EQUITY RISK PARTNERS, INC.

Executive Advisory Series: The State of the Insurance Market

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Bob Zenoni: Good afternoon. My name is Bob Zenoni, I am President of Equity Risk Partners, and I would like to welcome you to the latest edition of our Executive Advisory Series titled, "The State of the Insurance Market."

As we've been preparing for this event, we've been extremely gratified by the level of response and enthusiasm this topic has received.

There is clearly a great deal of interest in what is currently going on in the insurance and employee benefits marketplace.

Before we begin, I have just a few administrative items.

Your phone lines have been muted and will remain muted throughout the call. Should you wish to submit a question or ask for clarification on anything presented, simply click on the small Q&A box at the top of your screen and then type in your question in the drop-down box.

We have planned this call to be approximately 45 minutes and you should be aware, this call is being recorded.

For any of you not familiar with Equity Risk Partners, we are an insurance brokerage and consulting firm focused exclusively on the needs of private equity firms and their portfolio companies.

We have 40 professionals located in three offices: San Francisco, Chicago, and New York, and we provide a vast array of insurance and insurance-related services to clients in all 50 states and around the globe.

We are fortunate to have as speakers today three of Equity Risk Partners' most senior and experienced executives.

Ken Ambos is senior managing director and employee benefits practice leader. Ken has more than 20 years of experience in health & welfare consulting and consulting management. He is also a frequent author and speaker on benefit issues facing mid-sized employers.

Ken is based in our New York office.

Kim Hennessy is senior managing director and property & casualty practice leader. Kim has a wealth of experience in both underwriting and brokerage. She is a relative newcomer to Equity Risk Partners, having joined us approximately six months ago from Marsh where she was the middle-market practice leader.

Kim is based in Chicago.

Finally, Jeff Rubocki is managing director and executive liability practice leader. Like Kim, Jeff has experience on both the underwriting and brokerage sides of the insurance industry, and was with Marsh before joining Equity Risk Partners.

Jeff is based in our Chicago office.

Each of our speakers has structured their remarks to address three areas: general market and macro-economic conditions, issues and trends related to specific coverage areas, and, finally, the real world implications for private equity firms and portfolio companies.

We will begin with Ken Ambos who will provide his perspective on the state of the employee benefits market.

Ken Ambos: Thank you, Bob.

Good afternoon everyone.

Let’s jump right in to some of the broader economic issues that we see in the employee benefits arena, starting with the federal health care reform initiative which is moving into the forefront of the legislative agenda in Washington.

The immediate concern relative to reform for the health insurance industry is whether it will spawn a government or ‘public’ plan to compete with the private sector. Such a plan would be scary to the industry because it could have inherent competitive advantages and it represents a tangible threat of forming the basis for a single payer government program.

The Senate Finance Committee report just released will not ease these industry fears, as many of the system reform concepts outlined therein include a national plan intended to backstop the private sector system.

And, yesterday's announcement that the healthcare industrial complex is coming to the table with the promise of over $2 trillion in cost savings over the next 10 years signals the inevitability of system change being accepted by even the staunchest supporters of the current system's status quo.

A couple of healthcare related elements in President Obama's recent stimulus package have emerged. I mention them briefly here, but we'll be addressing each a bit more specifically in a few minutes. The first being the federal COBRA subsidy that was implemented in March, and the other being funding for medical information technology projects intended to help streamline some of the administrative burdens inherent in the system.

Switching gears now to more of the industry specific parameters we wish to talk about today, the healthcare focused carriers in the market specifically on the national scale: Aetna, CIGNA, United, and Blue Cross, are generally in better financial condition than other benefits and multiline markets relative to the economic downturn pressures impacting all industries. This is due in significant part to more conservative reserving and capital requirements these insurers need to maintain in order to play in that space.

Healthcare insurance industry consolidation has been progressing over many years, particularly in the last decade such that national scale market competition is concentrated largely in these four players. On a regional level, Humana, Kaiser, HealthNet, and others remain viable competitors though we see them as having greater volatility risk exposure on two fronts. One is geographical, in that some acute regional economic pressures such as those relative to having significant business in auto industry-focused states may come into play. Another is focus on particular product lines such as Medicare Advantage plans, where there is great uncertainty about what may happen to the level of government reimbursements in the years ahead relative to healthcare reform efforts.

