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Inside This Issue

- 1 From the Editor
- 2 Capital Raising –
Preparing for 2010 and
2011
- 4 Market Conditions
- 10 Corporate
Developments
- 14 Major Losses
- 18 Spotlight on Financial
Institutions Insurance
- 21 Run-Off Update

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From the Editor

We will shortly be reporting record profits for the 2006 year of account, at around 25% of premium income limit, and this is something to be cheerful about when the press is filled with gloom, such as the following:

“Around the world, people who don’t work in the financial sector are being told they have to pay to save the banks that destabilised the global economy. That’s hard to swallow. Your house price is collapsing, your job is under threat, your business can’t get access to working capital, your pension income has dived – in short, your life is being turned upside down by the collapse in the financial system.” Money Morning 5 March 2009

But things are not so bad in the insurance sector, except for those such as AIG who diversified into ‘Financial Products’, the consequences of which have been ruinous.

A recent Executive Briefing organised by the Insurance Insider was entitled ‘Endless Risk; Prodigious Opportunities’. Those two themes are reflected in this edition.

On the one hand, as is evident in our survey of market conditions, 2008 looks as if it was the low point in the cycle and rates are either rising or stable. In preparation for the perceived new opportunities, there has been a series of capital raising initiatives in the first weeks of 2009. We look at these, and why Lloyd’s operators are in a particularly advantageous position, in the opening article and the *corporate developments* section.

On the other hand, insurance is about risk, and the severity and frequency of loss can never be predicted with accuracy. We include the usual round-up of *major losses* and our ‘*Spotlight on...*’ series continues with an overview of Financial Institutions insurance, a sector that is likely to remain in the news for some time to come.

On a more cheerful note, our *Run-off Update* records the closure of a further seventeen years of account, many with a distribution.

The more the financial turmoil develops, the more opportunities will be created. Lloyd’s has the capital and the risk appetite to grasp those opportunities, under the proportionate oversight of the Franchise Performance Directorate.

Jeremy Bray - Editor

Capital Raising – Preparing for 2010 and 2011

In the corporate developments section of this edition, we comment on the capital raising initiatives of five Lloyd's Managing Agents – Beazley, Catlin, Chaucer, Omega and Hardy. Between them they have raised close to £600m. We expect other Lloyd's entities to be seeking additional capital in the coming weeks.

*Lloyd's Managing Agents
are raising capital*

The weakness of sterling against the US dollar is the principal driver of this fundraising. However, the reason why these capital raising measures have been successful is that investors support the managers' view that the current market presents opportunities to grow their businesses profitably.

In outlining the background to, and reasons for, raising capital the improvement in underwriting conditions is attributed to the following significant factors:

- **Reduced Capital:** From a position of 'capital adequacy' a year ago, when insurers and reinsurers were returning capital to shareholders or having to explain to analysts why they were not doing so, we have moved to capital preservation as top of the agenda. Natural and financial catastrophes have wiped an estimated \$100 billion from the balance sheets of the non-life insurers and reinsurers. There is a realisation that, if your balance sheet were to be impaired by a major loss, the usual sources for recapitalisation are simply not there and unlikely to be available for some time.
- **Alternative Sources of Capital:** Beyond the traditional sources of capital, alternatives such as that provided by hedge funds have greatly reduced amid the general de-leveraging of the markets. This affects in particular the retrocessional (reinsurance of reinsurers) markets, where alternative structures such as so-called 'sidecars' have not been renewed.
- **Exchange Rate Movements:** The weakness of sterling against the US dollar, euro and yen has resulted not just in increased profits reported in those currencies, but increased exposures and in consequence increased capital requirements, as Members will be well aware from their estimated mid-year Coming into Line requirements.
- **Low Interest Rates:** Insurers can no longer rely on investment returns to support falling or inadequate pricing of risk; investment returns are down sharply. There is increased pressure on underwriting to achieve positive overall returns.
- **Hurricane Ike:** After two years of relatively benign natural catastrophe activity, Hurricane Ike provided a salutary reminder of the scale of devastation that can be caused. Initial assessments underestimated the insured cost and there has

*Factors contributing to the
hardening market*

been a regular flow of revisions upwards, such that the loss is now in excess of \$20 billion, making it the third most expensive hurricane on record.

- **New Opportunities:** The difficulties encountered by AIG and others have focused attention on counter party risk, in particular the amount of any one placement with a single carrier. This has led to a revival of the subscription market and created opportunities for smaller entities to access previously unavailable business and, importantly, to be more selective about the business they underwrite.
- **Lloyd's well positioned:** With its A (Excellent) rating from AM Best and A+ (Strong) from Fitch and Standard & Poor's, along with a stable outlook from all three, Lloyd's is generally seen now to be a well run business, especially when compared to the disorder visible at some of its competitors. Assertions that Lloyd's has become the 'market of choice' for certain lines of business are entirely plausible.

These combined factors provide the basis for a hardening market. But is it actually happening? Rolf Tolle, speaking for the Lloyd's Franchise Performance Directorate (**FPD**), is cautious. Certainly the market is no longer softening, which was the position up until mid-2008. Significant rate increases are being reported in US catastrophe exposed zones due to a shortage of retrocessional capacity. Improvements are also reported for International (non-US) catastrophe reinsurance, but not so marked. Likewise significant increases are expected in offshore energy, returning to post Katrina levels and, given the recent loss experience, large commercial risks are set to improve. Elsewhere rates are generally flat and the improvement will be slower, notably in the liability classes, as can be seen in our *Spotlight on Financial Institutions Insurance* later in this edition. Rolf Tolle spoke of the hardening market as a "slow burn", which will manifest itself during the course of this year and into 2010.

In spite of the encouraging outlook, challenges remain. Investment portfolios that have included bonds, equities or derivatives will have suffered damage. Errors & Omissions (**E&O**) and Directors' & Officers' (**D&O**) claims arising from the financial turmoil, including the alleged Madoff fraud, are likely to increase. Although Lloyd's is less exposed than others to both of these threats, it is in the same position as all other insurers as regards the likely increase in fraud (i.e. moral hazard) that accompanies recession, as well as the consequent downturn in demand for insurance.

