigation has become an issue of increasing importance for insurers when it comes to evaluating clients' risks. ISO accreditation continues to play a crucial role in this, with insurers taking a more "hands on" approach during site visits.

Construction Works' Material Damage underwriters continue to avoid the heavy civil engineering projects (especially "wet" risks), in part due to the level of capacity that undertakings of such a size require. Major tunnelling projects are especially difficult to place, and underwriters tend to restrict coverage immensely where prototype technology is involved.

### Delay in Start Up

DSU insurance has also suffered in recent times, mainly due to the potential size and complexity of claims, with a number resulting in expensive and lengthy litigation.

However, demand for DSU cover is high both domestically and internationally, fuelled by the vast amount of private investment in construction.

Popularity of the product has grown significantly in the UK, with the emergence of Private Finance Initiatives (PFI), or Public Private Partnerships (PPP). These have proved more attractive to underwrite than traditional contractor arranged project insurances. Many PFI/PPP deals closed to date have experienced timely completion and excellent loss scenarios.

As a result, approximately 80% of the market is targeting this kind of business. Non-prototypical power construction projects also remain popular.

Purchasing DSU cover for tunnelling projects is also proving difficult. Some of the largest civil engineering insurers decline to offer the product other than in exceptional circumstances. Some large projects have had to attach DSU cover on the proviso that damage to the tunnelling element does not form a "trigger" event.

### Annual Design and Construction Professional Indemnity

2004 saw rating increases levelling off in Design and Construction cover, with 0-5% increases standard for clean risks, lower than expected at the start of the year.

The prognosis for 2005 is reductions on large blue chip Design and Construction risks, of 5-10%. Rate reductions in other areas of Professional Indemnity are likely to be much higher.

Deductibles and coverage are also likely to come under increased pressure, although large Design and Construction covers are likely to show more stability. Buyers are unlikely to see the back of exclusions for asbestos and toxic mould claims.

Following a number of new participants into the market in 2003 and 2004, the Lloyd's operation of Bermuda's Quanta became the latest market entrant, writing Professional Indemnity with effect from 1 January 2005.

Existing insurers are likely to look to write increased lines in order to maintain their premium income levels in an overall softening market, with all small to medium-size Professional Indemnity risks being subject to increasing competition.

Again, large Design and Construction business is likely to be subject to less competition, as legacy losses in the class quell the appetite of insurers.

Design and Construct is often described as short long-tail business because, although coverage is on a claims made basis, it can take up to five or six years to settle if negligence is alleged and the case proceeds to the courts. Some claims have settled well above reserve levels as long as eight years after the accident year.

### Construction Employers'/Public Liability

The larger contractors have a high level of sophistication in their approach to financing Employers' and Third Party Liability risks. This involves a blend of risk retention for high frequency/low severity exposures and selective purchase of excess coverage to protect against catastrophe losses. The typical risk profile created by contractor activities (offshore, tunnelling, rail) and the complex contractual arrangements involved, require them to buy high limits for both Employers' and Third Party Liabilities. This necessitates involving a wide range of

insurers, but capacity was generally available over the last year to meet most needs.

Project-specific liability placements for large civil and non-civil developments that require multi-year policy periods have more limited choices in terms of available markets. Relatively few insurers are able to commit without a break clause, beyond 36 month periods.

Rates for primary and excess Employers' and Third Party Liabilities have begun to turn and rate reductions of 10-15%, sometimes more, are now achievable. There is however still a cautionary approach to acceptance and rating of Employers' Liability risks with a relatively suppressed appetite still prevailing. This stems from the great uncertainty inherent in long-tail exposures. The emergence of new industry-related diseases, escalation of awards and an ever-more aggressive litigation environment mean that this continues to be a difficult class of business to cover.

## Energy

### Pricing

At the beginning of 2004 there was a general softening of rates over the market as a whole. In particular, there were substantial reductions on business with favourable loss records and involving large premiums. Many of the reductions were in the form of profit commissions and prompt payment discounts, but reductions they nevertheless were.

Due to the big increases in deductibles imposed by underwriters in prior years, the smaller claims were being retained and a relatively benign loss scenario was developing. Realising they had pitched their business at a profitable level, in 2004 they were prepared to offer rate reductions in return for deductibles remaining relatively high.

The result through 2004 was overall reductions in the region of 20%, although this itself could be seen as a continuing adjustment to the extraordinary rate increases seen in 2001/2002.

### The impact of catastrophes in 2004

The first two hurricanes to hit Florida caused few major energy losses either onshore or offshore. That changed with Hurricane Ivan, which struck the Gulf of Mexico on 16 September 2004.

The scale of losses from Ivan was not immediately apparent and many insurers initially assumed they had escaped again relatively unscathed. Over time, however, it became clear that the hurricane had had a major impact on oil production in the Gulf of Mexico, with significant Business Interruption and Contingent Business Interruption claims being incurred.

The result was that initial loss forecasts had to be revised upwards. Early estimates of insured Energy losses were in the region of US\$800m. Later in the year, that moved to in excess of US\$2bn, with approximately US\$1.2bn falling on the commercial market, over US\$500m purportedly falling on OIL (an industry mutual), and nearly US\$500m being borne by captives or self-insureds. Latest overall estimates are now in excess of US\$2.5bn and OIL's exposure has since been clarified to US\$394m.

With few noteworthy losses, neither the summer typhoons nor the South-East Asian tsunami, had a significant impact on Energy rates.

### Offshore energy review

The Offshore sector experienced significant pressure on rates, particularly for volume and well-managed business, until the hurricane season. The impact of Hurricane Ivan put a brake on the reductions, particularly for risks located in the Gulf of Mexico and other catastrophe areas, with Gulf of Mexico exposed renewals now seeing increases ranging from 10% for loss-free accounts, to anything up to 100% for accounts that suffered Ivan losses, depending on their individual magnitudes.

Berkshire Hathaway and Euclidian both exited the Offshore energy insurance business in 2004. This followed the departure of Allianz towards the end of 2003. However, the fact that Aspen Re took on key Berkshire Hathaway personnel may mitigate any loss of capacity and competition.

This is a mature market and there were no real changes in terms and conditions over 2004 with retentions remaining relatively high.

The table so far for 2004 energy losses in excess of US\$20m, is as follows:

2004 major energy losses (in excess of US\$20m ground-up)			
Jan	Fire & Explosion	Australian Gas Plant	US\$244m
Jan	Fire & Explosion	Chilean Mine	US\$28m
Jan	Fire & Explosion	Algerian LNG Plant	US\$470m
Jan	Fire & Explosion	Indonesian Petrochem Plant	US\$75m
Jan	Faulty Design/Workmanship	Canadian Refinery	US\$39m
Feb	Machinery Failure	Thailand Power Plant	US\$50m
Mar	Fire & Explosion	Texas Refinery	US\$35m
April	Fire & Explosion	Illinois Chemical Plant	US\$180m
June	Fire & Explosion	Israeli Refinery	US\$35m
Jul	Leg Punch through	Jack-up Rig, Indonesia	US\$31m
Aug	Blowout	Egyptian Semi Submersible	US\$213m
Aug	Fire & Explosion	Texas Gas Plant	US\$51m
Sep	Fire & Explosion	South African Chemical Plant	US\$45m
Sep	Windstorm	Gulf of Mexico Platform	US\$140m
Sep	Windstorm	Gulf of Mexico Platform	US\$245m
Sep	Windstorm	Gulf of Mexico Platform	US\$250m
Sep	Windstorm	Gulf of Mexico Platform	US\$28m
Sep	Windstorm	Gulf of Mexico Platform	US\$207m
Sep	Windstorm	Gulf of Mexico Platform	US\$31m
Sep	Windstorm	Gulf of Mexico Jack-up	US\$65m
Sep	Windstorm	Gulf of Mexico Platform	US\$80m

The effect of any self-insured retention is not taken into account and therefore losses are not necessarily those which insurance markets have actually suffered but give a rough guide to the overall magnitude of industry loss.

## Onshore energy review

The Onshore sector entered 2004 continuing the trend of the significant reductions seen in 2003. However, January saw two major losses: the Santos Moomba gas plant explosion in Australia and the Sonatrech LNG plant loss in Algeria. This had an immediate impact in the first quarter of the year, but after 1 April underwriters were unable to stop the tide and there was a return to a softening market.

There was significant competition particularly from local markets in Asia, with reductions of up to 40% being seen. Whilst for offshore cover London and Europe are the acknowledged main markets, for onshore risks Asian and US (re)insurers can and do compete. The London market was not prepared to follow the Asian and US markets down that far, but overall rate reductions of perhaps 20% were seen over the year.

There were no significant changes in onshore capacity and retentions remained at similar levels, the biggest adjustments having been made in 2002 and 2003.

