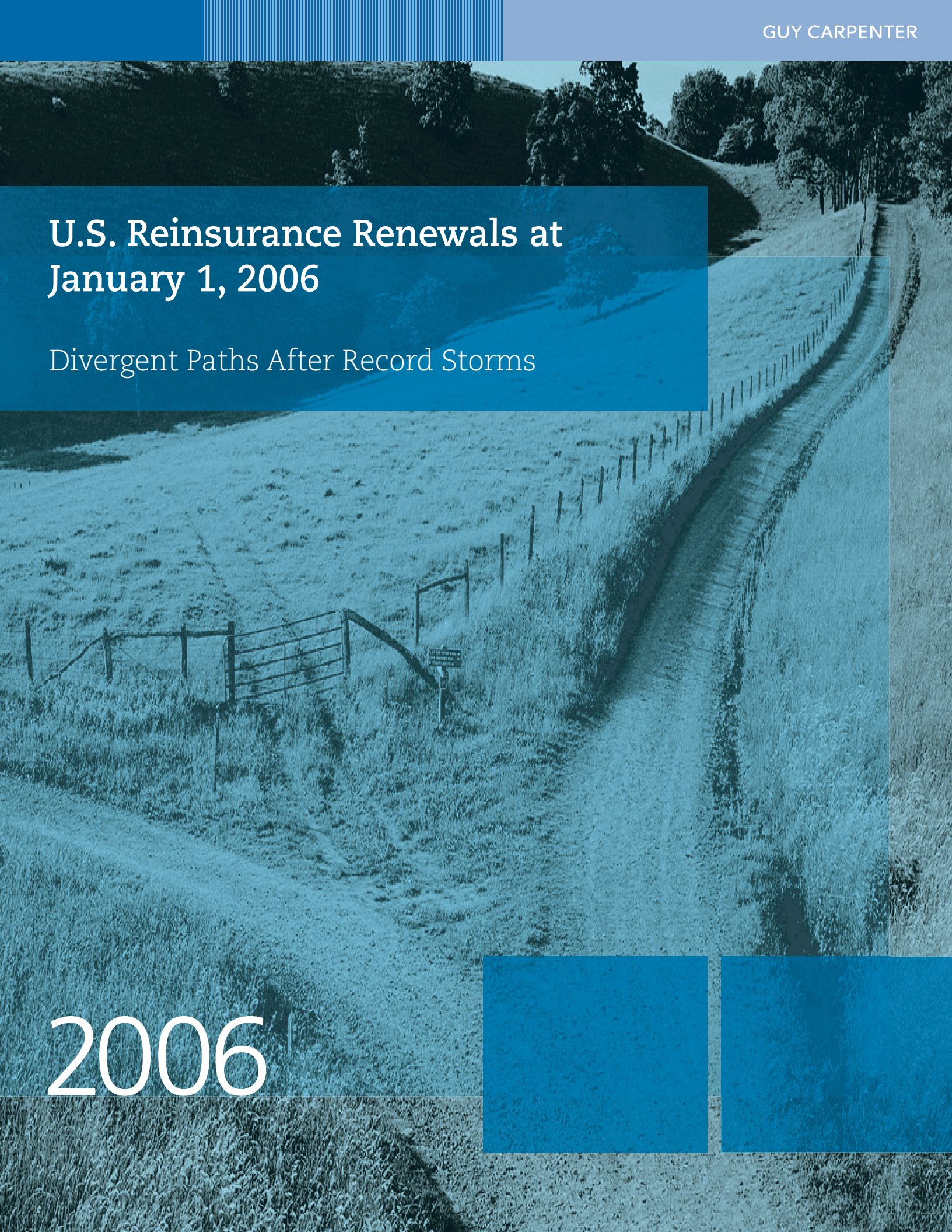


U.S. Reinsurance Renewals at January 1, 2006

Divergent Paths After Record Storms

2006



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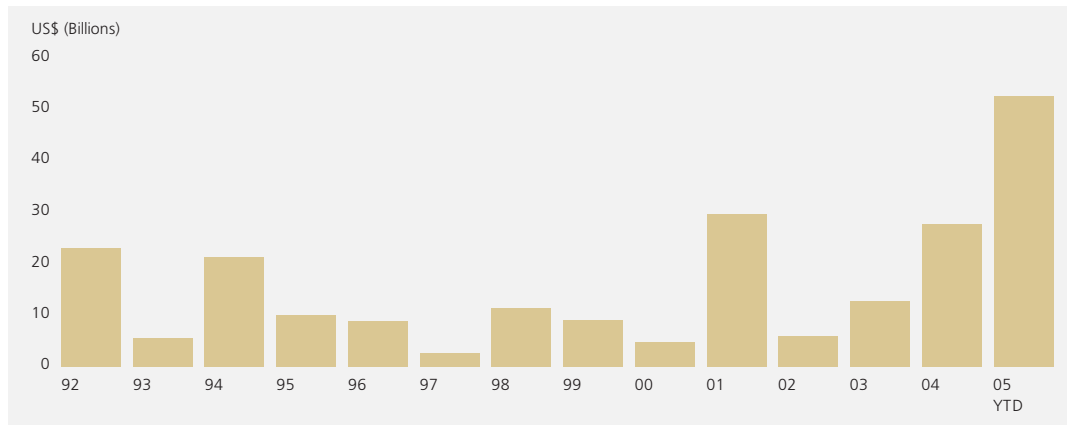
Overview

The defining event facing insurers and reinsurers this renewal season was the storms of 2005. These storms had highly divergent impacts at January 1, 2006 renewals. The storms resulted in major price changes for property and marine programs but had minimal effect on casualty and accident and health lines.

Total insured catastrophe losses for 2005 are estimated to be more than \$50 billion. This is the largest loss in the insurance industry's history – and more than double the size of 1992, the year of Hurricanes Andrew and Iniki.

U.S. Catastrophe Losses

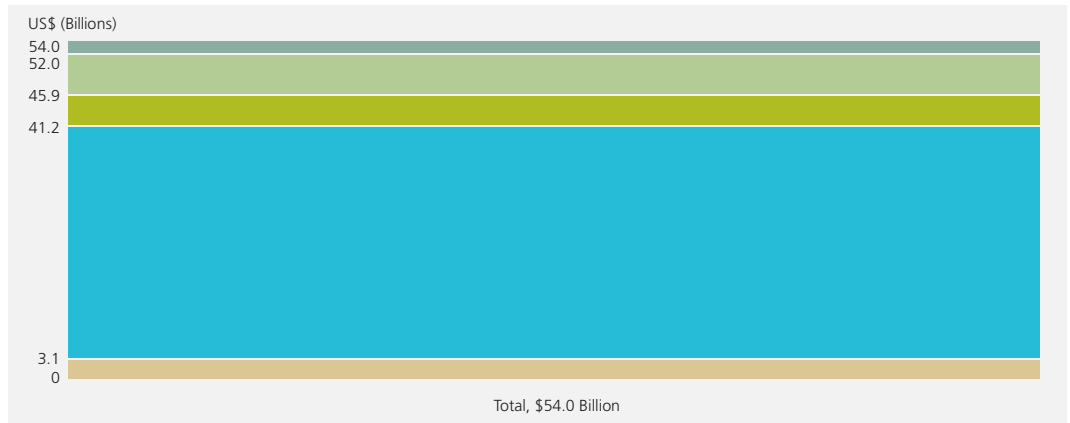
Source: Insurance Services Office.



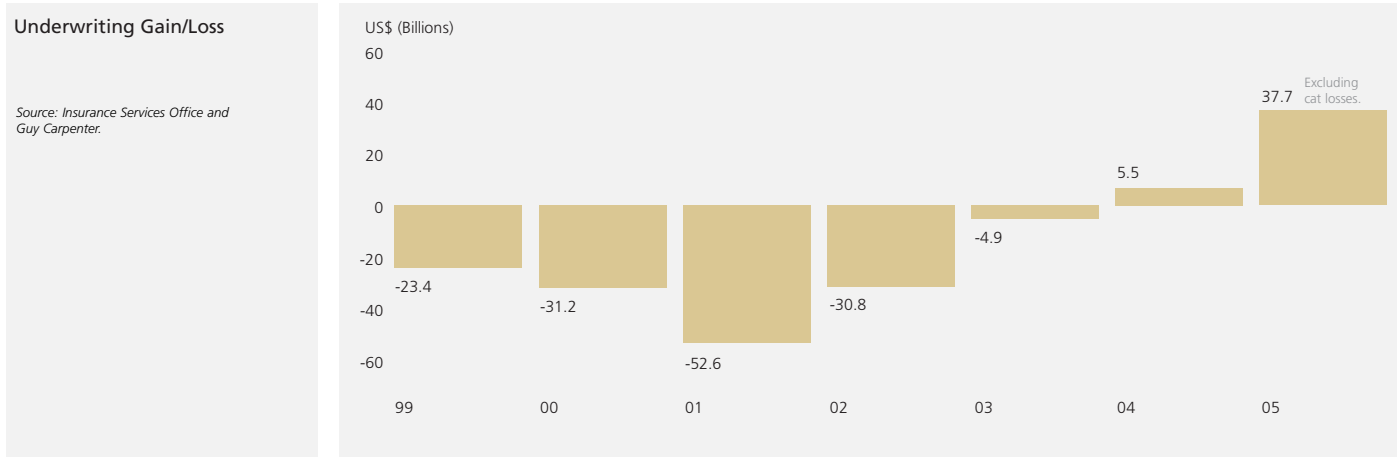
The insured losses from the three major hurricanes (Katrina, Rita and Wilma) are currently estimated by Property Claims Service (PCS) at \$48.9 billion, making up 90 percent of the total loss for the year.

