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The Cover Note

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INSIDE THIS ISSUE:

EDITORIAL

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Where do we go from here?

"Touch and go" is an expression that comes to mind when trying to describe the current state of the Insurance/Reinsurance market. You have all read about the investment losses of Insurers/Reinsurers, the rating agencies' downgrades of several of them, and the imminent hardening of rates.

Yet, there seems to be ample capacity still in the international and local markets and many accounts are being placed at significant savings to the Insured.

It seems Insurers/Reinsurers are eagerly going back to the essence of the business – underwriting what they perceive to be good risks to achieve underwriting profits. A far cry from the trend and rashness of recent years when they pursued investment income as zealously, if not more, than they did underwriting profitability.

All the while, Insureds are becoming more cautious in their choice of Insurers and are worried about the seemingly unreliable nature of financial ratings, as they experience first hand the pinch of the economic downturn. Results are often meager, jobs are being cut back and bankruptcies are up.

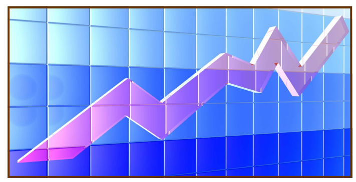
The situation is volatile

Have Insureds taken the opportunity of a soft market to prepare for the hard market by improving on their risk profile? And in dealing with the recession, will they reduce their limits of insurance and turn to Risk Control and self-insurance vehicles such as captives, to the detriment of Insurers/Reinsurers?

Faced with increasing difficulty in raising capital following a difficult performance in 2008, will Insurers/Reinsurers embark on a new merger binge, to the detriment of competition and of Insureds? Will they forego certain products or classes of business in the hope of improving on their results?

What have regulators learned from the situation and will they act upon this knowledge effectively in the future? Where will the next equilibrium between supply and demand rest and when can it be expected?

In an effort to shed some light on the situation and to help you make sense of the direction of things to come, we are dedicating the main article of this newsletter to the state of the Insurance market. We



have submitted questions to two market experts, one operating in the Canadian arena, and the other, in the London market. They share their insight.

Finally, our employee benefit consulting experts examine the rising costs of supplemental health care benefits and provide tips on how to contain them.♦

THE CURRENT STATE OF THE INSURANCE/ REINSURANCE MARKET

Jack Lee, National Marketing Manager, BFL CANADA
Stephen Ambidge, Managing Director, Lockton International

Q - What has transpired from the reinsurance treaty renewals which took place at the end of 2008 and what were the expected effects on the insurance markets? Have these effects materialized yet?

A - Canada

Canadian Reinsurers reported $2,200,000,000 in Gross Written Premiums for 2007 with a combined loss ratio of 86%. 2008 resulted in a Gross Written Premium of $2,000,000,000 and a combined loss ratio of 97%. Reinsurers look to Insurers to stress underwriting discipline in order to return to profitability. Rate reductions are not generally being entertained, but profitable accounts are being renewed as expiring or for less. The facultative market (special risks) is taking a hard look at difficult accounts and pricing them accordingly. If the first six months do not see improvement, look for considerable pressure in pricing by the third quarter.

A - International

In January 1, 2009, capacity was short in certain areas, such as for US catastrophe coverage and US Casualty. Elsewhere, rate changes were generally limited, reflecting regional and class conditions. This is likely to change, however, over the coming months—due to 2008 investment losses and reserves moving out on Hurricanes Ike and Gustav.

Q - Are the markets showing any signs of cutting back on the variety of products offered or the classes of business underwritten?

A - Canada

The only product seeing cutbacks is Credit Insurance. One would also expect Directors' & Officers' coverage to show caution, but Insurers are actually becoming aggressive due to the number of markets wanting to grow their portfolios.

A - International

In Financial Institutions business across all product areas we are seeing more restrictive terms, lower limits, and significant premium increases ranging between 20 to 100%. That is where clients are fortunate to be provided cover in the first place, because some organizations are being excluded all together.

In Commercial D&O, however, as far as the more-robust risks are concerned, there is still plenty of capacity available. There are no reductions in coverage and the interest from new carriers is still there—this is one area of the market that could be described as buoyant. One might conclude that commercial risks are being placed due to the simple fact that they are not financial institutions risks.

In other areas of the market, Credit Insurance, for instance, Credit Insurers appear to be going in fast retreat. Clients in this area are not only failing to secure cover against the risk of bad debt due to insolvency or protracted default of their buyers, but also for their suppliers.

