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INTRODUCTION

The global business environment in 2009 is rife with risk, challenges and opportunities as the credit crisis and recession continue to evolve. Risk management is front and center like never before. Company stakeholders want assurances that effective risk management is operational and vigilant. While risk and loss aversion is heightened, risk management maintains a key role in enabling growth.

The struggles of some insurers to weather the world financial crisis that began in 2008 is one of the biggest – if not the biggest – issues impacting risk management programs today. Defense companies historically were not overly concerned about placing a high concentration of their risk with a single carrier as long as the carrier had very strong financial ratings. The trend now is one of distributing coverage more widely and evenly among multiple carriers.

Risk-financing program benchmarking against similarly sized and operated peer organizations provides helpful decision-making support. However, credible and relevant data is often hard to come by. To assist in this process, Aon developed this industry report to provide benchmarking data from insurance programs of the U.S. Department of Defense’s major contractors, all of whom have trailing 12-month revenues greater than $8 billion.

Since defense is a consolidated industry today, we are working with a relatively small data set. In order to maintain client confidentiality, we have not included names nor revenues with the data provided in the report.

Aon appreciates the opportunity to be of service and trusts that you will find the results both informative and thought-provoking. If you have any questions or observations related to this report, contact your primary Aon representative, or you may contact me directly.

Best regards,

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Organizational sustainability demands proactive understanding and management of risk. History provides only a partial understanding of risk for the future. Recent events remind us that threats to organizations increasingly come from all directions and in many different forms. For successful organizations, effective risk management has never been more critical.

Effective risk management relies on informed and insightful decision making, which requires quality data and informed interpretation. Our Defense Industry Benchmarking Report provides comprehensive, industry-specific data on key issues and concerns. These findings will allow organizations to benchmark their risk management and risk-financing practices against those of others and can help identify practices or approaches that may improve the effectiveness of their own risk management strategies.

If you are interested in learning more about how you can use the industry’s most comprehensive set of data to refine and validate your risk management strategies, please contact us or your Aon account executive.

We hope you find this survey helpful and valuable – and as always, we welcome your feedback.

Best regards,

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RETENTIONS

Workers’ Compensation – Retention Analysis

Four of the companies in our study employ a $1 million retention\(^1\). The remainder of the companies’ retentions vary widely, both lower and higher, with two purchasing guaranteed cost programs, one employing a $500,000 retention and the last carrying $2 million.

Given that workers’ compensation is a no-fault system of medical and wage replacement benefits, the catastrophe potential is generally much less than exists with tort liability exposures that are open to the U.S. legal system. As a result, premium savings achieved through larger retentions tend to diminish more quickly for worker’s compensation coverage as compared to savings that can be accomplished for increasing retentions on other liability risks. Since the attacks of September 11, 2001, underwriters have closely monitored employee concentrations at both the insured and aggregate levels. The policy is now standard underwriting practice and has made the optimal retention/transfer trade-off level higher for large U.S. employers.

Should current soft market conditions reverse, higher risk transfer costs could induce companies to consider further retention increases. While too fluid at present to predict, U.S. federal healthcare reform efforts may also impact the medical component of workers’ compensation.

\(^1\) Retentions shown are for each respondent’s main “insured” program. Several respondents are qualified self-insureds in certain states and/or for USL&H coverage. Some retentions in those “self-insured” programs differ from the retention included above.
Defense Base Act – Retention Analysis

All but one of the companies surveyed purchase guaranteed cost programs for Defense Base Act (DBA) coverage. One company maintains a $1 million retention. Two companies do not have significant DBA risk.