Catastrophe Losses in 2005

- Other (2.0)
- Wilma (6.1)
- Rita (4.7)
- Katrina (38.1)
- Pre-Katrina (3.1)



The effect of such large losses on the primary insurance industry was mitigated by two major factors. First, the global reinsurance industry is estimated to have borne about 50 percent of the loss. The second factor was the relative prosperity of the industry at the time the storms struck. Absent the storms, the primary industry was headed toward record territory for profitability, as shown in the following chart.



Without catastrophe losses, the U.S. insurance industry would have reported a spectacular underwriting gain of \$37.7 billion. The net impact of the above factors – risk transfer to reinsurers and high profitability – is that on an industry-wide basis, the catastrophes of 2005 constitute an earnings event, not a capital event. This result was made evident in the nine-month financial results of the industry, released on December 27, 2005. The results indicated that, despite record catastrophe losses, the industry's net income and surplus both increased in the first nine months of 2005.

Indeed, the combined ratio for this time period stood at a breakeven rate of 100 for the first nine months, making it likely that the combined ratio for the full year will be below 100. This means that 2004 and 2005 will be the first years since 1978 of underwriting profit for the U.S. insurance industry. Not all insurers fared so well. Property insurers with heavy exposure in the Southeast suffered horrendous losses and in some cases went out of business.

The bottom line is that, despite unprecedented catastrophe losses, it is unlikely that there will be a hard market across all primary lines of business (both property and liability), which would normally be expected after such losses. As a result, primary insurers were not disposed to accept rate increases for reinsurance protection, since they would not have an easy time passing such costs along to insureds.

The storms of 2004 and 2005 had a major impact on property reinsurance renewals, although not via a capacity shortage, which is the typical hard market mechanism. An exception was large placements, where there was some reduction in capacity offered. Instead, the impact was indirect, as all key players in the marketplace (insurers, reinsurers, modelers rating agencies and regulators) recognized that the existing viewpoint grossly underestimated both the frequency and severity of North Atlantic hurricanes. In particular, reinsurers pressed for – and in some cases, received – substantial rate increases on property lines at January 1, 2006 renewals.

However, January 1, 2006 renewals were just the first act of a drama that will play out over the next year, as models get revised, rating agencies implement new rating methodologies for catastrophes and primary insurers engage regulators in contentious struggles for rate adequacy.

Impact of Katrina, Rita and Wilma on Casualty Lines

Prior to renewals, there were several opinions on the impact of renewals on the casualty side. There were three viewpoints that dominated the speculation: contagion, neutrality and diversification.

For a contagion effect to take place, companies that suffered severe losses from the hurricane season would begin to pull back cover from all lines. Diversification would be the opposite effect, as companies that suffered losses would look to diversify their portfolios and strengthen their balance sheets with higher returns from the variety of lines. If the renewals followed a neutral path, there would not be a pronounced effect of Hurricane Katrina on rates or capacity. The lines would instead follow their own characteristics.

At this point, the market is showing no signs of the contagion effect and very little evidence of diversification. The dominant theme in casualty has been neutrality. Reinsurers tend to approach the various casualty lines on their own terms. They are mainly influenced by rate and claims trends particular to the insurance line in question. In some instance, such as excess casualty, reinsurers have looked to raise rates based on the cost of the increased capital that they now need protect their security ratings.

New Capital

After Katrina, there is an expected total of \$21 billion in capital raised by new or existing companies. Of the amount raised, \$8.5 billion is by new entrants ("Class of 2005"). Most of the new companies have received ratings. Rating agencies have a significant influence over how companies allocate their capital.

Due to their late inception, the new companies did not play as significant a role in the market as this \$8.5 billion of capital might suggest.

Of note, Bermuda has become the fastest growing center for new ventures. It is the domicile of more than 96 percent of the new market capital.

TRIA Renewal

A major event of 2005 that impacted both property and casualty covers was the renewal of the Terrorism Risk and Insurance Act (TRIA) of 2002. This renewal averted a possible availability crisis in the property and workers compensation lines, particularly for urban risks.

Major provisions of the TRIA renewal in 2006 worth noting are:

- > The per-event threshold for federal government participation in insured losses with respect to an act of terrorism occurring after March 31, 2006, will be \$50 million, increasing to \$100 million for an act of terrorism occurring on or after January 1, 2007.
- > The bill excludes commercial auto, burglary and theft, surety, professional liability (other than directors and officers liability) and farmowners multiple peril.
- > Insurers' deductibles will be 17.5 percent in 2006 and 20 percent in 2007.
- > The industry's retention is increased to \$25 billion in 2006 and \$27.5 billion in 2007, up from \$15 billion in 2005.

Property

The property insurance industry is dealing with the harsh reality of seven of the ten costliest hurricanes in U.S. history (Wilma, Katrina, Rita, Charley, Ivan, Frances and Jeanne), all of which occurred in the past two years. As a direct result, the industry is managing developing views about frequency and severity expectations for hurricane risk. From insurance and reinsurance company management and equity analysts, to the rating agencies, catastrophe modelers and regulators, there is no party to the business that is not actively involved in this debate.

In this unsettled state, many primary insurers feel that they are being squeezed as the twin pressures from model revisions and rating agencies are forcing costs to go up while prices remain restrained in regulated insurance markets.

From a property catastrophe perspective, the world is now viewed as a riskier place - with wide-spread effects:

- > Modelers are driving loss expectancy higher for hurricanes. Clients have to deal with more loss potential even in an unchanged portfolio.
- > Rating agencies are noting the same trends as the modelers and have amended their stress tests for solvency rating.
- > Reinsurers are impacted by both of the above, as well as poor 2004 and 2005 experience, and are pushing for higher rates. The squeeze is due to insurers being unable to change rates quickly, particularly in the regulated residential insurance market. We expect that primary rates will continue to increase in an attempt to keep pace with the impact of the modeling and rating agency changes, but that process is harder and will take time.

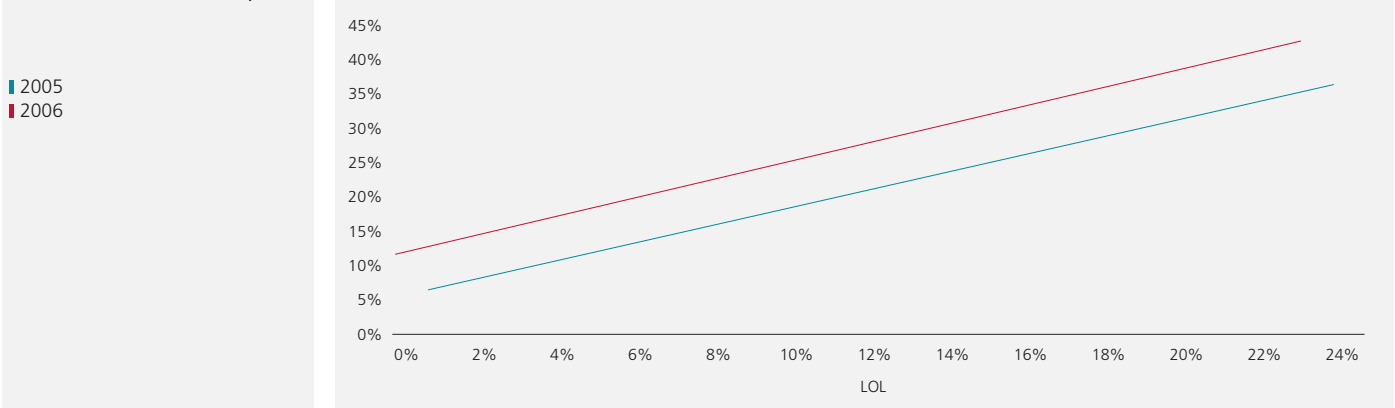
Property Catastrophe

Pricing

The market was unsettled, with a wide divergence between the price that insurers wanted to pay and the price for which reinsurers were willing to sell their capacity.

