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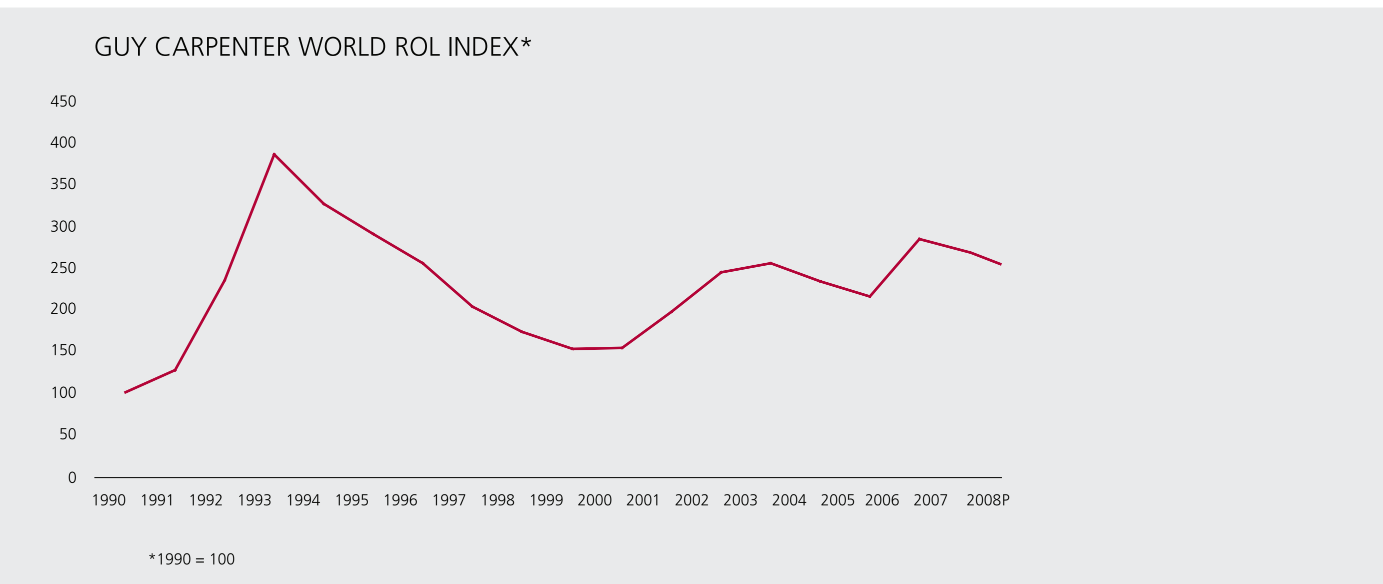
Near Misses, Plentiful Reminders
Global Reinsurance Review January 2008

Cedents took advantage of a buyer's market. Many 2008 renewals closed late as cedents held out for lower rates in the continuing soft market. Reinsurers were rewarded not only with lower rates, but often smaller lines. The absence of large catastrophe losses was a key factor in the softening of reinsurance markets. Barring large catastrophe losses in 2008, the downward drift in rates is expected to continue through 2008 and into 2009.

Market conditions may be deceptive. Though large reinsured losses were few, at least four earthquakes exceeding 7 on the Richter scale struck during 2007, and two Category 5 hurricanes made landfall. A near miss for Japan was the Noto earthquake (6.9 R). Windstorm Kyrill in Northern Europe, record floods in the United Kingdom, storms in Australia and wildfires in California and Greece were all reminders that the world remains a perilous place for risk bearers.

A buyer's market

On the property front, the rate on line (ROL) for property catastrophe reinsurance declined by nine percent from January 1, 2007.



Source: Guy Carpenter & Company, LLC

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The rate of decrease on the Guy Carpenter & Company, LLC World ROL Index from the 2006 peak has so far been markedly slower than from the 1993 peak. This may result to some extent from a more disciplined market than in the mid-1990s. However, the 1993 peak was more extreme than that of 2006, reflecting the considerable distortion of the reinsurance marketplace following the unexpectedly large losses from Hurricane Andrew in 1992. While Hurricane Katrina was almost three times the size of Andrew, the widespread use of models has acclimatized insurers and reinsurers to the possibility of such a large loss.

Despite two years of decreases, the ROL index remains considerably above the trough of 1999/2000. This suggests that most reinsurers are still experiencing prices that are adequate, an argument that is further strengthened by a long-term arithmetic trend toward lower ROLs as cedents have been increasing retentions.