DBA exposure profiles of the organizations included vary considerably in some cases and influence purchasing decisions. Organizations buying guaranteed cost programs usually consider one or more of the following in their decision-making process:

- Competitive insurance market conditions
- Favorable claims experience
- Ability of the insurer to recover War Hazard Act claims from the U.S. federal government
- Contracts requiring the coverage are often cost-reimbursable, minimizing any incentive for the contractor to retain risk
- Simplicity, including no tail liability to manage beyond contract durations
Auto Liability – Retention Analysis

The approach to retentions for auto liability is quite mixed. The greatest per-accident retentions held are $5 million (one respondent), $2 million (two respondents) and $1 million (one respondent). Other respondents carry much lower retentions; two respondents retain $500,000, one retains $250,000 and the other purchases guaranteed-cost insurance.

Auto liability can present significant risk for an organization. As such, significant savings may be available to those who are willing to bear the majority of the risk by carrying million-dollar-plus retentions. Fleet size, location and vehicle types, as well as loss history, are principal factors affecting the amount of premium reduction that may be achieved for incremental increases in retention. Companies surveyed with modest or no retentions in this group have smaller, lower-risk fleets.
General Liability – Retention Analysis

The results for general liability also span a wide range. Six companies carry retentions identical to their auto liability program retention.

It is interesting to note that all companies represented take general liability retentions equal to or higher than their auto liability retentions despite the fact that defense products and services have historically generated very few losses. This favorable exposure profile is largely due to the close working relationship between contractors and the military, immunity against many third-party claims resulting from government contractor defense judgments and rulings, and the generally low exposure to the public at large—both in terms of premises and products liability. The level of general liability retentions for these organizations is chiefly linked to a few key factors:

- The rating methodologies used by many underwriters are not particularly compatible with the risk profile of companies in the defense industry. Revenue or payroll-based insurance rates generate premium levels that are significantly higher than would be warranted for an entity with few significant general liability losses, which is the norm for defense industry. An alternative to revenue-based rating is experience or loss rating, which serves to develop premium-based on historical losses. This method does not work well for the defense industry either, in that underwriters cannot statistically model a loss profile with zero to minimal losses.
- The existence of non-federal government revenue streams that may result in real or perceived increased risk.
- Inadequate credit from underwriters for the value of the government contractor defense.
- The occurrence of one or more actual severe losses within the prior five years.

\[\text{Retentions (Thousands)}\]

\begin{tabular}{cccccc}
\hline
Respondents & A & B & C & D & E & F \\
\hline
Retentions & $5,000 & $1,000 & $2,000 & $5,000 & $2,000 & $250 \\
\hline
\end{tabular}

\[\text{* Extends government immunity to contractors in certain circumstances. Boyle vs. United Technologies Corp (1988) and subsequent decisions.}\]
Property – Retention Analysis

The chart below displays seven companies’ retentions for all the other perils. An eighth company has variable retentions that are not easily displayed for comparison purposes. Catastrophe retentions for wind, flood and earthquake were not captured in this survey, nor were any other special retentions or sublimits.

On the low end, one company retains only $500,000, but at the other extreme, one retains $15 million. Property retentions have been very stable over the past several years despite variations in the rate environment. Companies have found levels they are comfortable with and tend to seek the best rate they can achieve at those retention levels.
LIMITS

Umbrella/Excess Liability (Excluding Aviation) – Limit Analysis

Five of the seven companies indicated purchasing limits between $300 million and $500 million; the outliers of the group were $250 million and $940 million. The level of limits purchased varies both in the defense sector and all industries for several reasons, notably differences in complexity and severity of risk and risk philosophy.

Selecting an appropriate level of excess liability limits is not a science; there is no easy or consistent process or guideline to follow in making these decisions. When considering what limit may be most appropriate, risk decision makers must consider a number of issues, including: risk severity, risk mitigation already in place or under consideration, the legal climate in which they operate, historical loss activity, the insurance marketplace and appetite for the risk. Optimal program design should ensure consistent and broad coverage and maximize the use of insurance funds to provide protection against the impact of unpredictable and catastrophic loss.