The following chart indicates trend lines for rate on line (ROL, reinsurance premium divided by the limit) against modeled loss on line (LOL, model developed expected loss divided by limit) for large national companies. As shown, the pricing curve for the national companies moved up significantly at January 1, 2006 renewals versus January 1, 2005 renewals.

LOL vs. ROL: National Companies



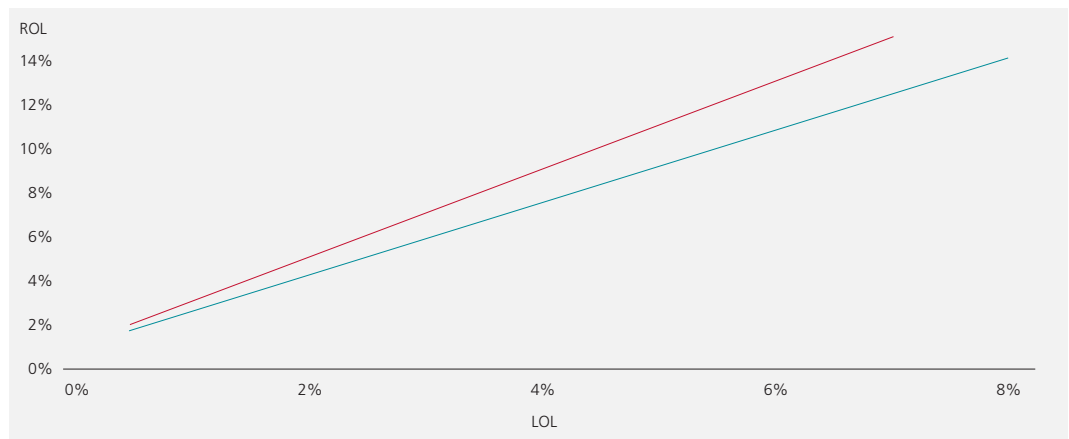
For national companies, the pricing moved as a result of three major factors: increased loss frequency, an expectation that the demand surge loadings in the models are deficient and the increased capital required to support catastrophic risk. The increased frequency, particularly of category 3, 4, and 5 events, generates more relative loss than the bottom or middle layers of programs. This leads to rate increases on the upper, capacity layers that are a higher relative rate than the bottom or middle layers of the program. From a demand surge perspective, reinsurers have become concerned that the current models and other actuarial techniques had not taken adequate account of the demand surge associated with mega-catastrophes like Katrina. The breakdown in infrastructure associated with such disasters results in extraordinary costs of assessment and repair that appear to have been underestimated.

While the previous chart indicates average price increases across large accounts, it is certainly worth noting that there was considerable disparity around these figures on individual accounts. Increases ranged from a low of 30 percent to well over 100 percent on capacity layers.

The following table shows the ROL versus LOL comparison for regional companies

LOL vs. ROL: Regional Companies

■ 2005
■ 2006



For regional companies, the ROLs increased across the spectrum of covers as well. However, unlike the national data, the degree of the price increases was less dramatic and the percentage increase between the upper and lower layers was much more consistent.

As with the national account chart, the above indicates average price increases across regional accounts, but there was considerable disparity around these figures on individual accounts. Increases ranged from 10 percent to 100 percent.

Regional pricing that was exposed to hurricane risk increased as a result of the frequency changes, demand surge loadings and capital requirements. However, because these programs offer a more efficient use of capital for the reinsurance market (they are exposed in fewer territories, requiring less capital to be allocated to support the placement), the pricing increases were more tempered. The fact that most of these accounts did not suffer any loss from either the 2004 storms in Florida or 2005 events in Florida and the Gulf of Mexico played an important factor. In this context, it needs to be noted that the regional data for January 1, 2006 renewals are concentrated on companies doing business in northerly latitudes, as reinsurance programs specific to Florida tend to renew in mid-year.

Retentions and Limits

In determining program structure, cedents had two main concerns:

- > Many cedents were looking to buy more limit to satisfy rating agencies and address model revisions. Because their portfolios are producing more loss, the same reinsurance program now attaches lower and runs out sooner from a return period perspective. For example, a program that used to attach at the 10-year level and go to the 100-year level now could attach at a seven-year return level and exhaust at the 70-year level.
- > Reinsurance is much more expensive, as previously indicated.

The result is that companies are increasing first layer retentions and buying more up top.

The overall limits for national accounts increased by 10 percent, while the retentions increased by 33 percent. The overall limits for regional exposures increased by 13 percent, while the retentions increased by 19 percent.

As indicated above, the retention increases came as a result of cedents both rescaling their programs to reflect the prior years return period attachment and exhaustion and an effort to manage year-over-year reinsurance costs. Additional limits were purchased to compensate for the revised perspectives surrounding hurricane risk.

Customers wanted higher limits because of modeling changes and concerns about maintaining ratings. An uncertainty factor also played a role, as the market was less confident in results of the models and extra cautious on the calculations of exposures.

Capacity

Capacity was adequate but expensive for most renewing programs. As indicated above, the biggest price change was in the upper layers. The impact of changing frequencies (particularly for category 3, 4 and 5 storms) drives more relative loss into the tails of loss distributions. As a result, higher layers are experiencing the most dramatic price increases.

For the largest programs, there was a reduction in the maximum available limit from prior years. The impact of the rating agencies' higher capital charges has reduced the maximum per program commitments that reinsurers are willing to make. It was anticipated that, in an effort to contract their aggregate liabilities, reinsurers would either write fewer large deals but maintain their maximum per deal commitments, or scale down the size of their per program commitments. Through January 1, 2006, it appears as though the latter approach has been adopted. The introduction of the new entrants has helped offset this capacity reduction in some instances. However, due to their late dates of formation, underwriting plans that are not fully operational and modest initial appetites, the net impact – even with this new reinsurance capital – has meant a reduction in overall large account capacity.

As a result of this potential capacity reduction, many of the largest buyers have reportedly begun exploring private placements, catastrophe bonds and other vehicles to secure additional limit outside of their existing syndicated placements. We anticipate that this activity may increase over the next 12 to 24 months.

Terms and Conditions

Not much has changed on the terms and conditions front. Buyers are highly focused on managing price and have not looked to gain or lose ground on contract provisions.

Several clients were able to expand their occurrence limitations from expiring 72 to 96 hours at January 1, 2006 renewals. As Guy Carpenter has discussed in the past, the models do not place hour limitations on the events that are stored in their event sets. As a result, the modeled information that is released to reinsurers for pricing includes events that are outside of the historical 72-hour limitation. Reinsurers are generating exposure and pricing for these longer duration storms, yet they are capping catastrophe treaties. We continue to believe that the 96-hour coverage is appropriate and will work with our clients and markets to attempt to include expanded hours as the new market standard.

Terrorism

Most property catastrophe and per risk contracts continue to provide full terrorism protection for personal lines and domestic terrorism coverage for commercial lines, excluding NBCR (nuclear, biological, chemical, radiological), subject to the normal, applicable per risk and occurrence limits. On occasion, regional carriers with exposures contained in rural or suburban areas far from target risk cities and business centers have secured full terrorism coverage, typically with some limitations as to the nature of the subject risk or subject event.

Beginning with renewal dates in 2004, certain national and super-regional companies sought and obtained TRIA-certified terrorism coverage in their property per risk programs. This was typically done through a separate coverage section, though such coverage is still the exception rather than the rule.

The renewal of TRIA in December 2005 was a great relief to cedents. The federal government backstop enables insurers and reinsurers to perform their appropriate roles in risk transfer while being shielded from the risk of incalculable loss. The increase in deductible to 17.5 percent in 2006 from 15 percent in 2005 was a concern, particularly for less capitalized insurers with urban exposures. Further, the increase in per event threshold from \$5 million to \$50 million needs to be addressed by small companies.

Property Per Risk Market

Guy Carpenter's renewal panel at January 1, 2006 for per risk programs is heavily weighted toward small, regional carriers. Large national programs for per risk mostly renew later in 2006.

The hurricanes of 2005 resulted in a significant number of large risk losses to hotels, casinos, hospitals, sports arenas, large office complexes, oil and petrochemical and other industrial risks in the affected area. Like the terrorist attacks on the World Trade Center, the storms of 2005 serve as a further reminder that even the higher layers of per risk reinsurance programs can clash in catastrophic events.

Considering that most of the large national per risk programs do not come up for renewal until mid-year, we have estimated the potential impact but do not have many data points to accurately assess the development in the risk market.

Our expectations are:

- > Per risk capacity will likely be reduced, especially since risk retro cover became rare and expensive.
- > Reinsurers will likely look to increase pricing as they revised their rate against exposed value (ROEV) targets, especially for the larger risk carriers that have suffered losses. This will most likely increase the pricing expectations on some unaffected business.
- > As is usually the case after some significant risk loss activity, payback loads will be included within affected programs. These payback amounts tend to become blended into the ROEV calculations and have the effect of driving up general market prices.