## Other areas

### Drilling contractors

2004 saw underwriters resisting giving headline rate reductions, but giving cost savings linked to profitability and long-term commitment. Whilst larger retentions and rating levels have made the book sustainable, losses during the year have increased with Hurricane Ivan doubling the quantum in one event. The effect of this was to stall any further cost savings and put pressure on exposures in the Gulf of Mexico.

### Offshore construction

The rating environment has seen little change over the course of 2004. Underwriters have not been prepared to reduce rates. The market involves a limited number of insurers, who have a firm idea of where their business should be pitched. There have been no changes in deductibles.

Wellington and Munich Re continue to dominate the offshore construction arena, although capacity has been eased by the construction coverage offered by OIL.

### Control of Well

“Stand-alone” and “Single Well” programmes continue to struggle for enough capacity to generate any real competition on rating. Generally insurers are keeping an eye on losses that they fear may occur from increased drilling activity together with ever-deeper water depths and target reservoir depths.

### Mutuals

OIL and its sister company sEnergy, which provides Business Interruption coverage, continued to grow and are expanding into other markets such as Pharmaceuticals.

However, they also sustained large losses in 2004, with estimated claims of over US\$1bn in 2004, including US\$394m from Hurricane Ivan. These losses mean that OIL will increase premiums by approximately 45% in line with their five year ‘post loss funding’ mechanisms. sEnergy is also likely to suffer a US\$200m claim from a Canadian oil sands Business Interruption loss that occurred in the first week of 2005.

### Terrorism

Underwriters are providing coverage on a limited basis as part of the softening market. Onshore energy terrorism cover remains a specialist market with significant capacity. OIL does not have terrorism exclusions, which partly explains its popularity with oil companies.

### Outlook for 2005

Generally, most buyers have paid significant premium increases since 2001.

Despite the effect of Hurricane Ivan and the significant onshore losses early in 2004, the market is still capacity driven rather than loss driven (at least until results are consistently bad). The losses of 2004 may have effectively blown away the entire annual Energy premium to the market (on a gross basis), but many will see 2004 as a particularly bad year, meaning that current rating levels should still provide profitable underwriting in an “average” loss year. Therefore insurers will be under increasing pressure as the year progresses to lower rates in certain areas.

However there is no doubt that underwriters were also unsettled by Ivan, with the general view that losses could have been much worse had the hurricane taken a slightly different trajectory through more densely populated lease blocks. It has also focused underwriters’ minds on the Business Interruption and Contingent Business Interruption elements, which made up so much of the ultimate losses.

Accounts with Gulf of Mexico exposures are already under immense pressure for increases in rates as perhaps are other catastrophe-prone exposed areas. Underwriters may also start favouring opportunities in non-catastrophe areas, spreading their risks further afield to West Africa, South America, the Arabian Gulf or the countries of the former USSR, which would result in a capacity reduction in catastrophe areas and resultant upwards pressure on rates. The Lloyd’s Franchise Board will also look to work with Lloyd’s syndicates to keep rates up.

## Financial & Professional

### Directors’ & Officers’

The D&O market has an estimated global premium of US\$8bn. However there are an estimated 2,000 outstanding US securities class action claims on insurers’ books which could create up to US\$18bn of unpaid professional liability claims. These include laddering exposures (investment banks’ allocation and pricing of shares in Initial Public Offerings [IPOs]) and the fall out from the collapse of Enron.

There are also consistently around 200 US filings a year (212 filings in 2004 against 181 in 2003) alleging Class Action Securities Fraud. Notable filings last year included ones against Parmalat, Shell, Marsh & McLennan, Nokia and Adecco. Settlements also continue to be significant, examples being Tyco which settled last year for US\$300m with insurers paying US\$280m and McKesson settling in January 2005 for US\$960m. Overall, there could be some 50 or so claims outstanding which have the potential to be “mega” settlements in excess of US\$100m.

Contributing to that factor is the decline of market capitalisation of affected companies, which increases the loss suffered by shareholders.

### Pricing

The vast increases seen in D&O rates in 2002/2003 came to an unceremonious end last year. Instead, the market saw downward pricing pressures for both US and international (non-US) risks.

Indeed, the decline in pricing for US risks took observers by surprise. Although largely a consequence of aggressive new capacity and a reaction to previous rate increases, it nevertheless appeared to defy logic.

A reality check, of sorts, did materialise towards the end of the year with a levelling off of reductions. Nevertheless, it was not unusual for programmes with US-exposed risks to see rates down at least 20-25% on the higher excess layers in 2004, with smaller reductions on the primary layers.

Rates for companies with no US shareholder base also softened markedly last year due to low claims activity and increased competition amongst carriers for these risks.

### Capacity

Insurers are continuing to resist enhancements to policy language beyond core coverage requirements and there continues to be a trend to limit entity coverage on D&O policies. The main area of contention for D&O cover in Europe is the insured vs insured exclusion, or lack of it. Due to corporate structures in Europe it is important that some element of this cover is given under the policy or the main source of claims will be excluded.

Market appetite for D&O risks continues to vary between different industries. Pharmaceutical and telecommunications companies remain the most difficult, because of poor claims histories with the latter experiencing greater capacity issues through the collapse of the Pender Mutual.

One of the sectors most exposed to US shareholder activism is Financial Institutions cover. This remains challenging and especially so for any client with a US presence. Limited capacity means large retentions and co-insurance through the programme.

Lower claims than expected occurred from the "late trading" scandal which infected US Mutual Funds in early 2004. This good news, however, is tempered slightly by concerns over the impact of the second stage of Sarbanes-Oxley later this year.

### Coverage

Retentions remain high, particularly so for US-exposed clients, although it was also noticeable that companies were seeking to buy bigger limits. This was particularly prevalent with "A side" cover that protects directors only when the company cannot or is unable to indemnify. The likes of Enron and, in the UK, Equitable Life, where former directors face potential bankruptcy for negligence claims, has reminded directors of the need for additional cover. There are also policies in the US purely for non-executive directors that have yet to become available in

Europe. Heightened regulatory interest in corporate governance, together with a culture of shareholder activism on both sides of the Atlantic, continues to create strong demand for cover.

### Errors & Omissions

As with D&O, the US management liability sector continues to face a legacy of massive losses. However, as a whole the E&O sector did not experience quite the sharp increases as the D&O sector pre-2004.

### Pricing

Nonetheless, reductions were again notable last year. As with D&O, falls were most pronounced on the excess layers where pricing has fallen to around 60% of the underlying layer's pricing (last year we noted that this was around 70-80%).

Other problem areas include Accountants' indemnity where capacity remains very tight; and insurance brokers. Here the market tends to divide between London Market (Lloyd's) brokers where pricing remains firm and non-Lloyd's brokers, where there is greater movement. There is little capacity for providing insolvency cover which indemnifies brokers in the event they place business with insurers who subsequently become insolvent.

Pricing generally remained flat for Solicitors'/Attorneys' cover in both the UK and US. Multi-year contracts are scarce but three and six month extensions have been noted.

### Capacity

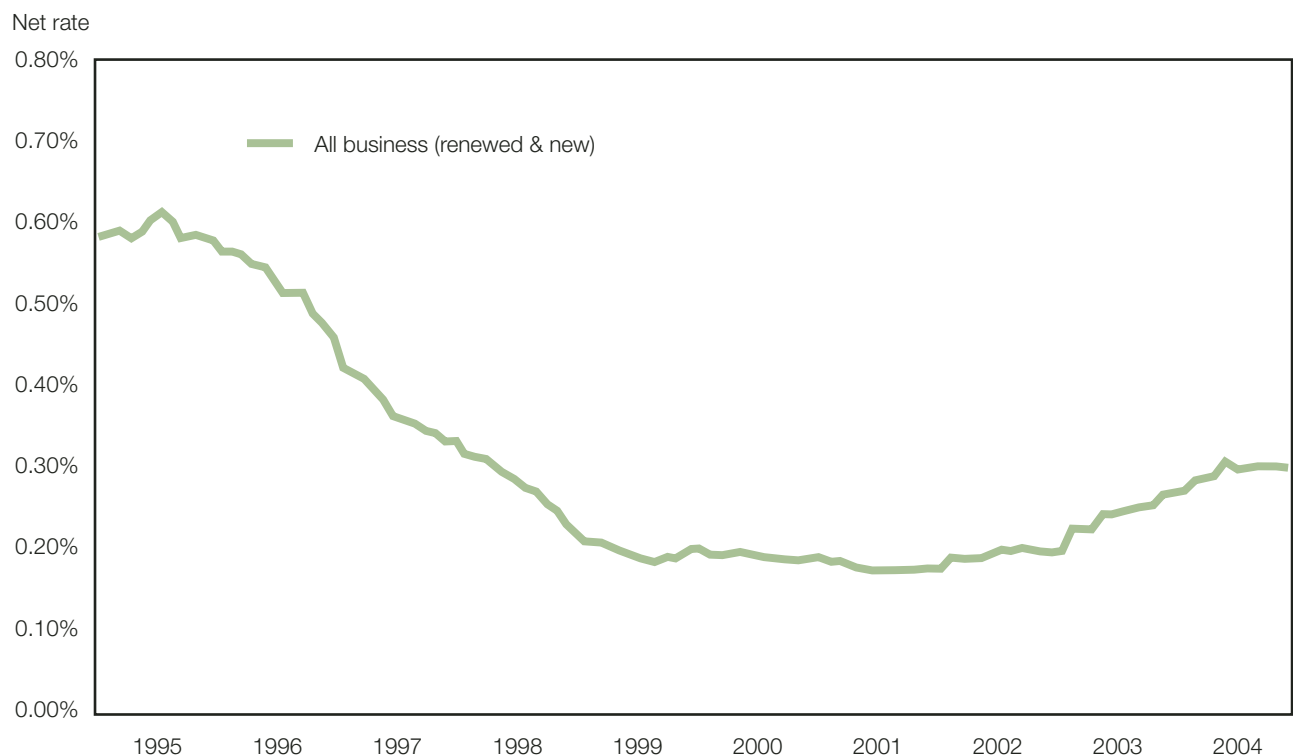
Capacity continued to come on-stream in 2004 and indeed contributed to the pricing pressures felt throughout many professional lines. Limited capacity remains for sectors with weak loss records, such as financial institutions, but even here there is more availability of cover than a year earlier.