The market we are in at present is not the same as that seen in 2002 after World Trade Center or in 2006 after Hurricane Katrina. There are moderate rate increases in certain lines, elsewhere rates are flat. However, as the financial turmoil continues to unfold, the factors listed above seem more likely to result in a widespread and sustained improvement through this year, next year and into 2011. On their own,

Rate increases evident in some sectors. In other areas, the transition to a hard market is more gradual

FPD cautious

Improving market but recession likely to see an increase in fraudulent claims

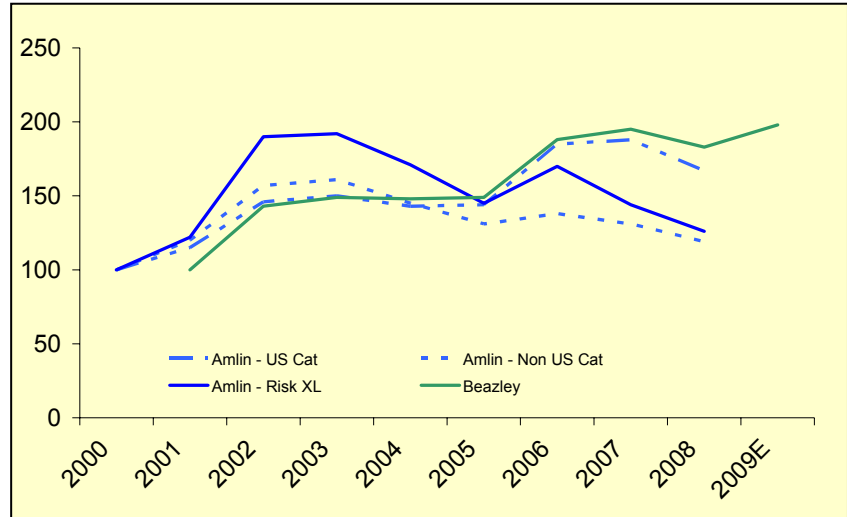
Emerging hard market likely to last longer

the 2008 hurricanes and large single losses might have caused a temporary halt in the softening market which, depending on loss experience this year, would have resumed earlier. So while 2009 may not in some sectors see the improvements anticipated, although US catastrophe reinsurance very probably will, the prospects for 2010 and 2011 look good. The message from the companies raising capital at this time is that they are in a good position to take advantage of the opportunities that will arise, in particular as an operator in the Lloyd's market, under the moderating influence of the FPD.

Market Conditions

We have once again included a number of the published rate indices as an aid to understanding the rating movements in each sector. We have selected Beazley, Amlin and Chaucer as representative of the business mix written by our members, but as can be seen from the charts themselves, the data is in many cases subjective and reflects experience on the insurers' own renewal accounts rather than the totality of the market sectors.

Property Treaty



January renewals better than expected in the US

The 1 January renewal date remains the most important in the calendar for reinsurance treaties. It was the first real test of resolve for underwriters promising a return to hard market underwriting and witnessed some meaningful rate increases on capital-intensive lines of business. Once again, retrocessional capacity (the reinsurance of reinsurers) was in very short supply, especially as some major players elected to move their allocation of aggregate for catastrophe business from retrocessional to primary reinsurance (i.e. reinsurance of direct underwriters).

In rating terms, the biggest moves were on Nationwide US programmes, i.e. companies that underwrite in more than two or three states and thus typically have catastrophe exposures to more than one Realistic Disaster Scenario (**RDS**) type event, with rate increases of up to 25%. Prices for Regional business tended to reflect loss activity, with loss hit programmes experiencing rate increases of up to 20%, but for loss free ones, smaller increases and in some cases renewal as before.

***International (non-US)
business begins to improve***

Away from the US, there were increases on Caribbean business and modest upward movement on most European and Australian business, but rates are still under pressure in the Far East - Japan's renewal season is not until 1 April.

***Change of attitude in
Bermuda – capital
preservation top of the
agenda***

Bermudian reinsurers have been circumspect. They had been criticised in London as generally taking a higher risk approach, with the view that a loss will cause the rates to rise and that new capital will always be forthcoming in a hard market. That attitude has changed and capital preservation is the principal concern. Companies that have extensively used catastrophe modelling software to underpin their prices have become more cautious, as these models have once again been undermined by actual experience. A further boost to Lloyd's has come from the desire of many buyers to reduce exposures to a single company and to spread risk through the subscription market, which is of course the very foundation stone of the Lloyd's market.

***Lloyd's benefits from revival
of the subscription market***

Most underwriters expect conditions to improve throughout the year as further investment and underwriting losses are announced. The results we have seen from insurers and reinsurers to date indicate a wide disparity, especially between those with either investment banking operations, such as AIG and Swiss Re, or exposure to credit insurance such as XL, and the rest, which seem to be holding up rather better.

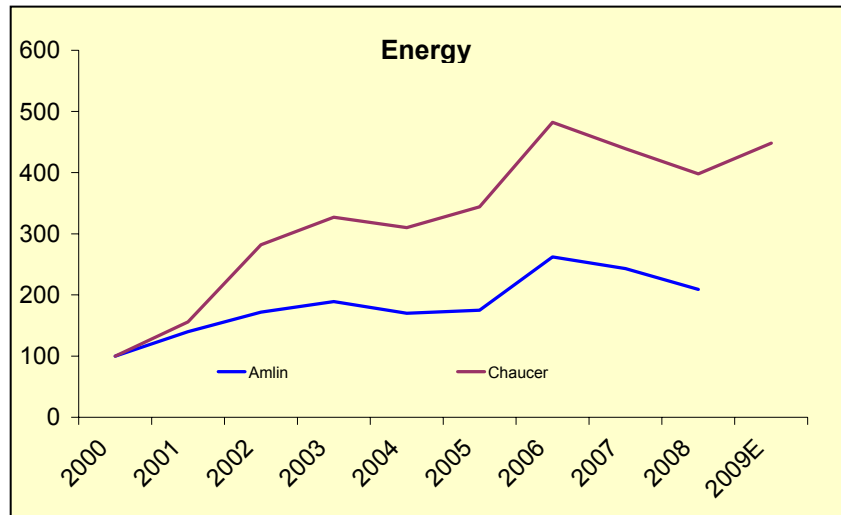
Florida

Florida squeezed

Florida's State Board of Administration met in February to discuss funding options for the Florida Hurricane Catastrophe Fund (**FHCF**). This state sponsored facility provides an aggregate \$29.5 billion of capacity to the homeowners insurance companies and is funded through a combination of commercial reinsurance and pre and post event bond issuance. As there can be no certainty as to whether the bonds can successfully be raised in the aftermath of a hurricane, this potentially leaves the FHCF some \$18 billion short. It was the expansion of limits of the FHCF in 2007 which began the softening of the reinsurance market, as many of the post Katrina start-ups specifically targeted the Florida reinsurance market. The quasi-nationalisation of the market, together with rating agents' demands for a more diversified business model, prompted these companies to cut rates on other business in order to build their books. Some underwriters have warned that the withdrawal of state capacity may not lead to the bonanza others predict for reinsurers. If the admitted carriers are unable

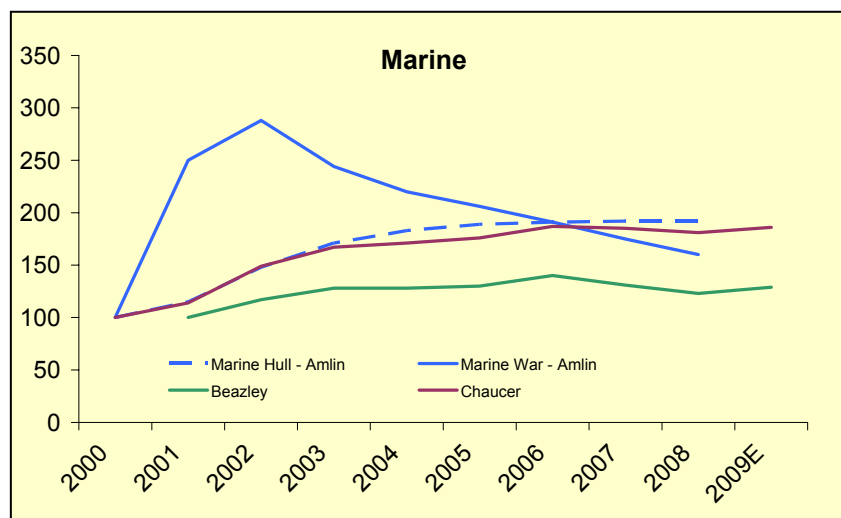
to raise their premium rating levels because they are not permitted to do so by State insurance regulators, this may mean that they are unable to afford the terms needed by reinsurers.

