<u>TRENDS 2011-2012:</u>

2011: Claims experience: Insurance industry claims in 2011 are on a track to set all time records. Catastrophes caused $ 25 Billion in losses in the U.S., caused by events such as the tornado that destroyed parts of Joplin, Mo. Included in the Joplin disaster was the destruction of the city's well-built hospital, an $800 Million loss for that site alone. Engineering, insurance and construction experts are studying the damage to the hospital to try to understand how damage might have been reduced from different design or construction techniques, with the hope that damage from future tornados will be minimized.

Hurricane Irene, the first Hurricane to make landfall since 2008 caused $7 Billion in losses to property owners. Extensive inland flooding affirmed more recent predictive modeling.

The worldwide reinsurance industry paid $265 Billion in claims in the first six months of 2011, exceeding their previous twelve month highest level of $220 Billion for the year 2005.

The experience of our clients proved no exception to this trend. We represented clients who experienced significant fire, water and theft losses as well large lawsuits.

2012 Pricing Trends: As a result of the 2011 claims experience, reinsurance costs are expected to rise by 10-20% or more for insurers, which will likely be reflected in homeowner's rate increases. This will have relatively less impact on companies like Chubb and Andover as they spend 8-9% of premium to purchase reinsurance (as compared to 22% for Chartis and Fireman's Fund and 80% for PURE). Allstate, the number two insurer of homes, increased homeowners rates by 5.6% through September, 2011. State Farm, the largest home insurer, increased prices in 2011, the third straight year. Travelers announced it will increase rates as a result of their reevaluation of storm risk

The Impact of Investment Income Changes: The continuing decline in the reinvestment rates of return on insurer bond portfolios is likely to be a contributing factor in upward pressure on pricing. A mid-sized insurer may have a bond portfolio with $100,000,000 of bonds maturing each month. As bond portfolios mature these funds are currently being reinvested at much lower rates of return, going from a 5% coupon rate to less than 1%. Reinsurance pricing relies more heavily on investment income than does a primary insurer because claims are paid out later.

2011: The Impact of Residential Construction Cost Trends: 2011 home reconstruction costs in the category of fine homes remained essentially constant or up somewhat, with the best contractors reporting slight improvement in demand. Contractors noted that well- informed clients now ask more demanding questions and seek greater financial guarantees, bonding, etc from their contractors. Builders have continued to absorb some cost increases by continuing to reduce profit margins, with several indicating that they are working on ¼ less profit margin than in 2005-6-7. There is no evidence that the reduced profit/overhead margins that are being offered for bid jobs are being extended to carriers like Chubb, Chartis and others in the event of an insured loss to property.

Suppliers to fine builders generally experienced an increase in sales in 2011. While most materials experienced increasing pricing in 2011, framing lumber fluctuated but generally fell in price by 3-4% by year end. The cost of specialty woods, including mahogany, cherry and maple rose 10%. Insurance costs for contractors have generally risen, and higher fuel costs were being managed by delivery charges in some markets. The cost of windows, doors and metals, including steel and copper, rose 10% in 2011, on top of 10% increases in 2010. Insulation and roofing materials prices were up. Some petroleum-based products, such as asphalt roofing shingles, were up to 20% more expensive. Appliances and cabinetry increased 2-3%. Sheetrock was up 3-5% while concrete was unchanged from the prior year.

Skilled-trades subcontractor labor wages remained flat or increased by up to 3%, while subcontractor pricing has generally remained flat or fallen slightly in most areas as contractors took smaller overhead/ profit margins. Labor/subcontractor costs for both sheetrock (down 15% since 2010) and framing remained the notable exception, with framing labor having decreased by approximately 20% since 2007.

2011: Martha's Vineyard/Nantucket Construction Cost Trends: Contractors indicated that the builders with the best reputations seemed to be keeping busy, and likewise the sub-contractors with positive reputations kept their core crews busy and generally did not discount prices. Subcontractor prices for labor and materials are increasing. One contractor for fine homes who formerly had a 3 year backlog of work now has a back-log of one and one half years. We were told that another island contractor who had built a reputation for particularly aggressive pricing over the past five years had some jobs get into financial difficulty with a significant negative impact on their financial strength and consequently island buying habits in general. The forecast for 2012 is for a continued slight improvement in demand for construction of fine homes.

2011: Florida Construction Cost Trends: Our clients continue to report that finding reliable contractors who show up and complete work on time continues to be a challenge in the Florida marketplace. Pricing is generally flat to moderate increases due to materials increases. We're told that contractors for fine home construction are typically cutting their profit/overhead margins on bid jobs from the historical 10%/10% to 5%/5%. There is no evidence that the reduced profit/overhead margins that are being offered for bid jobs are being extended to carriers like Chubb and Chartis in the event of an insured loss to property. Most materials experienced increasing pricing in 2011, with the expectation of further materials cost increases in 2012.

