

IN THE BALANCE...

BOTH MACRO AND MICRO FACTORS COULD UPSET THE CURRENT EQUILIBRIUM IN THE ENERGY MARKETS DURING 2012

With the 2011 Gulf of Mexico windstorm season behind us – leaving no trace of any energy industry losses in its wake – the period of relative stability in both the upstream and downstream energy insurance markets continues. With generally ‘flat calm’ trading conditions pre-eminent in both markets as 2011 draws to a close, is there anything on the horizon that might disturb the current equilibrium?

A glance at the chart below shows some of the factors (both macro and micro) that are likely to shape the direction of the upstream and downstream energy markets as we move into 2012. (Some apply more to the upstream market than to the downstream market; other apply equally to both.)

FACTORS THAT MAY AFFECT STABILITY IN THE ENERGY INSURANCE MARKETS, 2012

1. THE IMPACT OF THE THAI FLOODS (AND OTHER 2011 NATURAL CATASTROPHES) ON THE REINSURANCE MARKETS
2. THE EURO CRISIS
3. INCREASED MANAGEMENT DISCIPLINE
4. INCREASED POLICY LIMIT/CAPACITY REQUIREMENTS
5. SOLVENCY II

1. REINSURANCE IMPACT LESS THAN EXPECTED
2. PERCEIVED PROFITABILITY OF ENERGY CLASSES
3. NO SIGNIFICANT CAPACITY WITHDRAWALS
4. LOSS-FREE WINDSTORM SEASON AND INCREASED OFFSHORE CAR INCOME
5. INCREASED LEADERSHIP OPTIONS

HARDER?

2012

SOFTER?

Continued on next page...

OPOL MEMBERS CHANGE THE WAY THEY MEET THEIR OBLIGATIONS

The Offshore Pollution Liability Association (OPOL), which covers E&P activities on the U.K. continental shelf as well as other offshore areas of north-west Europe, has announced a series of amendments which change the way in which each member meets its obligations under the regime. We understand that these changes involve:

- An increase in the maximum deductible from USD 1 million to USD 10 million.
- A requirement that insurers now have to meet credit rating requirements of at least A- with S&P, A with A.M Best or A with Moody's or A with Fitch. In addition if a member chooses to self insure, they must show that they can meet these credit rating requirements.
- Members who purchase insurance to protect their liabilities under OPOL must now ‘ring fence’ these liabilities so that they cannot be eroded by other claims relating to any other insurance purchased.

We understand that these changes will be made effective from January 1, 2012 for new members, while current members must submit new FR1 and/or FR2 forms by June 30, 2012.



The Willis Energy Market Review (EMR) newsletter is a monthly publication that provides its readers with a round-up of news affecting the energy insurance arena.

The newsletter should be treated as a supplement to the Willis Energy Market Review, which is published in April each year.

Where information has been obtained from external sources, this is indicated at the end of each item.

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FACTORS THAT MIGHT HARDEN THE MARKETS IN 2012

1. The impact of the Thai floods and other 2011 natural catastrophes on the reinsurance markets (both sectors)

Last month Munich Re announced (http://www.munichre.com/en/media_relations/company_news/2011/2011-11-11_company_news.aspx) that worldwide economic losses from natural disasters amounted to USD 310 billion for the first nine months of 2011 alone, making it the costliest year ever for the (re)insurance industry. Of these economic losses, Munich Re advises that around USD 80 billion will be covered by the insurance industry, eclipsing the previous record year of 2005 (the year of hurricanes Katrina, Rita and Wilma). These losses have now been augmented by the recent disastrous flooding in Thailand, overall losses from which we are given to understand are likely to amount to as much as USD 25 billion. No wonder some market professionals are calling for a further mutual solution to address the issue of natural catastrophe risk.