Bermudian insurers, with aggressive budgets and who are free from legacy issues, continue to impact the market.

### Employment Practices Liability

There was a notable increase in demand for Employment Practices Liability (EPL) cover reflecting the growing awareness of high profile and expensive claims by employees against their employers. This was particularly so for companies with US employees.

## CEFOR (Norwegian market) hull rates at 31 December 2004 12 month moving averages



## Marine

### Hull & Machinery

An abundance of marine reinsurance cover, new capacity and an increasingly fragmented marine insurance market contributed to a continuing struggle for underwriters to increase rates in 2004.

### Pricing

These factors enabled shipowners to play the markets off against each other. As in the previous year, differential pricing in the international marine markets drove changes in percentage market shares towards the cheaper markets. Therefore in many cases, the assured ended up paying no extra, even though some markets charged an increase.

The Norwegian and London markets generally continued to be the most competitive for international business, with the French and US markets less aggressive than they were in 2003.

Overall average rate increases for the year were between 0-5%, representing a softening, though not yet soft, market.

### Capacity

Despite the inability of insurers to significantly raise rates, the market continues to be attractive for them. This is in part due to the fragmented nature of the market, which leaves plenty of opportunities for writing new business.

With only modest price increases in the previous year, many 2004 premium income targets were revised downwards, allowing marine underwriters the luxury of being more selective in the business they underwrote.

But this was tempered by the entrance of new capital and the movement of some underwriting teams between insurers, including Nick Metcalfe and William Beveridge, who transferred from XL London Market to Arch. The competition for new business put the brakes on the ability of existing insurers to charge more.

Whilst remaining conservative in its underwriting style, the Japanese market also expanded, seeking more international business due to pressure from ratings agencies to diversify. Mitsui Sumitomo led the way, with Sampo and Tokio Marine also involved.

## Disbursements and/or Increased Value

The market for this business continues to be flat, despite a high level of competition and ample capacity.

## Marine War risks

With the large rate increases in the immediate aftermath of 11 September 2001 and the subsequent additional Breach of Warranty voyage premiums charged as a result of the Gulf conflict, the market for war risks is highly competitive.

In 2004 the big premium volumes budgeted for Arabian Gulf and terrorism in marine accounts were never fully realised, as the market clamoured to write as much business as possible. Big discounts were offered from 'standard' rates, particularly in the war hull class.

As a result, rates dropped by as much as 25-40%, depending on the individual risk.

## Marine Business Interruption/Loss of Hire

The story in this sub-class is similar to 2003/2004, with a relatively small number of niche Business Interruption providers in the marine market. As a result capacity is extremely limited compared to other marine classes.

One explanation for the situation is the mismatch between the buyer's perception of risk and that of the insurers of this class.

Most demand for the product tends to derive from the German and Norwegian markets, with protection of cash flow seemingly higher up the agenda. The Norwegian insurance market remains the leading supplier of Loss of Hire cover.

## Marine Builders' Risks

Following a number of high profile cruise ship incidents and Typhoon Maemi losses in South Korea in 2003, the Norwegian and London market Builders' Risks class saw rate rises of anything up to 300% in 2004. This was accompanied by a paradigm shift in underwriters' views on safety. A Joint Hull survey requirement was introduced demanding increased risk prevention and loss controls.

The non-cruise segment of the market has suffered considerably less severe losses, but was tarred with the same brush as underwriters increased rates across the board.

Decreased capacity from fewer players in the market enabled underwriters to take more control on rates, as well as terms and conditions. Deductibles have also been increased, in many cases to mitigate the premium increases being demanded.

## Ports and Terminals

The seemingly insatiable appetite for container capacity is driving expansion and consolidation in the industry. The larger operators continue to grow through purchase of existing operations or by engaging in Port Management and Build Operate Transfer Contracts.

The requirement for substantial levels of cover in respect of Property and Business Interruption exposures, along with terrorism coverage, is becoming the dominant factor in choice of insurer for these large operators. The Through Transport Club, Navigators and the Wavelength Ports facility within Lloyd's lead this market. However, insurers remain sensitive to and limit cover for property and handling equipment risks in high catastrophe risk areas.

Where property risks are not a dominant feature, there is a greater choice of markets and healthy competition exists.

## Protection & Indemnity (P&I)

The International Group of Protection & Indemnity Clubs continue to dominate the P&I market, covering some 95% of the world's tonnage.

The 2003/2004 P&I year saw a return of significant investment and foreign exchange gains for the clubs. This was a welcome bonus as, despite a third consecutive year of pure underwriting surplus, the club's increasing expenses of US\$292m turned that surplus to a deficit for the year of US\$215m. Investment returns transformed this deficit into a US\$483m surplus; the first time that the clubs had made an aggregate surplus in the last five years.

For the 2004/2005 policy year investment returns have been modest (3.6%) with nearly all positive returns coming from the final quarter of 2004. The current flat investment environment makes it difficult for P&I clubs to rely on such income to cover their management expenses, which has been a core intention over the last 15 years.

In addition, the increased claims experience of 2003/2004, which resulted in net claims of US\$1.59bn, was expected to continue in 2004/2005. Increasing levels

of shipping activity correlate with increasing claims. This trend is unlikely to change in the near future and indeed may be exacerbated by revised international conventions on the limitations shipowners can place on their liabilities. Amendments to the 1976 Limitation Convention came into force in May 2004, resulting in greatly increased the limits of liability for shipowners for loss of life or property. Meanwhile, the adoption of the 2002 Protocol to the Athens Convention also raised the limit of liability relating to the carriage of passengers and their luggage.

The clubs' 2003/2004 aggregated combined ratio of 113% indicated that, at current claims levels, net premium across the whole Group needed to rise by 13% to break even.

As a result the majority of clubs have announced General Increases for the 2005/2006 year in the order of 7.5-12.5%. The question is, in the absence of significant investment returns and a potentially deteriorating claims environment, will this level of rise be sufficient? A growing need to satisfy the requirements of rating agencies and regulators means that clubs will be reluctant to fund any further deficit by dipping into their reserves, whilst the threat of supplementary calls would be unpopular with the membership.

From 20 February 2005 the amount each club retains (before the Group's pooling arrangements and the International Group Reinsurance Contract cut in) will increase from US\$5m to US\$6m. This follows changes to the upper level of club pooling for the 2004/2005 policy year, from US\$30m to US\$50m. It is also likely that plans to formalise a Group captive "Hydra" for claims in the US\$30m to US\$50m layer will be realised by

20 February 2005 (please see P&I reinsurance section for further details on this and the effects of the International Group, Reinsurance Contract renewal).

All of these developments, aimed towards greater sharing of risk at higher levels, is likely to lead to more pressure on clubs to be selective in the consideration of vessels for entry and place greater emphasis on and the sharing of information between the clubs.

## The market in 2005

No significant change is expected in the market dynamics for marine insurance. The Asian tsunami has had a minimal effect on shipping. There also appears to be a limited correlation between increases in freight rates and changes in terms or conditions.

Selective underwriting appears to be the watchword for the year ahead, with no sign of significant mandatory increases on premium projections in insurers' business plans. The market shows no desire for changes in wordings.

Shipping values continue to rise, driven by increases in freight rates and ship owners have experienced rating adjustments for this.

In shipbuilding, plenty of capacity remains to cover high levels of construction, with the only potential capacity shortage arising in cover for cruise ships.

