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New York Roundtable 2010



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Facultative concerns

Dear Reader,

The sun may have been shining as delegates gathered for *Inside FAC's* inaugural New York Roundtable at the Ritz-Carlton, Battery Park. But, as everyone was all too aware the gathering came at a tense period for the market, with rates pretty much across the board under pressure and underwriters reeling from severe claims in the year to date.

Naturally the extent and longevity of the soft market was a key talking point, with the general consensus that – offshore energy to one side – the market will have more pain to come, fuelled by abundant capacity.

Of course one difficult aspect of the present soft market is that rates are continuing to come down despite horrendous man-made and natural catastrophe losses in 2010. The list includes Windstorm Xynthia, Australian storms, the Chilean earthquake and more recently the blow out and loss of the Deepwater Horizon rig. Only in localised markets such as Latin America, or in very specific sectors such as offshore energy, are rates running counter to the rest of the market.

So what will it take to change the current course? Well speakers thought that with no shortage on the supply side, a truly market-turning event would have to be a loss in the region of \$50bn.

Another topical issue raised around the table concerned the US administration's approach to the Terrorism Risk Insurance Act (TRIA), the federal backstop for terrorism cover which President Obama was considering cutting back as part of proposals outlined earlier in the year in the US budget. However, only a fortnight before the Roundtable itself, the US market was given a horrible reminder of the dangers that terrorists continue to pose with the failed bomb attack on Times Square itself.

The consensus around the table was that Obama will now have to reconsider his intention to scale back the terrorist subsidy. And participants agreed this should not deter the stand alone facultative terrorist marketplace, which can and should continue to exploit what were generally thought to be gaps in coverage under the existing system.

The old chestnut of the tension between the admitted and Excess & Surplus (E&S) lines market was also raised. Attendees voiced their frustration that in the current soft market the boundary between the two markets is becoming increasingly blurred, and that many admitted players are now straying into the territory that should be the domain of E&S players. Other topics? The rise of the broker, the future of the Gulf of Mexico (re)insurance market, the problem with business interruption cover... dive in!

Enjoy the read,

Marcus Alcock,
Editor, *Inside FAC*



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The New York roundtable 2010

Marcus Alcock: How much more pain is there to come on rates? Is 2010 likely to be the nadir of the soft market?

John Trace: I think there's still more pain to come. I don't think we've seen the bottom yet. It's an interesting marketplace, though, where you have both depressed rates and depressed exposure bases; you have the combination of the two. So we're seeing many accounts that frankly have the benefit, if you're the insurer, of having both a decrease in rate and a decrease in exposure, resulting in a pretty good price.

A lot of new insurers have come to the table, or existing insurers have gone into product lines than they hadn't before. So whether you're talking about specialty classes or just all the general classes, from property and casualty, there's just a lot of choice out there.

Marcus Alcock: Could we see this continuing to 2011/2012, as long as that?

Matthew Keeping: I think it depends on what happens during the hurricane season this year. Obviously, we've seen a number of losses affecting the first quarter of 2010. What happens in Q3 and Q4 remains to be seen. What's happened so far hasn't meant that there's been less capacity in the market. In fact in some cases, it's been the reverse; there's probably more capacity coming in. And we're having reinsurers actually ask us for business which, as a fac broker, isn't commonplace.

Frank Costa: I envision a slightly different scenario in the offshore energy market. Our market doesn't really go in lockstep with general property or even marine, it's a subset. It's a specialty within a specialty. And just looking at the sheer quantum of loss put into the market in the past 12 months, coming after Katrina and Rita, working on that deficit, I suspect you will see significant changes in the offshore market starting mid-year renewals.

Marcus Alcock: Do you think it's going to turn the market around?

Frank Costa: It's true also that there is a significant amount of capacity. And for a market to truly turn, there have to be players that put their pen down. But even with the amount of capacity we have, underwriters are in a tremendous deficit

position; reinsurers are in a deficit position. And just dollars in and dollars out, there has to be a levelling off. So I think you'll see that in the second half of 2010, and certainly 2011.

Marcus Alcock: And is it likely to affect the onshore classes as much as the offshore class?