Energy and Marine



Offshore Energy reacts strongly in aftermath of Hurricane Ike

Gulf of Mexico offshore energy business has seen some significant rate increases. In addition, it is expected that the market will require changes to terms and conditions. For example, retentions and policy limits will be linked to total asset values declared on the policy and the market will no longer be prepared to offer such broad Operators' Extra Expense cover, a significant source of Hurricane Ike losses. Meanwhile, Berkshire Hathaway is offering a facility with broker Marsh for Gulf of Mexico windstorm cover, a pooled arrangement with "pricing stability" for a five year period.



Rate increases in Marine sector are the norm

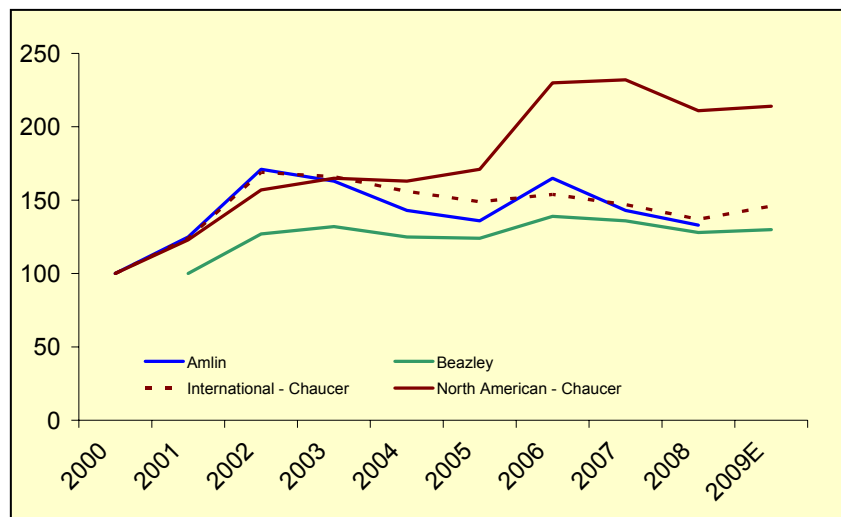
Collapsing marine freight rates have led to an increase in reporting of unrepaired damage claims and a subsequent upturn in attritional loss ratios for Hull insurers. Underwriters report that rate increases are now the norm for the class. War rates, in general, are under pressure save for hot spots where rates can be attractive.

The Marine Liability contract for the International Group of P&I clubs renewed in February. With 2007 now being one of the worst performing years on record for the contract, underwriters have succeeded in raising rating levels on much of the programme, especially the loss hit lower layers. However, loss free higher layers have enjoyed some reduction in pricing. We understand the overall increase in cost of the programme, unchanged in structure, is around 11%.

Political Risks sector benefits from banking crisis

In the political risks arena, increasing risk aversion on the part of the banking sector is prompting more clients to seek insurance. At the same time some risk characteristics are deteriorating, as economic problems can translate into political instability.

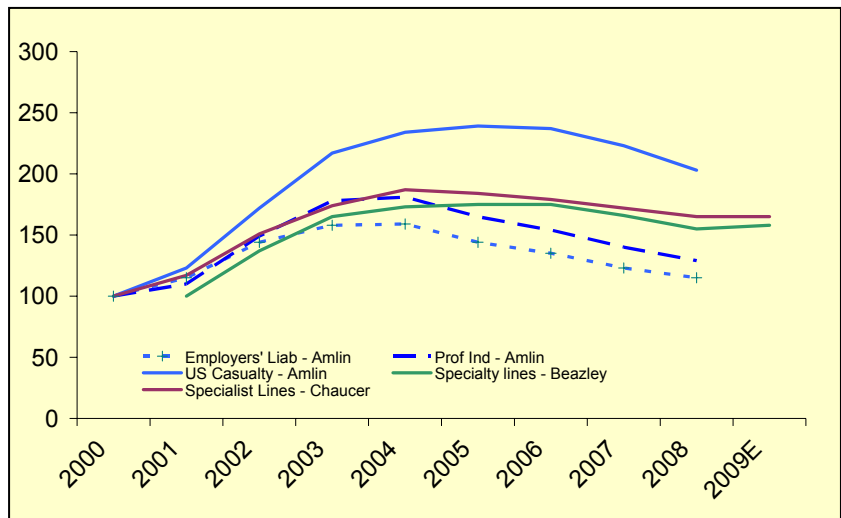
Direct Property



End of steep decline in non-catastrophe exposed property business

The sharp downward trend in pricing has been halted although at present there is scant evidence of rating increases away from the loss hit areas of mining and US hurricane prone regions. Amlin reported a small overall reduction in rating levels of 0.1% at the January renewals.

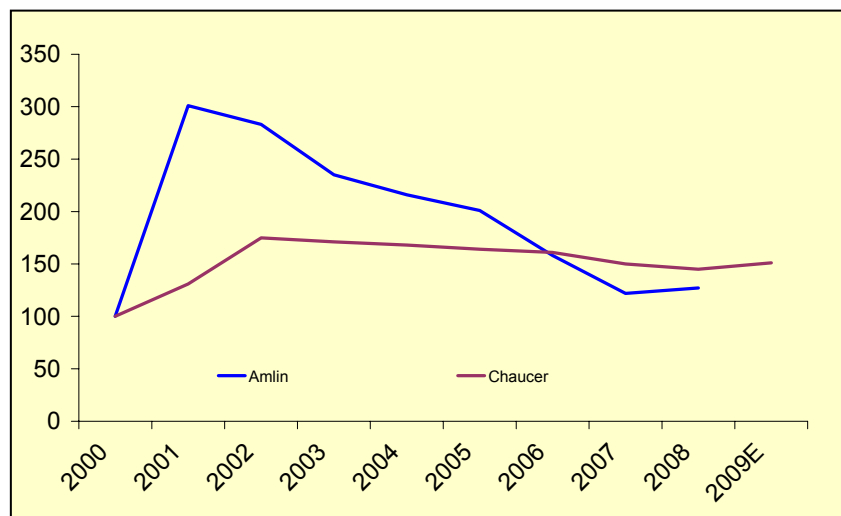
Non-Marine Liability



Conditions remain challenging

Rate increases are counteracted by a reduction in exposures. Exposures are measured by reference to turnover for General Liability risks, payroll for Employers' Liability and fee income for Professional Indemnity (PI). Most policies pay a minimum and deposit premium at the inception date based on an estimate, with an adjustment at expiry on actual numbers. Over the past few years, insurers have received additional premium from adjustments. As the economic downturn bites, this is unlikely to happen for a majority of businesses and there will probably be no final adjustment due. Underwriters claim to be holding rating levels and in some cases increasing them. This will not manifest itself as an increase in total premium volumes. Underwriters hope that the improvement in risk will be sufficient to compensate for the loss of adjustable income. One underwriter commented to us recently that the impact of the recession has yet to make its way through into the mindset of risk buyers.