Comparable decreases to the catastrophe market were reported for the per risk property line. Trends in this line are difficult to evaluate, since they are largely experience driven, but further signs of softening were evident from the expansion of ceding commissions for pro rata property covers. There was little change to terms and conditions in the property sector, one major exception being the expansion of the area clause to cover California fire exposures.

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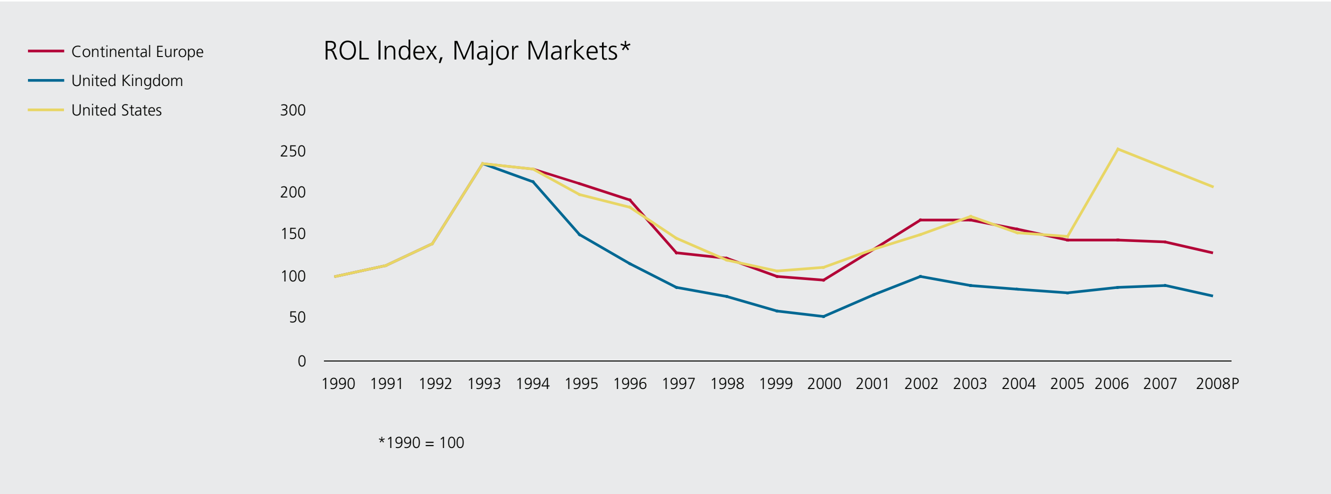
The picture was different for casualty where rates have been soft for several years. For a number of lines, reinsurers are experiencing a compound decrease in premiums, with rate cuts at the reinsurance level operating on a reduced base of primary premiums, reflecting declines in price at the insurance level.

Headline price remained the key driver for reinsurance buyers, followed by terms and conditions. Financial security remained an important consideration in the selection of reinsurance counterparties. Meanwhile, the rollout of Enterprise Risk Management (ERM) grading and the further evolution of the rating agencies' capital models added to the list of items that reinsurers need to consider.

Property
ROLs were down for all markets at January 1, 2008 renewals.



Source: Guy Carpenter & Company, LLC

Property Catastrophe Rate Indications

REGION	ROL Change 2008 vs. 2007
USA National	-10%
USA Regional	-12%
Continental Europe	-7%
United Kingdom	-7.5%
Asia	NA
World	-9%

Source: Guy Carpenter & Company, LLC

In the United States, the average ROL for national companies was down by 10 percent. For regional companies, the average decrease was slightly greater at 12 percent, reflecting the greater capacity available in the marketplace for smaller programs. While rates were down across almost all layers, decreases were most pronounced in lower layers, where there was more competition for the larger premiums.

Rates in Europe were lower by 5 to 7.5 percent on average. The headline rate movement represented a range of individual experiences. Opportunities for reductions were affected by loss experience, most significantly on programs hit by Windstorm Kyrill. In the most severely affected cases, rate increases of up to 15 percent were imposed. However, cedents with only small losses were sometimes able to recapture some of the increase at the bottom end from savings in the higher layers. UK prices were little affected by the record summer floods as high attachment points kept losses at bay for reinsurers. Capacity was generally plentiful for European programs, though there was some restriction of windstorm capacity for reinsurers whose line sizes had to be translated back to US dollars at unfavorable rates of exchange. Some cedents pressed hard for reductions, and significant blocks of capacity were available at reductions greater than 10 percent. However, some reinsurers stood firm; cedents and their brokers seeking large reductions had to judge the rate-to-capacity balance carefully.