Frank Costa: It depends. It will certainly affect the rig contractor book. And then the next ripple out will be the overall offshore book, the E&P book. And if loss activity continues the way it has in the general property market, with the Chilean earthquake, that all affects energy property underwriters as well. Certainly, from a reinsurance standpoint, I think you can see the hardening flow out to parts of the market, further away from just a drilling rig.

But it remains to be seen. We always speculate, and it always seems to take a little longer than we originally anticipated.

Martha Flanagan: In general, with property, we've definitely seen an acceleration decrease in rates over the last few months.

There's also been leakage, in terms of conditions, which usually means we're getting closer to the bottom of the soft market. An interesting way to look at it is to look at the Insurance Information Institute website. Dr Hartwig talks about 90 to 95 as the new 100. So in 1979,

if you were at 100, you had a 16 per cent return on equity (ROE). But in 2009, that's 6 percent. Combined ratios must be lower in today's depressed investment environment to generate risk appropriate ROEs.

Elliot Richardson: I'm interested in Frank's comments on the rig operators – will they buy or not? Because one of the other problems we've seen in the last few years is when you think your going to have a buyer, they decide to self-insure, or take bigger retentions.

John Trace: We saw that with the last wind, post Ike.

Elliot Richardson: A lot of people liken now to 2001. And I think what we've found is that, looking at the capital that came back into the reinsurance industry so quickly, after all the problems of two years ago, it's estimated it would need a bigger than \$50bn event to turn the market.

But you're going to have pockets, like energy. You're also going to have some property rates increasing in

"It would need a bigger
than \$50bn event to turn the
market"

Elliot Richardson

Latin American, because of Chile, so it does not apply to everything.

Marcus Alcock: And you definitely think there will be some turn in Latin America?

Elliot Richardson: Well, Chile's going to be a large increase in rates. Because it was a totally disproportionate loss to what everybody expected it to be. And you can only see that from what people are putting out in losses.

But generally, the market is shocking. And if you go outside the US, I would have said the UK's the softest market in the world right now. Martha was saying 95 percent combined ratio in the UK – they dream of 95 percent. And Europe and Asia is pretty close behind it.

Marcus Alcock: And do you think the pain is going to continue for some time, given the over-capacity?

Elliot Richardson: Without an event, definitely. Because we can't get to the bottom of what people are doing with reserves. And also the competitive retail broker market puts forth the pressure on rates.

John Trace: I absolutely agree. I've never seen the retail broking environment as it is now. It doesn't matter who it is, but each of the retail brokers are putting their fee on the line, if they don't guarantee rate decreases. It's a hyper-competitive market.

Elliot Richardson: The one area that we never seem to have enough capacity is on the large US corporate property accounts, which include cat and nationwide schedules, and even international. What clients are doing is buying treaty but pushing the retentions up. So they're relying more on facultative to bridge that gap. And there's just not enough capacity in the large US corporate world, for large property cat accounts.

Marcus Alcock: Has that become worse or better in the last couple of years?

Elliot Richardson: There are more buyers in the space now than there were in the last decade. It was a lost art, facultative buying in the US on those large property accounts. People would say well, our capital's x and we've got plenty of capital we can deploy, so why would we use reinsurance? And that's changed a bit, the last couple of years.

Marcus Alcock: And is softening as applicable for the mid-market?

Bill Jackson: I think the biggest problem is the mix right now between the admitted and excess and surplus lines carriers. I think a lot of the admitted carriers are writing business they should not be doing. And they can't get the proper rate, because the rates are filed. The E&S guys can change the terms and conditions, and we still have that – everybody's grabbing at market share and maybe writing

some things they shouldn't be writing.

Marcus Alcock: What sort of lines are you talking about here?

Bill Jackson: Some of the middle market commercial, particularly habitational. Traditionally, E&S guys would write the harder habitational risks; that middle income frame. These type of risks belong in the E&S segment where they can control it with higher deductibles. But the admitted carriers can't do that. They get the file rates, deductibles and forms. And that's where you kind of get killed.

I think that's happened over the last couple of years. And it's caused some trouble.