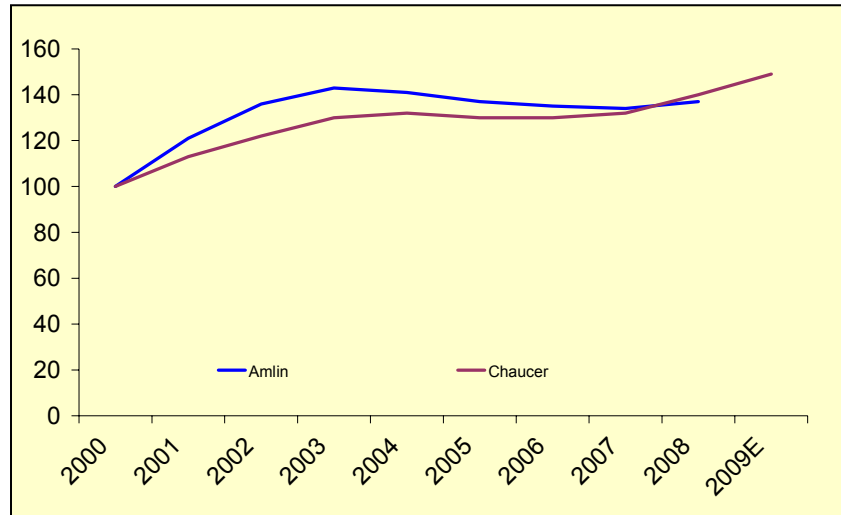
Aviation



Signs of the Aviation market coming off the bottom

The market for airline business began to firm during the final months of 2008. There are few renewals in the first half year, although signs are that the hardening will gather pace later this year. Premium volumes for this market have fallen by almost 25% since 2005. The worldwide economic downturn will reduce passenger revenue miles, the key underwriting value on which rates are calculated, so it will take more than simply rate increases to return the market to profit.

Motor



Headline UK Motor rate increases offset by other factors

The AA rating index for private car risks shows an 8.9% increase for the year to 31 January. Commercial motor risks continue to lag behind although rate increases are generally the norm. The economic slowdown will impact claims activity in a number of ways; reducing claims inflation as the cost of repairing cars falls, but increasing claims activity especially from theft. The number of uninsured motorists could rise even further increasing the burden on the Motor Insurers' Bureau. Claims inflation for accident victims' long-term care may not necessarily follow other inflationary trends (Admiral's recent results placed claims inflation on its book of business at 4.3% per annum since 2001). Thus the rate increases, which we expect to gather pace over the year, will not necessarily improve overall profitability, especially given falling investment returns.

Life

Recession may reduce premium income

With the dramatic reduction in mortgage and other lending, there has been a commensurate reduction in the number of policies sold to protect borrowers. Syndicates operating in this sector are likely to see income projections fall short. Other types of policies, such as group life schemes will suffer as companies seek to reduce their payroll costs and also as the credit life insurers look to other ways of writing income, prompting the class to become more competitive.

Corporate Developments

Beazley

Beazley US acquisition

Beazley has acquired First State Management Group, a US underwriting manager specialising in Excess and Surplus lines property insurance, from Hartford Financial Services. First State has six offices across the US and wrote gross premiums of \$164m in 2007. Beazley sees the business as complementary, fitting between its existing Excess and Surplus lines business and the larger commercial property account, and of a type that rarely makes its way to London. The business will be written in parallel by Syndicates 623/2623. The cash consideration for this business is \$35.4m and the members of Syndicate 623 will contribute to the purchase over the next five years. Members of this syndicate will therefore be entitled to proceeds on any future sale of the First State business. Full details are being sent to members of Syndicate 623.

At the same time, Beazley announced two other strategic initiatives. First, it plans to change the corporate structure of the business to be resident in Jersey but tax resident in the Republic of Ireland. Second, it is raising £150m through a rights issue.

Catlin

Catlin expanding

In announcing a small loss for the year to 31 December 2008, Catlin has revealed plans to raise an additional £200m to support new opportunities. When added to the small surplus of economic capital already in place, Catlin believes that it will be able to write a further \$1 billion of premium income using the infrastructure already in place. As it considers the upturn in the market to be sustainable, it believes permanent capital is more appropriate than what it perceives as temporary measures, such as further third party support from Members (Special Purpose Syndicates 6101 and 6102 ceased trading at the end of 2008).

Chaucer

Chaucer needs more capital. Merger talks with Novae

Chaucer has announced a placing of shares to raise an additional £75m. This highlights the difficulty faced by Lloyd's insurers funded in sterling following the depreciation of the pound against the US dollar. More sterling is required to support liabilities which are largely in US dollars. Compounding this, the business has recorded solvency deficits on open years and losses on investments. The majority of the capital is therefore required to prevent the need to curtail underwriting. Once this capital has been replaced, a proportionately small volume of additional capital allows a relatively large increase in prospective income volumes.

At the time that Chaucer announced its capital raising, it also disclosed that it had received an unsolicited approach from another Lloyd's vehicle, Novae, for a nil premium, all paper merger. The two parties have since entered mutual due diligence and Chaucer has further disclosed that it has been approached by a number of other parties interested in acquiring

the business. All are in various phases of due diligence, but none has publicly disclosed its identity. Rumoured potential buyers include rival Lloyd's operations and Bermudian businesses seeking to establish a platform at Lloyd's

Hardy

On 27 February, Hardy Underwriting Bermuda Limited, which manages Syndicate 382, announced its results and a fully underwritten placing and open offer to raise £40 million. It said that an improvement in underwriting conditions had taken place earlier than anticipated, due to a number of significant external factors of a global nature and also of more specific importance to the insurance industry. In particular, Hardy noted that the shortage of capital and resultant hardening of rates in 2009 and 2010 made fundraising necessary at this time, stating that "...the...Offer will provide Hardy with additional permanent capital to support the increased volumes of business that the Group now proposes to underwrite."

Hardy raises £40m – improvement in underwriting conditions earlier than expected

Omega

Omega Insurance Holdings Limited, parent of Lloyd's managing agent Omega Underwriting Agents Limited, raised £130 million in a share placing with new and existing institutional investors in December 2008. This placing increased the capitalisation of the business by almost 40% and was said to position the company to take advantage of the improving market conditions in the company's core areas (which are principally non-marine reinsurance and US surplus lines property insurance).