In considering program design and the selection of appropriate limits, many organizations are of the opinion that benchmarking against peer organizations allows them to benefit from the analysis and decision making of others with similar risk issues. While every organization has unique characteristics that must drive the final decisions on risk management programs, certainly there are insights that can be drawn from what others are doing that will assist in weighing and vetting options.

It is our observation that the long-term trend across the United States continues to head toward the purchase of higher limits. Driving factors include verdict inflation and corporate revenue growth combined with ample insurance capacity, making reasonably priced coverage available to most companies. Minimum premium per million of coverage for large companies’ higher excess layers remains around $2,000. At this level of pricing, the comfort of additional protection comes relatively cheap.
One area of difference among the companies surveyed is their approach to punitive damage coverage. Four purchase offshore punitive wrap-around policies; three do not. This appears to be an area of philosophical difference rather than one motivated by risk or a clear variance in exposures.

All companies with significant marine liability exposures indicate they include coverage for marine liability in their umbrella/excess programs; however, they do so at varying attachment points.

**Aviation Liability – Limit Analysis**

An area of specific interest and concern for a number of our defense companies is that of aviation products liability. The table below includes limits for 11 aviation products manufacturers, all of which have at least $800 million in aviation sales. Two purchase $2 billion in limits. Only two purchase less than $1 billion.

As noted earlier, the selection of limits is complex and decisions are impacted by a number of issues that can vary significantly from one organization to another even if they are in the same industry group. Unlike umbrella/excess liability, we did not note any real correlation of aviation liability limits to corporate aviation revenue. Differences in limits purchased would therefore appear to be a reflection of philosophical differences, varying exposure analyses (including the relative degree of non-governmental products risk) and perhaps demands in contractual requirements from customers. Capacity and pricing in the aviation products liability market is affected in part by loss experience in the airline liability market, where recent losses may lead to price hardening for aviation risks in general.
Directors & Officers – Limit Analysis

Several readers of prior years’ reports requested the inclusion of D&O limits. The seven companies included show a wide range of limits purchased with no correlation to corporate gross revenues. Aon’s Financial Services Group does extensive D&O benchmarking. Reduction or repositioning of capacity to reduce concentrations with certain carriers is affecting a number of D&O programs, sometimes resulting in higher total cost.

D&O rates have been soft for a number of years. The financial crisis that began in 2008 quickly hardened rates for financial institutions, but a broader hardening has not yet occurred. How much longer underwriters will continue to cut or hold flat D&O rates is unknown, but it would be prudent in today’s renewal strategies to consider a possible upturn. Reduction or repositioning of AIG capacity affects a number of D&O programs, sometimes resulting in higher total cost.
PREMIUMS

Defense Base Act – Premium Rates Comparison

The table below shows current rates for 18 companies with DBA insurance programs. Included are a wide array of sizes and operations. All but two are working in Iraq and/or Afghanistan. One company only has DBA exposure in Iraq and/or Afghanistan. Key factors that drive premium rate levels are:

- Insurance market conditions
- Volume of payroll
- Loss experience
- Type of operations and workers (e.g., manual labor is higher risk than office workers)
- Area of the world

Whilst Chartis continues to have significant market share of DBA insurance, ACE and Zurich continue to pursue growing their footprints and appear to be making inroads in this specialist class of insurance.

In 2008, DBA costs received heightened attention in Congress. A number of senators and representatives expressed strong concerns that the U.S. federal government – and the Department of Defense (DOD) in particular – was paying too much for DBA insurance under the current system, whereby contractors procure their own coverage in the private insurance market. As noted earlier, much of the premiums are reimbursed by DOD. Congress called on DOD to develop a new procurement strategy that would better control costs. At the time this report was finalized, DOD’s recommendations were unknown but expected soon. It is known that many options were considered during DOD’s review, during which input was sought from contractors, carriers and brokers. Aon provided considerable input, with an emphasis on factual material regarding the risks, losses and market dynamics that are essential to understanding and controlling DBA costs.
RISK MANAGEMENT DEPARTMENT SIZE

We continue to find no consistent pattern in the staffing of the risk management function. There does not seem to be a correlation to revenue size or to specific variances in risk profile. A couple of slight headcount reductions, apparently driven by economic conditions, were observed.

