



January 2010

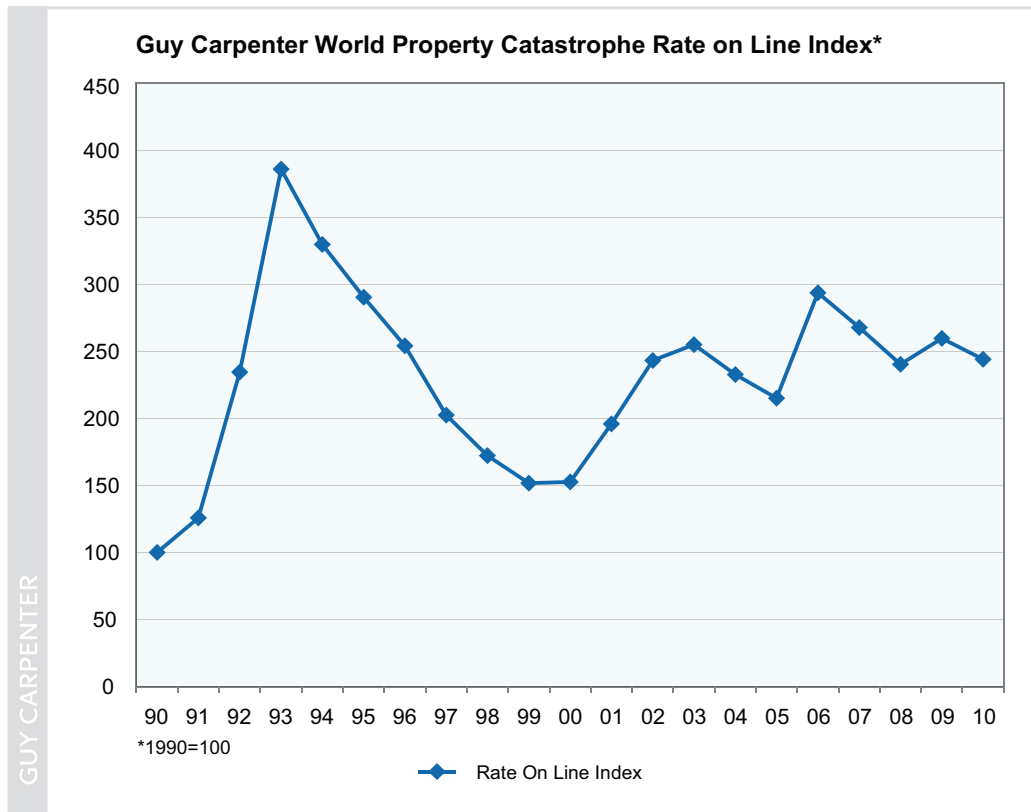
Rates Retreat as Capital Rebounds

Global Reinsurance Renewals at January 1, 2010

Reinsurance rates for most lines of business decreased at the January 1, 2010 renewal. The Guy Carpenter World Catastrophe Rate on Line (ROL) Index decreased by 6 percent in response to a swift and substantial recovery in the capitalization of the reinsurance sector. The combination of the rally in investment markets, much reduced catastrophe loss activity and recessionary effects on demand resulted in an excess of supply and increased competition. This was reflected in a slow renewal in which many contracts closed very late in the season as buyers sought to gain maximum advantage. The overall movements in pricing have also occurred against a complicated background of exposure adjustments, model revisions, program changes and other market noise.

Property

The Guy Carpenter World Catastrophe ROL Index retreated by 6 percent at January 1, 2010. This reversed the increase reported in 2009 that proved to be a temporary interruption to the downward trend that started in 2007. Storm activity in the North Atlantic was well below forecasts, and by certain measures, 2009 was the quietest year since 1997.