Another effect of the 2005 hurricane activity will be that reinsurers require more information to enable them to quantify the catastrophe exposure potential in per risk programs. Applied catastrophe loads will increase dramatically. Reinsurers are also looking for additional information on original risks within large risk programs to help them monitor their own aggregations.

Risk programs protecting 100 percent written business with little catastrophe exposure and a good track record should still be attractive to reinsurers and should not receive the same price increases as large risk business.

Proportional Reinsurance
Market

Many pro rata accounts experienced considerable losses from Katrina. Reinsurers were still looking to support pro rata treaties, especially where there was evidence that original rates hardened after Katrina. However, event caps were under close scrutiny, and ceding commissions were reduced to levels that may not have covered original expenses in some cases.

There appears to be increased appetite for pro rata business in areas that have the most primary rate movement, e.g., excess and surplus. Reinsurers writing this business are getting their catastrophe loading, plus enough margin in the new rate environment to generate a reasonable return.

Casualty

Commercial Automobile - Trucking

The trucking insurance market has softened modestly after peaking in 2005. Overall loss costs in commercial auto appear to have fallen in the past two years, which has led to limited rate pressure on primary pricing of larger fleets. Clients and reinsurers have benefited from overall favorable market conditions from 2002 through the present. Trucking insureds have enjoyed a strengthened economy, which has generated plenty of business opportunities, and the ability to pass on fuel charges to shippers and consumers, which has helped to subsidize costs such as insurance. With more units on the road hauling more goods, it has been difficult for trucking operators to find qualified drivers.

There have not been any significant new entrants into the primary market, but competition for larger accounts was fairly aggressive early in 2005 from under-capitalized regional carriers and various MGA-produced programs, often in limited geographic zones or business segments. Despite the numerous natural catastrophe losses in 2005, rate increases in property have not yet affected carriers in the trucking lines, given the typical commercial auto carrier's limited property writings. However, these conditions may have created a floor or, at a minimum, tempered price reductions. There have been some signs of stabilization in primary commercial auto pricing in recent months that is expected to continue through year-end.

While reinsurers continue to evaluate their losses from the hurricanes, and if tightening becomes evident in the commercial auto marketplace following the January 1, 2006 renewals, modest rate increases may appear in trucking insurance as reinsurers seek price increases in all lines to supplement losses in property. Carriers will likely pass on reinsurance rate increases to insureds and/or take additional retentions, given stabilizing or increasing primary rates. Carriers also will likely continue to pare unprofitable and marginally running trucking accounts and retain business that will provide profit through proper management and loss control. In addition, they will have to examine overall rate adequacy, given the compounded societal effects of the rising cost of auto liability and auto physical damage claims and increases in medical costs from bodily injury claims. Public auto has made headlines frequently in recent months with several catastrophic losses. For those carriers that are also providing public auto liability, there will likely be pressure on pricing of the excess \$1 million segment.

Trucking underwriters have also begun to target changes by class or geographic territory. For example, auto liability in California appears to remain profitable, but Florida has developed an unacceptable trend of loss severity that could result in surcharges for Florida miles. Furthermore, the refrigerated segment has developed an unacceptable profitability trend that will likely result in price increases for this segment and modification of risk selection. Other factors such as congestion, age of older drivers/population and added risk factors for spoilage are making carriers perform more in-depth reviews of individual segments of business and take a more sophisticated approach to their underwriting.

Reinsurers may continue to be less inclined to support fronted MGA programs. Instead, they are likely to target carriers that maintain price integrity and underwriting standards. The preference will be to support established carriers with a proven track record and not allocate capacity to new ventures. Reinsurers will not be willing to give away what is considered adequate margin with the limited redundancy built in the mileage-based models. We anticipate some tightening of reinsurance terms but expect to see continued reinsurance support overall for those carriers that are being responsible and analytical in their approach.

Directors & Officers Liability

Despite significant hardening in the directors and officers (D&O) reinsurance market in 2004 and through the first three quarters of 2005, D&O primary insurance rates continued to soften into the fourth quarter in virtually all segments. At the same time, loss trends have not been encouraging, particularly on excess business. This has added to reinsurers' ongoing disappointment with declining primary rate adequacy. These market trends present ceding companies with challenging D&O treaty renewals and threaten an already unstable D&O reinsurance market.

Beyond the headline settlements, particularly those above \$50 million (which by the end of the third quarter had already surpassed record annual totals), there is positive news on the claims side. Securities claim frequency is modestly down in 2005. Frequency of claims among Fortune 500 companies is within historical norms, with 26 securities class actions filed through early December. Perhaps most importantly, there has not been another event in 2005 impacting an entire financial institution segment, which was an assumption made by many insurers and reinsurers in their 2005 loss ratio projections.

While the expected claims from the insurance industry problems of 2004 continue to develop, carriers are receiving positive news on the mutual fund front. In addition, the bulk of the investment banking claims arising out of Enron, Worldcom and other corporate meltdowns have been settled. These claims truly represent one-time events for the industry, as banks are only able to purchase Side A D&O at this time.

Presenting yet another challenge, and perhaps an opportunity, for cedents is the impact of the 2005 hurricanes on reinsurers' real and perceived financial strength. The storms threaten to reduce the number of available reinsurance partners – an already shrinking group in D&O, given the substantial pullback of capacity over the last two years. However, the number of new companies being set up, combined with the amount of capital being raised, may offer some near-term relief to D&O cedents. Only one of the startups has expressed interest in D&O so far, but others may test the market because of the reinsurance terms and conditions available.

Reinsurers' current appetites for D&O, while not easily described, can be explained based on their approach to two segments: large market cap companies and what is broadly identified as middle market (including micro-to mid-cap public D&O and private and nonprofit D&O).

Large Market Cap D&O

Reinsurance capacity has been constrained in this segment for some time, with reinsurers providing approximately 40 percent less capacity than they did two years ago. Virtually none of this pullback is due to adverse experience, as all reinsurers acknowledge that they made money on treaties written in 2002 and forward. Rather, reinsurers have been increasingly unwilling to support the downward movement in rates and increasing loss trends in this space. This has continued despite an arguable reduction in large cap exposure, with the general decline in capacity and movement of the riskiest programs to Side A coverage only. Reinsurers that remain have significantly hardened terms and conditions, with a focus on acquisition costs (ranging anywhere from 15 percent to 23 percent) and aggregate loss limitations (generally two to three times the ceded premium).

Few reinsurance programs exist in the large market cap segment without some form of loss limitation, whether on a ground up quota share or excess of loss basis. Reinsurers have required these restrictions out of concern for what they perceive as runaway severity trends or leveraged reinsurance treaties. It is important to distinguish between loss trends on a settlement year versus an accident year basis. Settlement year statistics show a steadily increasing trend, which is to be expected given the claims filed up to and including the 2002 accident year. These claims are now settling against the backdrop of unprecedented market cap losses (e.g., Enron, Worldcom, Global Crossing). On the other hand, accident year statistics using market cap losses as a proxy for eventual settlements show a less stable trend and even a downward trend since the 2002 accident year.

Absent substantial new reinsurance capacity, ceding companies must differentiate their portfolios through sophisticated actuarial and financial analysis to maximize their chance of successful reinsurance renewals. This is in addition to the obvious elements: depth of underwriting staff, reputation and track record. The insurers most insulated from continued hardening continue to be those with diversified portfolios in terms of products (D&O, E&O), segments (Fortune 1000, small/micro cap) and position on insurance programs (primary versus excess).

Middle Market

Given its modest loss trends – and despite primary rate decreases comparable to the large market cap space – the middle market segment has not experienced significant reinsurance hardening. Reinsurance capacity, virtually all on a quota share basis, is abundant.

Higher ceding commissions (25 percent to 29 percent) are available due to the preponderance of commission deals rather than fees. Fewer aggregate loss limitations are seen or arguably necessary, as most carriers limit gross capacity to \$5 million or \$10 million.

Treaties that balance public with private for-profit or not-for-profit business generally receive better terms and conditions. The most successful reinsurance negotiations in this segment occur where cedents are able to demonstrate this balance and distinguish themselves from their peer group, using quantitative analysis to support lower ceded loss ratio picks.

Employment Practices Liability

In 2005, carriers were determined to keep “good” employment practices liability business and were willing to sacrifice premium up to a certain point to do this. On average, rate reductions ranged from 0 percent to 10 percent, but the overall sense is that rate levels were adequate. Barring an increase in frequency of large employment practices liability insurance (EPLI) verdicts and settlements, this rate trend should continue in 2006.

Retentions remained flat in 2005. Carriers seem reluctant to lower retentions because of a frequency of smaller claims and increasing defense costs. Mass claims continue to threaten larger, well known companies that are more concerned about reputation damage than the cost of a settlement. Most carriers mandate higher retentions or some percentage of coinsurance for multiple plaintiff actions.

There have been no significant changes in problem classes of business. Most carriers are offering coverage for third party claims. Coverage offered by carriers continues to become increasingly consistent.