It goes without saying that these catastrophes have had a major impact on the global reinsurance market. Despite this, it is generally understood that these losses have still been ‘earnings’ rather than ‘capital’ events; it appears that the composition of the reinsurance market is essentially the same as for 2011. With little sign of any withdrawals – or of any new entrants – the 2012 market is therefore composed of essentially the same reinsurers that have absorbed several significant energy losses in 2011, on top of their natural catastrophe losses (the Upgrader loss in the Canadian Oil Sands in January and the Gryphon A FPSO loss in March being the most prominent – see the chart below).

2011 ENERGY LOSSES EXCESS OF USD 50 MILLION (TO DATE)

TYPE	CAUSE	COUNTRY	UPSTREAM/ DOWNSTREAM	PD USD	OEE USD	BI USD	TOTAL USD
Oil sands	Fire/lightning/ explosion	Alberta	Downstream	710,000,000		600,000,000	1,310,000,000
MOPU	Heavy weather	U.K.	Upstream	460,000,000		500,000,000	960,000,000
Rig	Capsize	Mexico	Upstream	230,000,000			230,000,000
Chemical	Earthquake	Japan	Downstream	11,000,000		162,600,000	173,600,000
MOPU	Mechanical failure	USA	Upstream	150,000,000			150,000,000
Gas plant	Windstorm*	USA	Downstream	47,500,000		102,500,000	150,000,000
Well	Blowout	Israel	Upstream		130,000,000		130,000,000
Petrochemical	Fire/lightning/ explosion	USA	Downstream	20,000,000		108,000,000	128,000,000
Well	Design/ workmanship	Norway	Upstream	111,000,000			111,000,000
Rig	Design/ workmanship	Singapore	Upstream	8,500,000		80,840,000	89,340,000
MOPU	[unknown]	Brazil	Upstream	80,000,000			80,000,000
Rig	Collision	Venezuela	Upstream	25,000,000		47,250,000	72,250,000
Chemical	Earthquake	Japan	Downstream	36,000,000		35,000,000	71,000,000
Gas plant	Fire/lightning/ explosion	USA	Downstream	50,000,000			50,000,000

Source: Willis Energy Loss Database as at December 3, 2011

*This loss took place in Oklahoma outside the official Gulf of Mexico hurricane season



Despite the unprecedented natural catastrophe losses, the situation in the reinsurance market at the end of 2011 is not quite as serious as it was earlier in the year, when increases of between 35 – 40% were the norm in the wake of the Tokohu earthquake. Although most energy reinsurance programmes are still in the process of being marketed as this Newsletter went to press, the word from our reinsurance market colleagues is that reinsurers' starting point will be to increase retention levels, maybe in some instances by as much as 100%. It also seems probable that some direct insurers are likely in addition to have to pay as much as a double digit percentage increase for the same reinsurance protection. Reinsurers are also looking for additional information with regard to accumulations of exposures from a liability perspective.

Only time will tell if these attempts to increase rates and retentions will be successful. However, should reinsurers stick to their guns on these issues, this stance might threaten the participation in the direct energy markets of some of the smaller underwriting units (particularly from Lloyd's) who may decide that, with retention levels so high, it will simply not be practical to continue underwriting this class. However, such a minor withdrawal of capacity (which we would estimate to be no more than USD 100 million or so) in itself would be unlikely to change the fundamental dynamics of the market. This situation could change if more of the reinsurance market were to follow the wishes of the Lloyd's Performance Management Directorate, who wish to see more insurers base their exposures that they declare to their reinsurers on a revised RDS model.

So what impact will all this have on the direct market? Simply, that these pressures will act as a form of a brake on the downwards pressure on market rates caused by the present over-supply of capacity.

2. The Euro crisis (both sectors)

According to Swiss Re Global Insurance Review 2011 and Outlook 2012/13 published on December 1 (http://media.swissre.com/documents/Global_insurance_Review2012.pdf), the insurance sector, as a heavy investor in sovereign bonds, could lose as much as Euro 143 billion in the event of a restructuring or default requiring a 50%

'writedown' in Greek, Irish, Portuguese, Spanish and Italian debt. Swiss Re estimates that this would represent a 24.3% hit to overall European insurer capital. In its analysis, Swiss Re stated that:

'European insurers' capital buffers appear adequate to cope with direct losses on their sovereign bond holdings provided any debt restructurings are limited to the smaller peripheral European countries. But the direct and indirect implications would be much more serious if write-downs on Spanish, and especially Italian bonds, were ultimately required. In such a scenario, the prospect for heightened volatility, disorderly markets and a severe recession appear high, imposing additional realised and unrealised losses on insurers' investment portfolios as well as restricting revenue and earnings generation.'

