Willis Re-View
as @ 1.1.2006
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2005 has been an extraordinary year in terms of natural catastrophe. In the world of reinsurance it is the hurricanes in the Gulf of Mexico that are on all our minds as we strive to finalize the 1st January 2006 renewals.

However, we need to just cast our minds back over the whole year to remind ourselves of other disasters, many resulting more in tragic loss of life than insured damage. The Tsunami in the Indian Ocean ended 2004, and whilst it was much less devastating, people forget that there was a second huge earthquake later in 2005 in the same region. We also saw a massive earthquake in Pakistan, a major typhoon in Taiwan, sweeping forest fires in Southern Europe as it baked in the hottest summer on record, major floods in Central Europe and Mumbai and European Windstorm Erwin in Scandinavia.

However, it was hurricanes Katrina, Rita and Wilma that have left part of the insurance and reinsurance world reeling. I deliberately say “part” because currently we have reinsurance markets such as Retro, Marine, Energy and US Property in significant turmoil and undergoing major revisions of terms, conditions and structure. However, in other parts of the reinsurance market, whilst generally we have seen an end to the “softening” of the past 18 months, the environment is best described as “stable” rather than “hard”.

The question is whether this ‘Tale of Two Markets’ is temporary or will be sustained. One has to consider the backdrop. Certain factors would suggest temporary. Whilst rating agencies have naturally focused their efforts on those companies suffering significant losses and or starting up, their changed requirements in respect of the increased capital deployed against given loss scenarios will affect the insurance and reinsurance sectors globally. Also, as catastrophe models are recalibrated to incorporate more aggressive assumptions regarding potential losses, these will impact across the world. We must also remind ourselves that whilst hurricane loss estimates are extremely high, the values actually paid to date are currently still relatively small – the actual pain of significant outflows of cash is always a reality check.

However, there are also factors that suggest any hardening trend will be limited. When WTC occurred in 2001, the insurance and reinsurance balance sheets were generally in poor shape. This contrasts with 2005, where prior to the hurricanes, balance sheets have been strong and combined ratios have been healthy and improving. The hurricanes have severely damaged the financial health of certain US insurers, specialty line underwriters and many reinsurers, but outside of that insurers have had several good years and appear reluctant to risk losing market share by striving to increase prices.

Additionally, there is new capital arriving in the form of re-capitalization of existing participants, new start-ups, and new types of structured products. The hedge funds are major players in all of these areas, and are here to stay in one form or another. This new capital will provide a fresh supply of capacity, and will be encouraged to write business outside the distressed market if for no other reason than the rating agencies are looking for the markets to diversify.

The fundamental trends cannot be ignored however. Sources of risk are increasing, the frequency and severity of catastrophes seem to be rising, and the values at risk increase not only with urbanization and infrastructure development, but with increased penetration of the insurance product. Consequently, rating agencies, risk modelers, and reinsurance companies are going to require more transparency, analysis, exposure control and structural clarity. These will not be localized phenomena, but will be global requirements and will undoubtedly impact the reinsurance structures of our clients around the world. The team at Willis Re remains committed to helping our clients navigate this increasingly complicated and sophisticated environment.

Foreword by Grahame Millwater, Chairman and Chief Executive Officer
Willis Re
Willis Re Business Unit Commentaries

The leaders of our major business units add their own thoughts below.

Specialty
Specialty, particularly Marine and Energy (whose results, certainly on a gross basis, will be the worst ever on record) and Retrocession have been catastrophically impacted by the hurricanes. Going forward, there is an urgent requirement for transparency. The fact that the models failed to accurately predict how much damage a large hurricane would wreak going through the Gulf of Mexico means that greater clarity is necessary as to the precise nature of the risk underwriters are asked to reinsure.

The markets also need a miss factor, either by peril or territory, so that their entire aggregate is not impacted from a single event. Pricing and negotiations in the Specialty area have been clearly dominated by the Gulf of Mexico storms. Adjustments are also being made by the direct market cutting out classes, such as Contingent Business Interruption, aggregate Wind Combined Single Limits on insureds and by increasing deductibles and waiting periods. The issue of Wind in the Gulf of Mexico can to an extent afford to wait with resolution being achieved in the New Year in time for when it comes on risk in June 2006. Aside from this specific exposure, rates are increasing and conditions being tightened in every area of the Specialty book, which reflects the increased cost of reinsurers’ capital. The 2006 hurricane season will be pivotal to the long-term future of the Specialty market.

US
The impact of the 2005 hurricane season has obviously dominated the US Reinsurance renewal season at January 1st 2006. Some major catastrophe programs remain incomplete at this time notwithstanding significant elevation of attachment points and substantial increases in premium. Risk programs have had the limits cut back but despite initial posturing by reinsurers, the covers have maintained elements of catastrophe coverage albeit much reduced in quantum. The rating agencies and modeling companies (possibly stung by post loss criticism) have reacted by raising the bar and recalibrating their methodology although some of this has added to the year end confusion. The casualty market remains flat with a degree of softening perhaps encouraged by a need for reinsurers to diversify their property portfolios.

As we go into 2006, the reinsurance environment should become clearer though probably no more palatable to either party (Insurers and Reinsurers). Certain reinsurers will privately admit defeat in their retrocessional renewals and others will publicly announce further development in their 2005 losses. Some will do both. The rating agencies will continue to hold enormous power thereby, to some extent defacto regulating the market. They will also temper the enthusiasm of the new reinsurers possibly disappointing their investors and the promised ROE. The capital markets will continue to emerge as an alternative capacity source for clients but not the complete solution. Companies with large Gulf/South East exposures will encounter less debate at renewal than their peer group did at January 1st but this will be as a result of reinsurers finally realizing their own position rather than anything else. Consequently insurers must be carefully advised what the right price is, as paying over the odds will not necessarily attract any additional capacity.

The casualty market will continue to soften in many segments. Deterioration of back year results has slowed down, current profitability predictions for the 2002 - 2005 years seem justified and it will still be popular for capital to continue to seek diversification away from natural catastrophe exposure. It seems that the only thing that could prevent continued softening would be worse than expected hurricane losses materializing which might dramatically reduce surplus levels and so limit supply for all lines of business.
With adequate capacity supply most buyers have tended to support their existing reinsurers leaving limited opportunities for new reinsurers. The recalibration of international catastrophe models has not yet appeared as an issue and similarly the changes in rating agencies approaches have not significantly impacted ceding companies’ buying patterns. Looking forward into 2006 after a relatively calm 1st January renewal the key question is how the issues arising from the 2005 US cat losses will impact International markets or for how long the ‘Tale of Two Markets’ will persist.

The interpretation of advice on cat models has come under scrutiny post-Katrina as the model vendors re-think some of the issues that have been raised; and this need will grow increasingly in importance.

As models are recalibrated, the pressures from revised rating agency measures bite and the implications of a changing risk/return environment come home, there will be greater emphasis placed on the analysis of exposures and applicable capital performance measures as well as devising instruments to best meet the challenges.

Willis Analytics and Solutions is dedicated to helping clients make better business and capital decisions and the environment in 2006 will place great demands on these capabilities, as detailed in the observations later.
Our Re-View as @ 1.1.2006

Executive Summary

Property Cat Rate Movements
- No clear Global pricing trend
- Loss hit US - significant increases (up to 100%)
- Loss free US - small increases
- Loss free UK - 5-10% increases
- Loss free European – generally small increases
- Loss free Australia - small increases on capacity programs
- Loss free Latin America and Caribbean - small increases
- Asia (ex-Japan) – generally flat

Aerospace
- Trend of rate reductions reversed in final quarter of 2005
- Reinsurance capacity adequate
- With no further loss activity there will be pressure on direct market to reduce rates in 2006

Casualty (International)
- Reinsurers concerned to control their exposure to terrorism
- European pricing - at or just below 2005 terms
- UK Pricing - increased 10-15%
- European Pl and D&O Pricing - Flat to +5%
- UK Motor pricing – up to 15% increases
- European Motor pricing - France, some increases; Germany, flat; others, flat

Casualty (US)
- Direct market pricing reductions in 2005
- Reinsurance market pricing remained steady
- Some difficult exposures excluded by reinsurers
- Pro rata remained preferred structure for Umbrella and Excess reinsurers
- The benefits of casualty as a diversifying class may result in more reinsurer entrants

Life, Accident & Health
- Pandemic reinsurance protections still largely undeveloped
- NBC Terrorism capacity increasing but at a cost
- Catastrophe modeling for this sector is evolving
- Indian Ocean Tsunami did not result in significant insured losses

Marine
- 2005 Marine and Energy results the worst on record
- Gulf of Mexico energy exposures being split out from Global programs
- London market reinsurers may lose market share
- Modeling for exposures for offshore energy, yachts and cargo being examined
- Some reinsurers have exited the sector, whilst new entrants have also arrived

Non-Marine Specialty
- Information preparation difficult due to lack of certainty in property reinsurance arena
- Cedants flexible in how they accept capacity from different sources
- Significant (up to 40%) rating increases for property cat
- Use of ILW's resulting in increased volatility and basis risk being retained by cedants

Professional Liability (US)
- Less advantageous terms for treaties with public company D & O exposures
- Ceding commissions down 3-5%
- Loss ratio caps and corridors now seen again
- Some reinsurers believe that Financial Institutions E & O is uninsurable
- Reinsurers do not believe that rates are sufficient for the volatility and severity of settlements
- If pricing continues to decline, capacity will reduce
Willis Integrated Solutions

- Hedge fund investors have lost considerable money in risk-bearing transactions
- At least one cat bond is expected to be hit
- Still a vast amount of global capital seeking non-correlated, high return opportunities
- (Re)insurance industry needs to recapitalize in response to rating agency and regulatory pressures
- Capital markets now assuming non-cat risk (motor, casualty and mortality)
- Mis-match between capital markets and traditional pricing has narrowed
- Growth of hedge fund/capital market participants has outstripped their own infrastructure

Workers’ Compensation

- 2005 stable year for Workers’ Compensation
- Improvement in terms resulted in expansion of aggregate limit rather than pricing reductions
- 4th quarter cost of capital considerations and rating agency actions on cat-exposed portfolios caused prices to stabilize
- Workers compensation cat covers may become an attractive source of diversification for catastrophe reinsurers
- Capital markets interest in this sector may increase

Catastrophe Modeling

- Hurricane Katrina tested modeled event estimates which were found to under-represent actual loss potential
- Following the impact on New Orleans, flood remains poorly provided for in commercial catastrophe models
- Katrina now described as a "Super Cat Event" characterized by non linear loss amplification and correlation
- The 3 major vendors have updated their models in 2005 for many perils
- Differences between actual and modeled losses should result in greater research and understanding of natural hazards
- Workers compensation, life and personal accident insurers also turning to catastrophe modeling techniques to assess exposures