2011: Kiawah Island, Sea Island, and Hilton Head Construction Cost Trends: The construction business for fine residential homes is extremely distressed in this region: We're told that contractors for fine home construction are typically drastically cutting their profit/overhead margins on bid jobs, in at least one case to as low as 3%/3%, levels that are unlikely to sustain a business. These margins are not being extended to insurers in the event of an insured loss to property. Well-established contractors with good reputations have gone out of business due to a lack of demand. The new South Carolina building code (see *Impact of Revised Building Codes*) will have an impact of increasing reconstruction costs by modest amounts. Contractors expect materials price increases in this region of 5-10% in 2012.

A Disparate Impact on Profit/Overhead: We experienced several large property losses in 2011 and the profit/overhead margins charged by general contractors on our insured losses typically did not deviate from the historical industry standard of 10%/10%, in-consistent with a market that seems to sustain a profit/overhead margin of only approximately 12-15% on many discretionary new jobs bid by the property owners. Reputable contractors who had experienced underbidding in earlier years by smaller contractors reported the beginning of calls from clients who asked them to correct shoddy workmanship and complete jobs.

2012: Projected Construction Pricing Trends: A year ago general contractors we interviewed predicted flat or slightly increasing labor costs from subcontractors and modest increases in construction material costs. For 2012, some of these contractors now predict moderate to significant materials cost increases attributable to two factors: 1) construction materials being shipped overseas due to natural disasters, and 2) manufacturing plants decreasing the number of production shifts to keep supply down and increase demand.

The Impact of Revised Building Codes: Florida was the first state to adopt new building codes in coastal areas, designed to mitigate the impact of wind damage. Many states have now adopted similar codes, tailored to their region and risks, which typically require new methods of roof and wall systems and protection for all openings such as shutters or impact-resistant glass. They result in an increase in material and labor construction costs of up to 25-35%, and resulting insurable value. South Carolina revised its building code effective January 01, 2011 adding features similar to the Northeast Florida building code. The S.C. code now requires that all windows and door openings have some form of wind mitigation, ranging from plywood to impact resistant glass. If opting for the impact-resistant glass option, clients will increase their cost for windows by 20% or more. In Massachusetts, energy conservation codes were enacted in July, 2010 which will have an impact on smaller, simpler homes. Many more expensively built homes were previously incorporating these features voluntarily.

Insurer Competitive/Market Position: 2011 was another interesting year in the performance of the three principal carriers for insuring fine homes and high net worth families, Chubb, Chartis and Fireman's Fund. Two new competitors have been added to the mix. The first is ACE, a large company that previously was substantially a commercial insurer for very large multinational corporations. Ace offers an interesting combination of size and pricing. The second is PURE, a carrier that began writing Florida business in 2007 and is a very small company in comparison to the others. As was the case when both Fireman's Fund and AIG entered this market, both new competitors offer relatively lower introductory pricing for their early years in the business to build a book of business. We would be pleased to furnish a composite of financial comparisons and ratings of all of these companies if you would like to review it.

2011 was a year of continued strong financial performance by Chubb, whose financial condition remains the strongest of all these carriers. Chubb had no exposure to mortgage-backed securities or default swaps. Chartis, the former AIG, remains a strong competitor and often the most innovative and flexible of the three carriers. They have experienced mixed financial results for the past two years. Chartis remains effectively 79% owned by the U.S. Treasury and how that arrangement unwinds is unclear. Chartis continued to increase rates and tighten underwriting in higher risk areas such as Florida, Kiawah, Martha's Vineyard and Nantucket, thus narrowing the spread between their pricing and Chubb's. Fireman's Fund appears to be in a phase of reorganization, with continued management changes and closing of some local offices evidencing a transition period. As evidenced by the ratings of independent rating agencies, as well as strong stock market capitalizations, Chubb remains unique in the world of specialty companies insuring distinctive homes and the individuals and families that own them. If you'd like more specific information on Chubb or alternatives such as Chartis, ACE or Fireman's Fund, please let us know.

Wind Risk: The East Coast experienced Hurricane Irene in 2011. Though most models have predicted coastline routing, Irene followed an inland path west of New York City and caused $7 Billion of dollars of wind and flooding damage in New Jersey, New York and Vermont. The latest predictive models have focused on the reality that a significant amount of Hurricane damage since 2000 has taken place in inland areas, not in coastal areas and Hurricane Irene in fact caused this type of damage.

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We have seen some improved coastal area underwriting flexibility in the Northeast, ranging from the Cape and Islands to the Hamptons. We continue to see little wind underwriting flexibility or capacity in Florida. There has been no material re-entry of large, financially-sound insurance companies willing to insure property locations for wind risk in coastal areas from Florida to the New Hampshire border. The Florida market has effectively collapsed for wind risk. On an encouraging note, in Massachusetts we saw the entry of a small carrier (with $27M Surplus) that is willing to write some coastal risks. This is remarkably little capital for an insurance company. Hopefully this is the beginning of a market softening. In Florida some new carriers have entered the market with capitalization of less than $10M. In Massachusetts we've also seen the development of some new, narrower products.

Wind Deductibles in coastal communities: Chartis, a carrier that offers a homeowner's policy similar to Chubb's, is now offering homeowner's coverage in many lower-risk coastal communities without a wind deductible and a lower-cost, narrower policy form in selected higher risk areas including Martha's Vineyard and Nantucket.