One major carrier reduced the available EPLI capacity from \$100 million to \$50 million, but other carriers stepped up to fill this void.

Little growth opportunity exists in the area of large employers, since those that need EPLI already buy it. Growth potential does exist among small- to mid-sized employers. However, for smaller employers, the premium for EPLI coverage can be a prohibitively expensive percentage of their overall premium charge, so many choose not to purchase it.

Errors & Omissions Liability

The Errors & Omissions (E&O) market is very diverse, and pricing and terms and conditions vary by product line. By and large, there was a downward trend in original E&O rate levels in 2005, although certain classes such as Financial Institutions E&O (FI E&O) and specific types of lawyers professional liability experienced some rate increases. This downward trend is expected to continue in 2006 but will vary by line of business, depending upon the historical experience, rate change and degree of competition within the individual class. As for policy form, there continues to be minor broadening of terms and conditions in certain lines of business due to increased carrier appetite for various lines of E&O and increased agency/broker competition for E&O accounts.

In 2005, there was an increase in the amount of reinsurance capacity available for E&O business, especially with respect to small- to mid-sized risks. This increase in capacity is based upon a number of factors, including reinsurers' redeployment of capacity away from the publicly traded D&O arena and reinsurers looking to balance their overall professional liability portfolios. E&O portfolios that contain an overweight of large and/or very complex E&O risk do not necessarily benefit from this increase in capacity. While this capacity trend is expected to continue in 2006, it will likely be in an incremental manner instead of broadly based.

As in the past, reinsurance conditions (pricing, ceding commissions and loss recovery restrictions) at January 1 renewals were based upon the type of business ceded, the balance or leverage inherent in the reinsurance structure, the historical results and maturity of the portfolio and the carrier's level of E&O expertise. Reinsurers continue to heavily scrutinize the line of business and size of risk composition of the portfolio and view treaties with an overweight of large accounts and/or high hazard classes in a negative fashion. Similarly, treaties with poor historical results experienced pressure on reinsurance rates, ceding commission and/or loss limiting features such as loss ratio caps or corridors. On a positive note, E&O treaties comprised of small- to mid-sized, less complex risk with quantifiable positive results received incremental improvements in terms and conditions in 2005 and at January 1, 2006 renewals.

High hazard classes that continue to be of concern to reinsurance markets include the following: Big Four and next tier accountants, large insurance brokers, actuarial consultants, large lawyers, architects and engineers project business and FI E&O. There continues to be minimal capacity for large accountants and large insurance brokers on an insurance and reinsurance basis. The systemic losses experienced by the FI E&O policies spread to their third party professional services providers (large law and large accountants) to varying degrees. Within each of these classes, reinsurers will analyze the underwriting action adopted by the carrier to address these exposures and may impose coverage restrictions in the form of specific treaty exclusions in order to support the treaty (e.g., market timing and late trading exclusion for FI E&O and tax advice for large law). For FI E&O and large lawyers' treaties, reinsurers continue to be very selective in the treaties they support and deliberate in the amount of capacity they commit. Reinsurers are also actively managing their aggregate exposures in these E&O lines.

As previously indicated, reinsurers continue to view treaties with an overweight of large E&O accounts and/or high hazard classes in a negative fashion. Depending on the reinsurance structure in place, balance inherent in the portfolio and historical results, it is not uncommon for reinsurers to impose certain restrictions, including limitations on the number of large limit policies a cedent can write, minimum pricing requirements, minimum attachment point levels and/or size of insured restrictions for classes of business. Reinsurers' strong preferences for small- to mid-sized E&O risk business are expected to continue throughout 2006. To the extent that E&O carriers produce growth in businesses of these sizes and perceived lower hazard segments, thereby diversifying their overall E&O portfolio away from larger, more complex risks, there may be incremental betterment of terms for cedents.

The series of hurricanes in 2005 has prompted reinsurer interest in certain lines of E&O business potentially impacted by these natural events. Most notably, these include insurance company E&O, insurance agents E&O, real estate agents E&O, property managers and architects and engineers E&O. Cedents can expect reinsurer inquiries on possible exposures. Reinsurers have also acknowledged two trends in lawyers professional liability that are worth noting: an increase of severity of loss associated with mid-sized law firms and an increase in frequency and severity associated with the insurance defense area of practice.

Excess Casualty

Pricing

There was much confusion in the excess casualty marketplace in the first quarter of 2005, as uncertainty surrounding business protocols made doing business a bit more difficult. Overall, primary insurers saw original pricing decline on average by 5 percent to 10 percent in 2005, following several years of pricing increases that began in 2000. While the impact of the 2005 Gulf Coast catastrophes on original pricing for umbrella/excess casualty in 2006 remains unclear, early signs indicate that pricing will be flat up to 10 percent on average as the industry focuses on additional lines of business that offer higher returns in an effort to strengthen their balance sheets.

Reinsurers most affected by the storms have found it necessary to raise additional capital to protect their ratings, thereby ensuring their ability to do business. The cost of this capital has leveraged reinsurer margins and raised their hurdle rates. This, along with capital allocation scrutiny by A.M. Best, has forced reinsurers to consider individual account offerings as they relate to their entire portfolios.

Without the investment gains of the past, reinsurers typically are not discounting losses. This results in target loss ratio picks of approximately 55 percent to 65 percent, depending on the perceived volatility of the client's portfolio and the corresponding ceding commission. Ceding commissions are ranging between the mid-to-high 20s. With contingency arrangements gone, reinsurers are pushing for commissions on carriers writing national accounts business to be quoted at "original plus," with some form of cap typically set at 10 percent to 12.5 percent above the original commission to the broker/agent. In summary, reinsurers are looking to achieve a combined loss and expense ratio of approximately 90 percent to 92.5 percent, including brokerage, thus producing a margin of 7.5 percent to 10 percent.

Minimum premiums for national carriers tend to be \$1,000 gross per million of limit. However, some regional carriers offer minimum premiums of \$500 to \$750 per million.

Terms and Conditions

Exclusions typically required by reinsurers include asbestos and mold, residential construction (due to concerns over construction defect claims), nursing homes, pharmaceuticals, certain professional liability exposures and silica.

Emerging liability issues to keep an eye on include welding fumes, methyl tertiary-butyl ether (MTBE), obesity litigation, diacetyl, perchlorate, nanotechnology and genetically modified organisms (GMOs).

While Katrina produced massive hurricane and flood losses, the liability market will likely be impacted from claims arising in the following areas:

- > municipal liability as a result, for example, of alleged failure to respond.
- > pollution liability.
- > liability as a result of inadequate building structures and suits involving contractors.

Terrorism coverage is available in the reinsurance market but is typically subject to an aggregate cap equal to one or two times the treaty limit or, alternatively, influenced by the amount of ceded premium under the contract. High profile target risks such as the Sears Tower are often excluded.

Regarding reinsurance structures for this line of business, reinsurers generally prefer a standard quota share program. However, they will also support an excess cessions program, and in some cases a flat-rated excess of loss approach. Despite this, reinsurers nearly always find evaluating “excess on excess” to be a challenge.

Retentions and Limits

Reinsurance capacity is available. However, reinsurers continue to attempt to monitor and manage their aggregate exposures to any single insured via quarterly bordereaus that identify the account and corresponding policy limits. In addition, many reinsurers are controlling their accumulations by offering capacity to a select number of ceding companies. Some reinsurers prefer to support excess and surplus/non-admitted carriers due to freedom of form and rate. In some instances, reinsurers have been hesitant to support carriers writing umbrella on commercial multiperil (CMP)/package policies due to the perception that the carrier does not have a dedicated umbrella underwriter, which could lead to inadequate pricing on the umbrella policy.

During 2005, some reinsurers pulled back capacity due to concerns over softening market conditions. This trend may change if pricing stabilizes after the recent industry catastrophes.

It should also be noted that reinsurers' capacity is also influenced by the cedent's level of co-participation or retention. For example, in a quota share contract, the cedent would be expected to retain 20 percent to 25 percent of each risk in order to satisfy reinsurers.

Because auto liability is a major contributor to umbrella loss experience, some reinsurers have pushed for higher attachment points (e.g., \$2 million) on the underlying auto policy. In some cases, clients have purchased a separate reinsurance program for \$1 million excess \$1 million.

It remains to be seen if the new companies entering the Bermuda market will deploy any of their capital towards the umbrella/excess casualty marketplace.

Medical Professional Liability

In spite of the rising costs associated with the healthcare delivery system in the United States, there appears to be comfort surrounding the healthcare industry if judged by the number of insurers and reinsurers actively participating in it. The medical malpractice market as a whole appears to be emerging out of crisis and into a period of equilibrium. Five years of rate increases, re-underwriting actions and reserve strengthening have improved industry underwriting results and attracted new capital, both in the insurance and reinsurance segments. Tort reform legislation passed in many states in recent years, while still untested, has added a level of cautious optimism that rising loss costs may finally begin to taper. Offsetting these positive factors is lingering concern about the inherent volatility in medical malpractice and the trends toward the softening of rates and broadening of terms in this line of business.