Market Security

- Shareholder commitment of capital to established players was forthcoming relatively quickly post-Katrina
- Can the Class of 2005 create a long-term operating franchise?
- Class of 2005 facing more cautious scrutiny in areas such as underwriting and management experience, infrastructure and long term shareholder commitment
- Rating Agency methodology review placing pressure on reinsurers operating a catastrophe or monoline business model
<table>
<thead>
<tr>
<th>Territory / *Class</th>
<th>Property</th>
<th>Risk Loss free</th>
<th>Risk Loss hit</th>
<th>Cat Loss free</th>
<th>Cat Loss hit</th>
<th>Casualty</th>
<th>XL Loss free</th>
<th>XL Loss hit</th>
<th>General Comments</th>
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</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>Flat</td>
<td>-5%</td>
<td>+10%</td>
<td>+2%</td>
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<td>Hot Topics</td>
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<td>1. Retentions increased for Cat</td>
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<td>2. Minimum market rates, U/W's not offering cover below a certain rate</td>
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<tr>
<td>Australia</td>
<td>Commission terms unchanged unless driven by loss ratio, primary rate movements</td>
<td>Flat</td>
<td>Loss Ratio/Burning cost driven</td>
<td>0 to +10%</td>
<td>0 to +10% + Burning cost</td>
<td>Flat</td>
<td>+5%</td>
<td>+5% to +10%</td>
<td>Hot Topics</td>
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<td>1. Unlimited Third Party Bodily Injury – Swiss Re Australia Limited withdrawal (Casualty)</td>
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<td>2. Downgrade Clauses – Reinsurers pushing for dilution in triggers</td>
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<td>3. Exclusion of Fortune 500 risks and ‘target’ risks (policies with limits greater than USD200m)</td>
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<tr>
<td>Caribbean</td>
<td>Commissions under some pressure, original rates up 10%</td>
<td>Flat</td>
<td>Loss dependent</td>
<td>+5% +10%</td>
<td>n/a</td>
<td>Flat</td>
<td>Flat</td>
<td>Loss dependent</td>
<td>Hot Topic (Property)</td>
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<td>Expected new catastrophe model releases in the new year which will upwardly adjust windstorm results for both frequency and severity</td>
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<tr>
<td>China</td>
<td>+15%</td>
<td>Flat to +5%</td>
<td>+15% to +20%</td>
<td>Flat to +5%</td>
<td>+10% to +20%</td>
<td>Flat</td>
<td>Flat</td>
<td>Flat to +5%</td>
<td>Hot Topics</td>
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<td>1. Sliding scale commissions being introduced to majority of surplus treaties</td>
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<td>2. Generally tighter terms being seen on proportional treaties</td>
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<td>3. Inconsistent/unpredictable reinsurer pricing</td>
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<tr>
<td>Colombia</td>
<td>See Hot Topic</td>
<td>0 to+5%</td>
<td>+10%</td>
<td>+7.5%</td>
<td>n/a</td>
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<td>Hot Topics</td>
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<td>1. Pro rata property subject to protracted renewal negotiations</td>
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<td>2. New reinsurance capacities cannot access Colombian cat xl business because they are not registered</td>
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<tr>
<td>Eastern Europe</td>
<td>Flat</td>
<td>0% to -5%</td>
<td>Flat to +5%</td>
<td>Flat</td>
<td>Flat to +5%</td>
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<td>Flat</td>
<td>n/a</td>
<td>Hot Topics</td>
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<td>1. Impact of 2005 natural disasters</td>
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<td>2. More sophisticated reporting of catastrophe aggregate information</td>
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<td>3. Expectation that ‘Engineering’ will see return of operational risks in 2006 and beyond</td>
</tr>
</tbody>
</table>

* Engineering Commissions and capacity as expiry Stable Loss dependent
### Rates and Territories Re-View as @ 1.1.2006

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<td>Pro Rata</td>
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<td>Pro Rata</td>
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<td>Hot Topics</td>
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<tr>
<td>France</td>
<td></td>
<td>Flat</td>
<td>Flat</td>
<td>Increases according to loss activity</td>
<td>Flat</td>
<td>n/a</td>
<td>n/a</td>
<td>GTP: Flat Motor: +20% low layers and +30% high layers</td>
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<td>1. Motor prices continue to rise due to past under reserving and increased awards despite reduction in current frequency of losses</td>
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<td>2. GAREAT (state managed pool) – extension of terrorism cover to small property risks has been an issue</td>
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<td>3. State has now made it clear that all Property policies cover not just dirty bombs, but also actual nuclear explosions. GAREAT however excludes this</td>
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<td>Germany</td>
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<td>Flat</td>
<td>Flat</td>
<td>Increases according to loss activity</td>
<td>0 to +5%</td>
<td>n/a</td>
<td>Tendency to higher commissions</td>
<td>Flat, increases to follow exposure increase</td>
<td>Increase according to loss activity</td>
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<td>1. Reductions of original motor rates</td>
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<td>2. Tending for higher commissions for proportional business when profitable</td>
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<td>3. Solvency II and capital allocation/exposure</td>
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<td>4. De-globalization. German market did not react or reacted only in a minor way on global losses/trend for firmer terms</td>
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<tr>
<td>Hong Kong</td>
<td></td>
<td>Flat</td>
<td>Flat</td>
<td>+10%</td>
<td>Flat to -5%</td>
<td>+10%</td>
<td>Flat</td>
<td>-10%</td>
<td>Flat to +5%</td>
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<td>Impact from Tsunami not as great as anticipated</td>
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<td>Indonesia</td>
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<td>Flat</td>
<td>Flat</td>
<td>+10% to +20%</td>
<td>Flat</td>
<td>+10%</td>
<td>-</td>
<td>Flat</td>
<td>n/a</td>
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<tr>
<td>Ireland</td>
<td></td>
<td>n/a</td>
<td>+5%</td>
<td>+20%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>+5%</td>
<td>+10%</td>
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<tr>
<td>Italy/Southern Europe</td>
<td>Commission unchanged</td>
<td>0% to -10%</td>
<td>+5% to +15%</td>
<td>0% to +15%</td>
<td>n/a</td>
<td>Less capacity for motor third party liability Q/S with reduced commission – same capacity available for general third party at reduced commission</td>
<td>0 to +10% for motor third party liability</td>
<td>0 to +20%</td>
<td>Hot Topics/General Comments</td>
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<td>1. Continental market still aggressive on per risk property but less on casualty where almost all players have revised their models with price increases</td>
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<td>2. Very late renewals</td>
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<td>3. Many cedants still buying across the board reinsurance</td>
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<td>4. Less premium available due to merger and increased retention</td>
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<tr>
<td>Morocco</td>
<td></td>
<td>Flat</td>
<td>-5%</td>
<td>+15%</td>
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<td>1. Retention doubled for Cat</td>
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<td>2. Minimum market rates, U/W’s not offering cover below a certain rate</td>
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</tr>
</thead>
<tbody>
<tr>
<td>Nordic</td>
<td>Commissions stable or reduced</td>
<td>-5% to 0</td>
<td>0 to +20%</td>
<td>0 to +20%</td>
<td>+10% to +50%</td>
<td>Commission stable or improved</td>
<td>-10%</td>
<td>0 to +20%</td>
<td>Hot Topics: 1. Denmark – effects of Hurricane Enwin: Cat XL increases vary considerably per portfolio/location 2. Danish property risk retentions increased (by Clients) 3. Norway: Natural Perils Pool Protection increased by 25% to NOK 12.5bn 4. Casually retentions under pressure from reinsurers on smaller programs 5. Terrorism – NBC cover limited reinstatements</td>
</tr>
<tr>
<td>Philippines</td>
<td>Commissions terms and conditions stable</td>
<td>+5%</td>
<td>+10% to +15%</td>
<td>+5%</td>
<td>+10%</td>
<td>n/a</td>
<td>0 to +5%</td>
<td>n/a</td>
<td>Hot Topics: 1. BI sub limits 2. New VAT legislation. Reinsured to absorb 3. Review trigger on aggregate growth</td>
</tr>
<tr>
<td>South Africa</td>
<td>Flat</td>
<td>0 to +5%</td>
<td>+5% to +30%</td>
<td>0% to +10%</td>
<td>+10% to +20%</td>
<td>Flat</td>
<td>0% to +5%</td>
<td>+5% to +20%</td>
<td>Hot Topics: 1. Cat XL retention increases 2. Less Pro Rata reliance 3. Up to 30% increases on high layer Cat XL</td>
</tr>
<tr>
<td>Spain</td>
<td>No movement or slight reduction</td>
<td>No movement or slight reduction</td>
<td>Small increase</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>No movement or slight reduction</td>
<td>Small increase</td>
<td>Hot Topics: 1. Reducing incomes, especially motor 2. Very aggressive property market, esp. industrial risks 3. Still tendency away from proportional to XL</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Flat</td>
<td>Flat</td>
<td>+10% to +15%</td>
<td>n/a</td>
<td>+15% to +35%</td>
<td>n/a</td>
<td>Flat</td>
<td>+15% to +20%</td>
<td>Hot Topics: 1. Capacity more than adequate 2. Swiss business seen as attractive non accumulation Euro business to reinsurers</td>
</tr>
<tr>
<td>Taiwan</td>
<td>See general comments</td>
<td>Flat to -10%</td>
<td>+7.5% to +25%</td>
<td>Flat to -10%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>Hot Topics: 1. Buyer margins under pressure leading to low outwards spend 2. Risk programs impacted by the large ASE semiconductor loss emerged with lower price impact than many anticipated 3. Event aggregates were generally up, but cat programs also emerged favorably for buyers, with marginal reductions (adjusted for exposure)</td>
</tr>
<tr>
<td>Turkey</td>
<td>Flat</td>
<td>Flat</td>
<td>+20%</td>
<td>Flat to 10%</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>No particular hot topics</td>
</tr>
<tr>
<td>UK</td>
<td>Flat</td>
<td>Flat</td>
<td>+10%</td>
<td>+5% to +10%</td>
<td>n/a</td>
<td>Flat</td>
<td>+5%</td>
<td>+5% to +15%</td>
<td>Hot Topics: 1. Price 2. Continued firmness of slip terms 3. Indexation for bodily injury liability</td>
</tr>
<tr>
<td>Territory / *Class</td>
<td>Property</td>
<td>Risk Loss free</td>
<td>Risk Loss hit</td>
<td>Cat Loss free</td>
<td>Cat Loss hit</td>
<td>General Comments</td>
<td></td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>
| * US (P&C)        | Ceding commissions flat or reduced | +10% | +20% to +40% | +5% to +10% | +30% to +100% | Flat | 0 to -5% | +10% to 15% | Hot Topics (Property)  
1. Cat model changes  
2. Catastrophe capacity  
3. Contraction of cat cover in risk & quota share treaties  
4. Occurrence definition  
5. Terrorism – TRIA  

Hot Topics (Casualty)  
6. The impact (if any) from the recent spate of natural catastrophes on the Casualty insurance and reinsurance market  
7. 2001-2004 Accident Year profitability and whether there is enough margin in those years to justify rate decreases in 2005  
8. Reinsurance security (including willingness to pay)  
9. The re-evaluation of standard contract wording clauses by clients and markets |
| * US (Marine)     | As before but some new Bermuda capacity pressure for occurrence caps | +10% to +15% | +25% to +50% | +25% | +50% to +100% and more | Flat | 0 to -5% | +10% to 15% | Hot Topics  
1. Worst year ever for Marine & Energy insurance/reinsurance business  
2. Evaluating catastrophe exposures is of paramount importance  
3. Reinsurers' cost of capital is rising  
4. Reinsurers' profit targets are higher than last year |
| Venezuela         | Renewing as is | 0 to +5% | +10% | +3% | +7.5% | n/a | n/a | n/a | Hot Topics  
No particular hot topic to raise |
| Vietnam           | Commissions, terms and conditions stable | 0 to +5% | +5% to +10% | 0 to +5% | n/a | Commissions, terms and conditions stable | 0% | n/a | Hot Topics  
1. Reinsurance pricing appears more sensitive to growth in aggregates but still no catastrophe models available |
Rates and Territories Re-View as @ 1.1.2006

Rates and Territories (continued)

USA

Venezuela
Class Re-View as @ 1.1.2006

Aerospace

Hot Topics

- Potential new capital in Aviation reinsurance from the Bermuda start-ups
- Swiss Re’s acquisition of GE Insurance Solutions will conceivably affect both the insurance and reinsurance markets if they were to rationalize the two operations
- The A380 launch has been delayed until the end of 2006, and therefore has not impacted the current insurance and reinsurance renewal seasons
- Continued low loss activity (other than a number of smaller losses in August) has maintained the trend of rate reductions in the insurance sector. The last major loss was the American Airlines disaster four years ago at Queen’s, New York.
- The differential between the continued reductions in the Aviation insurance sector and the hardening of resolve within the reinsurance market

Excess of Loss

For the first time in the last couple of years, we have seen a hardening in resolve in the Aviation reinsurance market in the final quarter of 2005, with the majority of risks being renewed at best as expiring.

Where there is an increase in exposure, we have seen increases in the region of 5-10% - a far cry from the final quarter of 2004 where we were still seeing reductions even on more exposed portfolios.