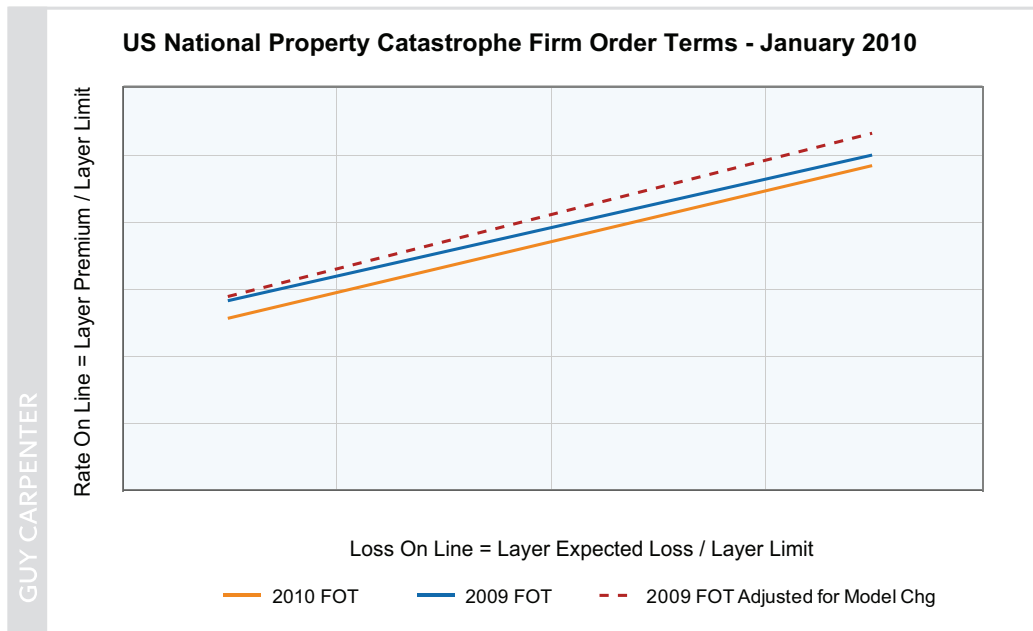


United States

Risk-adjusted catastrophe prices in the United States decreased by an average of 6 percent. This picture is somewhat complicated by adjustments to the vendor catastrophe models that have decreased predicted losses for earthquake and wind perils. By applying the 2010 modeling assumptions retrospectively to 2009, the revised impact is a reduction of as much as 11 percent on average. Meanwhile, the great majority of risk covers (especially the larger ones) renew at mid-year.

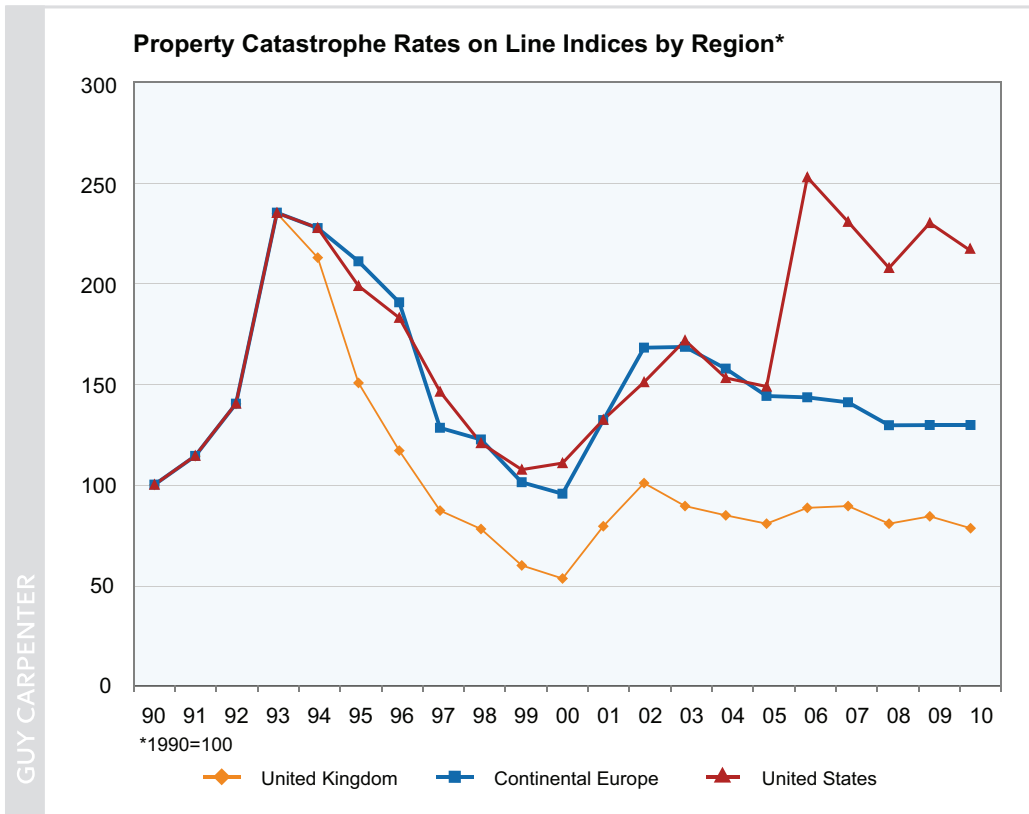
The following chart illustrates the dynamics introduced into the marketplace by the release of new model changes, which, in general, reduced modeled expected loss. The lower, orange solid line shows the loss on line (horizontal axis) versus the rates on line (vertical axis) for firm orders (FOT) at 2010 renewals. The middle blue solid line shows last year's (2009) actual firm orders. This line is higher than the 2010 FOT line, indicating that rates fell at 2010 renewals. The third (dashed) line showing last year's FOT relative to the loss on line as calculated using the new models is shown. This line is higher than the other two lines and reflects the impact of the move to a more competitive environment.