3. Increased management discipline (both sectors)

It's no secret that the impact of management discipline has been a key factor in recent years in preventing the development of 'rogue' insurers undercutting the existing market status quo in the perennial search for increased market share and premium income. Furthermore, as we have highlighted in previous editions of this Newsletter this year, the Lloyd's Performance Management Directorate has been very active recently in shaping the direction of Lloyd's energy underwriting philosophies. With such scrutiny becoming the norm, it is perhaps little wonder that for the most part insurers have maintained strict discipline on retention levels and policy forms.

Furthermore, individual underwriters have been very reluctant to be seen to be defying management instructions not to write business at reduced rates or with reduced retention levels and/or wider coverage. This apprehension is likely to continue into 2012 and will continue to act as a brake on any softening dynamic.

4. The impact of future Macondo judicial decisions (Upstream)

Despite the recent settlement between BP and its consortium partners, the fallout from the Macondo loss of 2010 is by no means over, with the insurance market's final bill still to be determined by the decisions of the U.S. courts. Of immediate concern to the insurers that have provided cover to the various stakeholders in the venture is the possibility that the Hold



Harmless agreements between the various contracting parties involved in the joint venture are not upheld by the United States courts. Should this prove to be the case – and that these courts rule that the coverages taken out in the market by all those involved in the incident were able to be ‘stacked’ on top of each other to the benefit of the claimants – then the impact on both the direct and reinsurance markets might prove to be very severe indeed. Should reinsurance costs then spiral northwards, then there would almost certainly be a knock-on effect in the direct market. So far, we understand that some courts have ruled in favour of these contracts, but there is still along way to go before this issue is finalised.

5. Increased policy limit/capacity requirements (Upstream)

In our April 2011 Energy Market Review we predicted that the upstream market might soften towards the end of 2011. So far, we have seen precious little sign of such softening. Why?

During 2011 we have continued to highlight the increased focus on ‘stand alone’ OEE and Marine Liability business following the Macondo incident in 2010. Although no legislation has yet been passed by the U.S. senate, it still seems likely that the minimum insurance requirements under the Oil Pollution Act (OPA) are likely to be revised upwards at some stage during 2012. We have seen almost no evidence of any additional competition for these classes of business outside the existing market leadership and we therefore believe that the hardening dynamic in these pockets of the market will continue – a factor which will be exacerbated by increased demands for additional OEE and marine liability cover.

The increased level of offshore construction activity that has taken place around the world in recent years has also helped enable upstream insurers to assuage their premium income appetites at the end of 2011. Some of these new projects, while not testing the full extent of the available market capacity, have required sufficient market participation to attract a significant degree of premium income. This income has been supplemented by the proceeds of the demand for increased policy limits and extensions as outlined above. By the end of 2011, this has enabled the upstream market, on the whole, to fulfil their premium income requirements more readily than might have been anticipated, allowing them the luxury of rejecting less enticing business offering a smaller return on their capital and strengthening their resolve to resist downward pressures.

In the future, the development of large scale FPSO (Floating Production and Storage Offshore)/ FLNG (Floating Liquefied Natural Gas) projects, potentially requiring capacity in excess of that currently available in the conventional energy markets, is likely to provide large sections of the upstream market with the opportunity to deploy their maximum capacity at an inflated rate and/or premium return.

The illustration below shows how upstream insurers have been able to ‘feast’ on ‘fine dining’ business during 2011 at the expense of less attractive fare – thereby preventing any softening dynamic brought about by plentiful capacity from manifesting itself.