This hardening in attitude within the reinsurance market is set against a backdrop of low loss levels (particularly no major losses) and a round of further reductions of on average 20% in the Aviation insurance sector during the major renewal season, the final quarter of 2005. There has been a strengthening in attitude in some quarters of the Aviation reinsurance market during the year, but there is absolutely no doubt that the greatest factor in the stabilizing of rates is the domino effect from the major hurricane losses.

Proportional

In general, reinsurers are very concerned at the reduced rating levels on the underlying business in respect of the major airline risks. This is having a direct impact in attracting new markets to the class.

On non-core areas, however, such as general aviation, non-core aircraft product manufacturers and hull war there is more interest as the business provides a good balance to core accounts.

The absence of major airline claims continues to be remarkable. However, some of our treaties this year have been hit by an unnaturally high number of rotor wing incidents. These have occurred for a variety of reasons and will have a clear, negative impact on some insurers’ figures.

In the longer term, major reinsurers continue to call for the development of limited reinstatement provisions or aggregate loss recoveries and until such conditions are introduced it will continue to limit the number of new companies that enter the class. Brokers and clients, however, are naturally determined to avoid these restrictions and, for the time being, in the absence of a run of major losses, will always find enough capacity to complete the placements.

Pre-View of 2006

The reinsurance market has stabilized in the final quarter of 2005 and the key element will be how this affects the direct market during the first part of 2006. There are signs that direct rates have found a level with certain markets either not renewing or considerably reducing their lines.

However, there has not been a major Aviation loss for over four years. If that trend were to continue into the final quarter of 2006, there will be considerable pressure within the direct market for further reductions, with a potential scenario of a flat renewal period.

This will be in contrast to the reinsurance market which will be under considerable pressure to at the very least maintain rates and in all probability increase rates during 2006 as the hurricane losses of 2005 work themselves through.
Hot Topics

- Terrorism within International Liability Classes – there is much uncertainty. Some insurers offer terrorism without charging; others are not giving cover (other than statutory) regardless of price. Ironically the statutory cover in EL is almost always included without charge.

- UK Courts Act – there is very little activity in the Courts. Market debate remains active but there is no agreement on how to capitalize an award.

- Is the market fragmenting? Some reinsurers seem to want it to do so – but it is not.

- Creditworthiness and Consolidation – the effect of the GE/Swiss Re merger is yet to be felt, but undoubtedly both buyers and sellers of international casualty are noticing the impact of higher security concerns combined with fewer mainstream casualty markets.

Re-View as at 1.1.2006

Casualty (International) General Third Party & Employers’ Liability

Some reinsurers have been very concerned to control their exposure to terrorism within International Liability Classes, almost regardless of the actual risk involved. The experience of the London attacks of 7th July, none of which have produced any Employers, Public or Products liability claims yet, has not done enough to bring some common sense to the treatment of this issue. However it is encouraging to see that a number of insurers and reinsurers have realized that terrorism might well be of only very minor concern under EL and PL within the European arena.

The UK Personal Injury market a year ago was highly sensitive to the implications of the Courts Act. It was thought that this might produce a large-scale deluge of claims with life-time payment obligations. We at Willis argued that any change would be very gradual. This has proved to be the case, with under 20 claims being handled in this fashion in the first six months of the primary legislation being active. The issues appear to have been given undue prominence.

Turning to price issues, the main range of quotations on Continental European business has been between minus 10% to plus 10% but firm orders have mainly been at, or just below, 2005 terms. Pricing into 2006 for UK and Irish business has broadly increased by 10% to 15%. Some EL and PL accounts with particularly strong track records have enjoyed flat terms but the general pattern has been that reinsurers have obtained increases, usually on the strength of loss experience.

There is pressure from reinsurers to increase some of the smaller deductibles and also some interest from clients to retain more. Coverage has not moved materially to the benefit of either reinsurers or reinsureds, but reinsurers are still looking at US exposures carefully.

Casualty (International) Professional Indemnity and Directors’ & Officers’

Coverage remains largely unchanged: no major changes to UK wordings have been either imposed or proposed by reinsurers. Early on in the season, some reinsurers were expressing concern over the Law Society changes to the minimum limit of indemnity (up to GBP2m from GBP1m) and the amendment to the Law Society’s Series Clause which in some case could aggregate claims that the previous clause may have treated as several claims. However, this concern has abated after discussions with clients.

European XL treaty rates have generally delivered quotes coming in between +10% & +15% (even on clean business) when set against a backdrop of falling original rates (e.g. in the UK where the average has been circa -10%). Reinsurers have been looking to achieve the same rate on exposure as expiring. Firm orders are expected to average out at roughly par with expiring, up to +5%, measured against exposure.
Pre-View of 2006

The Aspen Re quotation opposite gives a perspective which undoubtedly has some validity. In an ideal world, the New Year Resolution of both buyers and sellers of reinsurance ought to be to do it all with less panic, with a view to delivering earlier information, earlier quotes, earlier firm orders and earlier completion. But the pattern is against any progress being made despite the governance and compliance pressures all being towards a better business process. The “renewal season” into 2006 has been one of the latest ever.

Some of this may be down to poor reinsurer practices. This season has produced many examples of reinsurers suddenly coming up with a list of complex requirements with their first quotation in early or mid-December, many of which were embedded in an existing contract which could have been raised last Spring. Of course there are other examples of buyers not always being as fast with their information as they could be. But a key problem surely lies in some reinsurers’ passive wait for third quarter statistics. This stance contributes to the creation of the market’s annual autumnal congestion problems. There is little doubt that those reinsurers who press for this type of discipline may well be discarding any informational advantages when the operational frictions of late seasonal decision pressures are taken into account.

“By this time last year I had half of my 1/1 lines down, this year I have barely a tenth of my portfolio written. I find it astonishing that the renewals are so late, especially with such pressure to achieve contract certainty. It will be hugely challenging meeting FSA requirements next year. It may be that bringing forward the traditional conferences at the start of the renewal season makes sense. I would be perfectly happy to accept 31st August figures with any quotation then subject to no major adverse development in losses before, say, 31/10, rather than insisting on third quarter statistics.”

(David May, Aspen Re, 20th December 2005)
In the UK, exceptional performance is being rewarded with low or even flat rate changes. Otherwise rates are increasing between 7.5% and 15%, driven by continuing concerns about bodily injury claims inflation. Two single person claims of GBP 15m have put pressure on layers up to GBP 25m. Original rates are flat and some insurers are showing reduced EPs. Two large European reinsurers are insisting on attaching the Unlimited layer at GBP100m and placements are being split to accommodate them at cost-neutral rates. The Courts Act debate has lost momentum except with regard to Capitalization of awards.

In France, reinsurance rates are continuing to rise as a result of the re-alignment in historic reserving levels. Traditional leading reinsurers are trying to convince insurers not to raise deductibles in response to this but still try to impose 20% to 50% increases. For the first time, buyers are beginning to consider alternative markets as leaders of their programs.

The German market continues to see increased demand for limits up to EUR100m. Portfolios giving these limits pay between 0.04% and 0.08% in addition to the usual 0.1% to 0.11% for the Unlimited protection in excess of EUR15m cost. Excess of Loss rates are basically flat.

In the rest of Western Europe quotes range between minus 10% to plus 20% with placements being mainly completed at the same terms or slightly lower than 2005. The top end of programs including the Unlimited layer are renewing at expiring rates, reflecting the more controlled environment with regard to bodily injury compensation in many countries.

In Eastern Europe the move towards harmonization with the EU and the potential impact on compensation levels has manifested itself in a renewed interest in excess of loss protections. Willis Re’s Unlimited Green Card facility has generated much interest and prompted more competition for the limited exposures. Alea’s withdrawal has had a big impact on these markets but this has not translated into rate increases.

We watch with great interest as new entrants to the reinsurance market develop their strategies. The Bermudian “Class of 2001” and “Class of 2005” have, so far, not expressed a determined appetite for this line of business. However, rating agencies appear to be looking for diversity and balance within reinsurers’ portfolios and this may create new capacity for motor business.

Original pricing is set to remain stable during 2006 with some signs that rates will begin to increase as we move in to 2007. We expect more competition from the reinsurance market but this may be tempered by the continuing impact of social inflation on bodily injury awards.

“However, rating agencies appear to be looking for diversity and balance within reinsurers’ portfolios and this may create new capacity for motor business.”
Casualty (US)

Re-View as at 1.1.2006

After several quarters of price competition, the insurance market took its collective breath after Autumn’s natural catastrophes with many clients reporting relatively flat pricing for October. No one doubts that the 2005 storms will impact the entire industry, its capital structure and risk mitigation techniques. What is less clear is the degree of impact these events may have on the US Casualty market in 2006.

For the first eight months of the year, the admitted Casualty insurance market showed signs of continued weakness as the rate increases of 2001 through 2004 gave way to price competition and rate reductions. The large account Umbrella and Excess market witnessed the greatest movement with premium reductions for some reaching 25% as companies aggressively competed to maintain the larger accounts. Carriers reduced rates 5-10% for smaller accounts across a broad spectrum of class codes. Not surprisingly, all segments held relatively high retention ratios, as insurance buyers seemed content to maintain their existing relationships at a reduced rate. Limit usage for the most part remained flat. Market contraction was largely offset by several new entrants.

The E&S insurance market fared slightly better with renewals hovering around 90-95% of their expiring premium. Retentions and limit usage remained relatively unchanged from 2004. The Casualty reinsurance market appeared to hold the line on price, terms and conditions in 2005, especially on programs covering highly volatile lines of business. Reinsurers continued to set pricing targets at 90% combined ratios (or better), although more desirable business was renewed at higher ratio targets. Tougher exposures continued to be pushed out of treaties and either held net or reinsured within the facultative market. Reinsurers closely monitored pricing and exposure changes within the original business and in some instances controlled them via treaty terms and conditions.

Pro rata treaties remained the preferred structure for most Umbrella and Excess reinsurers, with only a handful willing to provide excess of loss capacity. There was a continued push for “original plus” ceding commission calculations as a larger section of the retail market moved towards a fee-based compensation structure, although portfolios with a consistent commission level were able to maintain flat ceding commissions.

Pre-View of 2006

Conditions within the Casualty insurance market in 2006 will be influenced by a number of factors in addition to the ultimate size and scope of the 2005 industry loss. The adequacy of the Property rate increases, the relative profitability of the 2001-2004 Accident Years, the amount of continued deterioration in the 1997-2000 Accident Years, and reinsurers’ view of the original marketplace should all play a role in influencing the Casualty market in 2006. Given the current competitive market conditions and the fact that many of these factors will take time to fully manifest, we would not expect any significant market hardening to occur prior to the third quarter of 2006.

The E&S marketplace is expected to remain flat with some degree of softening as new surplus lines carriers are established and existing players compete to take advantage of the dislocation in the market created by the 2005 storms and the ongoing anomalies within certain geographic jurisdictions.

Casualty reinsurers will likely continue to monitor price and exposure changes in the original business and exert their influence wherever possible; their ability being enhanced as the number of client approved Casualty reinsurers diminishes in the face of increased rating agency vigilance and action.

Should ceding companies increase their net positions in an effort to manage net premium income in a hardening Property market, competition could increase within the Casualty reinsurance market. Continued increases in interest rates and the frequency of natural catastrophes will make the benefits of long-tail Casualty reinsurance that much more attractive in 2006.
Hot Topics

- US Hurricanes (2005 season)
- Natural Catastrophe capacity allocated to Engineering/Construction lines of business
- Impact of 2005 natural disasters on original risk pricing, terms and conditions
- More sophisticated reporting of Catastrophe Aggregate information
- Expectation that Engineering will see return of Operational risks in 2006 and beyond

Re-View as at 1.1.2006

Most 'Engineering' accounts are not 'mass volume'. The premium written and policy count for each underwriting year is small in comparison to Property accounts. As a consequence, many underwriters prefer to avoid underwriting risks in areas of known natural hazard or that represent significant exposure to a single natural peril, let alone a potential catastrophic event. A severe loss of this type would seriously damage the underwriting results of most portfolios.