Massive and rapid growth of original business in many Asia Pacific territories makes rate change data more subjective than in mature markets. Overall we estimate that rates declined by 10 to 15 percent, though competition was fierce in many territories in the region. In some cases, reductions of greater than 20 percent were achieved. Japan is the largest buyer of catastrophe reinsurance in the region by a wide margin. Nearly all its renewals share an April 1 anniversary date, after which a full picture of the region for 2008 should be complete.

Casualty

In all major markets, casualty rates were soft at 2008 renewals.

In the United States, pricing for casualty business was down about 5 to 10 percent. As many casualty programs are loss driven, there was a wide dispersion in pricing of individual programs. Following four to five years of rate declines, there is some evidence in the market that rates are moving closer to break even. At 2008 renewals, competition was strong. A number of reinsurers were particularly aggressive on pricing, as they sought to win market share. In particular, clash and catastrophe covers benefited from these trends.

Reinsurers quoted promptly and were eager to show responsiveness to the cedents' needs. A small number of players held back from early commitments, as they struggled to discern the true direction of the market. Cedents were in no rush to complete programs in this buyer's market. The spread of quotes was approximately 10 to 15 percent. Particularly large ranges were observed in areas of high market uncertainty, such as California workers compensation.

Retrocession

The retrocession renewal was very late. The purchase of retrocession did not appear to constrain buyers' underwriting appetites as it tended to be viewed more as a partial rather than primary risk mitigation tool. The catastrophe Direct & Facultative (D&F) sector had ample capacity and generally was disciplined, despite some easing of terms and aggressive behaviour by some new entrants. Cat UNL treaty had ample capacity, but at terms that were often too high

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for buyers or did not match their requirements. Consequently, some buyers postponed purchases until later in January 2008. Some increased competition was evident from capital market players that are increasingly prepared to offer UNL cover and reinstatements. Capital providers were also supportive of catastrophe bonds moving into lower layers. At the same time, some short-term capital markets withdrew support for sidecars, seeking higher returns from short-term opportunities in other sectors.

Bulging balance sheets

A low level of reinsured losses, consequentially strong earnings and new entrants mean that supply exceeds demand. With low barriers to entry, it is easier to deploy the resources of wider capital markets to support insurance risk. Indeed, the development of Insurance Linked Securities (ILS) and other investment vehicles allow for the direct transfer of risk to investors without the intermediation of a reinsurer.

The relatively low level of insured catastrophe losses has played a direct role in bolstering reinsurers' balance sheets. Supply exceeded demand, with some reinsurers seeking alternative ways to deploy excess capital. But, it would be a mistake to overlook the variety of perils that could strike. In 2007, there was no shortage of events. The fact that frequency trumped severity led to balance sheet strength.

The special factors that led to a market squeeze for US property catastrophe covers in the summer of 2006 have lost their force. Modeling companies have made adjustments and increased hurdles for capital adequacy required by the rating agencies have been addressed and priced in by cedents and reinsurers.

Reinsurers face increased competition from cedents. The primary market in 2007 is reporting combined ratios in the low 90s. Increased retained earnings and strong underwriting profitability are motivating cedents to retain more net exposure.