As the final general observation, we anticipate the growing likelihood of carrier consolidation in the ‘ancillary lines’ market, those carriers which focus on other employee benefits coverage such as Group Life, Disability, etc.

Several carriers are struggling financially in this space. And as happens in many industries, the stronger will look to pounce on and take out the weaker. This may cause some pricing rigidity in the marketplace, but we do expect the number of viable insurers to remain sufficient to preserve competition.

Let’s move on to the second category Bob described, which is to address some of the coverage trends we’re seeing in the employee benefits field. I want to preface these remarks with the disclaimer; our perspective is clearly focused on the mid-sized employer market, which we define generally as those with 50-5,000 employees. The observations we will talk to you about here are specific to our focused experiences in that space; they may or may not apply to businesses outside either end of that size band.

Therefore, in the middle market what we are seeing are health plan premiums and pricing for new business and renewals trending toward the conservative. The markets clearly, at present, are pursuing a primary objective of preserving market share with their margins intact versus market share growth.

Rate increases continue to track for mid-market health plan renewals in the 9%-12% range, with plan design ‘buy-downs’ being used to mitigate these increases; driving down net renewal rate adjustments to the low- to mid-single digits range.

Typical plan design changes include increasing deductibles and copayments, restricting prescription drug plans by adding deductibles, and raising copays for non-generic drugs, etc. There is really nothing new here, but it is important to note that these elements are still being tapped to the extent they can be by employers, though some are running out of areas to squeeze after years of going to this well.

The next slide offers a little visual representation to illustrate the stats I just threw out at you. Look at the picture that tells a pretty ugly, but familiar story (http://www.equityrisk.com/executive_advisory_series.htm).

Health premiums have far outpaced virtually any other economic indicator over the past two decades. Particularly note that as of the end of 2008, the 5% health premium increase level aligns well with our mid-market observation of 9% to 12% gross rate increases, which are being driven down to the mid-single digit range after plan buy-downs are factored in.

An emerging plan design trend to note would be that consumer directed health plans or CDHPs are gaining favor. These plans are typically considered tax-favored saving vehicles such as HSAs or HRAs coupled to a high-deductible health plan.

As an indication of this, over 25% of our client base now offers some form of CDHP as an option to or a full replacement of prior traditional PPO or POS type programs.

Unless federal health care reform elements significantly alter the coverage landscape, expect further mid-sized employer movement in this CDHP direction.

The other more direct way employers can share cost with their employees beyond plan design are of course employee contributions. We are unsurprisingly finding this element rising in proportion with overall employer rate increases. Some are leveraging their employee contributions even higher than their gross cost increase to reduce the net; some are actually going lower in deference to salary freezes or reductions they may otherwise be imposing, but on par, employee contributions are certainly rising in proportion.

Some employers are unfortunately finding themselves in a position of having to weigh the impact of layoffs versus the cost share increases and/or plan design changes necessary to maintain a net cost affordable to the firm.

Another aspect of the current market trends that we see is the typical mid-sized employer's pain threshold for making a change to their health plan provider in terms of cost savings is declining. It is effectively a function of the overall state of the economy, but more specifically, simply the fact that the dollars spent on healthcare these days are so significant that even a small percentage savings is a meaningful consideration.

Beyond price, cost, and expense, other decision criteria that an employer may consider when assessing whether to transfer carriers would include:

- Provider network access, which effectively is an onus on the alternative proposed insurer to ensure there is a relatively seamless transition from a medical provider access standpoint.

- Service performance, which is mostly an issue at the doorstep of the incumbent provider. Occasionally, you will still find that in a case where there is no cost saving to be had, the incumbent's service performance has been so poor that change may be viewed in a positive light anyway.

- As a third-tier category, brand image, or reputation of the provider that is either in place today or the alternative being considered, can make it even more difficult to transfer coverage and do so with a meaningfully positive message if the new carrier may be suffering from negative attention in the media.

Switching gears to the federal COBRA subsidy that we mentioned briefly earlier, while adding this subsidy has significant positive social implications relative to the economic downturn it does indeed add to employers' administrative burden.