Many Engineering treaty accounts have the US excluded from the territorial scope. Nonetheless, the class is not immune to the general market effects post the US hurricanes despite most accounts not having had a claim reported. This comment would not apply to a domestic US account where building or construction risks may be underwritten as part of a Property portfolio or stand alone builder's Risk, Inland Marine or Course of Construction product line.

Engineering/Construction would appear to be paying the price of catastrophe capacity being a scarce commodity and is at risk of 'losing out' against other lines of business that can provide a more significant return on capital employed.

Similarly, Engineering/Construction has to fall in line with the more sophisticated information requirements for modeling Property catastrophe accumulation, although the risk characteristics and representative TIV of such exposures differ greatly. The building/construction and resistance to wind damage of a beach front hotel are markedly different from a Power station, whether it be under construction or operational.

Although it is expected that Engineering/Construction will be swept along with the effect of rising Property prices, the upside is that more operational covers, particularly for the Power sector, will again be seen in Engineering portfolios.

Pre-View of 2006

So much has happened in the Engineering market over the last few years, such as tighter wordings, improved slip discipline, adherence to stricter pricing and deductible control, that imposition of further treaty changes, requirements or controls are considered unlikely. Insurers and reinsurers have achieved such improvements in their portfolios and will take steps to ensure this position is not diluted. Pricing always has the potential for change but the market is not united in its opinions. It is likely a more precise picture will emerge as we go through the first few months of 2006 renewals.

As original pricing, terms and conditions become favorable, reinsurers develop an appetite for non volatile pro rata business to help balance their overall portfolio. This opportunity will be taken by existing markets and attract new markets, not only those located in Bermuda, particularly as the profitability can be demonstrated since the market recovery began in 2001.

Most insurers seem content to renew their existing capacity for 2006. If overall capacity remains as it is and there seems to be no sign of new insurance capacity entering the market it begs the question - how will the mega construction risks be placed? Is their sufficient capacity in the market for a typical large refinery construction risk where insured values can exceed USD3-4bn?

Many underwriters prefer to write construction projects of relatively short duration with the upper period between 36 - 48 months. This again could restrict capacity with the result that the placement of future mega construction projects may result in a joint proportional/non-proportional approach.

Both Swiss Re and GE Insurance Solutions are major reinsurers in this specialist class. In all probability we will not know until later in the year the effect of these two companies coming together.
Hot Topics

- Continued deceleration of rate increases driving further softening of the primary market and its impact on reinsurers’ view toward the medical malpractice environment
- Four years of combined year-on-year rate increases have strengthened the income statements of many medical malpractice companies setting the stage for market share growth and possible market competition
- Individual reinsurer security and reinsurance security portfolio balance among markets (US, Bermuda, Europe)
- Continued underwriter discipline on both the primary and reinsurer side relative to pricing and exposure selection
- Impact of 2005 hurricanes on reinsurance capacity, margins, underwriting appetite and its effect on medical malpractice reinsurance pricing
- Continued financial viability of physician company start-ups (now going into their 24 to 36 month of maturation), in light of the reduction in underwriting moratoria and the softening market

Re-View as at 1.1.2006

Average losses across the sector have doubled over the last 7 years and claims inflation is running 30% higher than for other torts. Despite this reinsurers’ appetite continues to grow.

In 2001, AM Best reported the overall med mal combined ratio at 153%; it is 130% in 2005. The PIAA (who represent 60% of US doctors) has a 2005 combined ratio of 109%, with 2006 expected to show further improvements. Therefore, with P&C reinsurers facing a very tough 2005 result, perhaps it is not surprising that they are keen to supply capacity to companies not exposed to natural catastrophes and able to operate acceptable combined ratios.

Yet, over the last few years, this plentiful supply of capacity has not resulted in significant price reductions. It is therefore useful to examine some of the main factors that prevent reinsurance rates falling despite a ready availability of support.

Frequency has remained in check, with severity continuing to drive loss volatility. Severity protections have therefore remained both necessary and desirable core purchases, thus maintaining a strong demand. Net premium to surplus ratios have also been at record highs and because reinsurance helps manage these ratios, this has also further fuelled demand.

Availability itself has also been moderated by reinsurers maintaining disciplined margin requirements, leading to a ‘jerky’ supply curve, where a small drop in rates can lead to a drastic fall off of capacity.

So for the last couple of years the market has maintained its taught balance.

Pre-View of 2006

With supply and demand being so finely poised it only takes a further increase in supply to cause a downward pressure on rates: The subscription levels currently being seen indicate that supply has started to increase more dramatically, with reinsurers pushing for significant growth. This is particularly the case for US based reinsurers and is probably due to the good results coming through for the 2002-2005 period, as well as perceived environmental improvements such as tort reform.

The past two hurricane seasons may also be leading to an increased appetite for casualty reinsurance, as capital seeks to de-leverage its portfolio away from natural catastrophe exposure and in so doing better insulate potential profits.

Reinsurers also have more confidence in their ability to model expected outcomes because they now feel they have a better grasp of potential frequency and severity. This increased confidence means that there is less margin for error loaded into prices and so rates are falling. And as a backdrop to all of this, there is the increased prominence of risk transfer testing having its own effect on reinsurance rates. Put simply, reinsurers can no longer unreasonably hedge their bets to the point where risk transfer becomes negligible. This has, in a way, placed a ceiling on the height of the hard market and brought transparency to previously opaque negotiations.

With all these conflicting pressures on rates a safe place to sit may well be on the fence. Nevertheless, with all these moving dynamics, the fence may become too uncomfortable a place to remain. Therefore, if a view had to be taken then falling on the side of supply exceeding demand would seem the safer option. However, if hurricane loss estimates keep increasing then we may well be wishing we had stayed where we were.
Re-View as at 1.1.2006

Another loss free year in the Life and Accident Catastrophe market has allowed for further stabilization. Despite the terrorist bombings in London on July 7, there has been little change to the terms or conditions being offered by reinsurers.

Pandemic threat has become the number one topic for discussion in the Cat market this year end. Conceptual reinsurance solutions have been initially viewed by prospective buyers as too costly. Capital market solutions in the US have allowed for some distribution of this risk for the larger Life writers.

As was the case last year, the evolution of Catastrophe modeling continues in this line of business. However, the challenges remain with insufficient location data on International portfolios. Recent skepticism of Property modeling has also knocked the credibility of the commercial Life and Accident models.

The US Medical market, having seen rates slide in the past 12-18 months, now seems to be holding on Employer Stop-Loss business. Medical Excess reinsurance continues to be aggressively pursued by a number of domestic writers this year end.

The significant loss of life as a result of the Indian Ocean Tsunami at the end of last year did not translate into measurable insured loss. While a few Travel-specific programs were affected, Accident and Life Catastrophe XL remain untouched.

Pre-View of 2006

While 2006 Catastrophe XL pricing seems to be consistent with 2005 we wait to see if possible rate increases on P&C business at 1/1 will have any domino effect on A&H rates and available capacity during the course of the coming year.

However, with the recent increased scrutiny of the Rating Agencies, the diversification into largely non-correlating Life, A&H lines, by P&C reinsurers may well have its attractions in 2006.

“We with the recent increased scrutiny of the Rating Agencies, the diversification into largely non-correlating Life, A&H lines, by P&C reinsurers may well have its attractions in 2006.”
**Re-View as @ 1.1.2006**

The effect of the Gulf of Mexico storms is forcing both the reinsurance and direct markets to re-evaluate their exposure to Catastrophe windstorms. RDS (Realistic Disaster Scenarios) models have proved insufficient in calculating the increased size and intensity of recent hurricanes. Reinsurance structures that include Energy business are being split by area between the Gulf of Mexico and the Rest of the World.

The pressure on ratings will inevitably follow as the full impact of the storms becomes known, as will pressure on structures, retentions and overall spend. The 2005 Marine and Energy results are likely to be the worst on record.

The Retrocession market has consolidated considerably, impacting on the decision-making of direct reinsurers, some of whom have pulled out of the Marine and Energy market. It is likely that others may well follow suit.

As with changes following the World Trade disaster, the market is being asked to re-evaluate, re-adjust and re-design itself. Profitable years are likely to follow based on the changes being implemented now.

“As with changes following the World Trade disaster, the market is being asked to re-evaluate, re-adjust and re-design itself. Profitable years are likely to follow based on the changes being implemented now.”

**Pre-View of 2006**

The choice of partners is being carefully considered by insurers, with emphasis on security and ratings issues.

On the direct business, energy rates will continue to rise as capacity restricts. Hull, War, Cargo, Specie and Fine Art rates are generally stable, but may also rise once reinsurance costs make their full impact on direct writers. For all areas of Marine business (not Energy) there is a surfeit of capacity still, but the availability of this capacity must come under pressure as other classes of businesses see sharply improving conditions.

Those not impacted by the Gulf of Mexico will find it hard to understand why their own reinsurance is under cost review. Outside the London market, reinsurance costs are relatively stable. Some non-London reinsurers have clearly seized the moment to show their commitment to selected clients. There have been few reductions in price, but blanket increases have not been applied unless the results require them. This has shown some continental reinsures in a positive light as far as clients are concerned and insurers may have a long-term effect when reinsureds evaluate partnerships in the future. London reinsurance markets are, by contrast, likely to lose some market share on International business as London strives to increase rates across the board.
Re-View as at 1.1.2006

2005 was an unprecedented year. It was not only the worst year ever for property catastrophe losses, but for offshore energy and marine catastrophes as well.

The offshore energy losses follow on the heels of Hurricane Ivan which, up to this year, was the largest offshore energy loss on record. If Hurricane Ivan in 2004 was meant to be a wake up call for offshore energy underwriters to address how they write exposures in the Gulf of Mexico, they missed the call. Post Ivan, offshore energy rates stopped slipping, but rates for other marine lines continued to slide. Reinsurance rates also slid for the first eight months of 2005.

Hurricane Rita on its own would have made 2005 the worst year on record for offshore energy loss. The offshore energy losses from Hurricane Katrina are of somewhat similar magnitude to Rita, but Katrina also produced large losses for cargo, primarily in storage, and yachts. The offshore property losses alone from Katrina and Rita are enormous, and were made much worse by direct and contingent business interruption, and the spike in the crude oil and natural gas prices in the aftermath of the storms.

Early on after the hurricanes, it was clear that these were market changing events. But aside from the enormous depletion of capital and disastrous underwriting results, the crystal ball was a little hazy in precisely gauging the impact on the insurance and reinsurance markets. Two months later, we have seen the exit of several reinsurers from marine and energy. We have also seen the creation of a number of new reinsurers, several of whom have expressed an interest in writing marine and energy reinsurance.

Pre-View of 2006

What does all of this portend for 2006? Reinsurance rates have risen due to reinsurers’ increased cost of capital, higher profit requirements and a heightened focus on catastrophe exposures. On this front, it is reasonable to expect this trend to carry on through the course of 2006. Reinsurers are struggling with assessing catastrophe exposures for offshore energy, yachts and cargo in storage. Currently there are no commercially available models that work well for these exposures. Expect to see developments on this front beginning in the spring. Reinsurers will require a greater degree of detail on their cedant’s catastrophe exposures. Turn-around time from reinsurers will increase further as a result of the time required for additional analysis and the higher level of management scrutiny that will be required for every transaction.

Rating agencies have heightened their scrutiny of reinsurers and we expect that reinsurance buyers will also be more discriminating. Offshore energy rates have risen steeply and we would expect other marine lines to follow suit, albeit to a lesser degree, if cedants are unwilling to live with further reduced margins resulting from increases in this expense factor.
Information preparation is proving to be problematic for our cedants, not least because it is so difficult for them to articulate their business plans for 2006 given the current uncertainty generally in the property reinsurance arena. Talk of worldwide writers being penalized by the rating agencies for taking on worldwide exposures is further hampering efforts to structure programs.

Cat models are being called into question and some modeling companies are talking about severe recalibration of their models early next year, which makes 1 January pricing yet more uncertain.

Existing markets are struggling to come to terms with the extent of their 2005 losses; Wilma, at this stage, is still an unknown quantity. Many have had a double hit from their Energy portfolios. New capacity forming, mainly in Bermuda, is also causing uncertainty. Cedants have been unable to factor in how they might play in the 2006 retro world.