John Trace: I think the distinction between the E&S marketplace and the admitted and non-admitted marketplace in the States has changed for a good long while. And frankly, I think facultative is starting to get burdened to that as well; it's all in the same kind of bucket. And a couple of my competitors' organisations have wholesale operations, as do we. It's very similar to fac in nature. So you're going to see the evolution of the fac role I think to look more and more like an E&S wholesaler.

"We're having reinsurers actually ask us for business which, as a facultative broker, isn't commonplace"

Matthew Keeping



Marcus Alcock: Would you agree with that, Martha?

Martha Flanagan: Difficult risks such as vacant buildings used to be written in the E&S market only and we're now seeing them from admitted carriers. There is a blurring of the market today.

Marcus Alcock: Where is Obama headed with TRIA? Is this an opportunity for the US fac market, both mid-market and large risk, to step forward with regards to terrorism cover?

Dan Gerber: Very early indications are that TRIA will be amended or watered down, or not renewed in some form in 2014. And so the question, of course, is obviously what will fall upon the market and how will the market react, in terms of filing that gap.

Martha Flanagan: There is nothing preventing the fac markets from 'stepping forward' now. Reinsurance purchases inures to the company's TRIA retention so reinsurance reduces a company's net payment – as in reinsurers pay first. However, since reinsurers can't participate in TRIA, fac markets just don't have the capital to respond to the worst possible events directed at the most likely targets.

"I think the biggest problem is the mix right now between the admitted and excess & surplus lines carriers"

Bill Jackson

Elliot Richardson: The recent failed attack here in New York has asked a few questions as well, based on the individual being a US citizen, despite being trained in Pakistan. So now that starts to make people think if that wasn't in TRIA, where are the gaps? Or do we not bother even with TRIA? Some people may start, as in other domiciles, to opt out of things.

But I think it's a great opportunity for the fac market to show some innovation.

Bill Jackson: I agree with that assessment, with the exception of the middle market. I've got a couple of large automatics, semiautomatics that are in New York City and Chicago and the purchase rate is very low. If you own a couple of apartment buildings, you don't want to spend the money. It just doesn't happen. I think the take-up rate on those automatics is less than 5 percent... They just don't feel

exposed. I don't think they really consider bioterrorism a real threat to them.

Dan Gerber: With respect to where President Obama is heading with TRIA, I think he may be forced to support a continued backstop in light of recent and continued near-terror events like the car bomb in Times Square. I suspect any administration will be forced to go

to the drawing board and come up with something that deals with the gap problem.

John Trace: My take on the whole TRIA and what Obama will do is a little bit different. We're seeing the rating agencies, more than ever before, taking a closer look at concentrations, whether it's property values, or employees. And we're actually seeing opportunities emerge in the middle market, which we like to see.

We're seeing bundling of accounts from areas that I don't think are particularly geographically exposed to a terrorism event or anything. Actually it's not limited to terrorism. It's any type of concentration of exposures, whether it's people or buildings... a grouping of accounts in specific locations.

Marcus Alcock: And what sort of timetable are we talking about here for things moving forward?

Jeff Kingsley: Well, TRIA was extended in 2007 to 2014. I think in some form it will remain. I cannot imagine a complete scale-back from the Obama administration. But in terms of going forward, I think that there will be some form of government backstop through 2014, and depending on the political composition of the government, probably beyond. What form that might take, it might be completely different to TRIA, but I think that there'll be some backstop.

Marcus Alcock: Is the US fac market really seeing the rise of the broker? Is this interest as evident across the board both for mid-market and large risk business?

Martha Flanagan: As you know, Gen Re is devoutly direct. However, we see value in both business models. Clients tell us that they like and appreciate doing business with a direct market, because we bring underwriting and claims expertise. However, we believe in peaceful coexistence. We think that in many programmes there is room for both models, because we think both models bring different skills to the table.

John Trace: Gen Re is devoutly direct and I'm ready to say that they're the only one. It's always pretty much been this way outside the US for a long time, but you have a line that's been blurred.

I think some of our markets would like to see some of the business that Gen Re normally sees – the non cat-exposed business, the fire business, the small overall business. But we have made a lot of strides, and I think where you're going to see the broker market make some inroads is via the fac automatic and semiautomatic plays we're seeing already.