It is known that the size of the risk management department is especially influenced by the approach to risk and general focus and scope of responsibilities. Some risk management departments focus primarily on risk financing analysis and insurance program management while others include responsibility for extensive claims, risk control or Environmental, Health & Safety activities. Clearly the size of the risk management department staff will reflect these differing approaches. Further affecting staffing levels is the degree of in-sourcing versus outsourcing of certain activities. Where responsibility for these activities is outsourced to vendor partners, the need for in-house staffing is significantly reduced. A true comparison of staffing would need to capture FTE information on all outside service personnel as well as internal staff in other departments, divisions or subsidiaries that have responsibilities for risk.
CAPTIVE USAGE

Defense companies are similar to other large corporations operating in the U.S. today in that the vast majority are employ one or more captives to help manage and finance property/casualty risks. We are aware of 10 large defense companies using captives and only two that are not. As a group, defense companies are more conservative in their use of captives. Keeping captive operations relatively straightforward makes sense, given the close relationships with the U.S. government and the consequential need for clear, consistent and supportable allocations of risk costs to different operations and contracts.
METHODOLOGY

This report is based primarily on data collected in May and June 2009 via survey of major contractors to the U.S. Department of Defense. The peers throughout the majority of the report are major contractors with 12-month trailing revenues of $8B or greater. The data presented in the Defense Base Act premium rates and Aviation Liability limits are exceptions to the grouping and contain a broader group of U.S. Department of Defense contractors.

Aon Analytics, along with the support of other Aon insurance and industry specialists, collected and tabulated the results, provided analysis and interpretation of findings and prepared the report.
AON AT A GLANCE

Aon Corporation (NYSE: AOC) is the leading global provider of risk management services, insurance and reinsurance brokerage, and human capital consulting. Through its more than 37,000 colleagues worldwide, Aon readily delivers distinctive client value via innovative and effective risk management and workforce productivity solutions. Aon’s industry-leading global resources and technical expertise are delivered locally through more than 500 offices in more than 120 countries.

Named the world’s best broker by Euromoney magazine’s 2008 and 2009 Insurance Survey, Aon also ranked highest on Business Insurance’s listing of the world’s largest insurance brokers based on commercial retail, wholesale, reinsurance and personal lines brokerage revenues in 2008. A.M. Best deemed Aon the No. 1 insurance broker based on brokerage revenues in 2007 and 2008, and Aon was voted best insurance intermediary, best reinsurance intermediary and best employee benefits consulting firm in 2007 and 2008 by the readers of Business Insurance.

For more information on Aon, log onto http://www.aon.com/.

Aon Analytics provides clients with forward-looking business intelligence, comprehensive benchmarking and total cost-of-risk analysis as well as global market insights using proprietary technology like the Aon Global Risk Insight Platform to enable more informed and fact-based decision making around risk management, risk retention and risk transfer goals and objectives.

Aon Global Risk Insight Platform (Aon GRIP™) is the world’s leading global repository of global risk and insurance placement information. By providing fact-based insights into Aon’s USD $54 billion in global premium flow, Aon GRIP helps identify the best placement option regardless of size, industry, coverage line or geography.

The Web-accessible data produced by Aon GRIP helps Aon brokers evaluate which markets to approach with a placement and which carriers may provide the best value for clients. It also gives Aon brokers a leg up when it comes to negotiations, making sure every conversation is based on the most complete, most current set of facts.

In the Aon Situation Room, clients will find current insurer financial strength ratings and the most recent updates from Aon’s Market Security Committee on specific carriers. The latest news, legislative action and earnings information is included on the site as well. Clients can also register to receive up-to-date e-mail alerts.
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