At this stage, a small number of Industry Loss Warranty contracts have been taken to the market at very high prices, again creating uncertainty over the feasibility of placing worldwide UNL catastrophe retro. At the same time, uncertainty over the extent of catastrophe cover that will be granted within risk excess of loss contracts also adds to the confusion.

Catastrophe retro programs are likely to be very patchy.

Cedants need to be flexible enough to accept capacity in different forms, on a private basis, in a way which delivers them the security they require while also matching the needs of the retrocessionaire.

There is some worldwide capacity available, as some markets are more comfortable with the limited downside generated by this product. Others will insist on a pillared approach, probably Americas and Rest of the World. It may be that the worldwide capacity will have to fit in the middle of two tiers of pillared capacity.

There will be UNL issues in abundance. Some markets will insist on the exclusion of certain lines, for example Direct and Facultative business, or risk excess of loss business, where others might choose to sub-limit it, thereby creating gaps in cover.

There may not be enough capacity for the larger programs, and other instruments may need to be bought, such as Industry Loss Warranty Covers, again increasing the volatility and basis risk retained by cedants.

The new Bermuda capacity has been quite late in starting and, as such, may look to accept Proportional facilities from established players.
Class Re-View as @ 1.1.2006

Professional Liability (US)

Re-View as at 1.1.2006

While D&O and non-medical E&O policies are often combined in reinsurance programs, particularly for the major carriers, reinsurers’ views and appetites are widely different depending on the coverage.

As regards treaties with significant exposure to public company D&O, reduced reinsurance commitments and less advantageous treaty terms and conditions are being negotiated for 1/1/06. This represents a second round of “tightening” and reduced reinsurance support. Since most treaties are either “proportional” or “cessions based,” the only pricing variables are ceding commissions which are down 3-5 points, to the mid- to low 20s. Reinsurers’ intent is to eliminate any overrides above actual ceding company costs. Loss ratio caps and corridors are again prevalent. Reinsurers’ share of this business has declined precipitously over the last five years. As a percentage of total capacity, reinsurance has gone from approximately 70% in 2000, to 50% in 2003, to less than 40% going into 2006. It is also important not to underestimate ceding companies’ heightened concern with their aggregate exposure to reinsurance credit risk as a factor in reinsurers’ diminishing share of the market.

While rates are still up between 150-300% from 2001, depending on the attachment of the policies, reinsurers are not convinced that premium levels are commensurate with exposure to inherent volatility and mushrooming severity of settlements. Despite evidence that the securities class action landscape has improved significantly over the last three years and, that the 2003 and 2004 accident years are potentially very profitable, reinsurers are generally skittish and inflexible.

Despite some erosion of underlying pricing and some modest expansion of coverages for E&O products, reinsurers are relatively sanguine about the health of this product line. Capacity for most classes including EPLI (often written in conjunction with professional liability) is adequate and, for some classes robust, at terms acceptable to clients. However, reinsurers are reluctant to support large risks for classes such as law firms that have experienced increased frequency and severity and perceived insufficient upward movement in both original rates and retentions. In addition, there is a widely held view among reinsurers, as well as many insurers, that large financial institution E&O is currently uninsurable.

Pre-View of 2006

If D&O pricing continues to decline, reinsurers will continue to reduce exposure to treaties with significant public company exposure. However, there are indications that pricing is flattening with the potential for modest increases. This would create stability in the reinsurance market. Regardless, there is a clear disconnect between reinsurers and ceding companies relative to the current profitability of this product. And until better tools to analyze the way portfolios are developed (which Willis Re is currently spearheading) or, pricing increases materially, it is unlikely that significant reinsurance capacity will return to the market.

As respects E&O, we do not expect material changes in reinsurance capacity or terms and conditions. Also, barring some major dislocation, we do not envision underlying dynamics of large account E&O to change such that appreciable new reinsurance capacity will be attracted at terms acceptable to our clients.
Hot Topics
- Catastrophe Models “Expected Loss” inaccuracy (demand surge)
- Frequency and Severity losses (Katrina, Rita, Wilma)
- Increasing role of collateralized reinsurance
- Role of Governments in insuring mega-catastrophes
- Reinsurers credit strength under review and exercise of downgrade clauses more common

**Cat XL**

**Re-View as at 1.1.2006**

Strong pre-Katrina balance sheets are allowing insurers to maintain higher retentions in a post-Katrina environment of rate uncertainty. The difficulties faced in evaluating Katrina’s damage make accurate loss estimation a matter of concern for insurers and reinsurers around the globe.

There are signs that rating agencies are asking for gross aggregates in key catastrophe exposed areas rather than relying on PMLs driven by rating models.

Reinsurers’ attitude (capacity and rates) vary dramatically by region, but there are signs of hardening in many territories. We are observing several general trends on International loss free renewals at 1/1/2006:

- Predictably, highest increases have been for US loss affected business
- Single Territory Cat Programs under GBP200/ EUR300m - flat to modest increases up to 5% with even isolated decreases where reinsurers are competing aggressively on small local business
- Multinational Peak Zone Cat Programs over GBP500/ EUR750m – increases of approx. 10%
- Continental European reinsurers are generally more competitive than other markets. This may be explained by the relatively lower impact of Katrina on the larger traditional reinsurers than on the smaller and less diversified London and Bermudian markets. This is coupled with the continental reinsurers’ objective of regaining market share in areas where they reduced post World Trade Centre

Our opinion is that Katrina is a “balance sheet” event for some markets – that is, it may affect the capital base, particularly in Bermuda and London, but for others it should be just an “earnings” event, only affecting 2005 profits. The impact of fresh capital entering the market is still not clear at this early stage.

**Pre-View of 2006**

There will be much greater emphasis on transparency of information and the consequent ability to benchmark different programs will be required.

Reinsurers will seek to increase their loadings on estimated modeled outputs, and adjust their own pricing models to cater for uncertainty. At the same time, reinsurers are also likely to increase their loadings to achieve higher ROE and meet tougher capital requirements post Katrina.

It is anticipated that there will be considerable additional capital for parametric contracts but since Katrina has clearly demonstrated the dangers of basis risk it is not clear how existing buyers will react to offers of capacity on a parametric basis.

Large property schedules have performed poorly against modeled outputs. Realization that these portfolios are difficult to model and are more highly correlated to catastrophe covers than previously anticipated will surely affect the market, although such impact is still unclear.
We expect further news on changes in reinsurers' security after record losses from the 2005 hurricane season, and as a consequence, a repeat of the “flight to quality” to higher security reinsurers.

“The difficulties faced by loss adjusters in evaluating Katrina’s damage make accurate loss estimation a matter of concern for insurers and reinsurers around the globe. There are signs that rating agencies are asking for gross aggregates in key catastrophe exposed areas rather than relying on PMLs driven by rating models”

**Pro Rata**

**Hot Topics**
- Continued pressure for reinsurers to move from pro rata to XL
- Business Interruption Losses hard to estimate and unpopular with reinsurers
- Reinsurers increasing need for a better balance between premium and limit
- Increased pressure for more transparent data

**Re-View as at 1.1.2006**
Ceding companies have been pushing for better terms based upon their own good results; however, reinsurers have been concerned over the reduction in original rates and there has been some demand from reinsurers for stricter commission levels.

Slightly unexpectedly, we have not seen as much pressure to take out catastrophe perils from pro rata treaties as we had expected; however, we have seen continuing pressure to limit such exposures through the use of event limits. With tightening rating agency scrutiny, most Bermudian companies are now no longer prepared to accept treaties without an event limit as a point of principle and many London/European markets are exerting similar pressures.

**Pre-View of 2006**
There will be a greater push towards data transparency and commission level practices, reduced capacity for pro rata treaties and the “event definition” discussions will remain on the agenda. Despite this, bouquet placements remain popular in some pro rata markets.

**Risk XL**

**Hot Topics**
- Cat perils on risk programs is the biggest issue
- Energy sector badly hit by US hurricane season
- Influence of terrorism risk and TRIA renewal conditions
- Lack of control of Business Interruption and Contingent Business Interruption accumulations

**Re-View as at 1.1.2006**
Reinsurers have been tougher on Business Interruption covers and increases on loss hit programs have been larger than expected. In addition, there has been a decline in the number of reinsurers offering combined risk and cat covers, despite the fact that some new risk and cat programs have been placed.

Reinsurers’ wish to exclude all natural perils from per risk contracts has not materialized to the extent that they would have liked, although it is clear that there has been a greater focus on this issue. It is further clear that pricing has been linked to movements in exposure as well as any relevant loss record.

**Pre-View of 2006**
There will be greater pressure in the Business Interruption and Contingent Business Interruption segments. There will also be the requirement for greater transparency of information and greater pressure to include catastrophe aggregates. There is also likely to be pressure to go to one loss per event.
The hurricane activity of 2005 is creating a “sea change” in the property segment of the reinsurance industry that will materially alter the way catastrophe reinsurance is transacted. It will change the universe of reinsurers and other capacity vehicles and provide interesting alternatives as ceding companies look for more vertical and horizontal catastrophe protection with enhanced reinsurance security.

Unlike natural catastrophes in prior years, the impact of Katrina, Rita and Wilma have provided successive punches that have prompted rating agencies to view reinsurers more critically differentiating between mono-line property writers and more diversified multi-line reinsurers. The impetus to require greater capital to support the greater shock loss volatility inherent in a mono-line property reinsurer’s portfolio will inevitably dampen the supply of catastrophe and per risk reinsurance capacity. This, at a time when the demand for catastrophe and per risk reinsurance is sharply increasing as buyers reassess what their worst-case loss scenarios might generate.

We are seeing quite clear differentiation in the pricing, terms, and conditions for territorially discrete ceding companies that did not have hurricane losses in 2005. For those companies with modest catastrophe exposures in the working per risk programs, reinsurers have evidenced their desire not to lose such business. For loss-affected programs, renewal pricing is being increased rather significantly.

We anticipate the combined effect of reinsurers reducing their property exposures and ceding company clients seeking to increase the reinsurance limits purchased will not be offset completely by new reinsurance capacity coming into the business (i.e. new companies and increased capital for existing reinsurers will not completely fill the void).

It is likely that loss-affected reinsurance programs will experience significant increases. The extent of the increased reinsurance premium outlay may be mitigated by ceding companies taking increased retentions. The implementation of non-concurrent terms (with differing terms applying to new markets that did not incur any losses) may mitigate the increase in ceded premium outlays.

There may have been USD1.5bn to USD2.0bn of traditional catastrophe capacity available in 2005 for territorially discrete programs (predominantly personal lines writers). In 2006, there is likely to be closer to USD1.25bn capacity, with less catastrophe capacity available for purely commercial/industrial property companies’ catastrophe programs.

Of perhaps greater concern to reinsurance buyers is the viability of loss recoveries from reinsurers involved in multiple large catastrophe events. Here we see a pronounced interest in creating integrated solutions to address the need for reinstatement protection, by simultaneously tapping alternative sources of capacity such as Hedge Funds and Capital Market vehicles. This capacity would supplement, not replace, traditional reinsurance capacity. The attraction to ceding companies is the ability to diversify their counter-party credit risk so that they do not need to put all of their eggs in one basket.
Unprecedented amount of surety support required by national home building accounts. Their robust appetite and need for subdivision bonds can only be met by spreading the liability among multiple sureties. The exposure aggregation this presents to the reinsurance community is creating concerns in light of rising interest rates and a potential real estate market slowdown. In addition, reinsurers have no historical point of reference for predicting potential loss frequency or severity.

The re-emergence of the large direct reinsurance markets is creating some downward rate movement and increasing competition between reinsurers for allocations of shrinking share allotments, in some instances leading to rate decreases.

The recent change in the State of New York Financial Guarantee Law allows sureties to write more classes of financial guarantee obligations which ceding companies may seek to include as covered business upon renewal.

What effect will the Gulf Coast “post-hurricane reconstruction” boom have on the broader construction market as budgets are modified to divert previously approved funding for highway and public works projects? In addition, what inflationary impact might result from potential labor and material shortages?