Medical malpractice claim costs are directly related to healthcare costs, and there is no question that healthcare costs continue to increase. Employers are facing an 8 percent increase in their 2006 healthcare costs, according to the 2006 Towers Perrin Health Care Cost Survey. The gross health care expenditure is expected to rise to an average of \$8,424 per employee, representing a 140 percent increase over the past 10 years.

Employers are generally moving towards models that increase employees' responsibility and accountability. As consumers shoulder more of the costs for their healthcare, it is anticipated they will have higher expectations with regard to their own health and healthcare outcomes.

Severity claim trend for physicians liability business is reported to range from 6 percent to 8 percent nationally, while hospital trend ranges are 8 percent to 12 percent nationally. The trend frequency for both physicians and hospitals is reported to be flat to the low single digits and is negative in limited jurisdictions. In spite of the cost increases, insurance rates appear to be declining.

Physician rate changes in 2005 range from increases based on the level of trend on the positive side to single-digit decreases, and it is contingent upon the legal jurisdiction. According to the 2005 survey by the *Medical Liability Monitor*, 81 percent of respondents indicated that rates are leveling and only 6 percent felt that additional large increases would be required. In 2006 many insurers across the country have reported they will be taking flat rate changes.

Hospital rate change in 2005 also varied from state to state and by account size. Hospital specialty carriers tended to keep rates flat or take modest increases to keep up with claim trend. Competition intensified on larger hospitals written by the commercial carriers, causing rate levels to drop in the range of 5 percent to 10 percent, with isolated reports of 15 percent to 20 percent reductions. The large hospital segment of the market was hit hardest by the market correction, taking 300 percent to 500 percent rate increases on top of significantly increased self-insured retentions. Large hospital accounts are now either seeing rate reductions or reduced retentions as pricing becomes more attractive or economically viable.

As insurance rates increased in prior years, hospitals expanded their retentions, often by establishing a captive. Hospital captives are a market for reinsurers as well as insurers, so competition for this business increased.

Hospital insurance limits purchased appear to have remained consistent over the prior year. For excess hospital placements, the market moved towards unaggregated underlying amounts in recent years. This past year has witnessed greater pressure to liberalize the terms towards aggregated underlying limits coupled with unaggregated maintenance deductibles.

Combining, or batching, separate patient claims under the same loss event (e.g., bacteria in the pediatric ward infecting multiple babies) is an emerging coverage issue for hospitals and their insurers. With significantly increased retentions, batch claims can result in a catastrophic event for a hospital. Guy Carpenter has introduced a reinsurance product to help provide a viable solution.

The American Medical Association identifies 21 states under medical liability crisis. However, tort reforms including non-economic damage caps, creation of medical review boards to qualify claims, reduced statute of limitation periods, limitations on venue shopping, and fees collected for redistribution to surgical specialty insurance costs have occurred in a number of legal jurisdictions. Separately, Senate Majority Leader Bill Frist identified that medical liability reform will be on the Senate's agenda in 2006.

There is talk of cases being won at trial this year while the same case profile resulted in a verdict against the physician in years past. Has press coverage regarding physicians leaving high severity legal jurisdictions affected jury decisions at trial?

Insurers' significant rate increases in recent years are believed to have caught up with loss costs. Conning & Company estimates that industry loss reserves range from \$2 billion deficient to \$3 billion redundant. The medical liability reforms, coupled with past rate increases, have provided insurers and reinsurers with the incentive to continue to allocate significant capital to the medical professional liability marketplace.

Insurance company rate increases in recent years has piqued the interest of the reinsurance marketplace. In some instances, property losses have encouraged reinsurers to take a stronger look at the healthcare marketplace. At January 1, 2006 renewals, there is significant interest in using reinsurance capital to support healthcare business. This competitive environment has resulted in a number of reinsurance programs renewing with effective rate decreases, while rates increases were an exception.

The following are observations about the healthcare marketplace at January 1, 2006 renewals from the reinsurance market's perspective:

- > Those insurers that have paid back reinsurance programs previously in deficit, and currently generating profitable loss ratios, are witnessing the most significant reinsurance rate reductions.
- > Optimal reinsurance terms are heavily influenced by a reinsurer's ability to gain an intimate knowledge of the insurer's business operations. It is incumbent upon the more complex insuring entities (e.g., national insurers, compared with single state insurers) to focus even greater attention on effectively communicating their business plans and execution strategies.

- > Excess reinsurance layers must develop sufficient premium to limit balance to achieve optimal reinsurance terms and conditions.
- > Even though excess hospital professional liability rates are declining, reinsurers remain comfortable with the profit margins in these rates. However, reinsurers are closely monitoring the rate decreases as well as the retentions underlying the excess layers. They remain concerned about marketplace pressures to convert unaggregated retentions to an aggregated retention. An insurer's ability to measure appropriate aggregated funding levels serves as a critical component.
- > Reinsurance capacity is available for occurrence form business on a following form basis, but it is limited.
- > Reinsurers are expressing interest in long-term care/nursing home business.
- > Open market start-up insurers (e.g., captives, risk retention groups) are less attractive today than in recent years. Competitive market conditions are causing pricing to be a greater factor in developing business as compared to the hard market terms and conditions achievable just a few years ago.
- > Nonstandard insurers are losing market share in today's environment.
- > Business model changes within managed care organizations have heightened reinsurers' interest in providing support for the managed care liability insurance, creating added capacity for managed care organizations.

The question often arises: "Have the 2005 hurricanes caused insurers and reinsurers to redistribute capital allocations away from medical professional liability insurers, putting pressure on rates to increase?" The answer is no, not yet. We have seen no evidence of rate increases resulting from capital reallocations; however, many believe it will take place within the first half of 2006.

Workers Compensation

Pricing

The softening primary market that began in late 2004 was borne out in most clients' subject premium bases, as final 2005 premium figures trended 5 percent to 10 percent lower than originally targeted. For 2006, most clients are anticipating that subject premium will remain flat.

Portfolio size played a small role in reinsurance pricing this year. Clients with a shrinking renewal book found that reinsurers initially looked to maintain the expiring dollar premium for their respective layers, effectively charging a rate increase. In addition, most reinsurers initially positioned for moderate price increases, citing the increased cost of capital due to the magnitude of recent hurricane losses, competition for a fixed amount of their capital with higher-priced property business and rating agency pressures on capital adequacy as justification for these changes.

Competitive forces usually prevailed, with most clients obtaining a price change of somewhere between a 5 percent reduction to a 3 percent increase for catastrophe renewals. Single state and non-earthquake exposed portfolios again fared the best in the marketplace, where incumbent reinsurers competed in order to retain their lines. Earthquake or terror exposed programs were most likely to see a small price increase.

Working layer pricing remained firm again in 2005. The primary market's impressive 94 percent accident year combined ratio for 2004 helped to maintain reinsurer support for working layers and increase interest in quota share structures. However, rising severity trends and medical escalation, softening primary rates and continued paltry investment returns are discouraging most reinsurers from getting aggressive on working layer business.

Capacity

Workers compensation catastrophe capacity continues to be abundant. While Bermuda continues as the capacity leader, a few recent rating downgrades have allowed some domestic and foreign markets to increase their presence in the marketplace.

Bermuda start-up operations were not a significant factor in January 1, 2006 renewals. Although several have expressed interest in writing workers compensation catastrophe business in 2006, most did not have capital or a financial rating in place in time for the renewal season. It remains to be seen how these entities will affect market conditions when they fully enter the market later in the year.

Limits and Retentions

At this time last year many clients focused considerable attention on reviewing their existing reinsurance program structures. Improved market conditions, abundant capacity and higher projected losses from earthquake and terror models encouraged some to purchase additional catastrophe limits. This renewal, few clients seriously explored pricing options for new top layers. This was possibly indicative of their satisfaction with the expiring structure or a result of increased reinsurance costs in other business lines, which left fewer funds available for additional reinsurance purchases.

A.M. Best has recently indicated that additional focus and weighting will be placed on workers compensation earthquake and terrorism catastrophe exposures when reviewing capital adequacy in 2006. For the first time, these exposures, both gross and net of reinsurance, will play a tangible role in the rating agency's review of a carrier's capitalization. As this methodology is implemented during the year, some exposed companies may be inclined to purchase additional cover.

Terms and Conditions

Terms and conditions remained largely unchanged for renewals, except where clients have explored higher Maximum Any One Life (MAOL) limitations or additional terror coverage. Most catastrophe programs are written with a \$5 million MAOL limitation, but some clients looked to increase this to \$10 million in their lower layers for an additional premium.