Q - Capacity seems to be unaffected by the current financial crisis – is this perception correct?

A - Canada

Over the past several months we have actually seen more capacity in the marketplace; however, this capacity is not universal. Conservative Insurers are offering capacity as expiring while new markets are very aggressive. US sales are not as big an issue on Casualty as they were previously. Distressed accounts with poor loss experience or loss prevention issues are certainly seeing negative signs however.

A - International

It depends on where you're looking. In Casualty, for example, while we are likely to see increases in rates at the lower levels of programs, additional new capacity that has entered the international market in the past year, including in Bermuda, may lessen the impact further up. In Property, however, the buyer's market of the past few years is undergoing a dramatic change, curtailing capacity, and raising prices on most catastrophe and loss-prone property programs. Insurers are passing on the rising cost of catastrophe reinsurance.

Meanwhile, in management liability in the financial sector, there are clear signs of significant retraction in directors and officers risks as capacity dries up across all territories around the globe. Clients have to meet intensive underwriting requirements in the wake of recent shocks, including Madoff, Stanford, and, of course, the problems caused by companies' well-publicised exposures to sub-prime loan portfolios.

Q - What are the emerging trends with respect to pricing of insurance products?

A - Canada

There is no simple answer to this question. 55% of the 141 insurance companies in Canada posted underwriting income losses in 2008. 68% reported combined ratios of 100% or more. Specialty markets and those writing commercial lines business performed better than others and are therefore more aggressive. Generally speaking, commercial markets are seeking modest rate increases in property, with casualty being flat. Premium adjustment credits are a factor as Insureds report decreased revenues from 2008, adding to overall premium reductions.

A - International

In global terms insurance buyers can expect upward pricing pressure in the coming months. Insurers saw underwriting performance deteriorate, investment income evaporate and profitability decline in 2008, a "perfect storm" of negative developments. Diminished capacity and financial pressures may give underwriters greater incentive to maintain pricing discipline than during the last several years. However, since insurance capacity remains fairly high compared to historic levels, it is likely that rates will not change rapidly. Certain risks have already seen increases, and rate decreases may be beginning to flatten across the board. There is no particular trend emerging and there will likely continue to be significant variation by line, industry, account size and according to loss history.

Insights and opinions from two market experts

Q - Are insurance buyers changing carriers in significant numbers for financial rating reasons – in general or in certain specific classes of business?

A - Canada

To this day, we have not witnessed any significant migration of client files. There are many factors that determine downgrades and it is the responsibility of the Broker to keep their clients informed of changes. The comfort threshold has always been 'A' rated markets. Lending institutions regularly dictate this financial requirement and business does move if a downgrade occurs. The majority of Insurers in the 'A' category have, so far, been able to maintain this level even though many have lost ground. This may become a major issue later in 2009 if claims or investments deteriorate by even a few points.

A - International

The industry as a whole remains healthy, although poor investment results and acquisitions have resulted in several carriers seeing rating downgrades. While XL, AIG, Hartford, Liberty Mutual (and recently Berkshire Hathaway) made headlines, most Insurers saw their ratings confirmed in 2008. As a whole, we believe Insurers remain sufficiently capitalized and the industry's balance sheet strength and liquidity is sound.

We have not as yet seen a mass exodus of business from any carrier. Indeed, some clients have sought stronger primary layers by seeking a co-surety arrangement supported by a downgrade endorsement that gives clients an opportunity to replace capacity if required.

Q - Have significant numbers of insurance buyers filed for bankruptcy or is there a movement on the part of insurance buyers to cut back on insurance products purchased (number, lines or limits) to obtain savings?

A - Canada

There has been an increase in bankruptcies. Companies involved in the automobile industry or the financial sector have been particularly hard hit, but re-designing their insurance program would have little impact in protecting their solvency. All Insureds are feeling the strain of the economy and are looking for every possible saving. We have offered higher deductible options to many clients but rarely did it entail sufficient savings to welcome major restructuring. Clients are aware that a major deductible increase, say from $10,000 to $1,000,000, would have a major impact on their bottom line at a time they could least afford the shock.

A - International

We have seen significant numbers of bankruptcies on the International scene and insurance buyers are trying to cut back in order to achieve savings – lower revenues can allow for reduction or outright discontinuance of the need for business interruption insurance for example. Lower limits, higher deductibles, the election to discontinue the purchase of nice to have forms of coverage which add to the total insurance expense; every option is on the table for insurance buyers with restricted financial needs or a problematic loss experience.