For the larger sureties, the effect of hurricane-related losses on reinsurer balance sheets may restrict their list of acceptable surety reinsurance markets and re-shape the supporting reinsurance panels.

Current renewal and placement activities point to continued stability within the surety reinsurance sector in the United States. Capacity constraints have eased somewhat due to increased appetite from existing reinsurers in the face of improving performance of the underlying industry. Reinsurers appear more comfortable with both the quantitative and qualitative analysis of prospective clients, and the primary sureties should benefit in cases where they can demonstrate improvement in credit quality and exposure management.

Reinsurers will continue to support, and, in some cases, to aggressively pursue primary companies who have clearly demonstrated a competency in managing their portfolios and provide superior returns over time. Consolidation and concentration within the surety industry has continued during 2005, with at least four established writers of surety withdrawing from the market. This has given reinsurers reason for concern, as they implement their strategies where fewer target clients exist.

The reinsurance marketplace will continue to soften moderately as trading conditions continue to improve. Loss activity should continue to trend downward for most companies as the implementation of portfolio management techniques should continue to produce an improvement in credit quality of surety portfolios, in an improving overall credit environment. Moderate reductions in reinsurance rates could also be influenced by increased appetite for surety business from both current and new reinsurers. Exposure-based rating modeling, currently used when analyzing and rating reinsurance coverage, should temper the reduction and keep overall trading conditions stable — barring unforeseen events.

It is likely that reinsurers will offer some relief to their ceding company clients with respect to underwriting restrictions imposed on the industry during 2002 — 2004. Such relief shall be more prevalent in situations where ceding companies can demonstrate the need for change, as well as the technical expertise to manage that change. These concessions should help lessen the need for special acceptances in most cases.
Class Re-View as @ 1.1.2006

Trade Credit, Political Risk and Bond

Re-View as at 1.1.2006

In a year which has been characterized by major losses on Property reinsurance contracts, some reinsurers have been content to have portfolios diversified into other classes, such as Credit and Bonds.

Although the general economic climate remains sluggish, Credit Insurance has recorded outstandingly low loss ratios during the cycle 2003 to 2005 inclusive. This has been due to a period of strict risk selection and a tightening of underwriting by the main Insurers (the world market for Trade Credit remains predominately European and dominated by 3 large groups).

The reinsurance market remains almost as highly concentrated, with 12 to 15 active participants writing almost all of the business. Those reinsurers that remain active are still able to provide the capacity that the market requires, despite the continuing consolidation of exposures, and the high capital charges indicated by rating agencies for the class.

Pre-View of 2006

Reinsurance margins for 2006, both pro rata commissions and Excess of loss rates, have come under pressure from "windfall" profits experienced during the past 3 years. In addition the stricter underwriting of the original business has improved the quality of the underlying portfolios, reducing the probability of default. Against a background of flat or increasing rates on mainstream business classes, Trade Credit reinsurance has seen further increases in commissions on pro rata contracts and rate reductions on Excess of Loss contracts.

Pure political risks reinsurance has fared slightly less well, having suffered a widely spread market loss during 2005. The direct market’s premium income base has continued on a downward trend, so even stable prices have resulted in increases in adjustable rates. Some clients have reacted to this by increasing retentions.

Although the privatization of European Export Credit Agencies has not continued at the same rate during 2005, these agencies are increasingly interested in engaging the wider reinsurance market.

The new countries of the European Union represent a capacity challenge, whilst their economies are still in a state of transition. Demand for cover still remains despite their new status, but the capacities required are increasing rapidly.

“Although the privatization of European Export Credit Agencies has not continued at the same rate during 2005, these agencies are increasingly interested in engaging the wider reinsurance market.”

Hot Topics

- Margins under pressure from “windfall” profits, especially on Trade Credit
- Reinsurance market remains highly concentrated
- New countries of European Union represent a capacity challenge for the market during a transition period for their economies
Workers’ Compensation

Hot Topics
- Extension and revision of TRIA
- Medical severity, especially as respects pharmaceuticals
- Accurate monitoring of employee concentrations
- Predictive modeling, both up-front for improved risk selection and back-end for fraudulent claim detection

Class Re-View as @ 1.1.2006

Unlike the property sector, 2005 proved to be a stable year for workers’ compensation. Working layer rates remained flat or experienced slight reductions. Improvements in terms resulted more in an expansion of aggregate limit (either as free and/or paid reinstatements), rather than pricing declines. Reinsurer concerns remain regarding adverse development from the late 90’s, prolonged durations and severity, although it appears that the sharp double-digit increases in medical severity that occurred in prior years have finally moderated. Some states, such as California, have experienced actual decreases in medical costs within the last year. Because there are relatively few reinsurers actively writing working-layer programs, those markets should be extremely pleased with the market position they have established and the benefits they have received from continued pricing increases (although at a lower rate) and significant reform measures that were implemented in a number of states.

Capacity was adequate for buyers at reasonable retention levels. Affordability was the defining factor in determining retentions, which ranged from USD100,000 for small buyers to USD5m for national carriers. Limits up to USD10m that are single-person exposed (i.e. without a Maximum Any One Life provision) were available and many companies chose that option.

Catastrophe capacity remained abundant (estimated at over USD1.5bn) and rate-on-line pricing continued to fall 10 - 12%, which was consistent with the decreases from the prior year. However, in the 4th quarter cost of capital considerations and rating agency actions on catastrophe-prone portfolios caused pricing to stabilize. Although reinsurers generally did not use commercial catastrophe models as a pricing tool, they were keenly interested in their cedants’ ability to accurately collect and monitor employee aggregations.

On both working and catastrophe layers, non-certified terrorism was routinely offered without a surcharge. Adding certified coverage on a capped basis resulted in a 10-15% surcharge. Typically NCB was excluded from mainframe programs, but it could be purchased on a stand - alone basis. Capacity was limited, reinsurers were very selective about the risks they accepted, and the cost was beyond the reach of many companies.

Pre-View of 2006
Pricing and terms should remain stable on working layer business with declining medical severity and frequency offset by the low interest rate environment, higher cost of capital considerations, somewhat softening primary pricing and the lack of any new capacity.

Following the string of hurricane losses it appeared that catastrophe capacity might suffer as markets redeployed their capital into those lines of business which were expected to receive the most significant increases in price. However, the rating agencies are now putting a much greater emphasis on diversification of risk by imposing more stringent capital thresholds for property concentrated reinsurers. Workers’ compensation cat covers, which have been written at a 0% loss ratio since 2002, are a natural fit as existing property-only companies look to expand into other lines of business. In addition, it appears that the Bermuda reinsurer class of 2005/06 will bring with it a significant expansion in the number of players in this sector.

The request for data, both on working and catastrophe layers, will continue to have a high priority. In addition to providing individual loss development on large losses for working layers, companies should be prepared to quantify the effects of medical management, re-underwriting, up-front predictive modeling and loss prevention services in order to differentiate themselves from their competitors. On catastrophe placement, there are still inconsistencies in the quality of employee concentration information being presented. Although payroll and number of employees by zip code is commonly provided, reinsurers will look more favorably on portfolios that are geocoded to the street address level.
The interest of hedge funds in insurance risk continues to grow. Infrastructure and processes of hedge funds need to be improved to enhance delivery.

Rating and regulatory pressures are driving the insurance industry closer to the model of other financial markets.

The market for insurance-linked securities is demonstrating increased appetite and flexibility.

The range of capital solutions for re/insurers is more fluid than before.

The KRW events (hurricanes Katrina, Rita and Wilma) have placed the non-traditional markets firmly in the spotlight. Prior to KRW, there was much speculation regarding the robustness of non-insurance risk capital post a major loss. “Hedge fund” investors have lost considerable amounts of money in risk-bearing transactions and at least one cat bond is expected to be hit. Despite this, new capital has flooded into the arena, driven by two factors: the vast amount of global capital seeking non-correlated, high return investment opportunities and the perception that, post KRW, the insurance industry will need to reinforce its capital base in response to rating agency and regulatory pressures. This new capital has entered the industry at every level, from traditional equity, through hybrid debt instruments to direct participation in event risk.

At the start of the year, the capital markets could mostly be found participating in high level natural catastrophe risk, predominantly via the cat bond market. By the end of the year, capital market investors were assuming a broad range of perils and levels of risk. The growth of the hedge fund market for insurance risk has been most notable, a hunger for return driving investors towards higher frequency exposures. The cat bond market has largely remained focused on low frequency – high severity risks, but a resurgence of activity has seen this market assume large quantities of non-natural catastrophe risks including casualty, motor and mortality. Investors’ pricing expectations have increased post KRW, but perhaps not in line with the traditional markets. The mis-match between capital markets pricing and traditional reinsurance pricing is now often no more than the effective value of full collateralization.

Many capital markets investors have developed infrastructures to facilitate accessibility to the re/insurance markets. Nonetheless, the growth of the involvement of these investors has been swift, occasionally outstripping their own infrastructure. The ability to co-ordinate and manage approaches to these markets and understand the differences in market practices and terminology has become an important part of the broker’s armory.

Securitization is a means of achieving this objective. The market for insurance linked securities, fuelled by investor demand, will continue to develop and demonstrate increased appetite and flexibility. There will be an emphasis on transactions that achieve tangible capital benefits for sponsors, be that in the form of off-loading peak catastrophe exposures or realizing opportunities for capital arbitrage.

Almost without exception, the major funds and banks are demonstrating interest in participating more directly in the insurance sector. Historically, the insurance industry has shown great resilience in the face of onslaught from the financial markets and talk of convergence has been over-hyped. This time round, conditions in both the financial and insurance markets suggest a much greater commonality of interest. An interesting and exciting year ahead can be expected.

Pre-View of 2006
Continuing pressure on capital can be expected as re/insurers adapt to a new perception of risk driven by the events of the last year. Rating agency and regulatory pressures will drive the insurance industry closer to the model adopted by other financial markets who de-risk their balance sheets by accessing external capital, so introducing an aspect of agency to their operations.

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It is reported that in 2005 catastrophe events worldwide caused more than USD135bn in economic loss and killed more than 110,000 people.

The past year saw the most devastating hurricane season in the Atlantic basin since records began in terms of economic and insured losses.

Perceived underperformance of commercial catastrophe models, particularly related to the Atlantic basin hurricanes, led to questions from some parts of the insurance industry about the purpose and role of such models.

Model estimates for, in particular, Hurricane Katrina, were problematic. Katrina was deemed a “super catastrophe” where the devastating effects of the hurricane caused the loss to be amplified in ways never before experienced, thus moving beyond the design parameters of conventional catastrophe models.

Flood events and their subsequent effects were a major component of the year’s extreme losses, however this peril remains poorly provided for in commercial catastrophe models.

The performance of catastrophe models gave rise to increased scrutiny of the quality of location and insurance data entered into models.

2005 will leave a significant mark in the record books as far as catastrophes are concerned, and saw a significant change in the attitude of the insurance industry to catastrophe modeling. A year of unprecedented hurricane activity in the Atlantic basin, 2005 will go down in history as the most costly for insurers ever recorded. This year will also be remembered as another year where catastrophe models were vigorously tested, and frequently found to misrepresent actual loss potential, particularly in areas affected by the largest losses.

Select Major Catastrophes in 2005

Although it occurred late in 2004, the South East Asian Tsunami had effects which lasted well into 2005. It devastated areas of Indonesia, Thailand, India, Sri Lanka and other territories around the Indian Ocean. At least 200,000 people were killed and millions left homeless however, this tragedy resulted in relatively few insured losses. There are currently no commercial tsunami models available and the Indian Ocean is generally not well covered by catastrophe models.

The Atlantic basin Hurricane season was the most active since records began in the mid 19th century, with 26 named storms, 14 hurricanes, 7 intense hurricanes, with three category 5 storms. Three storms in particular caused major insured losses; Katrina (USD38.1bn), Wilma (USD6.1bn), Rita (USD4.7bn), according to the Property Claims Service division of the Insurance Services Office (ISO) as of year end 2005. Real time forecasts of these events using commercial models gave very wide ranges of loss estimates which were not found useful by much of the insurance market.