## P&I International Group Clubs underwriting surplus/deficit

Financial year	Pure underwriting surplus/(deficit)	Expenses	Investment income and tax	Surplus/(deficit)
1999 – 2000	US\$(188,200)	US\$(228,585)	US\$318,450	US\$(98,335)
2000 – 2001	US\$(76,301)	US\$(206,799)	US\$43,638	US\$(239,462)
2001 – 2002	US\$81,795	US\$(226,744)	US\$(56,230)	US\$(201,179)
2002 – 2003	US\$7,498	US\$(245,665)	US\$153,201	US\$(84,966)
2003 – 2004	US\$77,032	US\$(292,259)	US\$688,060	US\$472,833
Total five years	US\$98,176	US\$(1,200,052)	US\$1,147,119	US\$(151,109)

Figures in US\$'000's.  
Investment Income includes realised and unrealised investments.

## Medical Malpractice

Following the tough conditions of 2003, the US healthcare business has become more stable in terms of both premium levels and retentions. With underwriters initially seeking inflationary-based increases only, accounts are now generally renewed on an “as before” basis with some instances of premium reductions, although these often involve a change in the structure of the placement. We have even witnessed a two year deal being put in place on a non-cancellable basis with pre-agreed terms for the second year.

In selected US States tort reform has had an impact on attachment point, for example in Texas where tort reform has been written into the constitution, underwriters are looking more favourably upon attachment points for such risks. Elsewhere insurers are still waiting to see what effects tort reform will have on the claim record before making their move.

## Pricing

Pricing is stable except for the physician area where doctors are still facing significant increases. Many doctor groups are forming risk retention groups and seeking reinsurance, not necessarily to beat the premiums quoted by their carrier, but more to stabilise premiums in the long-term to avoid the vagaries of the insurance cycle.

## Capacity

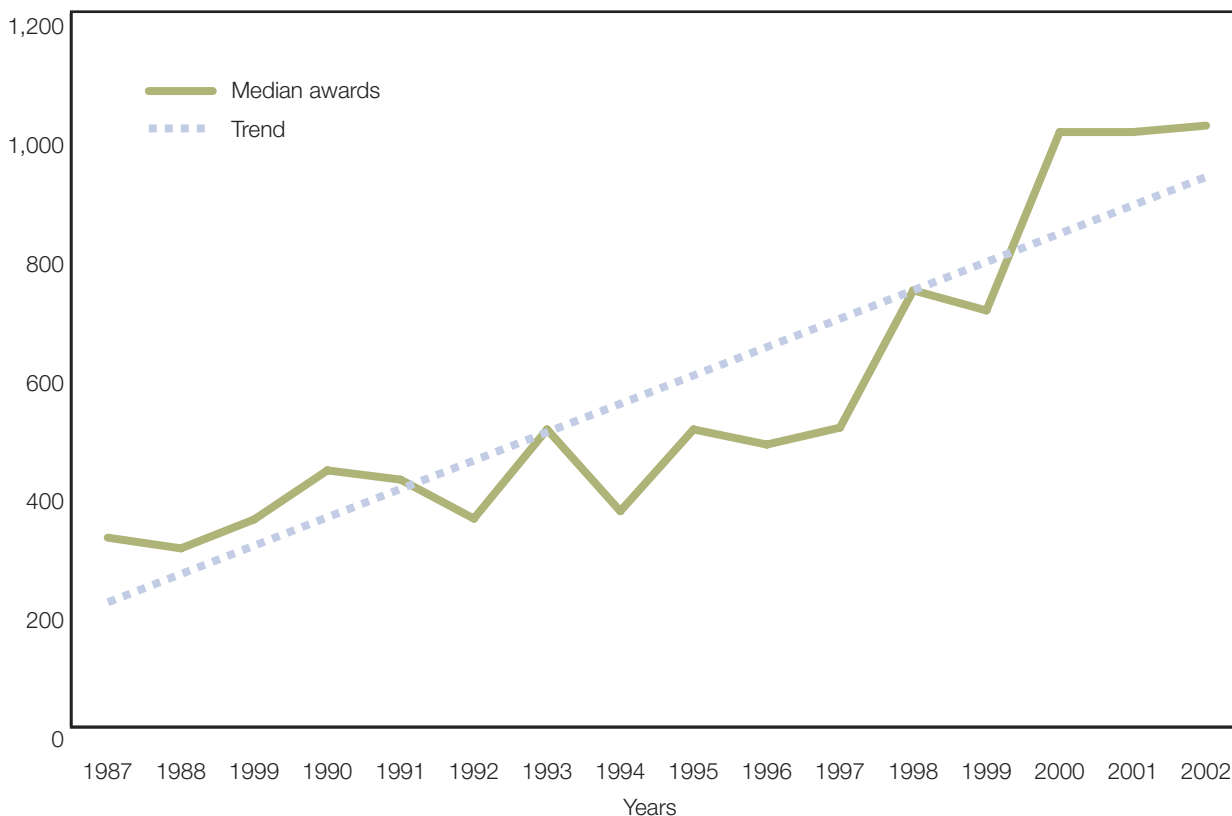
The new (re)insurers in the US and Bermuda are now firmly established, which together with continued strong participation from London and Europe, means there is sufficient capacity to satisfy buyers.

At the forefront in Bermuda are markets such as AWAC, Endurance, Max Re, Renaissance Re and XL. In Europe the participants are Lloyd's, Hannover Re, Swiss Re, Lexington, Aspen Re and ALEA.

In addition the traditional medical malpractice carriers such as ERC, CNA, Lexington and Zurich augmented by the new, but now established carriers such as OneBeacon, ARCH, ACE, Munich American Risk

### US median medical malpractice awards

Awards (US\$'000)



Source: Jury Verdict Research

Partners and Berkley provide meaningful capacity. Many buyers seek a combination of London, US and Bermudian markets on their placement.

For international business the story is similar although different territories bring their own challenges for insurers. In comparison to US rates the international rates and retentions are modest. Insurers such as Marketform continue to dominate, but others are testing the water to determine whether they can underwrite profitably in this area. Lloyd's, Chubb and MPLC are amongst the growing number of international insurers.

## Coverage

There hasn't been much movement on policy forms as far as broadening of coverage is concerned although isolated instances can be reported. Coverage is still on a "claims made" basis and even ERC, a major exponent of "occurrence" coverage, is trying its hardest to move its portfolio to a "claims made" basis. One area that needs to be addressed in all policy form discussions is the growing number of inter-related or "batch" claims that hospitals and physicians are facing. These are claims for more than one medical operation, but which involve related issues.

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## Political and Credit risk

The post-9/11 years were a barren time for the political and credit insurance sector as foreign trade and investment slowed down, capacity dried up and the legacies of the Argentina debt crisis continued to cause great uncertainty.

2004, however, saw a welcome return of meaningful capacity to the sector combined with an increased willingness by insurers to support substantial trade projects. This capacity came from new entrants such as Quanta, Hardy Underwriting Group and Atradius, as well as from the existing market. Many of these existing insurers had either shrunk or withdrawn their capacity in 2002/2003 as they concentrated on the perceived higher yielding, conventional Property and Casualty lines. The price weakening seen in Property and more recently Casualty, has encouraged insurers to again devote more support to this sector, where pricing continues to be consistent.

## Political risks

This new capacity coincided with an upturn in foreign trade and investment. Typically, the lending banks make up around 70% of the market for political risk cover; the more trade projects they support the greater demand for insurance cover.

In addition, much of the legacy of the Argentina crisis was resolved. When Argentina defaulted on its debt repayments to the World Bank on 14 November 2002, it sparked an economic collapse and an estimated US\$4bn of political risk and credit claims. This was far higher than the losses seen from the Asian and Russian economic problems of 1998/1999.

However, not all of these claims fulfilled the traditional criteria of political risk coverage, leading to a mismatch of expectations between the cover banks thought they had purchased and what those policies actually covered. Whilst insurers paid almost all political risk claims arising from lendings to Argentine state institutions and all claims arising from trade/lending with private companies, they were more circumspect on some private utility debt obligations covered under "Lender's Interest" policies. This is because political risk insurance only covers default of a private company where the default can clearly and unambiguously be traced back to the defined "political" risks set out in the policy's insuring agreements. At times the distinction between what is or is not deemed to be a "political" risk can be very unclear. The lessons from Argentina demonstrate that there is a need to broaden the coverage so that all defaults generally attributable to country economic difficulties are covered. As a result potential claims of US\$4bn translated into actual claims in the region of US\$600m.

There are other opportunities for the sector in the year ahead. The perceived bureaucracy of the Export Credits Guarantee Department (ECGD) for UK exports, means the private market will continue to be regarded as an alternative for credit insurance.

Planned project finance developments in Libya will also generate demand for both political risk and credit insurance. In contrast the chaos in large parts of Iraq makes insurers very wary and only if stability returns to the country will insurers provide meaningful capacity.