UPSTREAM MARKET UNDERWRITING APPETITE, END OF 2011

SMALL LINE/DECLINE



- Poor loss record
- Outdated equipment
- New technology
- Deep water
- High well pressure
- No spread of risk
- No premium volume

WRITE



- Good loss record
- Modern equipment
- Tested technology
- Shallow water
- Low well pressure
- Spread of risk
- Premium volume

WRITE MAXIMUM LINE



- As ‘write’, but also:
- Capacity risk
 - High excess point/rate on line
 - Good underwriting information
 - Proven risk partnership with buyer
 - Significant premium volume

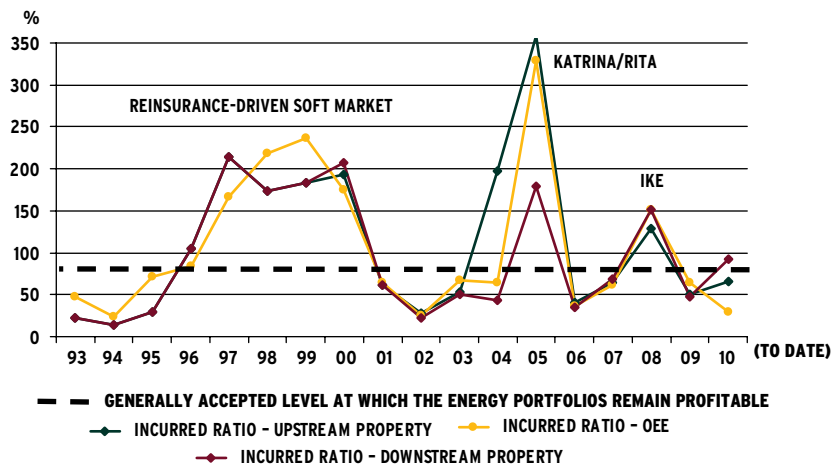
Should upstream insurers continue to be able to ‘pick and choose’ from the business offered to them in 2012, then this dynamic will continue to act as a brake on any softening process – particularly for less attractive risks.



FACTORS THAT MIGHT SOFTEN THE MARKETS IN 2012

1. Perceived profitability of energy classes (both sectors)

LLOYD'S ENERGY INCURRED RATIOS, 1993 - 2010 (AS AT Q3 2011)



Source: Lloyd's

A glance at our chart of Lloyd's incurred ratios (premium versus paid and outstanding claims) over the last 17 years or so shows that today's stable market conditions are by no means the norm. With figures not in yet for 2011, it is difficult for us to determine how these figures will eventually mature for 2011. Be that as it may, in 2010 the chart shows that in general terms Lloyd's underwriters still, for the moment, appear to be making an overall profit for their upstream energy portfolio, although the downstream incurred loss ratio figure has very nearly reached 100%. While we are sure that these figures are still likely to deteriorate further, at the moment there appears to be no reason, if these Lloyd's figures are reflective of the markets as a whole, why insurer management might suggest that the recent historical record is any grounds for a withdrawal of capacity in 2012.

2. No significant capacity withdrawals (both sectors)

In January 2012 Willis Energy will conduct our usual exercise whereby we ascertain maximum underwriting lines for each insurer operating in both the upstream and downstream markets. Bearing in mind the figures that we have just reviewed, all the indications are that, despite recent losses, there will be no significant withdrawals of capacity from either energy market, and only very limited contraction of line sizes. If this proves to be the case, logic suggests that the softening process – which was certainly evident in the downstream market until the Tokohu earthquake in March this year and in the upstream market prior to Macondo (reappearing earlier this year before being halted by a combination of Gryphon A and the Japan earthquake) – will, in the absence of any further losses, begin to re-assert itself. However, given the availability of new 'capacity-testing' business in the upstream market (see above) this is more likely to be a factor in the downstream market.