The U.S. Gulf Coast’s Hurricane Katrina: This event has been described as a “Super Cat Event”, i.e. an event characterized by massive damage that gives rise to nonlinear loss amplification and correlation. Losses from Katrina were caused by high wind speeds and storm surges, as well as by flood defence failure which left much of New Orleans under several meters of water. Losses were often caused by a combination of perils which gave rise to insurance coverage disputes. Considerable and on-going and contingent business interruption issues remain. Many lines of business experienced significant losses, including property, motor, cargo, and energy. Economic losses are expected to exceed USD100bn and insured losses are expected to exceed the figure currently reported by the PCS. Modeled post event estimates were usually only for wind damage and thus did not properly reflect the large proportion of losses from flood and business interruption. Initial loss estimates also reflected the apparent under reporting of insurance aggregates which appears be wide-spread.

Pakistan EQ: A magnitude 7.6 earthquake occurred in northern Pakistan and caused over 80,000 deaths. Economic rebuilding costs are estimated to be at least USD10bn; insurance penetration and therefore insured losses are minimal, so although there is commercial catastrophe modeling available for Pakistan, it was not relevant in this event.
European Flood; Flooding occurred in several European countries including Switzerland, Austria, Germany, Romania, Slovenia, Bulgaria and Croatia. Economic losses of USD1.5bn were reported from Switzerland and of USD1bn from Romania. Commercial flood models for this region are under development but not yet available. The actual loss records from these flood events should benefit the development of loss functions for the various imminent models.

Mumbai Flood; Severe flooding associated with extreme rainfall caused more than 1,000 deaths and caused severe damage and disruption in Mumbai and the state of Maharashtra. Insurance losses were estimated to be USD39m. There are no commercial catastrophe models available for flood in India.

Catastrophe Model Updates in 2005
The three major catastrophe model vendors continued to expand the scope of their offerings and integrate recent developments into their existing models. In 2005, AIR released the first US winter storm model, updated its US Atlantic hurricane model to include aggregate demand surge and new frequency parameters, updated the Western US earthquake model, and updated its Mediterranean earthquake model (covering Greece, Italy and Portugal). Meanwhile, EQECAT updated its US earthquake, US hurricane model, and its Belgium earthquake model. RMS upgraded the Japanese earthquake and typhoon models, its Australian earthquake and cyclone models, and its US hurricane model manufactured housing vulnerability function.

These updates have and will benefit the companies operating in affected territories, however the events of 2005 are likely to drastically affect the modeling companies treatment of Atlantic basin hurricanes, and thus to make the changes made in 2005 largely irrelevant. The reaction to these events is also likely to affect some of the fundamental functions of the catastrophe models in the longer term.

Pre-View of 2006

Catastrophe Models
Some areas of the insurance market reacted to the major losses of 2005 by criticizing catastrophe modeling. This response typifies the need to better understand the purpose and practice of catastrophe modeling, and in particular, the roles and limitations of catastrophe models. Models are intended to be just one of a set of tools used to estimate risk and exposure. Catastrophe models should, therefore, be used to assist reinsurers and insurance companies, but should not be solely relied upon in setting risk management strategy. It is essential that catastrophe modelers and risk managers fully understand the principles of modeling and the assumptions underlying the models so that they can recognize model capabilities and, most importantly, limitations. For example, the experience of Katrina illustrates that the phenomena of what are being referred to as “Super Cat” events is not well reflected in catastrophe models. The insurance market is becoming more interested in estimates for all forms of losses associated with catastrophes, for example demand surge, storm surge and flood, and business interruption, among others. It is important to understand that models only estimate losses for the limited set of risks for which they are designed. Many of the perceived problems with catastrophe models relate to the expectation that they will estimate not only the direct loss associated with the peril but also all possible corollary losses. The large differences between the actual losses produced by Hurricane Katrina and the modeled losses should not cause a move away from modeling, rather a move towards better understanding and more intelligent use of models, as well as greater research and additional understanding of natural hazards, in particular those which have correlation. This is a key area for development for each of the commercial vendors and significant upgrades and changes to the Atlantic hurricane models should be expected in 2006. There is little doubt that this will mean significant increases in loss projections. Increased hurricane activity in the Atlantic basin and elsewhere is an observed phenomenon. The mechanism behind this increase is subject to considerable and increasingly animated discussion in academic circles.

Whatever the answer to the question of why activity in increasing, modeling this change in the environment is likely to have considerable repercussions on modeled results in 2006 and beyond.

Data Quality
Modeling output can only be as accurate as the input data. Accurate modeling results rely on the provision of high quality data. For sound business decisions to be made with the assistance of modeled results, data needs to be of the best possible quality. Data can be enhanced by proper auditing to ensure that the exposure is modeled and analyzed using appropriate values.
Data quality has emerged as a key weakness during the 2005 hurricane season, with many portfolios greatly underestimating the total building values as well as misrepresenting the construction elements such as the year of construction and structural details. A renewed look at data capture, coding, and quality control is needed to ensure the insured portfolio is properly represented with the models. Another aspect of the losses in 2005 has been the appearance of losses to property which was not included in the exposure analysis. This indicates an undercounting issue which may be due to process problems or to simple error. A review of the entire process is essential for organizations, and has recently revealed cases of undercounting of up to 40% of a portfolio.

Data quality extends to not only property business; workers’ compensation, life, and personal accident insurers are also turning to catastrophe modeling techniques to further explore the wider scope of risk in their portfolios. The need for detailed information about these exposures is becoming a major requirement from reinsurers and those assuming the potential risk. It is also becoming an essential tool for the major ratings agencies, without modeling, they are likely to increase “uncertainty rating” on companies. The ratings agencies reaction to changes in catastrophe models is likely to be crucial to their acceptance by the wider insurance industry. Overall it is likely that the insurance industry will benefit from the lessons learned from recent catastrophe events regarding the use of catastrophe models in risk management decision making.

Summary
The market is reacting to lessons learned over recent years by tightening up risk management plans, underwriting controls, capacity allocations, and pricing assumptions. A need for “back to basics” underwriting calls for more and better tools and modeling applications. Insurers are no longer relying on simple single-point loss estimates for key return periods for making business decisions; rather, they require exceedence probability curves, full understanding of the uncertainty in the loss estimates and potential correlated losses to develop sophisticated plans for managing risk in order to maintain their capitalization and profitability requirements.
Hot Topics

- Increased competition between captive domiciles. This includes serious new entrants such as Malta, as well as reinvention by others – Luxembourg, previously favored as a reinsurance domicile, is now marketing itself as a direct writing location. Jersey offers a new form of corporate structure, the ICC.

- Captive locations are committed to bringing their regulations up to the best international standards, as part of the global trend towards greater consistency of insurance regulation. As part of a move to ensure that their regulatory offering matches that of competing locations, the Isle of Man, for example, is introducing an amalgamation law.

- Introduction of EU Reinsurance Directive. Ireland has opted for early adoption, whilst other member countries are planning to implement in 2007-8.

- Impact of introduction of International Accounting Standards (IAS) and changes to UK GAAP (bringing it into line with IAS).

- Superequivalence. This is an issue for EU regulators and relates to the comfort margin each regulator is insisting on being added to the EU minimum solvency margin. It is linked to the revised solvency standards being introduced, leading to ultimate adoption of the Solvency II standard. As an example, the Irish regulator is requiring a 200% uplift for direct writers.

Re-View as at 1.1.2006

The soft market dampened demand for start-ups, with the exception of distressed classes, strategic decision and middle-tier parent operations. This has been a feature of the captive market for many years.

Malta has now achieved critical mass (anticipating more than 12 captives by year-end 2005, with a particular niche in the migration of German-owned captives).

Tax strategies of domiciles are being fine-tuned (In Guernsey, Jersey and the Isle of Man designer tax rates are being abolished in favor of a 0% rate. Gibraltar is currently in dispute with the EU, but are trying – and intending – to introduce a low tax rate).

Gibraltar start-ups are now maturing and the market for Gibraltar is expanding and diversifying internationally, away from its historic core (UK).

Pre-View of 2006

The impact of the EU Reinsurance Directive is yet to be fully assessed and understood. We are, however, anticipating a move by a number of reinsurance captives from their current onshore location to offshore unless their strategy is to convert to being a direct writer in the future.

There is a possibility that EU domiciles might try to discriminate against reinsurance placed with non-EU-regulated reinsurers, though the resultant implications for major established EU-based direct insurers suggests that this potential threat could face significant opposition.

We anticipate continued migration of captives to more appropriate domiciles. The growth of previously unestablished locations, such as Malta, and the trend towards convergence of regulations, provides opportunities for company migration. Local tax differentials continue to apply, and will still be of significance for some companies.

The significant hardening in insurance markets generally suggests that there will be renewed interest in new captive establishment in 2006. Regulators are already beginning to report increased interest.
Hot Topics

- Demand for financial modeling has entered a new paradigm, with our insurance and reinsurance company clients now treating it as an essential activity, and taking an active role in the scoping, the definition of requirements, agreement of methodology and output design.

- New regulatory and solvency standards are providing a substantial impetus for more complex modeling of insurance company risk, beyond that of pure reinsurance modeling.

- Financial modeling is being integrated into insurers’ business planning, strategic development and underwriting management, as well as being used for regulatory and risk management purposes.

Re-View as at 1.1.2006

2005 has seen a further increase in demand for financial modeling services from our very largest, global and complex clients, through to some of the smaller, single-territory and single-portfolio insurers. Three years ago, the vast majority of financial modeling work was carried out for reinsurance managers, to assist in the design, costing and marketing of reinsurance programs. That work is still being carried out, and to ever-greater degrees of sophistication, but the impact of financial modeling is now far greater, with increasing numbers of insurers finding far wider applications.

Most clients are making extensive use of pre-reinsurance portfolio modeling, with portfolio diversification (and, conversely, correlation and aggregation) a particular point of focus. Interpretation of outputs to identify key insurance risk drivers and is becoming a standard analytical exercise. With the enhanced role of actuaries within the general insurance market, discussions around key assumptions, fitting of distributions and interpretation of output have become commonplace – and are providing a useful basis for informed reinsurance discussions.

Pre-View of 2006

2006 will see the use of financial modeling extended beyond pre-and post-reinsurance renewal exercises into a year-round activity, incorporating business planning, underwriting support and ever-wider capital management activity.

The combined resource of catastrophe modeling and financial modeling will assume greater importance, as updated catastrophe models are released during 2006. Integration of new understandings of catastrophe exposure, including the application of business implications arising from new research into risks such as seriality of windstorm, will be key to the delivery of financial modeling in the future.

There will be increasing attention on the correlation of risk, in particular between the performance of asset classes with insurance liabilities, and between credit risk and peak insurance / reinsurance losses. To date, this has been a largely unexplored and unexplained phenomenon, but it is likely to be next on the regulatory agenda, at least for the more forward-thinking regulators.
Re-View as at 1.1.2006

Whether because of the increased disclosure requirements now required under International Accounting Standards, or because of the adverse publicity generated by various US-led enquiries, the finite reinsurance market has virtually died – at least as far as new deals are concerned.

EU-listed insurers and reinsurers are required to publish their 2005 financial statements under International Financial Reporting Standards, and most have now published a restatement of their 2004 accounts in line with these. The impact is bigger than just IFRS 4, which deals with issues specific to insurance, and the overall size of the adjustments varies significantly from company to company, depending on the size of the various adjustments.

Typical positive adjustments include:
- Revaluation of investments to market value
- Write back of claims equalization reserves

Typical negative adjustments include:
- Recognition of deficit on pension fund

Pre-View of 2006

During 2006/7, work is expected to continue on Stage 2 of the International Accounting Standards Board’s work on accounting for insurance contracts, which may be ready for implementation in 2009. This is currently proving very controversial, with representatives from several countries trying to overturn the previously announced intention to “mark assets and liabilities to market” – thus abandoning the well established principles of earned premium, incurred claims and combined ratios, but without announcing what will replace them.

Work will also progress on the EU Solvency II project. The basic shape of this is now becoming clear, with a two-tier solvency regime. The lower mandatory hurdle will give regulators the power to close companies down, while the higher target requirement will be based on companies’ own internal capital adequacy models, once these have been approved by regulators.