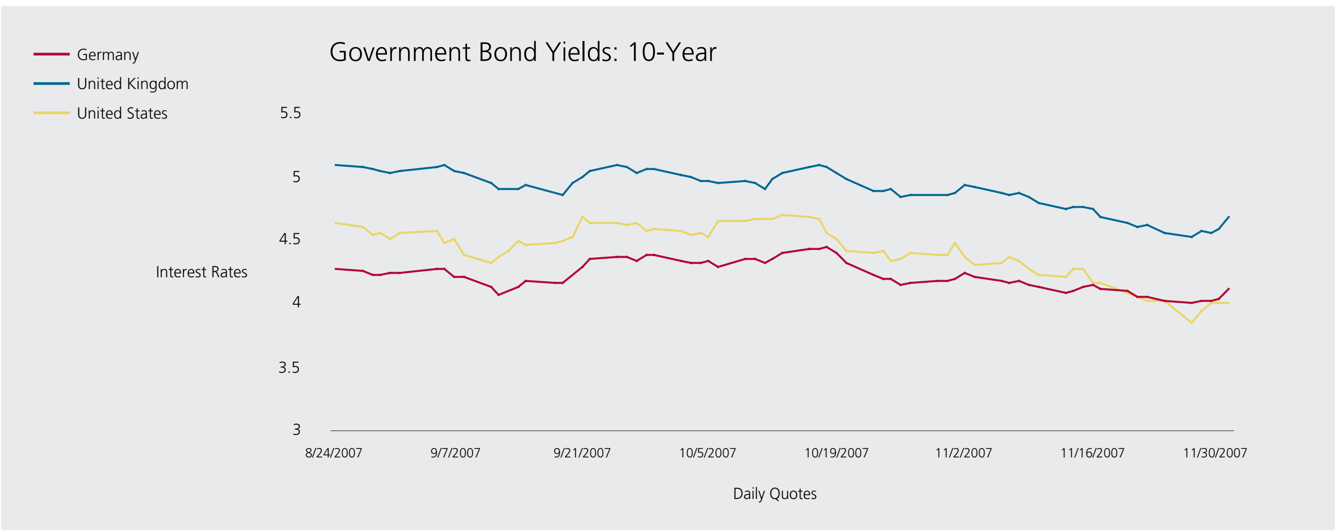
Financial strength and near misses have had a positive effect. Reinsurers currently are generating strong profits. The combined ratio for the top 10 reinsurers dipped below 90 percent last year and rates of return are above Fortune 500 averages. Buoyant balance sheets have caused confidence to increase among underwriters. As memories fade, the shock years of 2004 (Florida storms) and 2005 (Katrina, Rita, Wilma) begin to look more like exceptions than an emerging norm of catastrophic storm activity.

Subprime

The collapse of the subprime mortgage market did not impact reinsurers as deeply as anticipated. Conservative investment behavior insulated most reinsurers from the crisis. While the total economic damage from the subprime mortgage crisis could hit $400 billion, the exposure on the asset side of the property-casualty insurance industry was less than two percent, according to A.M. Best.

For insurers, Guy Carpenter estimates that Directors and Officers losses could reach only $3 billion through 2009. In addition, financial guarantors are under considerable pressure, either in their roles as credit guarantors or from their exposures as holders of assets tainted by the sub-prime debacle.

There has been speculation that the credit crunch could impact reinsurers' ability to pay claims following a mega event. Reinsurers sometimes use short-term credit facilities to finance catastrophe losses, avoiding more costly transactions (e.g., issuing stocks and bonds). Guy Carpenter believes there is sufficient capacity in the financial markets to address such short-term needs. Long-term interest rates are at historical lows, and prices are at record highs. By issuing, bonds, for example, reinsurers would be selling at close to peak values. With the current inversion of the yield curve, reinsurers are likely to hold more short-term debt assets to benefit from current high returns, and thus have more liquidity.



Source: Bloomberg Financial Markets

US Terror Reinsurance Program Renewed
On December 18, the US Congress passed the Terrorism Risk Insurance Program Reauthorization Act of 2007. The Act continues the existing federal terrorism reinsurance backstop program for seven years and drops the exclusion for domestic terrorism acts under the current law.

Outlook
Barring a major shock, we anticipate soft market conditions to prevail in most reinsurance markets for a number of years. The soft market following the crisis of Hurricane Andrew in 1992 persisted for six years, and a protracted period without large losses will put further pressure on prices and increase the temptation to chase market share.

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The sector can expect to hear frequent exhortations to maintain underwriting discipline and sound capital management. As premium declines are reported, reinsurers may pronounce the shortfalls as a reflection of market discipline, but in many cases they could be rationalizations for lost revenue due to price rather than volume cuts.

Nevertheless, there are some sound reasons to anticipate less of a boom-bust cycle in reinsurance markets. The most basic change seems to be at the management level. Today's reinsurance senior managers are attuned more closely to the demands of their owners. Further, they appear to be focusing more on generating above average returns to shareholders instead of more traditional goals such as increasing top-line and market share.

Low and falling interest rates reduce incentive to engage in the sin of cash flow underwriting, and the emphasis on managing capital is curbing reinsurers' interests in taking on more inadequately priced business. External capital may also help flatten the peaks and valleys of the insurance cycle.