These two solid bottom lines are calculated to include the impact of modeling changes in both periods and the downward pressure can be seen. In order to reflect the impact of price changes, the third (dashed) line showing last year's FOT relative to the loss on line as calculated using the new models is shown. This line is higher than the other two lines and reflects the impact of the move to a more competitive environment.



Source: Guy Carpenter & Company, LLC

The significant exception to the general downward trend in pricing is programs with primarily tornado/hail exposure in the middle of the country. Many of these programs sustained losses in 2009, and as margins traditionally have been very competitive, pricing has adjusted upward in response to the loss activity.



Source: Guy Carpenter & Company, LLC

Europe

On average, catastrophe pricing in Continental Europe was flat to 5 percent lower. However, the general picture concealed the effects of a number of localized losses in a year of above-average weather-related events in Europe. Windstorm Klaus was the most severe event. In France first layers of programs were penetrated, and for these programs, prices rose by 10 percent on average. Austria was hit by severe hailstorms, producing a fourth successive year of frequency losses that resulted in a restriction of capacity and consequential price rises of up to 20 percent to 30 percent. Elsewhere in Europe, rates tended to be pulled down by competitive forces.

UK Property

UK property catastrophe rates were 5 percent to 10 percent lower, and risk excess prices were flat to down 15 percent, subject to loss experience. The UK remains attractive to reinsurers because of its profitability over time. Supply tends to be finite because the UK falls into the northern European catastrophe peak zone, but this was mitigated somewhat by the entry of several new markets offering UK capacity. Retentions were little changed, but localized yet severe flooding in northwest England in November 2009 highlighted the need for protection against attrition events. Risk excess pricing remains under pressure due to the depressed rating levels of original business.

Retrocession

Capacity for treaty retrocession increased modestly. Two underwriters in Lloyd's and Bermuda entered the market to write US treaty retrocession, while a number of existing markets showed an increased appetite. Uncertainty about Berkshire Hathaway's intentions was an issue in the earlier stages of the renewal. Pricing in the underlying market was down by 5 percent to 7.5 percent. Guy Carpenter's objective was to align retrocession pricing as closely as possible with the underlying peak catastrophe zones in order to minimize the difference between primary and retrocession pricing. The renewal was late, and this factor, combined with buyers' limited budgets, meant that there were few changes to program structures and slip terms and conditions.

ILW prices in some areas were down by as much as 30 percent from the spike that occurred in January 2009. Satisfactory capacity and the effects of recent revisions to catastrophe models contributed to the weakening of pricing. There were few major purchases at January 1, 2010, due to the focus on ultimate net loss (UNL) placements by clients. Several prospective new providers appear to be poised to enter the market to exploit any up-turn that might occur in a post-loss situation.

Casualty

Rates for US casualty lines were flat to down 10 percent over the past two renewal cycles. Given the weakness in insurers' finances in the latter half of 2008, it would have been reasonable to expect that rates would have increased at a substantial rate, reflecting reduced supply and the absence of external financial capital. However, a different dynamic seemed to control the market. In early 2009, strong commercial insurers, taking advantage of their competitors' weakness, moved aggressively in terms of price and market conditions to gain market share. Later in the year, when it became clear that the commercial insurance market was not going into meltdown, these players reversed roles and the weaker competitors put pressures on pricing to regain market share that had been sacrificed earlier for survivability. There were some pockets of resistance, with rates for financial institutions professional indemnity showing single digit increases, particularly in London.