Bill Jackson: I joined Brit in December and prior to my arrival there was a business plan written that included both a brokered and direct component. And I quickly had that one erased from my computer. I said, I'm not prepared to go out there and compete with Gen Re and Swiss Re and Munich Re.

I think the better play is the broker market down low, and I don't compete with Gen Re at that level. They don't like the attachment point, they don't want the cat perils, they do a better job up top with their clients in the fire business, or specific capacity business, if you will.

Matthew Keeping: Being the new boy in town here in the United States, I've been visiting various clients, of which many have said that, historically, they've preferred to go direct than to via the broker market. When you start talking to them about things that the brokers can do and can achieve for them in the marketplace, and how it does compliment what the direct writers are doing, the broker option becomes far more viable.

Elliot Richardson: I respect Gen Re for being a pure out and out direct market. I do however get frustrated with some of the other reinsurers who jump between the two – when it suits them they're direct, and they're a broker market. Pick what you're going to be and let's get on with it. Let the client decide.

Marcus Alcock: What is the view on the availability of, and appetite for, catastrophe cover, especially in the light of astonishing 2010 losses to date?

Elliot Richardson: There's not enough. In the larger accounts, definitely not enough. And I'm sure everybody is trying to find more ways of offering new capacity... We come away on every one of these major accounts and we wish we had four or five more markets.

Marcus Alcock: Are the capital markets where growth is likely to come?

Elliot Richardson: It's a long walk; we've done one transaction and they take a long time to put together. And, of course, it's the same as anything; this market had never even heard of fac two years ago. So it's an education process. People will probably watch the one that we did last year and see if that goes okay. But as soon as you've done one and it works, then I suspect you will have many of them queuing up to do the next one.

But probably the only three brokers who can do it are the three brokers that are sat round the room. And I'm sure everybody in certain areas would like more capacity, but most people are very nervous about offering that amount of capital in traditional way.

Marcus Alcock: Do others agree that there's a need for capacity in certain cat areas?

Matthew Keeping: There's not enough cat capacity out there to fulfil the original client demands, which are coming right the way through to the food chain. Demand is coming from the insureds, right the way through to the insurers who want to give it to their client base. We have seen situations where the insurers themselves use their net retention, their treaty, they've got fac, and the client is still asking us for another \$100mn.

John Trace: When the answer comes to how do you get more capacity into the marketplace, capital markets is definitely one area. I think the facultative market could do a better job trying to convince some of these E&S carriers that are being boxed out of places that they've been in to operate as a facultative market. So some of our efforts on market creation are kind of centred there.

Martha Flanagan: I would definitely agree there is frustration around the pricing; that except for the directly affected areas, like Chile, we really haven't seen any increase in pricing in cat at all out there. And talking to some of our clients that have pretty balanced global books, they also aren't seeing increases in pricing, except in those particular small areas.

Matthew Keeping: It is bizarre though that you've got an event there which is likely to top around the \$10bn mark in Chile and it's only affecting Chile.

Marcus Alcock: What's it like in energy?

Frank Costa: There's a capacity shortage for wind cover. There has been since the hurricanes, and it's not a matter of price. The reinsurance offerings were at an attachment point and price that made them not viable propositions. So

underwriters, if they are covering wind or writing wind, it's very much a net proposition these days.

Marcus Alcock: With industrial production hopefully picking up in 2010, should we brace ourselves for more sizeable claims to come from the US manufacturing arena?

Matthew Keeping: Just a short time ago these factories were churning out tons and tons of goods and equipment, running at virtually full capacity. At that time we did see some sizable industrial claims driven mainly by business interruption. I do not see the US at that level of output at the moment and it will take a while to get there.

Quality of workforce could be an issue as to whether these companies employ the same experience or quality as before.

Frank Costa: I think, even with the most recent reports of a slight uptick in the economic numbers last month, it would take somewhere around two to two and a half years to just reach where we were pre-drop. So something immediate doesn't seem likely.