At this time, most clients, other than smaller regional companies, have incorporated some level of terrorism coverage into their corporate catastrophe programs. Pricing and capacity for terrorism coverage has continued to improve over the past year, and more reinsurers are now willing to provide options for nuclear, biological and chemical (NBC) perils. Terrorism coverage is offered on both a per occurrence and aggregate excess basis. When clients add terrorism coverage to an existing catastrophe program, reinsurers have priced the additional coverage as a surcharge above the natural perils pricing. This pricing has improved, with reinsurers now charging between 5 percent to 15 percent of additional premium.

Last year's increased retention under the Terrorism Risk Insurance Act (TRIA) encouraged many clients to seek additional reinsurance coverage to reduce their effective deductible. This trend did not continue this renewal period. Clients, on average, were not looking to secure additional terrorism coverage as a precautionary measure while the renewal of TRIA was debated in the House and Senate. Instead, most clients appeared prepared to hold exposures net above any existing terrorism reinsurance.

Some reinsurers have quietly voiced concerns that the current workers compensation catastrophe product is not priced adequately for extremely remote events that would be covered under the normal contract. Perhaps the recent natural disasters – the strength of Hurricanes Katrina, Rita and Wilma in 2005, the frequency of Florida storms in 2004 or the massive destruction from the Indian Ocean tsunami – have given reinsurers slight pause, questioning whether market pricing currently contemplates proper returns for remote events that would cause widespread compensable claims. Nevertheless, abundant capacity and moderate competition have left product pricing and coverage relatively unchanged. Existing markets continue to show strong support for the product, while new players prepare to enter the market in 2006.

U.S. Marine and Offshore Energy

Capacity

The unprecedented hurricane activity of 2005 had a dramatic impact on the marine and the offshore energy reinsurance marketplace.

While yacht underwriters have been dramatically affected by such losses as Hurricane Ivan in recent years, commercial marine underwriters also suffered great loss in 2005. For instance, Hurricane Katrina resulted in significant cargo, hull and, to a lesser extent, liability losses, with the port of New Orleans severely affected. Hurricane Rita similarly affected the commercial marine marketplace, while Hurricane Wilma, with its path through Florida, understandably caused a greater degree of yacht loss.

In the offshore energy market, there has been a dramatic impact on original insurance capacity and the reinsurance community. It is estimated that Hurricane Katrina and Hurricane Rita will each ultimately cause nearly \$5 billion in offshore losses. The offshore exploration platforms affected by Rita were not as mature as those impacted by Katrina, and the damage there may arguably be even greater in terms of platform sinkings and damage to expensive exploration equipment.

As a result of the hurricane losses, several reinsurers have reconsidered their positions and adjusted their underwriting philosophies accordingly. Those that sustained a significant reduction in their surplus through large hurricane losses in both property and marine departments have elected to withdraw from any marine business that includes Gulf Coast exposure. Some companies in London have withdrawn from the marine reinsurance class overall.

Retrocessional capacity has become extremely tight, with very few companies prepared to offer this product.

In general, there is still enough capacity to meet insurers' needs. Many programs were significantly oversubscribed at January 1, 2005, and the introduction of new capacity in Bermuda is likely to further reinforce the marine and offshore energy marketplace. Indeed, some companies in Bermuda are focusing principally on marine and offshore energy opportunities and specializing in this class of business.

The issue of acceptable security remains paramount in the minds of all of our clients, and several of the new "Class of 2005" reinsurers in Bermuda have been assigned a Best's rating.

Pricing

We are seeing a very noticeable change in reinsurance pricing. Even on those marine whole accounts that have been relatively unaffected by hurricane activity, we are witnessing rate increases of at least 10 percent. There is some disparity in reinsurers' thinking on pricing, and some renewals have been impacted by new leaders. There is major pressure on catastrophe pricing.

Many price increases will likely be tempered by additional retentions, via the form of an annual aggregate deductible (AAD), franchise, or differentiating between commercial risk and catastrophe retentions. Lower rates of premium increase are evident in liability business, and "as expiry renewals" are few and far between.

Marine reinsurers continue to look to catastrophe modeling and use actuaries for analysis in their underwriting methodologies. There is still much work to be done on marine modeling, but reinsurers are increasingly attaching so much importance to the monitoring and control of aggregate exposures that modeling techniques will have to be improved. This is especially true in offshore energy reinsurance, where reinsurers are particularly concerned about changes in coverages offered by cedents. For instance, several insurance companies are changing the way they offer business interruption insurance, and some companies have withdrawn from this class.

Retentions and Limits

The impact of the hurricanes has been most marked on offshore energy accounts. While pro rata coverage is still available, there is much pressure on commissions, and many reinsurers seek to implement occurrence caps on energy treaties.

The excess of loss reinsurance market is similarly responding to the likelihood of future catastrophe losses and is seeking to introduce differential retentions by class of business. For instance, several marine operations that have significant yacht exposures are being subject to far greater retentions for that line of business.

Generally, most reinsurers seem comfortable with current retention levels for traditional hull, cargo and liability exposures. The retention levels on such business have been steadily rising in recent years, as cedents have sought to mitigate successive renewal premium increases.

Terms and Conditions

Some cedents continue to focus on special termination. At times this has been met with resistance by reinsurers, depending on the actual nature of the trigger mechanisms. Terrorism remains a major concern for the market. Reinsurers continue to provide cover through the so-called marine "write-backs," and it will be interesting to see how the specific details of the TRIA extension will affect the market's thinking.

Summary

The disastrous and unprecedented hurricane losses of 2005 continue to put great pressure on the marine and offshore energy reinsurance community. Several companies have already exited this class of business, and those that remain will likely respond with a combination of price increases and a focus on retention levels. There may also be greater focus on cedents' original business plans. Those that can demonstrate change geared to effective control of catastrophe exposure will likely experience more favorable reinsurer response.

It remains to be seen whether the introduction of significant new capital will transform market competition. The appearance of the hedge fund community in various shapes and forms may further alter the nature of this business. The one thing of which we can all be certain is that there will be continued change in 2006.

Accident and Health

Life and Personal Accident

Pricing

Pricing for life and personal accident catastrophe reinsurance continues to be driven by both the type of coverage sought and the concentration of exposures within a given portfolio. The most significant pricing driver is the inclusion of full terrorism coverage including nuclear, biological and chemical (NBC) perils. Regional concentrations, particularly those with exposure to California earthquake and high profile urban centers such as Manhattan, New York, and Washington, DC, also exert a strong influence on both the price and capacity available for any one program. Other factors influencing catastrophe pricing include average benefits per life, Maximum Any One Life (MAOL) limitations, quality of reinsurance market security and the retention of the reinsurance layer.

The reductions in catastrophe pricing experienced during the January 1, 2005 renewal season generally came to a halt for the January 1, 2006 season with the exception of NBC-excluded (x-NBC) programs that continued to see slight reductions. Although a few NBC catastrophe programs experienced a rate decrease, the majority of NBC programs experienced increases in the low-to mid-single digit range. When considering the range of recent catastrophic events – the Indian Ocean tsunami, the London bombings, Atlantic windstorms and the devastating earthquake in Pakistan – coupled with the legislative uncertainty surrounding the renewal of the Terrorism Risk Insurance Act (TRIA), the stabilization in pricing can be interpreted, in part, as a reflection of the underwriters' heightened concern with the potential for catastrophic loss.

Contributing to this year's rise in pricing is the cost of capital, which increased for catastrophe reinsurers. Windstorm losses, while an unrelated - and largely noncorrelated - peril in the life and personal accident lines of business, demonstrated the common relationship of capital among all lines of catastrophe reinsurance, including property, workers compensation and life and personal accident. Further, A.M. Best increased the amount of capital that reinsurers are required to hold in support of catastrophe reinsurance, which in turn was reflected in January 1, 2006 catastrophe reinsurance rates.

Retention and Limit

In response to pricing after the terrorist events of September 11, 2001, insurers purchasing life and personal accident catastrophe reinsurance have become increasingly comfortable holding larger retentions. At January 1, 2006 renewals, this trend was evident on a number of the larger programs, with costs re-deployed from the lower end of the program to purchase more meaningful limits. This trend is especially true for programs with full terrorism coverage, including NBC, as loss severity from such events continues to be considered dramatic.

Overall, average retentions increased in the range of 10 percent to 15 percent. Retentions vary widely from program to program, reflecting the buyer's risk profile and portfolio characteristics. Full terrorism program retentions average in the \$15 million to \$20 million range per occurrence, with the largest programs retaining in excess of \$50 million. Programs that exclude NBC generally attach lower, in the \$3 million to \$10 million range.

While a few insurers have expressed interest in obtaining limits up to \$500 million per occurrence, including NBC coverage, the largest programs are in the \$200 million to \$300 million range. The average program size is approximately \$60 million, and there is a wide range of limits purchased, depending upon portfolio characteristics. More sophisticated methods of accumulation modeling and increased scrutiny from rating agencies have also stimulated interest in catastrophic protection.