## Credit insurance

For credit insurance, one of the greatest opportunities for the sector is provided by the Basle II accord concerning the regulatory regime for financial institutions. Under the current rules, banks cannot use their credit (and political) insurance for relief against capital adequacy. They will, however, be able to do so under Basle II from 2007. That creates the opportunity for a significant uplift in demand from the lending banks. However they will only be able to do so if the insurance fulfils certain criteria, in particular that there is nothing in the policy which gives underwriters the ability to void cover that isn't in the control of the assured. There are long-established political risk exclusions that are clearly outside of the assured's control (such as war between the five great powers, nuclear, etc.) that will therefore need to be amended.

If the market can be persuaded to address these issues, it could potentially open up a significant new area in which the insurance market can participate and provide a product with value and demand.

Looking forward to the year ahead, the sector is likely to benefit from the continued influx of capital and upturn in world trade.

### Pricing

Overall, yields remain firm and with the Argentina losses so fresh in the memory, together with the difficulties experienced in the telecommunications sector, insurers appear reluctant to chase down rates.

There is a clear differentiation between rates for short-term business (up to 36 months) and rates for medium-term (60 months) or long-term (above 60 months) business. In general, it is true to say that the market is very soft for short-term business, moderately firm for medium-term business and still moderately hard for long-term business. All areas, though, are softening with the increase in capacity, new entrants and improving results.

### Capacity

As noted, capacity is much more prevalent following the difficult years of 2002/2003. Both the limits and the terms for cover have broadened, but there is significantly less capacity available for the longer-term projects.

For instance, in political risk there is significant capacity for projects up to five years (US\$250m) but much less

(and no Lloyd's capacity) for longer-term transactions above 60 months. For credit insurance, 24 month terms and below are in plentiful supply but the market is significantly firmer for 24 months and above.

## Property

### Global programmes

Rates in the global Property market continued to weaken. Despite insurers' attempts to hold up the slide, the market is now freely accepting reductions, almost across the board. The fact that underwriters are prepared to offer longer-term deals is an indication of the market's thinking. The hurricanes have had a surprisingly limited impact on overall global Property rates.

There remains a strong appetite with plenty of supply lines for good quality risk-managed accounts. Bermuda has shown particular enthusiasm for major corporate business emanating from UK and continental Europe, with a number of these Bermuda based insurers (including Arch, Axis and Endurance) accessing business through London market operations.

With financial strength ratings gradually creeping up, a wider pool of underwriters is becoming more acceptable to clients and facultative buyers of reinsurance. This, together with new capital in the market, is increasing competition and compounding downward pressure on rates.

In the market's favour, catastrophe perils such as Florida and Caribbean storms and California Earthquake have been one area where rates have shown less decline. Also the tightening seen in Contingent Business Interruption risks in previous years has been largely maintained.

Underwriters are additionally benefiting both from the quality of underwriting information being provided, allowing them to make more informed decisions; and the generally increased standards of risk management. Indeed the higher self-insured retentions imposed during the hard market have changed the mindset of buyers. They now feel comfortable managing such levels of risk and few have taken the opportunity to lower their deductibles, despite softer market conditions. Price has been and remains the overriding driver in the market.

There has been a divergence between the treaty reinsurance and primary markets, leading to pressure on the direct market to increase its retentions to avoid squeezing profits further.

### Coverage

Wordings were fairly stable in 2004, as underwriters tried to maintain discipline, although there was slightly less intransigence over terms of cover and restrictions. Underwriters are likely to adopt the same approach during 2005, although their position will undoubtedly come under increasing pressure.

### Pricing

Typically reductions of 10-30% were experienced during 2004, although reductions at the upper end of this range were more rare. For 2005, reductions of 10-20% are predicted, depending on risk profile, the treatment post-9/11 and the extent of any remarketing activities.

### Terrorism

Despite the possibility that TRIA will be extended through to 2006, the uptake for cover has been moderate, with buoyant levels of capacity available in the open market.

In the UK, a number of Lloyd's syndicates have pulled out of the domestic terrorism backstop Pool Re. They joined Pool Re to write then attractive UK Property business, but the subsequent fall in rates has made the market less attractive, with more lucrative opportunities of writing UK terrorism risks on an open market basis (members of Pool Re are precluded from writing this business).

Coverage enhancements are also becoming available. With T3 and T3a wordings open to amendment, terrorism cover has been blended with some political risk covers. Pool Re "wraps" are also available, topping up cover for assureds vulnerable to attacks not covered under the Pool Re stipulation that an incident must be an act against government. Examples of this are pharmaceutical companies seeking cover against the actions of animal rights activists.

### International Property and Power

In 2004, Property rates in most regions came under further pressure following the reductions which began in 2003.

Again, plentiful capacity contributed to the price falls although, after three strong underwriting years, many insurers appear resigned to the fact that they have to accept some reductions to maintain the prestige accounts. Generally rates reduced by between 10% and 30% in 2004, with Power and Utility rates typically seeing 15-25% drops whilst other areas experienced 10-15% reductions.

The return to strength of many local markets, together with the continuing appetite of wholesale markets such as London and Bermuda (which has become an increasingly significant player following the post-9/11 start-ups), means capacity will again be in plentiful supply for most risks in 2005. As a rule, 2004 reductions tended to be more pronounced among the larger premium risks, with underwriters reluctant to lose business of significant volume. These trends are expected to continue through 2005.

Only in loss specific regions, such as Eastern US, the Caribbean and parts of Asia, or on programmes with exceptionally poor claims histories, is the tide being stemmed. Nonetheless, it is testament to the durability of the industry (and for that matter the levels of capital in play) that most insurers' balance sheets will not be impaired, despite the heavy natural catastrophe losses.

Local insurance markets re-emerged in 2004, with a noticeable impact on orders to London and elsewhere:

#### *Asia*

Asian markets continue to be very competitive and capacity has grown, both through local players and the participation of the large European insurers on the ground. Rates are expected to decline by a further 10-20% in 2005.

#### *Australasia*

Confidence locally is growing and rates are expected to come under further pressure in 2005.

#### *Latin America*

Rate reductions are slowing and there is always a requirement for the international markets to participate due to the limited capacity available locally.

### Coverage

There has been less movement in terms of wordings or deductibles, although there was some easing of Business Interruption clauses and deductibles (something insurers have resisted in earlier years). Catastrophe limits also increased, although to levels which insurers appear comfortable with.

## Pricing

Most programmes experienced falls in 2004. In general, international (non-US) business saw declines of 10-30% last year with Power and Utility firms tending to see larger reductions than most.

European business possibly experienced smaller falls, explained by the fact the area didn't see the same rate increases as other regions in 2001 and 2002.

Notwithstanding the South-East Asian tsunami, rates in most parts of Asia are expected to come under further pressure following reductions which began last year.

In the US, rate reductions were experienced throughout 2004 and the hurricanes did little other than to stall declines in affected areas (i.e. South-East US and the Caribbean).

## US Property and Power

2004 saw significant reductions in Property rates. Risks with reasonable loss records experience reductions of 20-30%. During 2005 the trend is expected to moderate, so that rate decreases of up to 15% may be seen. The Power and Utility sector was slightly less soft and reductions of 8-10% may be seen in 2005.

## Coverage

There has not been much change in coverage. Although some buyers have succeeded in reducing their retentions, underwriters have generally attempted to resist this. There is continued resistance to reducing Business Interruption waiting periods.

## Capacity

Capacity is plentiful but with no significant changes other than Max Re and Quanta in Bermuda entering the fray in late 2004.

## Terrorism

With TRIA renewal creating uncertainty, some insurers are offering terrorism cover on renewals, often as options, for the period of the policy after TRIA expires. However limits apply, particularly as more Lloyd's syndicates can only write this cover on a net basis as they have no treaty protection in place for such cover. At this stage European markets are not providing this extension.



## Aviation reinsurance

### Coverage and Pricing

In commercial terms the pressure created by the US terrorism losses has continued to ease and an unprecedented period of low claims activity has inevitably lead to a softening in the market.

Risks Attaching (LORA) cover which had been difficult to obtain in the past has regained popularity as price and availability have improved with most buyers switching away from Losses Occurring During (LOD) programmes. Rate reductions of around 10% at the start of 2004, became circa 15% at 2005 renewal. Some cedants have taken advantage of these conditions and bought more primary cover, albeit for Lloyd's syndicates the Lloyd's Franchise Board continues to monitor the ratio between gross and net line retentions.

Rate movement in the retrocession market was rather more modest with reductions of up to 7.5% and General Aviation non-airline excess of loss business held firm except in cases where a significant reduction in exposure was clearly demonstrated.

Some reinsurers have tended towards proportional (quota share) business, realising that perhaps rates in the non-proportional (excess of loss) book have dropped further than the original, direct business.

### Capacity

London and Europe are still the leading markets, where perhaps as a consequence of the softening in the market, there is somewhat more capacity available below US\$500m Original Loss. The Bermudian and US markets continue to prefer the mid to upper levels on both general and retrocession programmes.