John Trace: I think you are going to see an uptick, but I think the economy has to chug along a bit more. We're not there yet. I think we're a good two to two and a half years away.

I'm a casualty person so when there's an economic downturn and people are concerned about being laid off, all of a sudden their back goes out and they need to go out on disability, they need to go out on workers' comp. We

absolutely did see that manifest itself over the last 18 months, which doesn't really affect the fact role because it's more on frequency as opposed to severity.

Elliot Richardson: I would say, on the casualty point, over the last 20 years the risk management around US manufacturing has just got better and better. That could be partly driven by the litigious nature of society, making sure they protect their workforce, as well as the actual plants.

Marcus Alcock: The US always used to be known for the big industrial nasties and huge claims, so do you think that era's at an end?

Elliot Richardson: No, I think they're still there. But you're going to get more of them internationally because, as things are getting bigger, some of the losses that are coming out of the international market now

are eye-watering compared to 10 years ago. You wouldn't have expected a loss that big because these days – and it's not just Taiwan semiconductors – so much stuff that's surprising. And there's the business (BI) interruption element. And, of course, in Chile, there was no limit on BI.

Martha Flanagan: Well, I would just say the largest contributor to the outcome that you described would be the lack of maintenance due to budget constraints over the last few years.

Bill Jackson: I agree with Martha. The moral hazard is certainly something you've got to watch after in the economy that we're at. But on the whole I think it's going to be better.

"Some of the losses that are coming out of the international market now are eye-watering compared to 10 years ago"

Elliot Richardson

I would not be so concerned. I think people are going to get back to work; they want to protect their jobs. And they're going to be excited about getting their salaries back, and maybe their bonuses back, and having a livelihood and security for the family.

Dan Gerber: I think the maintenance point is a very good one because that's one of those items that corporations look to save on first. Put a little less into it in a down year. Experience has shown us just a few dollars applied upfront can forestall major catastrophe. This is often the case in large environmental losses where certain employees are often waving their hands to signal there is a problem.

Marcus Alcock: Deepwater's dominating the headlines, but do you have concerns more broadly about safety standards? Or is this just an event that you would expect, unfortunately?

Frank Costa: Deepwater is actually part of the industry that's growing and safety standards are quite high offshore. But it only takes one incident, such as the one that happened a couple of weeks ago, to put it on the headlines. I really can't comment specifically on the situation, but I think the standards offshore are quite high.

Marcus Alcock: And have they improved in your experience in, say, the last five to ten years?

Frank Costa: When you consider they've drilled thousands of deepwater wells without incident, I think that's a safety record that is quite acceptable and quite impressive. The nature of offshore exploration and production is that it's continually a new frontier area. At one time, 300 feet of water was considered ground-breaking; now, it's 10,000 feet of water. And that will continue.

Marcus Alcock: Moving on, is the Gulf of Mexico a viable insurance proposition any more?

Frank Costa: I believe it most certainly is. I think the problem in the Gulf of Mexico with respect to wind, it wasn't the fact that there were hurricanes; it was the fact that underwriters severely misunderstood the extent and the breadth of their exposure. The contingent business interruption exposure, which was never even looked at, and the extent of it on covers was problematic, both with Katrina and Rita.

So I think it is definitely a viable proposition. It's a matter of understanding your exposures and understanding and aggregating them in properly. And that's where people got it wrong.

No-one ever envisioned that you could have thousands of wells that had to be re-drilled because of the hurricane. Re-drill wasn't considered; operators' extra expenses (OEE) was never considered a cat exposed cover. But in fact, it is. And I think it's been an educational process in the Gulf.

And I think underwriters would be poorly served if they pull out of the Gulf of Mexico because you need to have the ability to spread your risk. And the Gulf accounts for a significant part of worldwide E&P operations, and I think there's a way to underwrite it there, yes.

Marcus Alcock: Are you concerned about moves towards self-insurance?

Frank Costa: We insure some of the most highly capitalised companies in the world that have very strong balance sheets and self-insurance is something that's been a part of these large companies' risk management structures for many years. So to say it concerns me, no; it's just a part of the equation.