What we are more concerned about is that there are negative potential financial impacts of this new regulation. One, in terms of the cash flow implications, another in terms of the premium effects it may have.

From a cash flow standpoint, the timing of government credits for the subsidy being received by employers can put the employer in the position of having to lay out cash to pay monthly premiums and be reimbursed by the government via a tax credit subsequently. Therefore, depending on the level of COBRA activity there could be a substantial negative cash flow impact for employers inherently least able to absorb it.

From a premium standpoint, the increased burden of COBRA claimants, a group that typically represents considerably higher utilization of healthcare services than average active employees, is likely to drive deteriorating claim experience. This will inevitably be reflected in higher future premium rates.

A final coverage trend we would like to note would be the increased use of voluntary or employee paid ancillary plans - particularly Dental, Vision, Life, Disability and so on.

Clearly, if employers are pushed to the point of having to look at reducing or eliminating these coverages, having the option to at least make them available on a group basis with positive price implications at the employee's cost is a worthy consideration.

Let's move on to our third category - private equity and portfolio company implications of employee benefit related market issues.

We would anticipate that the federal healthcare reform agenda would potentially generate and elevate focus on healthcare related technology and process support investments in the private equity community.

Next, a case of stating the obvious, but I will state it nonetheless. Healthcare carrier consolidation and the conservative underwriting environment issues outlined previously will certainly translate to less aggressive price competition for portfolio company healthcare business. The impact that set of conditions will have on a portfolio company's bottom line is certainly a trend worthy of note to our private equity friends.

And back to our friendly COBRA subsidy issue. We recommend private equity firms pay attention to this scenario and assess it carefully as part of any go-forward deal due diligence, particularly in distressed asset, and bankruptcy scenarios where there is greater likelihood of significant cash flow implications and elevated compliance risk.

Other than the first note above about higher interest potential for healthcare IT investments, overall, we would suggest that current benefit issues and market conditions are not likely to significantly impact near-term private equity investment decisions.

However, economy-driven longer investment hold periods may drive private equity firms to take a more active role in portfolio company benefit cost management decisions, possibly in the areas of providing more forceful support to transition to CDHP options or/and taking a harder look at reducing or eliminating certain ancillary benefits.

And that, my friends, concludes our employee benefits segment.

Bob Zenoni: Thank you very much, Ken.

To follow up on the private equity front, do you have any observations you can share relative to prevailing market conditions for employee benefit focused portfolio programs?

Ken Ambos: Sure, Bob.

Two quick things on the portfolio program front do come to mind.

First, there is a growing insurer awareness and interest in participating in such arrangements, which correlates directly with private equity firms giving the concept more serious consideration than ever before.

The attraction of securing multiple new business hits in one shot is driving a greater market willingness to explore ways to overcome some of the inherent challenges such as contractual and control issues, plan structure complexity, and related financial reporting requirements.

As an aside, anyone with interest in a deeper dive on this subject should check out our June 2008 white paper addressing and titled Employee Benefits Portfolio Programs on our web site (http://www.equityrisk.com/white_papers.htm).

The other observation we would like to highlight is that we are seeing more situations where portfolio companies are asking their private equity owners whether access to a master program is available, given their difficulty (particularly for smaller companies) in securing competitive plans on their own.

We anticipate that such ground-up situations will have a greater chance of successful implementation than aggregation initiatives being pushed down from the ownership level, given the historical reluctance of portfolio company management teams to relinquish local control of this employee-sensitive coverage.

Back to you, Bob.

Bob Zenoni: Thanks, Ken.

We'll now turn to Kim Hennessy who will provide her observations on the property & casualty market.

Kim Hennessy: Thank you, Bob.

The property & casualty market is faced with significant challenges that will have a long-term impact on insureds and insurers. Downsizing and corporate failure rates are significant concerns to the industry. Bankruptcy rates have increased 36% over the same time last year.

Lack of investment income is an issue for insurance carriers as they report their first quarter investment income. AIG is down 72%, Zurich down 75%, Liberty down 92% and Traveler's down 21%.