Omega raised £130m – positive outlook and Omega well placed

View from Throgmorton Street

Our regular review of Stock Exchange listed Lloyd's vehicles. This is for general information and must not be construed as being any form of investment advice.

ILV sector retreats, but less than FTSE 100

Having substantially out-performed the major indices during 2008, the ILV sector has lost some of its lustre in the opening weeks of 2009, with Argenta's index of Lloyd's stocks falling by almost 9%. The biggest faller was Advent, following a trading statement in early January which disclosed that Hurricane Ike losses were now likely to exceed the reinsurance programme. All bar Omega are lower than they were in December last year. This seems to be a reaction to the capital raising announced by about half the companies in the sector and an expectation that at least some of the others will follow suit.

	Share price			Change since	
	31-Dec-07	08-Dec-08	03-Mar-09	31-Dec-07	08-Dec-08
Advent	245	170	118	-51.8%	-30.6%
Amlin	302	371	365	20.9%	-1.6%
Beazley	179	121	107	-40.2%	-11.6%
Brit	229	222	180	-21.4%	-18.9%
Catlin	385	435	403	4.8%	-7.4%
Chaucer	102	65	42	-58.8%	-35.4%
Hardy	295	283	262	-11.2%	-7.4%
Hiscox	287	329	288	0.5%	-12.5%
Omega	157	148	149	-5.1%	0.7%
Novae	335	308	298	-11.0%	3.2%
Lloyd's*	97.2	101.1	92.0	-5.3%	-8.9%
FTSE100	6,457	4,300	3,512	-45.6%	-18.3%
FTSE250	10,651	5,948	5,850	-45.1%	-1.6%

* AIRL's Index of Lloyd's quoted companies

Other Industry News

AIG

AIG revealed its full year and final quarter 2008 results on 2 March. The \$61.7 billion (£44bn) quarterly loss is the largest in US corporate history and brought the full year loss close to \$100 billion. Since AIG was forced to seek US government assistance in September last year it has proposed to repay loans out of asset sales. The worldwide recession has severely reduced both the number and ability of buyers to raise the necessary capital to acquire business units from the AIG. For the first time, AIG is now contemplating the sale of its property/casualty insurance operations, possibly through a public offering. A second revision of the terms of its support sees total US government assistance increase to \$163 billion and a restructuring of the business, in the words of AIG Vice Chairman Paula Rosput Reynolds, aimed at "redirecting the divestiture process away from relying solely on immediate sales for cash and will use a greater variety of tools to maximise the value of individual businesses". Although most rating agencies continue to have AIG's insurance companies on negative watch, the ratings are all 'A' or better and AIG continues as an aggressive competitor to Lloyd's in a number of business lines.

Munich Re buys Hartford Steam Boiler

In one of the first disposals of an insurance interest by the fallen giant, AIG sold Hartford Steam Boiler, a specialist in engineering business, to German reinsurer Munich Re in December. Munich paid \$742m for the business. AIG acquired the business in 2000 in an all share deal that valued the business at \$1.2billion.



Max Capital / IPC Re Merger

Max Capital and IPC Re have announced plans for an all-paper merger of the two reinsurance businesses under the name Max Capital Limited. The business will be headquartered in Bermuda but has a London presence as Max acquired a managing agency business from Imagine during 2008 (Max at Lloyd's manages Syndicates 1400, 2525 and 2526). The merged business will have a capital base in excess of \$3 billion with underwriting offices in Bermuda, London, Dublin and in six US cities.

Swiss Re

Swiss Re reported preliminary results for the year ended 31 December 2008 at the beginning of February. It predicts a loss of SwFr 1 billion (£580 million) and estimated that its regulatory capital fell up to SwFr 2 billion short of that required for it to maintain its current ratings level. It has secured SwFr 3 billion in capital from Warren Buffet's Berkshire Hathaway, in a deal that potentially gives Berkshire rights to convert the loan into equity and could see Berkshire owning more than 20% of the business. Berkshire Hathaway took a five year quota share of Swiss Re's Property Casualty business in 2008 and simultaneously took a 3% stake in the business. Swiss Re's share price has fallen from a 2008 high of SwFr94 to less than SwFr20. The principal losses stem from Swiss Re's investment banking operations which traded securities such as Credit Default Swaps. The company will be winding down these operations. In a move underlining this return to core reinsurance business CEO, Jacques Aigrain, a former JP Morgan investment banker, announced he was leaving the group on 12 February to be replaced by Stefan Lippe, regarded as a reinsurance veteran. The major rating agencies have placed the company on ratings watch with a view to a possible downgrade.



Royal Bank of Scotland

As the credit crisis began to unfold, Royal Bank of Scotland looked to asset sales to plug gaps in its balance sheet. One of the non-core businesses considered for disposal was the insurance division which includes Direct Line, Privilege and Churchill, three motor insurers with a combined share of the UK market exceeding 30%. A value of roughly £7 billion was placed on the division. As the financial crisis has moved on, equity prices have fallen, as have the number of able and willing buyers. During this time RBS has also become 70% government owned. RBS has now withdrawn any proposals to sell this division as it believes that this would "destroy value for shareholders".



New Syndicates

Arch Capital has become the latest in the series of Bermudian reinsurers to form or to buy a business in Lloyd's. Arch has confirmed that it has received conditional approval from the FPD and from the FSA to establish a new managing agent and syndicate to start underwriting later

this year. The details of business classes to be written, personnel and premium volumes have yet to be announced. Arch is a Bermudian domiciled insurer and reinsurer which wrote net premiums of \$2.9 billion in 2007. It was formed in the aftermath of the WTC attacks of 2001 and as of 30 September 2008 had over \$3.9 billion of capital.

2008 start-up, Torus, formed by, amongst others, former Lloyd's underwriter David Hope, has been widely quoted in the insurance press as being keen to access the Lloyd's platform by either acquisition or formation of a managing agency.

Major Losses

Ike and Gustav Update

Many of the companies releasing their preliminary 2008 figures are reporting an upward movement in losses reported from Hurricanes Ike and Gustav. The consensus estimate of the total damage caused by Ike continues to move upwards. Catlin's recent preliminary report reveals a 25% increase in its estimated cost of the hurricanes compared to a 33% increase in the estimate of the cost to the insurance industry. Advent advised investors in January that the net cost of Ike had increased from £15m to £42m as offshore energy loss estimates had escalated beyond the limit of its reinsurance cover. Property Claim Services (**PCS**), widely used as the index which determines whether losses are triggered under Industry Loss Warranty (**ILW**) contracts, has increased its estimates for onshore losses from Hurricane Ike to \$11.6billion. Offshore losses are estimated at \$3 billion. Many insurance and reinsurance companies believe the cost to the industry will ultimately be closer to \$20 billion for Ike.