3. Loss-free windstorm season and increased offshore CAR income (mainly upstream)

Once again the Gulf of Mexico windstorm portfolio has rewarded those insurers who have continued to offer capacity for this high profile risk. Profits have now been substantial for the three years since hurricane Ike and have gone some considerable way to subsidise these insurers' entire upstream portfolio. On the other hand, those insurers who tend to avoid natural catastrophe risks have of course been denied the benefit of this profitable premium.

It is therefore perfectly possible that those leaders who write windstorm risks may have more freedom of manoeuvre if they are confronted with increased reinsurance costs compared to those who do not. If so, this would obviously limit any upswing in the upstream market.

This factor could of course equally apply to those recipients of increased Construction All Risks premium income (see above) as this fresh income will not as yet be associated with any major losses and so might also mask the final impact that these new programmes might have on their portfolio.



4. Increased leadership options (mainly downstream)

In the downstream sector in particular, 2011's buoyant capacity is fuelled by an extensive array of leadership options. There is a marked contrast this year in terms of leadership options compared to the time of the last truly soft market in 1999. Then there were perhaps only six or seven insurers that could command a real following in the downstream insurance market: now perhaps as many as 17 different insurers could reasonably be called market leaders.

Why should the additional number of extra leaders make such a material difference to downstream market conditions?

A simple answer is that more leaders means increased options for brokers and therefore an increase in the opportunity to create further competitive pressures. However, we believe that, with each leader under pressure to generate additional income to pay for the not inconsiderable costs of establishing a leadership team (co-underwriters, engineers etc), what will be key is the reaction of leading insurers who do not currently participate of a given programme.

For example, imagine a sought after programme written by some (but not all) of today's leaders. In the first year, the incumbent leaders offer a price of A and all is well. However, by the time of the next renewal other leaders express an interest in writing the programme and, because they are not already participating, can offer a rate reduction without having to inform their management that they are offering a reduction on their existing portfolio. A further year goes by and the same dynamic is repeated.

We appreciate that this example could be seen as somewhat of an exaggeration and is unlikely to occur in practice to this degree – certainly in today's stable market climate. It is also perhaps more appropriate for the International (i.e. non-North American) portfolio, as modest rating increases for U.S. downstream business are still the norm while the market for Canada Oil sands business, following the recent upgrader loss has hardened a little more with the possibility of sharper increases, capacity restrictions and amendments to policy wordings on the horizon (we shall be reviewing this sector more closely in our next Energy Market Review next April).

However, in general terms it does show that, in the absence of further losses, more competitive terms might emerge from the downstream market in the months ahead, assuming no withdrawals in January.

In the upstream market we have also seen some new leadership options emerge. New potential leaders include Paul Dawson at Hardy and Brian Randall at Brit (a full list of market movements in 2011 can be found at the end of this Newsletter). However although these underwriters will naturally wish to build up their own book of business and assert themselves in these new positions, these are both experienced appointments and so we do not see this development in itself as indicating a softening dynamic within the upstream market.

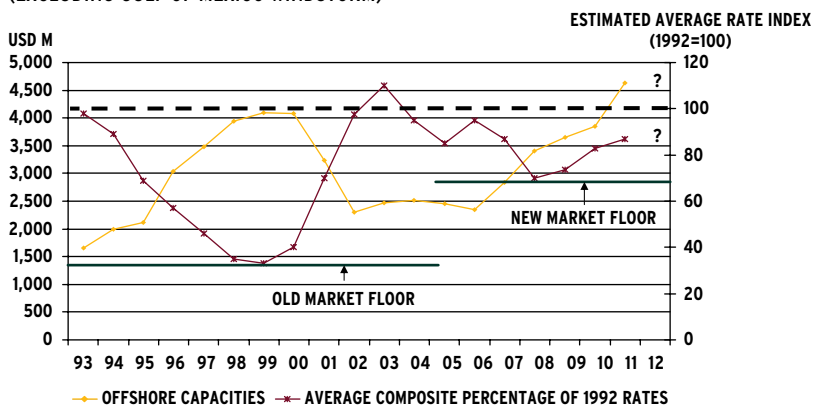


CONCLUSION: DOWNSTREAM MARKET TO SOFTEN FIRST?