Capacity

As noted above, capacity for both full terrorism and x-NBC coverage has increased steadily since 2001. In 2005, reinsurers continued to increase their maximum line size.

Total capacity is split fairly evenly between reinsurance markets in Bermuda, Europe, London (both Lloyd's and the company markets) and North America. There have been four new life and personal accident reinsurance markets, including three Bermuda markets with new capital. As these companies continue to build infrastructure and staff, their interest in alternative lines of catastrophe business, such as life/personal accident, should increase.

As mentioned above, despite the increase in full terror capacity, there appears to be insufficient traditional reinsurance capacity to meet the catastrophe buying needs of the largest insurers. Although we are seeing interest from these companies to utilize the capital markets, the cost and lack of flexibility relative to traditional reinsurance markets remains a barrier.

Terms and Conditions

The Indian Ocean tsunami disaster in December 2004 highlighted the restrictive nature of standard loss occurrence definitions, particularly geographic limitations. In certain cases, the radius restriction has either been increased substantially or removed altogether.

Pandemic

The potential for a pandemic outbreak, and the heightened awareness of the avian influenza in particular, created considerable interest on the part of life and health insurers in the last year. The U.S. Department of Health & Human Services estimates that 1.76 million U.S. residents could die from an avian flu pandemic, and Standard & Poor's has predicted that insurance industry losses could reach \$200 billion worldwide in a worst case scenario. A recent report from the Congressional Budget Office indicated that a pandemic would last for three months and 30 percent of the American workforce could become ill.

These alarming statistics are a concern to risk managers since traditional catastrophe reinsurance is designed to protect against sudden and accidental death, not death due to sickness and disease. Currently, Guy Carpenter is assisting both life and health writers in exploring pandemic coverage options and estimating the potential impact that an epidemic may have on their portfolios. We are working with industry partners to create reinsurance capacity and achieve convergence on terms and conditions.

Medical**Capacity and Pricing**

The medical reinsurance market for both quota share and excess of loss reinsurance has remained relatively stable over the last year and for the January 1, 2006 renewal season. One new medical reinsurer entered the market in 2005, and none have exited the medical market. Reinsurers, however, continue to refine their appetites for quota share and/or excess of loss reinsurance.

The consistent state of medical reinsurance capacity has resulted in a relatively stable and competitive pricing environment. Medical excess of loss reinsurance pricing remains commensurate with ground up and leveraged medical trends. In addition to the usual low frequency, high severity claims (e.g., organ transplants, burns), the \$1 million excess \$1 million layer has experienced new loss activity generated from newer treatments and procedures, including complications from gastric bypass surgery, diabetes and dialysis. High medical excess layers can expect double digit rate increases in 2006 in line with anticipated leveraged trends.

Catastrophic terrorism risk continues to be a concern for writers with heavy urban concentrations. Pricing and capacity for medical terrorism reinsurance remains competitive. Health insurers are also fearful of an avian influenza epidemic.

Retention and Limits

Maximum treaty limits remain constant and reflect the lifetime maximums of the underlying policies. Excess of loss retentions continue to increase gradually as the underlying loss activity grows. In addition, many of the large insurers attached at higher levels, providing them with greater underwriting flexibility. This resulted in the capability to gain market share from smaller, less flexible managing general underwriters (MGUs). Quota share retentions remain fairly static, with reinsurers willing to consider 90 percent quota share arrangements.

Terms and Conditions

Terms and conditions for both excess of loss and quota share reinsurance continue to remain reasonably constant. For MGUs, underwriting guidelines remain tight as they struggle to maintain premium volume year over year. Reinsurers continue to push for better notification of potential losses during the quotation process, especially on excess of loss programs. Identifying high-risk insureds remains a common practice for which additional pricing cannot compensate.

Disability**Pricing**

Rates are hardening on both the primary and reinsurance sides of the disability business. These price increases, along with the tightening of contract terms, are the result of negative profitability trends due to higher incidence, decreased terminations, lower investment income, the churning of existing disability business and limited retrocessional reinsurance capacity.

It is expected that the group disability market will continue to produce return on equity (ROE) in the mid-single digit range for the foreseeable future, considering current trends in the macro environment. Consequently, traditional disability reinsurance markets will take a conservative approach to renewing their in-force books of business. Additionally, demographic trends such as the aging of the nation's population, obesity and the shrinking skilled labor pool will likely continue to remain significant risk management challenges for all players in the disability insurance and reinsurance industries.

Retention and Limit

Maximum treaty limits remain capped at \$25,000 or \$30,000 per month per life. On the other hand, retentions are increasing for primary disability writers as a result of higher reinsurance renewal rates and tighter terms and conditions.

Capacity

Group disability reinsurance markets can be split into two general categories: private label/turnkey and automatic. Each segment is experiencing a retraction of capacity from both a lead and retrocessional reinsurance perspective, and the full impact of this trend is likely to continue beyond 2006. It is expected that the shrinking of capacity and market consolidation will enable the remaining disability reinsurers to firm up pricing, terms and risk management parameters.

Terms and Conditions

Complex group disability market dynamics require disability reinsurers to design creative solutions to meet the needs of primary writers. Some of these reinsurance products include protracted reinsurance rate guarantees, market segment-specific arrangements, swing plans, structured reinsurance products, reserve buyouts and participating contracts. Traditional reinsurance markets have historically been slow to respond to these needs, but progress is being made.

Many disability reinsurers are moving away from a percentage of gross written premium pricing basis toward exposure, monthly indemnity and bifurcated SIC-based pricing to account for shifts in the primary writer's business mix. Increased data requirements for new premium determination methods are expected to add a limited administrative burden to cedents.

In addition to price and reinsurance market security, cedents continue to seek value added services as part of their partnership. These services include, but are not limited to, actuarial, claims management, underwriting, product development, research and training services. Additionally, cedents are requesting guaranteed service days and web-based administration.

Product Development

Existing per person excess of loss reinsurance treaties are not meeting the needs of some major long-term disability writers. These companies are interested in better quarterly and annual volatility protection. Guy Carpenter is working with industry partners to create reinsurance capacity and achieve convergence on such coverage.

Life and Annuity

Pricing and Capacity

Increased expenses, adverse lapse results, slowing improvements in mortality rates and a limited base of retrocessional reinsurance capacity have all contributed to increases in reinsurance rates. Legacy reinsurers are wielding increased pricing power as the majority of in-force business ceded is now concentrated in the top five life reinsurance companies. The consolidation of reinsurers has presented a dilemma for some primary insurers. When two reinsurers in an existing pool merge, the cedent must choose between allocating a higher percentage to the combined entity or adding a reinsurer with potentially weaker market security.

Despite hardening market trends, life insurers continue to utilize first dollar quota share reinsurance to meet capital needs resulting from Regulation XXX and Actuarial Guideline 38 on level term and universal life contracts with no-lapse guarantees. A shortage of collateral capacity has kept pricing firm where unauthorized domestic reinsurers and offshore accredited reinsurers are used. The constrained credit markets may have difficulty supporting the future collateral needs of direct writers. Regulators in the United States and Europe have discussed possible solutions, but most recognize that it will require a long and tedious process to bring meaningful resolution.

Although the largest companies are interested in utilizing capital markets, the cost, complexity and lack of flexibility relative to traditional reinsurance markets remains a barrier. Despite the growing use of capital market solutions, most direct writers may not find them feasible to deal with reserve strain.

Due to the low interest rate environment, there is little annuity reinsurance for fixed rate products. Variable annuity reinsurance for living benefits and guaranteed death benefits is increasing, although slowly and with limited coverage. Recent poor results in the variable reinsurance market are still having a dampening effect on new players entering the marketplace.

Hardening life reinsurance markets have attracted competition, as evidenced by several new market entrants in the past two years. These new entrants compete on the basis of pure reinsurance capacity rather than the full-service platform that traditional markets have historically offered.

The potential for a pandemic outbreak and the threat of terrorism continues to loom over the industry further inhibiting pricing relief (see the Life and Personal Accident section on page 22).

Retention and Limit

Life companies are increasing their share of proportional reinsurance retentions primarily because of increased reinsurance costs, but also because of their improved capital positions. As proportional retentions have risen, there has been a corresponding increase in the use of nonproportional reinsurance structures, such as stop loss protection, excess of loss coverage, catastrophe reinsurance and other financial risk management tools.

Terms and Conditions

Reinsurers continue to tighten terms and conditions and have attempted to insert more onerous clauses in new treaties. Realizing that underwriting guidelines have not been adhered to by many companies, reinsurers have moved from a guideline-based to a rules-based approach to underwriting, leading to more precise treaty provisions. Of particular concern are historical underwriting exceptions. Direct writers have seen more frequent underwriting audits, and in some cases, retroactive price increases have been enacted. In other cases, bound coverage has been denied.

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