Madoff

The alleged "Ponzi Scheme" run by Bernard L Madoff has prompted a wave of litigation against advisers and fund managers that placed client monies with Madoff's company, Bernard L Madoff Investment Securities. Investors may be able to sue their advisers under a range of different insurance policies, including D&O, PI and Fidelity. Aon Benfield has estimated the impact on the insurance industry in the range \$760m to \$3.8 billion, with a best estimate of \$1.8 billion. Any claims will be made on the 2007 and 2008 policy years. Global premium volumes for the types of cover involved are put close to \$20 billion. A further complication may arise in that early investors, who made handsome returns as they were simply paid monies from later investors, were the unwitting beneficiaries of fraud and may face the unwinding of profit distributions, which may in turn prompt further litigation.

Argenta's research suggests that the impact on Lloyd's is likely to be modest

As to be expected, there is a queue of US law firms seeking client briefs to recover lost monies. One commented "The misconception is that there is no real recourse through insurance claims. That is not the case at all. We believe that there are hundreds of millions of dollars out there to be recovered through insurance claims".

Argenta's research and conversations with underwriters lead us to believe that, while there will undoubtedly be losses and defence costs, the impact on Lloyd's is likely to be modest. There is little appetite amongst Lloyd's underwriters for large financial institutions on either a direct or reinsurance basis. Although Lloyd's had a dominant position twenty years ago, this has been eroded over time and following the Enron, Worldcom and dot.com scandals Lloyd's withdrew as AIG, Chubb, CNA and XL moved into the financial institutions sphere. In addition, the large accountants now largely self-insure via offshore captives. The business which has remained at Lloyd's is generally with wholly corporate syndicates. Rates are beginning to increase in this area, the banks are taking a lower risk profile and some of the insurance markets that write this business have become distressed. Lloyd's underwriters are watching this space with interest.

Stanford

Stanford Financial Group was placed in receivership following allegations of fraud by the US Securities and Exchange Commission. Stanford had assets under management of \$50 billion, although the fraud allegations are centred on \$8 billion of Certificates of Deposit issued by Stanford. Clients of Stanford were largely based in the US, the Caribbean and Central and Southern America. As yet, no lists of individual investors who have lost money have appeared in the press. Certain insurances are known to have been written at Lloyd's, although not policies that protect any of the investors' funds. We understand that none of the three syndicates involved is supported by private capital. If proven, fraud on the part of Stanford will invalidate the policy in any event.

Windstorm Klaus

On 23 January 2009, Windstorm Klaus struck Southwest France and Northern Spain with wind speeds up to 100mph – the equivalent force of a Category 1 Hurricane. The destructive force was comparative to Windstorms Lothar and Martin in 1999, albeit the footprint of Klaus was far more contained.

The majority of damage caused by the storm resulted from trees and building fixtures falling on residential property and cutting power supplies to 1.75 million households. However, business interruption losses are likely to be contained as power was fully restored to 95% of affected properties within four days.

Catastrophe modelling firm RMS sent a team of surveyors to Bordeaux, the area of France subject to the strongest winds, to gather preliminary damage reports and estimates. The subsequent report found that many



of the properties in the area were well maintained and the damage was “as expected” from a storm of Klaus’ magnitude. In some cases property was rebuilt after Windstorm Martin in 1999 and therefore damage sustained was limited, with the majority experienced in the hilly and coastal regions where houses are of older construction.

Reports of the damage caused in Spain are few and far between, although there are some reports of damaged power lines causing forest fires in Tarragona, Alicante and Valencia.

The European property insurance market is heavily dominated by domestic (re)insurers and some of the losses are expected to be picked up by the French and Spanish governments. Munich Re has announced its expected loss is around €100m.

Initial estimates for insured losses in France are wide ranging (similar levels are expected for Spain).



Authority	Lower Estimate	Upper Estimate	Comment
AIR Worldwide	€300m	€700m	Excludes utility losses and business interruption
RMS	€1bn	€1.8bn	
EQECAT	€800m	€2.5bn	
FFSA*	€1bn	€1.4bn	Increased from an earlier estimate of €600m-€1bn

* (Federation of French Insurers)

The historical uncertainty over European catastrophe estimates has created a demand for an equivalent to the US Property Claims Services (PCS), charged with calculating aggregate loss estimates across the industry. Perils AG – a Zurich based company created by a group of European insurers – will operate as an independent body from the beginning of 2010, collating loss information from individual insurers. This is a necessary progression if the use of catastrophe bonds is to be increased for European risks. The initial total insured loss estimate release by PCS for Hurricane Ike in 2008 was widely regarded as optimistically low by industry bodies and there could be some scepticism when the first estimate from Perils AG is released.

Australian Bushfires



Although the full economic and insurance cost of the bushfires that have swept the Australian state of Victoria may not be known for some time, an early estimate placed damage in excess of A\$500m (£230m). An area of 1,200 square miles (roughly the size of Suffolk) has been burned, 181 deaths have been confirmed and over 1,000 homes have been destroyed. While these losses are severe, they are sadly a regular occurrence in Australia. Fires in Canberra in 2003 cost insurers over A\$250m and the Ash Wednesday fires of 1993 more than A\$300m. Lloyd's syndicates tend to participate in the higher levels of reinsurance protection that will be impacted by earthquakes or cyclones rather than bush fires. Neither the 1993 nor the 2003 fires caused material losses to the Lloyd's market.

US Airways Flight 1549



A US Airways A320 suffered loss of both engines just after take off from New York La Guardia airport on 15 January 2009. The plane was controlled without power to land on the River Hudson, and although some suffered minor injuries all 150 passengers and 5 crew were successfully rescued by Coast Guard and New York ferry vessels. All experts have said that to land a commercial plane on such a busy stretch of waterway without colliding with watercraft or breaking apart was truly amazing. The aircraft hull floated away after the evacuation and ended partially submerged near the southern tip of Manhattan Island. The aircraft, valued at around \$40m, will be a total loss given the impact with the water and the time it spent submerged. We understand that the US Airways programme is led by AIG.

Continental Connection flight 3407



In the first fatal crash of a US commercial airliner in over thirty months, a Bombardier Dash 8 Q400 (a twin engined turbo-prop aircraft with maximum capacity of 75 people) crashed into a house in Buffalo upstate New York. The flight had left Newark Liberty Airport in New Jersey less than an hour before. All 48 passengers and crew were killed, as was one person on the ground. While the hull has been valued at \$19m, the liability loss could be much more significant. Commentators have placed the estimated cost to liability insurers anywhere between \$80m and \$300m.

Indian Terrorism



172 people were killed and more than 300 injured when a team of militants armed with explosives and guns caused extensive damage to several tourist sites in the Indian financial centre of Mumbai in attacks that started on 26 November and ended on 29 November 2008. Security officials said as few as 10 highly trained militants carried out the attacks and they targeted key sites in the city that included two upmarket hotels (Taj Mahal and Oberoi), a popular café (Leopold Café), a major railway station (Chhatrapati Shivaji), a hospital (Cama) and a Jewish centre

(Nariman House). The buildings were badly damaged by the explosions and gun fighting and Insurance Day estimated that the attacks could cost the insurance industry between US\$300 million and US\$600 million in property claims.