Elliot Richardson: From a pure property point of view, I think the next one we're all going to probably learn from is a California earthquake because we've learnt more and more from a windstorm point of view. If California has something, the contingent business interruption (CBI) ramifications could be huge. It depends where it hits. If it's a heavy manufacturing area, it's going to be a problem.

Marcus Alcock: Is CBI a problem then?

Elliot Richardson: Oh, without doubt. And that's on the known losses.

Martha Flanagan: BI is a very key part of our underwriting process. We pay very close attention to any supplemental coverages that we have, or the actual valuation that goes into the underwriting of it, and we're very concerned about that.

Elliot Richardson: And there could be issues of egress/ingress – there could be all sorts of issues connected to, say an isolated mine. Is there one way in, one way out? We're seeing people buying as much as they can get because that's what the insureds want. Because if the price of coal is x then it makes economic sense to buy extra cover.

John Trace: Speaking as a fac broker, I'm never going to be the answer for \$1bn worth of capacity in your industry. But you know what? I could be an answer for someone who wants to reduce their retention from \$100mn to \$75mn or \$100mn to \$50mn. So I think that's the part we take a closer look at.

Jeffrey Kingsley: Deepwater is going to continue to evolve in terms of total exposure. From a legal perspective, I think a large portion of exposure, as with *Exxon Valdez*, will be natural resource claims asserted by state and federal agencies. For example, when the oil comes ashore, you're dealing with numerous entities where a number of people are affected not only for the short-term but over the next 10 to 15 years.

So when the federal and state government become more directly involved, I think that you'll see the claim rise exponentially.

Marcus Alcock: Swiss Re were suggesting that the claim, the total, could be as high as \$3.5bn. Do you think that's a feasible figure?

Jeffrey Kingsley: I think that's a little bit of a low number... based upon other large losses like this that we have been involved in. Environmental matters are viral in terms of damages. When it comes onshore, it affects a large number of entities. Therefore, when you deprive certain segments of this country of their ability to use and enjoy natural resources, I think that you are talking about very significant claims.

Now, this is based on the assumption that there is going to be a large impact to our natural resources. But if the spill continues at its current trend... I think that you'll see the claim rise exponentially as the year ends out and into next year, in terms of the degradation of the natural resources around that area.

Marcus Alcock: Frank, are you worried? Do you think the claim could rise exponentially?

Frank Costa: I really can't speculate. But I do think it's a market-changing event for offshore underwriters, there's no doubt.

Marcus Alcock: Actually, you'll be pleased to know there's a special supplementary question. What, if any, changes have been made in facultative underwriting practices in the wake of *Wasa v Lexington*?

Jeffrey Kingsley: I guess in terms of the question, have there been any changes or significance, either in terms of going to that market in particular, or in terms of moving away from the fac market and maybe more into treaty and things like that in terms of the weight of that decision?

Marcus Alcock: Does anybody notice anything yet?

Elliot Richardson: From a UK perspective, I would say there's more fac being bought in the UK, so it hasn't made any difference. I think some of the issues on that claim concerned transparency issues, from what the reinsurer knew, to actually what the insurer did.

Fac certificates are tightening up the way fac is done, that's cleaned up the whole industry. And that was happening anyway. And what we saw was a few cedants of ours tighten some things up last year in the wake of that judgment. But a lot of it had already been done.

Matthew Keeping: I think that, yes, looking back a number of years, any insurer is right in saying what have I got in there that's similar to this? And they should be asking themselves that. And probably investigating a bit more internally what's going on there.

But we've gone quite a long way to cleaning ourselves up as an industry. A lot of work's gone into contract certainty and linking the fac cert/ slip to the insured's actual policy number.

John Trace: I think what you're seeing – I've got to be careful not to speak specifically about this particular incident, but I think what you've seen, but not necessarily as an outcome of this specific ruling, is an extreme tightening of the facultative terms – virtually all the large buyers of fac have now worked that way onto their certificate.

I think, when I contrast it to treaty, a large degree of comfort can be taken, over more recent years, that most fac certs state pretty specifically reinsurance conditions.

"Environmental matters are viral in terms of damages. When it comes onshore, it affects a large number of entities"

Jeffrey Kingsley

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