A strong credit rating remains essential but even then some cedants continue to require reinsurers to securitise their participation.

There were two high profile changes in the Aviation reinsurance market during 2004. Mario Montelatici, formerly Converium's Head of Aviation, is to join Sirius International, which is now part of Bermuda's White Mountains Group; and Robbie Klaus, previously with ERC Frankona, is heading up the new operation, Glacier Re.

### Renewals

Many cedants have aligned their reinsurance renewals to their incoming book of Airline business, 75% of which now renews during the last two months of each year. As a consequence, less than 50% of reinsurance programmes are now renewed at the traditional 1 January date.

Risk and exposure modelling techniques are now common throughout the insurance and reinsurance markets for both underwriters and brokers.

Overall, policy terms and conditions remained largely unchanged with asbestos exclusions now standard. However changes are expected in war coverage with the US Terrorism Risk Insurance Act (TRIA), due to expire at the end of 2005.

### Space

There is no real sign of weakening in the direct market with average rates at 19% for "Launch" and 2.4% for "In Orbit". Policy periods, terms and capacity remain tightly controlled.

2003 saw a much needed return to profit with loss ratios in single figures but 2004 has ended disappointingly. With three "In Orbit" losses and several launches slipping into the New Year, an overall market loss ratio of 60-70% is generally anticipated.

For the period 1994 to 2004 the market is at break even and so rates are likely to stay firm in 2005. However, some of the larger satellite operators may well move towards co-insurance or self-insurance and this could bring some downward pressure on pricing.

The Satellite excess of loss market remains very restricted with perhaps only 10 underwriters and there is no sign of any real increase in capacity or possibility of rates reducing.

Although some quota share treaty cedants have increased commissions for 2005, those with better results than the overall market should continue to attract good quality reinsurers.

## Marine and Energy reinsurance

The devastation caused by Hurricane Ivan, which tore through the Gulf of Mexico whilst much of the industry gathered at the Monte Carlo Reinsurance *Rendez-Vous* in September, was the defining feature of 2004.

It was the largest-ever insured energy catastrophe claim, causing over US\$2bn of losses, with between US\$1.2bn and US\$1.3bn expected to sit with energy reinsurers.

One consequence of Ivan, however, was to remove the downward pricing pressures that had developed throughout the first half of 2004. Reinsurers had begun the year by maintaining firm pricing, although restructuring of programmes in some cases did obtain reductions and cedants generally retained more risk. As the months progressed however, it was clear that buyers, often facing declining returns in their primary markets, were insisting on reductions.

In the wake of the hurricane season, rates for international energy business began to climb, with programmes affected by the Ivan loss often seeing rate rises of 10-15% (and up to 30% on particular layers) at 1 January 2005 renewals. Even non-affected Ivan business was flat at renewal and it often required some programme restructuring to ensure no rate increases were experienced. Many of the increases were experienced higher up the programmes. There is, however, greater stability in the working layers. For the direct energy writers it creates a difficult market where they face being squeezed by declining rates on the front end and yet higher reinsurance costs.

Onshore energy, which as a sector was unaffected by Ivan, saw more of a mixed picture. Overall, however, rates were also up following some big losses in 2004. For pure marine, the picture is also weaker although again Ivan did relieve some of the downward pressure that mounted in 2004. Nonetheless, this market is expected to weaken in 2005 for most marine lines, including hull and cargo. However, proportional capacity remains quite scarce.

## Retentions

The steep rate rises seen between 2001 and 2003 provoked some insurers to increase their retentions, sometimes to very high levels. Whilst the market is profitable, why cede business and share those profits with others? Not only were buyers deterred by the price environment, but capacity shortages and a feeling that too much unnecessary cover was purchased in the aftermath of the 11 September attacks had also encouraged primary writers to cede less business.

Ivan also inspired discussions for the need to restructure their claims modelling and to purchase more catastrophe cover. But in practice this often didn't materialise again, in part, a reflection of the rate increases buyers experienced.

In contrast to Ivan, the South-East Asia tsunami had little impact on the sector, and made no notable impact upon either pricing or terms. It may, however, dampen pressure for rate cuts in Asian business in 2005.

Security concerns remain especially important although, as with the reinsurance industry as a whole, this has not led to variations in pricing. Downgrade clauses, which often include the requirement by reinsurers to collateralise their exposures in the event of a downgrade by the rating agencies, are becoming increasingly prevalent, despite reluctance by reinsurers to agree to them.

## Coverage

Terms and conditions remain stable. The Chemical, Biological, Bio-Chemistry & Electromagnetic Weapons exclusion clause (CL 370) remains widely imposed.

Uncertainty over the TRIA extension is causing some concern.

## Capacity

Overall, capacity remains fairly constant. Proportional cover is more restrictive, especially in certain energy lines, but was more available in 2004 than in earlier years.

Reinsurance start-up Glacier Re was formed in December 2004 with a high profile underwriting team and ambitious business plans. Its one handicap is a relatively small capital base (US\$300m), which may deter some cedants, despite its strong financial rating.

New hedge fund capacity is unlikely to make much impact in 2005, with most funds focusing attention on non-marine risks.

## Non-marine reinsurance Casualty

Overall, it was a relatively stable renewal season with reinsurers reluctant to agree to reductions despite growing pressure from clients who have experienced rate reductions on many international direct Casualty lines. This disparity with the direct market is likely to test reinsurers in 2005.

Greater downward pressures were felt on professional lines and Workers' Compensation catastrophe business, which typically saw reductions of 10%, whilst in contrast motor experienced increases. However, on the whole 2004 was a year in which Casualty reinsurers held firm. The only real movement in terms and conditions was a slight extension of terrorism coverage as reinsurers gained further understanding of this relatively new peril.

Hard bargaining by reinsurance buyers, however, meant there was a larger than usual change around of lead carriers and participants on programmes at the renewal. Indeed, a growing number of clients were prepared to test historic relationships with reinsurers because they were unhappy with their terms. Others chose to increase their retentions.

New competition primarily came from Bermuda where reinsurers showed willingness in 2004 to grow their Casualty books, but competitive quotations from these markets were in short supply. Bermudian companies also demonstrated an interest in writing quota share business. Despite the downgrades of Converium last year, there was also significant European-based capacity for most standard risks, although interest did not always translate into participation.

In the UK, some uncertainty has been created by the Courts Act which, from 2005, allows the UK courts to deliver awards which provide for continuous payments throughout the lifetime of the plaintiff. Reinsurers have argued this warrants an increase in pricing because the tail has effectively increased – a stance that has understandably vexed the direct markets. A consensus of sorts was reached at renewal with reinsurers giving

cedants until the summer months to help develop a solution. A consensus is also required on the new policy wordings the Act will require, which are being developed by the International Underwriting Association of London.

Uncertainty was also felt in the US on whether TRIA would be extended beyond 2006. Terrorism is the one area where there are some restrictions on capacity and there will be interest in buying more cover if TRIA is not renewed, something the market is gearing up to.

Nuclear, Chemical or Biological (NCB) exposures remain excluded. There were requests for NCB coverage under Workers' Compensation programmes but this has raised issues with parts of the nuclear exclusion clause, which is already on almost every treaty reinsurance contract.

Looking forward, it is difficult to escape the conclusion that rates will continue to be under pressure, despite reinsurers' resolve to maintain discipline. However, many of the macro-economic features that have sustained rates in recent years: low interest rates, legacy exposures, actuarial driven pricing and emphasis on modelling, are still present.

## Non-marine reinsurance Property

It was a year of mixed fortunes for both primary insurers and reinsurers. The benign catastrophe experience of the first six months of 2004 was completely reversed in the latter half of the year as 10 typhoons as well as the Niigata M 6.6 earthquake affected the Japanese mainland. In addition, the exceptional hurricane season had a significant effect upon the net retentions of ceding companies.

Whilst the frequency of these events was unusual in relation to the historical record, the severity was in most cases within the expected range. The damage arising from the four hurricanes that struck the South-Eastern US was comparable in cost to the single event of Hurricane Andrew in 1992.

However, the structure of reinsurance programmes is now such that many of the losses, both in the US and Japan, were absorbed within ceding company retentions. For example, it is estimated that of the typhoon losses suffered by Japanese non-life insurance companies in 2004, only 13.6% of the losses will be recovered from reinsurers.

Despite the fact that these losses have in part stopped the wholesale reduction in reinsurance pricing that was expected to occur at 1 January 2005, many cedants were able to achieve reductions for those programmes not affected by losses.

The continued growth in modelled reinsurance pricing has led to more specific rating in respect of Property catastrophe programmes. Therefore the loss suffered by reinsurers has not led to widespread price increases. Instead the loss activity served to reduce expectations of large price reductions, whilst increasing rates for territories impacted by these loss events. It should be noted that main programmes impacted by the aforementioned events renew at either 1 April in respect of Japan or 1 June/July in respect of mainly Florida exposed programmes. The full effect of these losses on pricing has, therefore, still to be felt.