While they aim to reduce their expenses by assuming more risk, insurance buyers will need to pay even more attention to risk control in order to avoid getting hit from the other side...

Q - How are regulators supporting the industry?

A - Canada

OSFI has done a remarkable job in safeguarding the solvency of markets and in some cases, protecting Insurers from themselves or from their foreign parents. Our regulators are approachable and work on an ongoing basis with the industry to promote confidence in our financial institutions and protect insurance buyers.

A - International

Each national or regional regulatory body has its own particular take and approach to this situation. It is safe to say that maintaining/restoring trust in the financial markets is paramount, especially with respect to international financial hubs such as the London market.

Q - What should insurance buyers expect in the current market and in the next 12 months?

A - Canada

Considering all the factors, certain insurance buyers should see overall increases in 2009; however, this is not the case if the client has been profitable or is in a target area where Insurers want to grow. Our market remains very diverse and there is plenty of capacity and competition. Underwriters want and need premium increases. Choice accounts, however, are still desirable and competition remains fervent.

A - International

We are living in interesting times and it would be a very wise or lucky person that can predict where the insurance market is heading with even close to 100% accuracy. However, it is safe to say that insurance buyers in many areas can expect upward pricing pressure in the coming months. But due to the fact that insurance capacity remains fairly high compared to historic levels, it is likely that rates will not change rapidly.♦

Jack and Stephen have graciously answered our questions. However, the extraordinary and volatile situation in the financial markets makes any insight or analysis tentative.

Beating the High Cost of Group Insurance

Thomas Guay, President, BFL CANADA Consulting Services Inc., Montreal

Statistics

The cost of Supplemental Health Care benefits is rising at a rate greater than inflation, whereas the other benefits keep pace with inflation. Prescription Drugs makes up on average 70% of claims. The balance of claims is for professional services such as laboratory tests, X-rays, MRIs, and other ancillary services.

The average amount spent on prescription drugs per individual in Canada increased from $573 in 2005 to $740 in 2008, an average increase of 8% per annum. In 2007, overall Canadian public and private prescription drug spending had grown to $22.5 billion. By 2010, predictions are that Canadians will consume more than $30 billion in prescription drugs.

The drivers of this increase are:

1. An upward trend in consumption
2. Ingredient costs
3. Dispensing fees

Utilization accounts for 36% of the total increase. There are more eligible members making claims and more prescriptions being prescribed per claimant.

Ingredient costs account for 57% of the total increase. The shift to newer, more expensive drugs and treatments largely explains the rising costs. Specialty drugs are being developed by pharmaceutical companies to provide treatment options that were not previously available for certain specific conditions; oral cancer drugs are examples of this. They are unlike any of the previously existing drugs and much more expensive. Their market share is also growing at a faster rate than the traditional brand name drugs.

Dispensing fees account for the remaining 7% of the total increase.

Drug spending varies by province, age group and type of claimant. Ontario has the highest spending per capita followed by Québec. Not surprisingly, age is also a factor to be considered. The average amount spent in the 56-65 age group, over $1,200, is double that of the 36-45 age group.

Only 13% of all claimants spend more than $1,000 annually on prescription drugs, yet their claims account for nearly 66% of the total costs. Less than 3% of claimants include persons suffering from very serious chronic conditions such as rheumatoid arthritis, multiple sclerosis and cancer.

Solutions

A range of measures can be undertaken by companies to help control the rising costs of group insurance with respect to prescription drugs:

1. Lower the percentage of coverage on drugs. Many plans still cover drugs at 100%. If you were to reduce this to 80%, your Supplemental Health Care rates would be reduced by an average of 16%.
2. Maintain accurate information on the employee's spouse and dependent children coverage. This insures that the Coordination of Benefits clause is applied properly when claims are reimbursed.
3. Introduce generic drug substitution into your plan. As an example, your plan could cover generic drugs at 100% whereby brand name drugs would only be covered at 80%, unless, of course, the doctor states that there should be no substitution.
4. Add a dispensing fee cap. Dispensing fees vary significantly from one pharmacy to another. Adding a cap can help to ensure that fees remain reasonable (except in Québec where dispensing fees are not disclosed).

Other cost containment solutions can be identified/designed by Consulting Services professionals.♦

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