Having reviewed the various factors that might influence both markets to move in a particular direction, it seems more probable that any new softening process is more likely to materialise in the downstream rather than the upstream market as 2012 unfolds. While the availability of additional sources of premium revenue is now being welcomed by an upstream market still reeling from the Macondo and Gryphon A losses, the downstream market is being offered no such luxury. If the sheer variety of leadership options available in the downstream market is also factored in it seems clear that it will be this market that will be the first to feel the impact of softening conditions – especially in light of the tragic sinking of the OJSC Arktikmorneftegazrazvedka a few days before this Newsletter went to press, as well as the recent Petrojarl Banff FPSO loss.

Moreover it is still difficult to determine exactly at what stage the upstream market is in the underwriting cycle as we move into 2012. In our April 2011 Energy Market Review we highlighted the lack of alignment between those programmes renewing in the first quarter of 2011 and those that renewed thereafter in the wake of the Gryphon A loss. Now that it is nearly time, for those first quarter programmes to be renewed once more, it will be interesting to see how they will be treated by the market. There can be little doubt that the ‘mean’ rating level taken through the underwriting cycle has shifted upwards since 2005 in the wake of the Katrina, Rita, Ike, Macondo and Gryphon A; should any softening dynamic re-assert itself in 2012 it is unlikely that rates would fall back to pre-2005 levels (see chart below).

UPSTREAM ENERGY INSURER CAPACITIES AND AVERAGE RATING LEVELS, 1993 - 2011
(EXCLUDING GULF OF MEXICO WINDSTORM)



SOURCE: Willis

IF RATES FALL IN THE UPSTREAM MARKET IN 2012, THEY WILL ONLY FALL TO A NEW, ELEVATED MARKET 'FLOOR' WHICH IS NOW MUCH HIGHER THAN PRE-2005

In conclusion, we should re-emphasise that much will depend on the macro factors that we outlined earlier in this article. In our 2012 Energy Market Review, to be published at the end of the first quarter of 2012, we should be in a position to determine the future of both markets with a much greater degree of accuracy.



2011 UNDERWRITER MOVEMENTS

UNDERWRITER	FROM	TO
Julia Aasberg	Allianz London	Chaucer London
Neil Baldwin	Beazley London	Hardy London
Brad Berg	ACE Bahrain	Chartis Singapore
Paul Calnan	CV Starr London	Unknown
Alison Clarke	CV Starr London	Zurich London
Poorna Chandra	Q Re	Trust Re
Pete Connors	Zurich New York	Allianz New York
Mark Cubitt	Marsh London	Brit London
Richard Dare	QBE London	QBE Singapore
Paul Dawson	Beazley London	Hardy London
Kevin Dunmore	QBE London	Unknown
Phil Finlay	CV Starr Hong Kong	Starr Asia, Singapore
May Hallieh	Allianz Singapore	Amlin Singapore
Kevin Hannington	Price Forbes London	Catlin London
Julian Harris	Chaucer London	NMB London
Matt Holmes	Catlin London	Beazley London
Richard Hooks	Kiln London	Catlin London
Mark Johnson	Zurich London	Ascot london
Mojgan Khoshabi	ACR Bahrain	ACE Bahrain
Will Martin	Catlin London	Atrium London
Mark Mckay	Infrassure Zurich	Allianz Singapore
Paul Millen	Aon London	WR Berkley
Steve Miller	Marsh London	Axis London
Greg Parker	Zurich London	Arch Re
Phillip Sexton	Torus London	XL London
John Swan	Aon London	Zurich London
Brian Randall	Watkins London	Brit London
Rachael Weatherup	Chaucer London	Beazley London
Nick Wooton	Amlin Singapore	Amlin London