Spotlight on Financial Institutions Insurance

Continuing our series of focusing on a specific class of insurance, in this edition we look at Financial Institutions insurance, which covers such institutions against Crime, Professional Indemnity and Directors' & Officers' liability exposures.

What is covered?

Crime

Crime risks are broadly classified as those which result in financial loss from theft. The theft can occur in physical or electronic form arising from an act of infidelity by an employee or third party. The electronic technology used by many financial institutions to handle funds has given rise to computer crime policies which provide security against electronic theft or fraud.

Some crime policies will also cover unauthorised trading where employees act beyond their authority, not for financial gain, but to enhance or conceal their apparent performance.

Professional Indemnity and Directors' & Officers' Liability

Professional Indemnity (**PI**) risks arise from negligent acts by employees of financial institutions which result in liability to a third party. If an employee is deemed not to have performed his or her duties diligently, the third party involved would have grounds to claim under the institution's PI policy.

Directors' & Officers' (**D&O**) policies cover the directors and officers of a financial institution against third party liability, as with professional indemnity, but are specifically tailored to cover negligent acts by the institution's board of directors. This cover will often extend to any indemnification the parent company's board may be obliged to make to its directors and officers should it be found to have committed any wrongful acts.

Who buys the cover?

- Central, international, commercial and private banks
- Hedge fund, private equity and investment managers
- Stockbrokers and wealth managers
- Stock exchanges
- Corporate finance advisers
- Building societies
- Depositaries, settlement and clearing operations

Which Syndicates?

Syndicate	Financial Institutions Premium Income (£)	Proportion of Total Premium Income (%)
2007	46,441,564	19.30%
1200	5,755,020	2.09%
727	355,598	0.88%
386	2,231,226	0.68%
2121	598,400	0.62%
623	677,143	0.45%
1965	62,599	0.35%
510	1,001,363	0.18%
2791	167,504	0.07%
570	6,717	0.01%
2010	4,505	0.00%

Syndicates with third party capital underwrite very little Financial Institutions business

Among the syndicates open to third party capital there are few that underwrite a Financial Institutions book. The largest participant in 2008 was Novae Syndicate 2007, but third party capital has been bought out by a capacity offer for 2009. For the current year Heritage Syndicate 1200 plans to underwrite little over 2% of total gross premium income, mostly in the Crime class, with some PI. Among other syndicates that show planned income in the Financial Institutions classes are QBE Syndicate 386, Kiln 510, Beazley 623, Argenta 2121 and Meacock 727, but in each case less than 1% of total gross premium income. In all cases income is exclusively or predominantly in Crime rather than PI or D&O liability, although QBE Syndicate 386 does have a book of non-US PI for Financial Institutions.

Current Market Conditions

Unknown impact of alleged Madoff fraud

Any losses arising from the credit crisis or Bernard Madoff's alleged \$50bn "Ponzi Scheme" are seen as likely to impact principally Financial Institutions insurers. There has been much speculation as to how much these losses might cost. Broker Aon Benfield has estimated a range of \$760mn to \$3.8bn of direct insured losses, with a best estimate of \$1.8bn, arising from Madoff. Maximum potential exposed insurance limits are estimated at over \$6bn, although how that figure is arrived at is something of a mystery.

In reporting their results, companies feel obliged to comment on potential exposure. For example, Beazley in its preliminary results announcement on 13 February 2009 states the following:

"In recent years, Beazley has had a limited appetite for professional liability risks within the financial institution sector which are viewed as the highest impacted areas. Whilst the number of sub-prime related lawsuits (as reported by Advisen) has recently been updated to exceed 450, we provide D&O coverage for only seven of the affected entities and other

types of professional or liability related coverage for a further seven. As such, we currently expect that our exposure will remain within our reserves.”

Lloyd’s exposure is thought to be limited

As for the overall exposure of the Lloyd’s Market, we have seen few specific references to Madoff or sub-prime related claims in the current results reporting season. Specialists in financial institutions and professional liabilities will have more exposure to these types of events. Pronouncements from Lloyd’s to date have been along the lines that claims are expected to be “within the normal course of business”.

Quite apart from the uncertainty surrounding possible claims from these sources, the Financial Institutions market has also been hit by a large claim, estimated at \$175 million, arising from an alleged fraud against the Tokyo branch of Lehman Brothers, perpetrated before the collapse of the bank in September 2008.

In addition, certain participants in the Financial Institutions market may be hit by claims arising from a new product launched last year by Protean Investment Risks. Standard financial institutions policies will not cover liabilities to a third party arising from a deliberately fraudulent act. The Protean policy is held by individual or corporate investors to protect against any loss incurred on a portfolio of investments as a direct consequence of a fraud perpetrated by a hedge fund manager or employee thereof. It seems very likely that Madoff related claims will arise on such policies.

Other Financial Institutions losses

Against this background renewal of reinsurance protection bought by Financial Institutions underwriters at 1 January 2009 has proved difficult for some. It is reported in the Insurance Insider (February edition) that the renewal of Bermudian reinsurer Aspen’s reinsurance programme dragged on until the end of January due to concerns over the cover for US investment banks (such as remain).

Difficult 1 January renewal

The current market is reported to be ‘difficult’. Reinsurance costs are increasing but, probably because few actual losses have been advised or paid so far (even though there is an awareness that losses could arise), there is not yet direct pressure to increase rates. Another factor, which had been expected to have a beneficial effect on the market, is the position of AIG. Contrary to predictions, AIG is still very much a force in the Financial Institutions market; it has not pulled back or reduced its participations which, had it done so, might have eased competitive pressures. Although it is widely recognised that fraud increases when there is an economic downturn and underwriters are pushing for improved terms, there is little sign of such increases yet being achieved.

The Financial Institutions market appears to be divided. Those buyers that can demonstrate that they are insulated from credit crunch, sub-prime, Madoff and now Stanford related claims are able to negotiate

Signs of an improving market, but Lloyd's likely to remain on the fringes

renewal at the same rate and possibly improved coverage. Those that cannot, such as Aspen referred to above, are obliged to accept more onerous terms. Developments in the last two months, in particular the Madoff and Stanford scandals, are making underwriters increasingly nervous and therefore more inclined to push for increases across the board. A sign that matters are improving is that there have been reports of a hardening market, encouraging underwriters to re-enter the market on a short-term opportunistic basis.

From the Lloyd's perspective, we do not see a sudden increase in exposure to Financial Institutions business. Hardening of the market is more talked about than actually happening. The experience of the last downturn in the market and the Wall Street claims that arose in the late 1990s caused Lloyd's to cut back, leaving a more specialised mix of business. As the FPD remains cautious, the level of Lloyd's involvement in the sector is likely to remain low in the short term and in consequence a very small part of the portfolio of third party capital providers.

Run-Off Update

Good News

Despite the calm above the surface, beneath, run-off managers and reinsurance to close (RITC) providers alike have been paddling furiously to achieve finality for a significant number of run-off years of account. Over the last two years the number of run-off years, where third party capital has an involvement, has roughly halved from 74 to 36 and we expect this number could halve again as at 31st December 2008. This can be attributed to the stability of reserves and the larger, more competitive market for RITC business. Remaining obstacles to closure include significant exposures to personal accident reinsurance, reinsurance disputes and/or WTC aviation losses, although in the latter category, two syndicates (2 and 566) will close. A summary of run-off years of account by syndicate and whether they are expected to close or not at 31st December 2008 is shown on page 22.