In Europe, motor liability reinsurance rates continued to experience flat to 10 percent increases on working excess layers, depending on experience. Underlying concerns about increases in loss cost projections, due principally to medical care inflation rising in many jurisdictions at a significantly higher rate than retail prices or average industrial wages and to periodic payment orders in the UK, have been offset by the wide availability of excess reinsurance capacity. Pricing on unlimited layers is largely commoditized in each territory, and despite efforts by some reinsurers to obtain increases, is flat with many reinsurers looking to increase their market share. Underlying insurance rates for product liability are largely unchanged, but the effect of the recession has reduced turnover in most sectors except pharmaceuticals and medical devices, which in turn impacted reinsurance revenues on the main commercial/industrial liability placements. There is some evidence of looser conditions, with more write-backs of exclusions based on market pressures to expand coverage in better-performing client segments.

Aviation

Rate changes for aviation risks were essentially flat at January 1, 2010. The increases that have occurred have been variable according to size of loss, exposure changes and overall program premium banks. During 2009 the aviation market suffered two significant losses: Colgan Air, a US regional carrier, and Air France, over the South Atlantic. These losses, which were generally contained within insurers' retentions, prompted the direct market to increase premium and rating levels in the second half of 2009. A combination of potentially significant per passenger awards and the overall quantum of loss led the excess of loss (XL) market to charge a higher price for its product in the November 2009 to January 2010 renewals.

The underlying market for general aviation is generally flat, although some sectors (such as commercial helicopters) faced increases following a spate of losses, while others (such as good quality corporate aircraft risks) continued to see reductions. The XL placements have mainly followed the performance of direct markets, so insurers have paid increases in some cases. For general aviation emanating from the US, where very significant amounts of reinsurance are purchased, there was some pressure by reinsurers to increase rates on risk excess business. Reinsurers, however, accepted that they cannot control the pricing of the original business in this way.

Marine

Overall marine rates reduced by an average of 5 percent. Given the economic sensitivity of marine premiums to world trade, it was not surprising to find a general decline in premium income for marine exposures, leading to cedents' attempts to decrease their reinsurance spend. At the reinsurance level, rates have tended to come down, with the net result of a decline in reinsurance premium income. Capacity is growing and was ample for the January 1, 2010 renewal. Competitive conditions and price cutting were widespread, particularly for non-Gulf of Mexico business. There was little loss activity in 2009, and this favorable experience was also reflected in renewal terms. In the absence of significant losses, downward pressure in the marine sector is expected to continue into 2010.

Key Influences and Trends

Catastrophes

A very quiet hurricane season in the North Atlantic, coupled with relatively low losses for other weather-related events, meant insured losses reached USD24 billion in 2009¹, a significant fall from USD52 billion in 2008. Weather-related events continued to be the largest source of losses in 2009 at USD21 billion, while man-made disasters triggered insured losses of USD3 billion. The 10-year moving average of insured losses retreated slightly from USD38 billion in 2008 to USD36 billion in 2009, the first decrease since 2002.

The 2009 Atlantic hurricane season produced a total of nine named storms, the lowest number since 1997. Only three storms became hurricanes, two of which reached major hurricane status at Category 3 strength or higher – again, the lowest number since 1997. Two weak tropical storms (Claudette and Ida) made landfall in the United States in 2009, but no significant damage was reported. GC ForeCat², Guy Carpenter's pre-season forecast of hurricane landfall rates in the United States, developed in conjunction with WSI, successfully predicted a below-average number of landfalls.

¹ Swiss Re.

² GC ForeCat estimates the hurricane landfall rate for four different regions along the US coastline (Gulf, Florida, Southeast and Northeast) from January through to May each year - <http://www.guycarp.com/portalapp/publicsite/catdocument.pdf?instratreportid=1902>

Other forecasters, including Colorado State University (CSU), WSI Corporation (WSI) and the National Oceanic and Atmospheric Administration (NOAA), said the low activity in the basin was due in part to an El Niño event. All predicted below-average hurricane activity in the Atlantic when the formation of El Niño became apparent from mid-2009 onwards (see Table 1 for full details).