Carriers have little or no choice, but to begin to seek rate increases as a way to offset the reduction in exposures, which has a direct correlation to the premiums they collect.

Reportedly, carrier surplus is also down 10%.

Economic conditions generally have a direct impact on claims. Litigation tends to increase and workers' compensation develops more severely.

Consolidation is anticipated as carriers face the business challenges discussed previously and at the same time fend off new competition that is not burdened by the same legacy issue. Unlike hard markets from the past, new carriers are emerging in an effort to time the market and then benefit from the fallout of AIG and other struggling carriers.

Net incomes of these markets for the first quarter are robust. ACE is up 50%. Iron Shore and Allied World as an example, are both up 21%.

Moving on to property, we will spend a little bit of time focusing specifically on that market space.

Traditionally, the property market hardens before the casualty market. We tend to expect the same to be true in this challenging market. Combined ratios are used by insurance companies to measure the insurance premiums the companies are taking and the amount of claims that they are paying out.

Many of the carriers combined ratios are in the high 90s and some are exceeding 1.0. Many property reinsurance treaties renewed in January and the overall treaty cost increased by 5.8%.

In catastrophe insurance wind areas, earthquake areas, and flood areas, capacity will become challenging as we begin to see the increases in deductible and pricing.

The property market is beginning to firm. We do expect that clients will see increases in the property sector between 5% and 20%.

Insurers have invested heavily in catastrophe modeling. They have determined in many cases that they are overexposed in catastrophic areas.

As a result of AIG's public issues earlier in the year, many clients sought replacements for their AIG property capacity. In many cases the insurers were unable to replace that capacity for the same terms and conditions. The pricing in most cases were multiples of what clients were paying to renew with AIG. This gives brokers additional signs that the property market is beginning to harden.

The importance of insurers having good information to populate the property modeling systems will be increasingly important. The carriers will rely heavily on their models and their results when they choose which risks to work on and determine how they are going to price those risks.

Now, let's turn our attention to the casualty market.

Casualty traditionally trails the property market in rate increases; we are expecting this market to follow that general pattern. In the first quarter of 2009, most carriers are trying to maintain flat premiums by increasing rates to offset reductions in exposures. That said, clients with challenging loss history will likely see increases in their casualty program.

In addition to erosion in the carrier's book of business, they are also faced with audit returns on prior-calendar year policies. This further impacts the carrier's profitability.

Emerging carriers are entering the market space trying to capitalize on struggling carriers. Several of these markets are duplicating or enhancing terms, conditions and pricing in an effort to capture their share of the casualty marketplace before the pricing escalates.

Claims are on the rise. Unlike the property market, the casualty market has a long tail. Challenging economic times have a direct impact on losses. Typically, a more litigious environment will emerge as it becomes more difficult for companies to extend goodwill because of their own financial pressure.

Worker's compensation also becomes a challenge as impacted workers cannot rely on health insurance and seek remedies under worker's compensation.

Safety and loss control programs are put in place at the portfolio company level to control claims. Clients are often forced to make difficult decisions in tough economic times as money for these programs is often redeployed. In the future, this will have a direct impact on claims.

In addition to all of the drivers above, medical costs continue to rise. This will have a direct impact on worker's compensation experience.

So what does this mean for our private equity and portfolio companies?

Premium increases in the casualty market may not be completely offset by the reductions in exposure. In the future, we expect the casualty market to firm and claims to begin to outpace premiums collected.

Property premiums, in particular capacity in wind, flood, and earthquake prone areas will become more challenging for portfolio companies from a limit, deductible, and pricing perspective. Outside of the catastrophe driven property market and accounts challenged by significant losses, near-term insurance costs are predictable.

ERP will continue to work with our private equity and portfolio companies to be sure that we advise our clients and strategically deploy the carrier's resources and ERPs resources in an impactful way that benefits our clients.

ERP is monitoring carrier stability carefully and consulting with clients regularly on the developments that we are seeing in the market.

And that wraps up the property & casualty section.

Bob Zenoni: Thanks, Kim.

What advice can you give our audience on the specific steps they might take to mitigate the price increases and coverage restrictions that appear to be on the horizon?

Kim Hennessy: We are taking several steps to help clients mitigate those increases.