Closure of run-off years continues...

Future

However, the dynamics of the RITC market are changing, with the credit crisis also affecting run-offs! Not by increasing the uncertainty within any run-off year of account, but, first, as a result of reduced investment yield expectations and, second, the possible uncertainty over the additional capitalisation required to write the business. One of the considerations in the calculation of the premium charged by an RITC provider is the investment returns that it might make on the funds that it takes on. With

...conditions changing and the RITC market will become more restricted

investment returns expected to be poor, at least in the short term, RITC premiums may either increase to compensate or the contract becomes less attractive to the reinsurer such that they are not prepared to write it. The second question is capitalisation. RITC syndicates are required to provide the capital to support an RITC at the time that they write the RITC contract. In the current climate, providing this additional capital may not be as easy as it has been and may deter some providers from writing as much RITC business as they might have done otherwise. This would have a dampening effect on competition. Nevertheless, we believe that the RITC market is sufficiently buoyant and hungry that we will see all but a few run-offs closing within the next couple of years, although the cost of doing so is likely to rise.

Syndicate	Year	Result ¹ %	Called to date %	Balance due ² %	Closing @ 31.12.08
2	2001	-48.9	-30.0	-18.9	Yes
	2002	16.8	4.2	12.6	Yes
53	1998	-178.6	-157.6	21.0	No
	1999	-64.5	-67.1	2.6	No
138	2000	-58.4	-61.4	3.0	Yes
	2001	-22.7	-36.7	14.0	Yes
340	2000	-71.4	-67.6	-3.8	No
	2001	-13.8	0.0	-13.8	No
529	1998	-79.7	-103.0	23.3	No
	1999	-109.6	-113.7	4.1	No
566	2000	5.1	-0.9	6.0	Yes
957	1997	-22.4	-34.3	11.9	No
	1998	-64.9	-77.1	12.2	No
	1999	-112.6	-124.6	12.0	No
991	1998	-27.2	-48.0	20.8	No
	1999	-43.0	-36.9	-6.1	No
	2000	-38.4	-35.7	-2.7	No
1007	2002	-7.5	-8.5	1.0	No
1047	2000	-188.0	-199.0	11.0	Yes
	2001	-68.0	-70.0	2.0	Yes
	2002	-24.0	-30.0	5.0	Yes
1101	1997	-39.2	-49.3	10.1	No
	1998	-89.2	-81.5	-7.7	No
	1999	-66.9	-56.6	-10.3	No
1121	1998	-87.7	-76.0	-11.7	Yes
	1999	-69.9	-66.8	-3.1	Yes
1171	1998	-15.2	-16.8	1.6	No
	1999	-6.1	-7.5	1.4	No
	2000	14.2	-7.9	22.1	No
1173	1999	-90.0	-91.0	1.0	Yes
	2000	-65.0	-70.0	5.0	Yes
	2001	-35.0	-58.0	23.0	Yes
	2002	-35.0	-34.0	-1.0	Yes
1204	1997	-44.0	-47.7	3.7	Yes
	1998	-115.0	-126.2	11.2	Yes
	1999	-103.0	-11.4	-2.6	Yes

A further 17 run-off years of account are closing at 31 December 2008

Notes:

¹ For syndicates closing, this is the result calculated from their closure proposals and remains subject to audit. Where remaining open, this is the mid-point of syndicates' September 2008 forecasts so may change.

² For syndicates closing the amount shown will be called/distributed in June 2009. These figures are in bold.

Closing Syndicates – Update

A brief comment on each of those syndicates closing at 31st December 2008 is given below. The indicative costs given are still subject to audit and, in some cases, adjustment for movements during the fourth quarter of 2008.



Syndicate 2 – In July last year, Advent approached Members' Agents with a proposal to close the 2001 and 2002 years of Syndicate 2 into a new in-house syndicate. Although two (more expensive) alternative quotes had been received by Advent, we had reservations about the process adopted and the lack of any form of consultation. As a result, the proposal was put on hold. During the latter part of 2008, Advent re-approached the two reinsurers who had originally quoted for Syndicate 2. Both confirmed that they were not prepared to reduce their original price. Additionally, Advent approached one further reinsurer who was not prepared to quote given the current investment climate and the capital requirements involved. Consequently, Advent proposed to close Syndicate 2 into a new in-house syndicate at the current level of reserves held by the syndicate. This time, a consultation exercise was undertaken and confirmation has now been received that both years are closing with a call of 18.89% on the 2001 account and a surplus of 12.64% on the 2002 account.

Syndicate 138 – Having thoroughly canvassed the RITC market, Syndicate 138 Agency Limited has accepted a quotation to close all years of account into Meacock Syndicate 727. This will result in releases to members of 3% and 14% for the 2000 and 2001 accounts respectively.

Syndicate 566 – We understand that QBE has been in discussion with one external RITC provider but the risk premium indicated was not acceptable to the Board of QBE. Members were therefore consulted on a proposed internal closure offered by QBE. This has been approved and will result in a release to members of 6%.



Syndicate 1047 – Having thoroughly canvassed the RITC market, the managing agent has accepted a quotation from RITC Syndicate Management Ltd. The 2000, 2001 and 2002 accounts will close as at 31st December 2008, resulting in releases of 11%, 2% and 5% respectively.

Syndicate 1121 – Having received quotations to close from two RITC providers and concluded a period of consultation with members, Spectrum intends to enter into an RITC contract with Shelbourne Syndicate Services. As such, the 1998 and 1999 years of account will close as at 31st December 2008 with calls of 11.75% and 3.09% respectively.

Syndicate 1173 – Having thoroughly canvassed the RITC market, the managing agent has accepted a quotation from RITC Syndicate Management Ltd. The 1999, 2000, 2001 and 2002 accounts will close as at 31st December 2008. This will result in releases on the 1999, 2000 and 2001 accounts of 1%, 5% and 23% respectively and a call on the 2002 account of 1%.

Syndicate 1204 – Having concluded a period of consultation with members, Spectrum intends to enter into a RITC contract with Centrewrite. Although the quotation was viewed by Spectrum as severe, other options for closure seem remote, leading its Board to conclude that it was acceptable. The 1997, 1998 and 1999 years of account will close as at 31st December 2008 with releases/(calls) of 3.65%, 11.16% and (2.59%) respectively.

Almost there but not quite

Syndicate 529 – Having received positive interest from the market in early 2008, the managing agency, Shelbourne, entered into full due diligence with one reinsurer. However, the delivery of the final quote did not fall within the timeframes required to close at 31st December 2007. The managing agency has since re-approached the market and received firm quotes from two parties. However, the Board of Shelbourne has concluded that these are not acceptable and as such the 1998 and 1999 years of account will remain open.