The increasing use of a very limited number of catastrophe models has again resulted in a narrow range of quoted rates for catastrophe contracts. Those contracts that fall within this acceptable band of pricing

have attracted significant reinsurance capacity, whilst those that do not have often been re-quoted at higher rates in order to secure sufficient support.

The continued uncertainty relating to the extension of the US Terrorism Risk Insurance Act has led to significant growth in the development of alternative insurance markets for this risk. Reinsurance capacity has now increased to the extent where there is the requisite support for cedants' programmes.

### International Proportional

Terms for proportional business improved at 1 January 2005 for those portfolios with attractive loss records and little natural hazard exposure. Commission terms were, in general, stable or increased.

The trend for a move towards excess of loss purchasing continues, especially in those areas with significant natural hazard risks. Reinsurers continue to be unwilling to provide coverage for large catastrophe exposures on some proportional contracts. This often causes problems for ceding companies, especially in the Caribbean, where the specific original income base, combined with the capitalisation of many companies, often cannot support excess of loss reinsurance structures.

With most South-East Asian proportional contracts completed prior to the events of 26 December 2004, any impact of losses to those treaties will not be felt until the 2005/2006 renewal season.

### International Risk Excess of Loss

Property per risk pricing was very much dependent upon exposures and loss history, although for loss-free covers with flat exposures pricing has reduced by up to 10%. More capacity was available at the upper end of programmes, but reinsurers continue to seek a respectable balance between gross limits and cedants' net retentions.

### International Catastrophe Excess of Loss

Pricing for loss-free contracts declined by up to 30% in some areas of South America to only 5-10% in the UK. Most areas that had not suffered losses enjoyed reductions of between 5% and 20%, based upon a similar exposure profile. Capacity was plentiful within the modelled pricing range, although there were limited examples of reinsurers willing to write business outside of this range.

## Catastrophe Excess of Loss pricing trends at 1 January 2005 renewals

Territory	Price movement	Comment
Asia Pacific	-10% to -20%	Most programmes were already placed prior to 26 December 2004 and therefore the pricing effects of the tsunami will be felt at 1 January 2006. The effects of Typhoon Nanmadol in the Philippines have yet to feed through into programme losses but most programmes in this area are subject to a review clause. Much of this area has always relied on proportional reinsurance and enlarged treaty capacity here has led to improved terms for cedants, although catastrophe exposures are often excluded.
Australia	-10%	Limited number of programmes renew at 1 January 2005. Companies purchasing with one free reinstatement due to regulatory requirements.
Caribbean	+10% to +35%	Programmes that suffered losses as a result of the hurricanes were subject to price increases of up to 40%. Much of the Caribbean's catastrophe exposure is reinsured on a proportional basis and as a result ceding commissions have been reduced in those areas impacted by recent losses. Even some loss-free programmes have seen price increases.
E. Europe	-10%	Catastrophe pricing in many parts of Eastern Europe that suffered flood losses in 2002 was already high and the loss-free years of 2003/2004 have allowed for some reductions
France	-10%	After the massive losses incurred in 1999 pricing has steadily reduced as reinsurers achieve payback. Some programmes were heavily oversubscribed, with up to 300% offered by reinsurers.
Germany	-12.5%	Most German companies were able to achieve reductions in pricing of between 10% and 15%. Those companies with regional portfolios that are less exposed to North European windstorm have enjoyed the higher reductions.
Nordic Area	-10%	In general most programmes enjoyed reductions although many reinsurers still view this area as underpriced in terms of its catastrophe exposure. Windstorm Erwin (8-10 January 2005) is expected to result in medium-sized losses in Sweden and the Baltic States which will affect programmes renewing later in 2005.
Latin America	-20%	Competition, primarily local in nature, was again evident on many programmes. A lack of modelled data in this territory has traditionally led to a wider range of pricing options.
UK	Stable to -5%	Most companies were able to achieve reductions in pricing' especially those companies writing a local or specialist portfolio. Recent storms in the UK, whilst not causing substantial losses will, nevertheless, focus reinsurers' minds for major renewals during 2005.
US	-10% to +20%	Pricing varied between loss free programmes and those impacted by the hurricanes. It should be noted that many Florida exposed programmes do not renew until June/July 2005. As is usual, price reductions were varied between truly nationwide exposed companies and those with genuinely regional portfolios.

### US Catastrophe Excess of Loss

Once again the greatest pressure on prices was for specific regional programmes. Loss-free contracts were renewed as before or were subject to reductions of between 5% and 10%. Loss-affected programmes saw

increases of up to 20%. Amendments to pricing were often dependent upon the perceived adequacy of the programme's existing price. Unlike in 2004 there have been no major changes to the main vendor models for 2005, although there was increased focus on Winter Storm and Tornado losses by the modelling companies.

## US Risk Excess of Loss

In general the trend in rating for per risk covers was marginally downward. Reinsurance capacity was available at all levels of protection, dependent upon exposures and loss history.

Catastrophe exposures continue to be watched closely by reinsurers who are unwilling to dramatically extend the amount of catastrophe coverage afforded through per risk covers, although there was some evidence that reinsurers were willing to broaden coverage rather than reduce pricing.

## Retrocession

Considering the number of catastrophe losses occurring in 2004, the retrocessional market was only affected to a limited degree. Increased retentions over the last few years meant that much of the loss that was suffered by first tier reinsurers failed to materialise as retrocessional losses, although certain specific programmes did experience claims on to the lower end of their programmes.

These losses served to reduce expectations of pricing reductions and in many cases cedants again decided to retain more risk at levels where retrocessional pricing was viewed as untenable.

## Capacity

Despite some capacity withdrawals during 2004, (Tryg Baltica International, Gothaer Ruck), capacity was generally plentiful. Some organisations were seeking to increase their participations or enter the market for the first time. Glacier Re also entered the market at the end of 2004.

Hedge funds were a significant supplier of new capacity during 2004 as they sought to exploit the lack of correlation between catastrophe events and global equity indices, although their effect upon catastrophe pricing has yet to be fully felt.

## Protection & Indemnity reinsurance

### The International Group Reinsurance Contract

The largest element by far of the P&I reinsurance market is the International Group Reinsurance Contract, now providing coverage in excess of US\$50m for 90% of the world's shipowners. The contract renews on 20 February, the commencement of the P&I year.

Retention under the International Group Reinsurance Contract rose last year from US\$30m to US\$50m with the clubs using the US\$20m no longer directed to the reinsurance market to pre-fund a new Bermudian cell captive named Hydra. Despite the barriers of regulatory approval for individual clubs, such as the Japan Club, significant progress has been made and all the clubs will have the provisional Hydra arrangement approved in early 2005.

This year, various revisions to legislation governing liability limits for shipping have been the new focus for reinsurers, notably the Civil Liability Convention for Oil Pollution and the proposed amended Athens Convention for passenger liabilities. Reinsurers are increasingly looking to future exposures and therefore to index old claims to these new conventions. As an example, had the "Estonia" ferry disaster been subject to the provisions of the revised Athens Convention, we calculate that limits of liability to passengers would have been in excess of US\$600m.

However, at the time of writing, it is understood that the first layer of the Group reinsurance programme has increased in premium by 3% as a result of world tonnage growth only whilst the upper layers have reportedly seen reductions. This suggests that the clubs have succeeded in persuading reinsurers to focus on the credit balance of the programme, rather than future exposures.

The ultimate effect for shipowners of the reinsurers renegotiation for 2005 means that whilst the cost of reinsurance for dirty tankers remains almost the same as last year, other vessel types have generally seen reductions (including voyage surcharge rates of the vessels going to the US). The clubs undertake the allocation exercise of reinsurance costs every year and

this year the "Athos I" claim of about US\$100m to date has influenced the allocation exercise, hence the dirty tanker owners have received less of the benefit.

The clubs were successful in 2004 in an initiative to provide a limited amount of P&I Bio-Chemical cover otherwise excluded under the CL370 exclusion. The agreement of clubs to pool this cover into the lower layer of the International Group pooling arrangements provided their members with access to approximately US\$20m of cover on a limited basis. This has risen as the pooling limit increased to US\$30m in 2005. Two P&I clubs also provide their members with additional coverage over and above the amount provided under this International Group scheme.

### **P&I Retention Reinsurance programmes**

Most individual clubs also purchase reinsurance below the Group pooling arrangement and within the US\$6m individual club retention. The importance of this cover is increasing, not only because of the increase in the retention from US\$5m to US\$6m, but also as a result of a regulatory and rating agency focus on capital adequacy requirements.

# 18 Sector analysis: Risk Finance

Risk Finance is a sophisticated market, from the perspective of both buyers and providers. It is constantly adapting and is characterised by pockets of activity and one-off transactions requiring significant lead times. Often referred in the past as Alternative Risk Transfer (ART), the market is, in our view, now wider and better reflected by the more generic term of Risk Finance.