The first is that we are meeting with clients very early in the renewal process and determining what the incumbent carriers are going to do on renewal.

Secondly, we have gathered an enormous amount of information in regards to our clients and we are using that information in a manner that the carrier finds beneficial.

We are working with our carriers and have built great relationships in an effort to serve Equity Risk Partners' clients.

We think early preparation for the market, and being sure that you have a good strategy set with Equity Risk Partners will be of benefit to you as we renew programs in 2009.

Bob Zenoni: Thanks very much, Kim.

Our final speaker today is Jeff Rubocki who will cover the area of executive liability.

Jeff Rubocki: Thanks Bob.

Much appreciated.

This is the overall look of the executive liability world.

Right now, the economic meltdown is projected to cause directors' & officers' liability (D&O) insurers to lose over $6 billion for the 2007 through 2009 underwriting years. These losses, as Kim had mentioned earlier, are in addition to the significant losses insurers are suffering on their investment portfolios.

The majority of claims at this point are coming from the financial services sector. Although, claims from the non-financial services sector are also expected to increase due to the amount of recent bankruptcies and defaults.

Because of surmounting D&O losses, it is expected that reinsurers will increase pricing, decrease capacity, and potentially place more restrictive terms on underlying executive liability programs. This would force primary carriers to reconsider pricing and acceptance of risks at renewal. However, at this point, D&O carriers have only experienced price increases on treaty renewals and have yet to see a pull back on capacity and terms.

Furthermore, the consolidation of major D&O carriers could also have an impact on D&O pricing. It has been in the press that Hartford has put their property & casualty unit on the block. If the sale of Hartford does come to fruition, the impact it would have on the D&O market would depend on who the acquirer is.

If it is a carrier that is already a major player in the executive liability space, then we expect future pricing for D&O to increase since there will be less capacity and competition. If it is a carrier that is not a major D&O player, then the disruption on the market will be less significant.

Now, switching over to coverage trends.

D&O pricing for the publicly traded non-financial services sector has stabilized. We are not seeing the decreases in premium that we did for 2007 and early 2008. However, for the financial services industry, we are seeing dramatic increases in pricing upwards to 50%, sometimes doubling.

Furthermore, companies suffering severe financial stress are also seeing double digit increases. Carriers are generally offering extended aggregates on the renewals in lieu of a new policy limit for these companies.

Another indicator that the D&O market may continue to harden is the recent report on security claims. For the first quarter of 2008, there were a 134 claims reported whereas for the first quarter of 2009, there were 169 security claims reported. It is projected for 2009, that the total number of security claims will exceed 670. The total number of security claims reported in 2008 was 490. Basically, this is around a 40% increase.

Pricing for the private D&O sector is mirroring the public sector. It has stabilized for this non-financial services sector, increased significantly for the financial services sector, and companies on the verge of bankruptcy or that have filed for bankruptcy are seeing double-digit increases with carriers generally offering an extension to the current policy instead of a new policy limit.

The positive note is that the D&O market still has excess capacity that we believe is a major factor of why the non-financial services sector is not experiencing greater increases in pricing on renewals amidst all of the current economic turmoil. In fact, carriers such as AWAC, ACE, and CV Starr have made it clear to us that they want to increase their market share in the private D&O space.

The Employment Practices Liability (EPL) market has not yet seen significant changes to date but this is expected to change, as the recent amounts of mass layoffs will most likely result in an increase of claims. The recent report from the EEOC shows an increase of complaints being filed by employees. In 2007, there were over 82,000 complaints filed. And in 2008, there were over 95,000 complaints filed. It is expected this trend will continue for 2009.

Another factor that may have a negative impact on EPL pricing is the legislation that is expected to be put into place by the new administration. In fact, the first law that President Obama signed was the Lilly Ledbetter Fair Pay Act that increased the statute of limitations concerning when an employee can bring a pay discrimination claim against their employer.

The plaintiffs' attorneys are already trying to use the new law for other means such as promotions which would otherwise have a limitation of 300 days from when the incident first occurred to bring the lawsuit in lieu of the last paycheck the employee received thereafter. As laws become more favorable for employees, it can be expected that the amount spent defending the claims and/or settling the claims will only increase for employers and EPL carriers.