The internal models are required to estimate the capital necessary to ensure the company will be able to meet its liabilities over a one-year time horizon, with a probability of 99.5%. Preliminary results from the UK FSA’s interim regime, adopted during 2005, suggest that companies are not putting enough emphasis on Enterprise Risk, or on counterparty credit risk. The FSA is also determined that the capital management process should be an integral part of the company’s management, rather than just a regulatory chore.
The enormous losses suffered by both the primary and reinsurance markets have required substantial capital raising exercises to be conducted by many, and, as followed 9/11, a wave of new capacity has been established, to take advantage of the upswing in rates.

Shareholder and capital commitment to established players was largely forthcoming relatively quickly, and demonstrated considerable confidence in individuals. Whilst there was an appreciation that these were indeed exceptional market events, there were issues surrounding individual companies as well; control mechanisms, modeling, reinsurance protections for example, which will be addressed over coming months.

In respect of the new start-ups, the key difference versus the class of 2001 has been timing. A more cautious approach has prevailed, with areas under scrutiny ranging from underwriting and management experience, to infrastructure, and long term shareholder commitment. As a result, the time taken to secure capital investment and thus rating agency opinion, has taken us perilously close to the end of the year before both were in place and the companies operational. However, both are now in place, bringing additional choice for clients in selecting reinsurance partners, at least for this renewal season.

The profitability of the reinsurance sector over several years has meant that despite the recent losses there have been relatively few rating downgrades thus far. So with rates increasing (though not yet consistently), prospects for 2006 are reasonable, assuming catastrophe losses return towards something resembling historic levels! However, with the influence of newly available capacity, the sustainability of rate increases over the medium term is more of an issue for long term security.

The inevitable post-mortem over the magnitude of the 2005’s losses has also started; focusing on internal control mechanisms and dependency on cat models.

The rating agencies’ focus is the exposure being run by many reinsurers operating catastrophe and/or mono-line business models. Thus we expect to see an acceleration in the re-evaluation of rating agency models and methodologies over the coming 6 months. For example, aspects such as operational risk, always part of the capital adequacy assessment, have assumed a heightened importance, as the rating agencies seek to introduce ever more comprehensive capital adequacy models. In addition, they are increasingly looking to initiatives such as enterprise risk management to improve their analytical capabilities in capital assessment.

Whilst we are not expecting wholesale movement in ratings, it will be critical for both buyers and sellers of reinsurance to appreciate and understand the impact of refocused rating methodologies, once the details become clearer in the coming months, as it will influence their detailed annual rating review meetings over the course of the next 12 months.

One often frustrating aspect will certainly be the variation which comes from the different rating agencies’ approaches, to issues, models and specific companies.

This all serves to emphasize that the balance clients seek from their reinsurance program, in terms of financial security, capacity, location, rating, service quality, long term and prospective relationships remains critical for both for this and future renewal seasons.
2005 began with the Bermuda insurance and reinsurance companies capitalized at an all time high. The Bermuda reinsurance companies had avoided many of the losses to impact the market in 2004, paying only an estimated 12.5% of the market insured loss of USD25bn from the four major storms in Florida. Earnings for 2004, although down on 2003 results, remained resolute. In the first half of 2005, rates for primary insurance and catastrophe reinsurance, which were under pressure in 2004, continued to soften and more than USD1.2bn of capital was handed back by Allied World, Axis and Montpelier Re in the form of share buy-backs and dividends, and many reinsurers openly stated they would not support downward pricing.

The third quarter changed everything. The 2005 Atlantic Hurricane season resulted in 26 named storms, including 7 major hurricanes. The Bermuda reinsurance market is expected to pay approximately 25% of the expected market loss from the three largest storms, Hurricanes Katrina, Rita and Wilma (USD48bn of insured losses reported to date).

There are three main reasons for the increased Bermuda share of the loss. Firstly, the Bermuda market has generally offered more capacity at the mid to top-end of catastrophe reinsurance programs, which were mostly unimpaired by the 2004 hurricanes, but were severely impacted by Hurricane Katrina. Secondly, the Bermuda reinsurance market had grown its market share during 2005, not only in property catastrophe lines, but also in some of the specialty lines such as Marine, Energy and Property Retro. All of these lines suffered major losses because of the 2005 hurricanes. Thirdly, sections of the Bermuda reinsurance market had written significant levels of risk excess business with broad occurrence limits, resulting in an exceptionally high number of risk losses, especially from Hurricane Katrina.

As a number of Bermuda reinsurance companies, and in particular the class of 2001, are not significant buyers of retrocessional protection, 2005 losses have not only affected earnings, but also reduced paid-up capital for many of the companies, especially those with a mono-line, short-tail portfolio.

This erosion of capital has had a number of knock-on effects. Since Hurricane Katrina, A.M. Best has downgraded 12 reinsurers, 9 of which are domiciled in Bermuda, and placed another 12 under review, 7 of which are domiciled in Bermuda. There has also been a rush to replace the lost capital with an estimated USD18bn of new capital entering the Bermuda market since Katrina. The new capital is split roughly as follows:

<table>
<thead>
<tr>
<th>New capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Reinsurers</td>
<td>50%</td>
</tr>
<tr>
<td>Side-Car Vehicles</td>
<td>15%</td>
</tr>
<tr>
<td>Lloyd’s Start-Ups</td>
<td>5%</td>
</tr>
<tr>
<td>New Start-Ups</td>
<td>30%</td>
</tr>
</tbody>
</table>

Given the level of losses that have affected the Bermuda reinsurance market, and the major deficiencies in catastrophe pricing models which became apparent with the losses from Hurricane Katrina, we are likely to see a number on developments in 2006.

- **Pricing and Level.** Loss affected accounts, and in particular US nationwide business, are likely to see major price increases, as well as higher retentions. Pricing adjustments for International business is harder to forecast, as this has generally not been hit by major loss activity in recent years. In addition, International business is appealing to reinsurers due to the non-correlation with the US accounts.

- **Risk Excess Business.** Restriction of coverage for natural catastrophe losses within risk excess may become a factor, especially for the nationwide and E&S accounts.
Rating Agencies. Higher capital charges, especially for worldwide accounts, will result in a reduction in catastrophe-exposed aggregates written and/or retained, and the pricing at the top-end of catastrophe programs may “flatten” as reinsurers will have minimum pricing targets in order to generate sufficient income to meet their target ROEs.

Recalibration of Models. The models are being recalibrated to recognize greater loss severity and frequency, as well the correlation between different lines of business. This will put more pressure on reinsurers to raise the pricing of cat-exposed business.

Much of the above applies to the worldwide reinsurance market and not just Bermuda, but with the replacement capital in place for the incumbent markets and the expected establishment of the start-up companies, Bermuda’s role as the major provider of catastrophe reinsurance will continue apace in 2006.
### New company breakdown

<table>
<thead>
<tr>
<th>New Company</th>
<th>Capital</th>
<th>Backers</th>
<th>Management / Staff</th>
<th>Business Mix</th>
<th>License</th>
<th>Rating</th>
<th>Date Active</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harbor Point Re Limited</td>
<td>USD1,300m</td>
<td>Chubb</td>
<td>CEO – John Berger, Chairman – Stephen Friedman, Tom Wafer, Jed Rhoads, Greg Richardson</td>
<td>Renewal rights to Chubb Re. Property Cat, Risk, Pro Rata, Retro, Casualty, Energy</td>
<td>Class 4</td>
<td>AM Best A</td>
<td>Active</td>
</tr>
<tr>
<td>Validus Reinsurance, Ltd.</td>
<td>USD1,000m</td>
<td>Aquiline Investments</td>
<td>CEO – Ed Noonan, President – George Reeth</td>
<td>Property Cat, Risk, Pro Rata, Retro, Marine, Aviation, Energy</td>
<td>Class 4</td>
<td>AM Best A</td>
<td>Active</td>
</tr>
<tr>
<td>Ariel Re</td>
<td>USD1,000m</td>
<td>Blackstone</td>
<td>Chairman, CEO -Don Kramer, CEO Co-Presidents – George Rivaz, Mark Herman</td>
<td>Renewal rights to Rosemont. Short-tail reinsurance mirroring Rosemont, but larger lines. Expansion planned into short and long-tail insurance lines</td>
<td>Class 4</td>
<td>AM Best A</td>
<td>Active</td>
</tr>
<tr>
<td>Lancashire Insurance Company Ltd</td>
<td>USD1,000m</td>
<td>Cypress Capital</td>
<td>CEO - Richard Brindle, Alex Richards</td>
<td>Property, Marine, Energy, Aviation insurance. Property Cat, Risk and Pro Rata</td>
<td>Class 4</td>
<td>AM Best A</td>
<td>Active</td>
</tr>
<tr>
<td>Arrow Capital Reinsurance Co. Ltd</td>
<td>USD600m</td>
<td>Goldman Sachs</td>
<td>Tom Milligan</td>
<td>Property Cat and Retro via collateralized indemnity</td>
<td>Class 4</td>
<td>Not sought</td>
<td>Active</td>
</tr>
<tr>
<td>Flagstone Re</td>
<td>USD530m</td>
<td>private equity</td>
<td>Chairman – Mark Byrne, CEO – David Brown</td>
<td>Property Cat, Risk, Pro Rata. Marine, Aviation, short-tail Casualty, Energy Mono-territory ILW</td>
<td>Class 4</td>
<td>AM Best A</td>
<td>Active</td>
</tr>
<tr>
<td>New Company breakdown</td>
<td>New Company</td>
<td>Capital</td>
<td>Backers</td>
<td>Management / Staff</td>
<td>Business Mix</td>
<td>License</td>
<td>Rating</td>
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<tr>
<td>Amlin Bermuda Ltd.</td>
<td>USD1,000m</td>
<td>Amlin</td>
<td>Underwriting Director - John Andrews Ben Savill</td>
<td>Property Cat, Risk and Pro Rata</td>
<td>Class 4</td>
<td>AM Best A-</td>
<td>Active</td>
</tr>
<tr>
<td>Hiscox Bermuda</td>
<td>USD500m</td>
<td>Hiscox</td>
<td>CEO - Rob Childs Chris Sharpe</td>
<td>3rd party QS of Hiscox existing insurance business. International/US Property Cat, Risk, Pro Rata. Energy</td>
<td>Class 4</td>
<td>AM Best A-</td>
<td>Active</td>
</tr>
<tr>
<td>Omega Specialty</td>
<td>&lt; GBP90m</td>
<td>Omega Underwriting Group</td>
<td>n/a</td>
<td>Property Cat, Per Risk, Marine</td>
<td>n/a</td>
<td>n/a</td>
<td>Target 1st qtr 2006</td>
</tr>
<tr>
<td>New Castle Re</td>
<td>USD500m</td>
<td>Citadel Investment Group</td>
<td>CEO - Chris McKeown</td>
<td>Property Cat and Risk, Energy, Terrorism and Workers’ Comp Cat</td>
<td>Class 4</td>
<td>AM Best A-</td>
<td>Active</td>
</tr>
<tr>
<td>Blue Ocean</td>
<td>USD300m (estimated)</td>
<td>Montpelier Re Private Equity</td>
<td>Tony Taylor John Bassett</td>
<td>Collateralized Property Retro (for third parties only)</td>
<td>n/a</td>
<td>Not sought</td>
<td>Target 1st qtr 2006</td>
</tr>
<tr>
<td>Cyrus Re</td>
<td>USD525m</td>
<td>Highfields Capital</td>
<td>n/a</td>
<td>3rd party QS of XL Re’s Property Cat and Retro business</td>
<td>n/a</td>
<td>Not sought</td>
<td>Active</td>
</tr>
<tr>
<td>Ascendant Re</td>
<td>n/a</td>
<td>n/a</td>
<td>David Whiting Richard Black Rick Pagnani</td>
<td>n/a</td>
<td>Class 4</td>
<td>n/a</td>
<td>2006</td>
</tr>
<tr>
<td>Cayman Islands</td>
<td></td>
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</tbody>
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- Review April 2005

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