MARKET NEWS ROUND-UP

- The release of the **new WELCAR offshore construction policy form** has been postponed from its original date of January 1 following a significant degree of feedback from both brokers and clients to the original draft released in November.
- **Pete Connors** will join **Allianz Global Corporate & Specialty** as Offshore Energy Global Product Leader effective January 3, 2012. Pete most recently served as President and CEO of Zurich Global Energy, the international arm of Zurich North America's energy operations. Connors, who will be based in New York, will oversee AGCS's offshore business worldwide. His core focus will be global product management, including global pricing strategy, underwriting appetite, product development and underwriting compliance.
- **Graham Farebrother** joined Willis Energy in September as Executive Vice President and Sales Team leader for our Houston team, reporting to Mark Oakley, Head of Houston Office. Farebrother has had an outstanding 35 year career in the insurance industry. Trained at Lloyd's of London, he became the youngest-ever Vice President of Alexander & Alexander before founding his own retail agency, Specialist insurance Services Inc.,



in 1985. Later in his career Farebrother had spells at Aon Natural Resources Limited and most recently at Gallagher Global Energy, where he built a substantial Energy portfolio within two years of his appointment.

- **Simon Wynn** joined Willis Energy in London in November from Aon. Simon's role is to co-ordinating upstream business emanating from the Asia Pacific region. Simon has 30 years experience working in the insurance industry. Having graduated from university in 1981, Simon started his career in the marine and energy division of one of the leading marine brokers as a placing broker, specialising in hull business. He went on to run their European marine team for five years. Simon spent five years in America working for a major broker gaining experience of the U.S. retail energy market. Since 2001 he has worked as an Account Executive and Client Service Team Leader for one of the largest insurance brokers, handling major integrated energy clients and national oil companies, responsible for programme design, consulting and ensuring delivery of quality client service.
- **Hardy Underwriting Bermuda Limited** has issued a strategy and trading update. The company has announced that it has received several preliminary expressions of interest in its business. In view of this, and in the light of the incidence and size of catastrophe events in 2011, the Board has concluded that it should undertake a strategic review; this review will include consideration of whether shareholder value might best be maximised and business opportunity might be enhanced by finding a buyer or strategic partner.
- **Swiss Re** has announced that **CEO Stefan Lippe** will take early retirement in 2012.
- **Argenta** has announced that Singapore-based **Lloyd's Syndicate 1965** will no longer be accepting new business. The Syndicate, which operates exclusively in Asia, has been affected by the unprecedented frequency and severity of natural catastrophes in the region during 2011, culminating in the recent Thailand floods.
- **Torus and Starr Underwriting Agents Limited** have entered into an agreement whereby Torus Syndicate 2,243 acquires the renewal rights to CV Starr Syndicate 1919's Continental European Marine, Casualty, Financial Lines and General Property business, effective January 1, 2012. Both Torus Syndicate 2,243 and CV Starr Syndicate 1,919 are managed by Starr Managing Agents Limited.
- **Allied World Assurance Co. Ltd**, which received a local operating license in July 2011, is to start underwriting reinsurance business in Malaysia from its **Labuan** branch with business lines being managed from Allied World's Singapore branch office.
- **Willis** has announced the appointment of **Scott Pickering**, President, Willis Asia Pacific, Middle East and Africa, as CEO of Willis South Africa. Pickering, who will remain President of the wider region, will relocate to Johannesburg to start his new role in January 2012. Pickering joined Willis two years ago, bringing with him extensive experience in international business development and emerging markets.
- **Catlin Group Limited** has announced the formation of a strategic partnership with **China Reinsurance (Group) Corporation** – the largest reinsurance company in China – that will result in the establishment of a special purpose syndicate at Lloyd's. Catlin said that the quota-share reinsurance underwritten by Syndicate 2,088 will allow Catlin to increase premium volume in 2012 at a time 'when rates are expected to rise for certain classes of business' without seeking additional capital from existing shareholders.
- **Liberty International Underwriters** has opened a branch in Hamburg, Germany. LIU Europe, a wholly owned subsidiary of Liberty Mutual Group, has operated in the country since 2003. The new office will be managed by senior D&O liability underwriter, Alexander Breig, who will be joined by additional members of staff by the end of 2011.