ERP has also seen an increase EPL claims being reported to carriers by our own clients.

In regards to the fiduciary liability market, it still remains soft, but this could change as losses on employees' defined contribution plans and defined benefit plans may lead to an increase in claims.

Now, switching over to our final category, private equity coverage.

The economic turmoil has definitely had an impact on the executive liability coverage also referred to as GPL (General Partner Liability) for private equity funds.

Carriers have seen an increase in claims and anticipate future claims activity from:

- distressed portfolio companies and bankruptcies
- government investigations from the SEC, Department of Justice, and Attorneys General
- Declining portfolio values and volatility created by the accounting rule FAS 157, the mark to market rule, and
- the expected increase in regulatory oversight.

Another sign that the market is turning is that underwriters are demanding more information for renewals. They are viewing everything under a microscope.

In general, ERP has been seeing price increases of 5% to 15 % and the majority of our clients are remaining with the incumbent on their GPL renewals. However, we have seen larger increases for funds with multiple distressed portfolio companies and funds heavily invested in financial institutions.

A couple of positive aspects are that we have not seen at this point, carriers pulling back on coverage or a lack of capacity, but this could certainly change in the near future. In regards to capacity, IronShore and AXIS will be entering the market and we will be writing GPL coverage through a new MGA, Sharebridge Underwriting Group.

Overall, the executive liability market has stabilized except for the financial services sector, which for the last year has been experiencing significant price increases. However, it is our thought considering all the recent trends that the D&O market will most likely harden throughout 2009 and 2010 for all business sectors.

And that concludes the executive liability portion.

Bob Zenoni: Thanks, Jeff.

As you look at today's market and see it begin to harden, how does it compare to past periods of increasing prices?

Jeff Rubocki: One of the big differences to the recent hard markets in '01 and '02 was a sweeping change across all business sectors. Essentially, on the renewal, regardless of the industry, you could expect a double-digit increase, a pullback on coverage, and for the carrier to potentially reduce your limits. Whereas in this market, the underwriters are focused on the financial services sector and distressed companies. Again, that could change as the economic trends continue to deteriorate.

Bob Zenoni: Thanks, Jeff.

On the screen, you will see contact information for our speakers (please see the introduction page one). Please feel free to contact any of us directly to ask questions or follow up on anything we talked about today.

While we have completed the formal presentation portion of the call, I do see that we have a few questions that were submitted online so let me quickly go through those.

The first question is directed at Ken Ambos so I'll throw this one his way. The question is as follows. What trends are you seeing with Wellness programs?

Ken Ambos: Bob, it seems relatively clear to us that the momentum for wellness initiatives that had been building before the economy went sideways has lost some steam in the middle market.

Most businesses have survival as their foremost near-term objective, versus programs with longer-term ROI expectations such as wellness initiatives. So, implementation of initiatives like these are in something as a holding pattern in our present view.

However, I would expect focus on wellness programs to increase again coincident with the economic recovery that will we hope begin to take root in the ensuing months.

And there’s a good likelihood that as healthcare reform efforts in Washington begin to unfold, wellness and prevention will be a focal point given those are clearly embedded in the Obama administration message relative to overall system reform.

Bob Zenoni: Thanks, Ken.

The other question submitted during the presentation relates to D&O coverage so I will give this one to Jeff.

Jeff, the question is how have AIG's financial problems affected the overall D&O market?

Jeff Rubocki: Initially, we thought back in September when we were preparing for AIG to go into runoff that it was going to have an immediate impact on the D&O market considering they are the biggest carrier. However, after the government bailout, which prevented AIG from going into runoff, it hasn't had as large of an impact as initially thought because they are still underwriting

And it's giving our clients enough time to make an informed decision as their renewals come up whether or not they want to move from AIG or remain with them and hope that, as they distance themselves from the current parent company that they will remain a viable insurance organization.

Bob Zenoni: I don't see any further questions so we will wrap-up the call at this point. I would like to thank our three speakers as well as all of you who attended, and we look forward to having you join us again soon, when we present another edition of our Executive Advisory Series.

Thank you and goodbye.

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