With the softening of the traditional Property and Casualty markets, we expect to see a resurgence of interest in some forms of structured risk financing. However, underwriters' approach will, without doubt, be more cautious and more carefully managed than some of the market's last foray into this non-conventional area.

The landscape was dominated last year by the activities of the US regulatory authorities. Whilst the New York State Attorney General Eliot Spitzer broadened his investigations into allegations of bid-rigging to include finite (re)insurance, he was joined by bodies such as the Securities and Exchange Commission, who continued to probe particular transactions which they alleged were improper accounting devices rather than risk transfer.

As a consequence, the sector was plunged into uncertainty towards the end of last year, typified by the decision of Platinum Re to publicly unwind a reinsurance contract with Berkshire Hathaway because of fears it did not contain sufficient risk transfer.

Indeed a misconception began to develop that finite reinsurance transactions were only about trying to hide past problems.

## Finite (re)insurance

'Finite' insurance has taken on many different meanings. We view the term as describing an insurance contract with the following characteristics:

- Multi-year term
- Annual limits and aggregate limit terms
- Fixed pre-agreed premium for entire contract duration
- Profit sharing and/or risk participation between client and insurer.

Fortunately, greater stability has returned to the sector together with recognition that finite (re)insurance remains an efficient and flexible method of dealing with some long-term Property and Casualty liabilities. The expectation therefore is that 2005 will continue to see strong demand for legitimate transactions that involve risk transfer on a multi-year/long-term basis. Indeed, the price weakening experienced in many of the conventional Property and Casualty sectors is expected to encourage reinsurers to provide more finite (re)insurance capacity in the year ahead. There has been little change in capacity in this sector, but the deals are more stringently scrutinised, with auditor approval being the key factor in the viability of the proposal.

## Structured credit

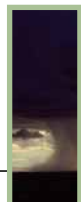
In contrast, however, the market for credit enhancement has contracted even further. The sector retrenched following a series of high profile losses such as Enron and WorldCom, together with the US terrorism losses. This provoked a capacity shortage as insurers refocused their capacity to core lines. However, the start of 2005 has seen some new markets created specifically for Collateralised Debt Obligations (CDOs).

Also contributing to this decline was the fall-out from insurance backed film finance placings which highlighted misunderstandings between insurers and capital markets over coverage issues and the numerous financial strength ratings downgrades in 2002/2003. These had the impact of reducing the number of (re)insurers with sufficiently high ratings to provide meaningful credit enhancement.

There is now very little supply of Residual Value Insurance.

## Loss Portfolio Transfers (LPT)

The market for non-life LPT remains strong, but reinsurers are facing increased competition from a range of specialist buy-out investment funds offering potential clients an alternative exit strategy. Nonetheless, demand for LPTs is likely to remain strong, not least because investors in the insurance industry remain nervous of



adverse loss developments on legacy exposures. These can cause unexpected dips in earnings as companies are forced to take charges on current earnings to boost prior year reserves. They can also free up insurers' obligations to provide collateral on outstanding exposures. However, there has been little if any capacity available from reinsurers to provide LPT cover on solely asbestos exposures for a number of years. Asbestos deals generally now tend to concentrate on the best methods of running off the management of claims or smoothing out asbestos related exposures by combining them with other liabilities rather than seeking a better price for the ultimate exposures.

Although 2005 will continue to see regulatory authorities scrutinising some, particularly finite, transactions, many of these were structured in a pre-Enron era. Looking forward, we expect to see a strong demand for properly constructed, multi-year risk financing products.

## Catastrophe bonds

The popularity of catastrophe bonds has grown in the past few years as the industry became increasingly familiar with the concept, but last year saw that usage plateau with fewer transactions in 2004 than there were in 2003.

In part, this may reflect reducing reinsurance rates. It may also reflect a move by hedge funds, significant counterparties to catastrophe bond issuers, towards becoming active reinsurers. Please refer to page 22 for further analysis on hedge funds.

Nevertheless, catastrophe bonds should still continue to feature in 2005, as indicated already in January by Swiss Re's issue of two tranches of bonds, with total limits of US\$300m, from the Redwood programme for the California Earthquake Authority.

### Catastrophe bond transactions in 2004

Date	Cedants	Capacity	Placing agents	Commentary
Nov 2004	The Hartford via special purpose vehicle Foundation Re	US\$247.5m	Goldman Sachs, BNP Paribas and MMC	Two coverages: US\$180m for US East Coast hurricanes, together with US\$67.5m for US earthquakes or hurricanes in the year following a major US earthquake/hurricane
June 2004	Japanese exposed (re)insurers via special purpose vehicle GI Capital	US\$125m	Swiss Re Capital Markets	Japanese earthquake risk predominantly in Tokyo
June 2004	Converium via special purpose vehicle Helix 2004 Ltd	US\$100m	Aon Capital Markets	Five year bond covering European (15%), North Atlantic hurricane (28%) windstorm (46%), US earthquake and Japanese earthquake (11%)
June 2004	USAA via special purpose vehicle Residential Re 2004	US\$227.5m	Goldman Sachs and BNP Paribas	Three year, two tranche deal (US\$127.5m low probability and US\$100m higher probability) covering US hurricane and earthquake risks
Jan 2004	Electricite de France via special purpose vehicle Pylon Ltd	US\$246m (€190m)	CDC IXIS Capital Markets and Swiss Re Capital Markets	Five year, two tranche deal covering damage from European windstorms to electricity supplier

Source: Artemis

# 19 Sector analysis: Other markets

## Latin America

2004 was a better year economically for Latin America, with improvements in international trade performances, together with declining public and external debt burdens. A number of large construction projects are also planned for countries such as Brazil, Mexico, Venezuela and Colombia with conservative projections of investment in such projects exceeding US\$70bn over the next 10 years.

Despite the recent challenging economic and legislative environments in many Latin American countries, premium across the region in 2003 grew by 9.5% to US\$37.3bn, according to Standard & Poor's. Property risks have driven such growth in recent years. In the future other lines of insurance should develop such as liability, credit and guarantee, agriculture, life and pensions. There are some signs that these classes are beginning to grow, but it will be a slow process.

For the moment Property classes dominate and with the limited capacity of local insurers, London continues to be an important market for big risks or large treaties, particularly at the higher levels. However there is also significant capacity either from the major reinsurers with a presence in those countries, or in the Miami market, which seems to be becoming increasingly important.

The insurance environment as a whole is competitive, with pricing reductions being seen across the board. The number of brokers involved in the region is also increasing, particularly in Brazil.

## Australia

The general insurance market in Australia has seen significant consolidation over recent years with two companies, QBE and IAG (Insurance Australia Group), controlling almost 60% of net premiums in 2004.

On the Property side the market is seeing downward pressure. Generally there is more competition on pricing with resulting reductions, particularly for the better quality risks. Casualty business is also competitive, although

underwriters are trying to hold firm. QBE have been strong in this area for the last three years, but various Lloyd's facilities are now very aggressive in the middle market and AIG have returned to the fray, following their exit from the primary Casualty market in 2000.

The Professional Indemnity and D&O market is less aggressive, but still seeing reductions and with more capacity available.

A lack of major catastrophes in Australia in recent years has contributed to the availability and pricing of reinsurance.

## Asia

Asia continues to have significant local capacity and is very competitive on pricing, although policy conditions remain stable. Many of the global insurance players now have separate capacity available in the region.

China remains a market in its own right with very significant proportional reinsurance capacity having been ceded to the local market. Pricing in China is therefore well below the already low levels elsewhere in the region.

The international market remains important for capacity and specialist risks, such as the larger financial solutions business, offshore oil and gas, as well as certain heavy construction business. Elsewhere however, for risks such as Power and Property (even catastrophe business), programmes can be structured with local capacity and on very competitive terms.

## Canada

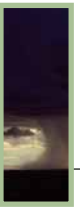
With most of the major (re)insurance companies operating in Canada, the market has seen similar pressures on pricing experienced elsewhere. The market is competitive and experiencing rate reductions. Some risks however, remain difficult, particularly certain construction risks based upon past Canadian loss experience. D&O premiums also remain firm in the face of US losses and an increasing number of claims within Canada.



Capacity in the market continues to expand, with Lloyd's making steady progress, particularly through binding facilities granted to Canadian brokers or UK based Lloyd's brokers who are actively soliciting business.

Elsewhere, Arch is expanding into Canada, with operations focusing firstly on financial services products, but with the intention of expanding into large commercial risks to compete against companies like AIG, ACE and Liberty. ING are also expanding, having taken over the commercial insurance operations of Allianz Canada and with a likely public share offering in 2005 to fund expansion. Endurance Re also opened a branch office in October 2004 writing Property treaty reinsurance for Canadian risks.

Market consolidation is also on the cards for 2005.



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