Table 1: Hurricane Forecasts for 2009

	Total Named Storms	Hurricanes (>63 knots)	Major Hurricanes (>95 knots)
Average storm development (based on climatology data between 1950-2000)	9.6	5.9	2.3
First forecast for 2009 season (released in December 2008)	14 (CSU) 13 (WSI)	7 (CSU) 7 (WSI)	3 (CSU) 3 (WSI)
Mid-season storm forecast (released in August 2009)	10 (CSU) 10 (WSI) 7-11 (NOAA)	4 (CSU) 5 (WSI) 3-6 (NOAA)	2 (CSU) 2 (WSI) 1-2 (NOAA)
2009 observed storm development	9	3	2

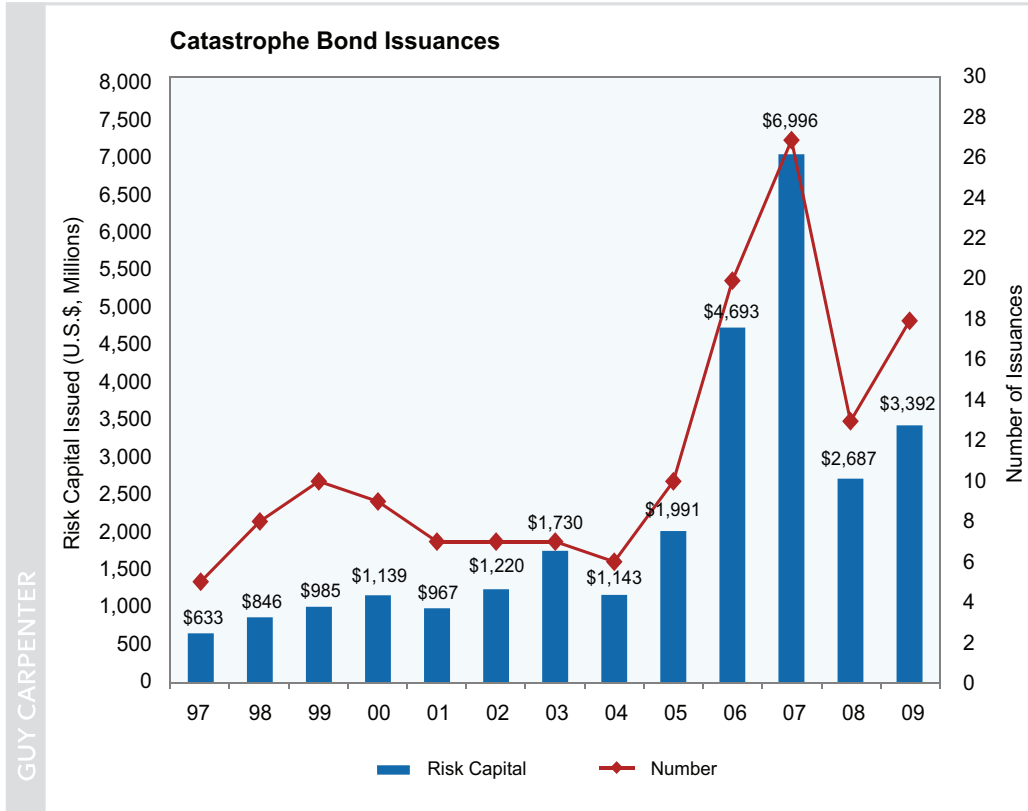
Source: CSU, WSI, NOAA

Weather-related catastrophe activity in Europe was above average. Windstorm Klaus hit France and Spain with hurricane-force winds in January and was the most powerful storm to hit France since Windstorm Martin in 1999. Windstorm Klaus was the most costly event of 2009 after it triggered insured losses of about USD3.5 billion. Elsewhere in Europe, severe hailstorms hit Switzerland, Austria, Poland and the Czech Republic in July, causing a total insured loss of USD1.25 billion.

Catastrophe Bond Market

Despite the challenging financial conditions of late 2008 and early 2009, the catastrophe bond market continued to play a critical role for both sponsors and investors over the past 12 months. Throughout the year, as financial markets stabilized generally, catastrophe bond issuance conditions continued to improve. In 2009 USD3.4 billion of risk capital was issued through 18 transactions. In terms of risk capital, this is a 25 percent increase over 2008. After declining over the first two quarters of 2009, total catastrophe bond risk principal outstanding increased from USD12.0 billion at year-end 2008 to USD12.2 billion at year-end 2009, reflecting a particularly strong fourth quarter for issuance.

Pricing and capacity conditions in the cat bond market were dramatically different between the first and second halves of 2009. In the first and second quarters, with the turmoil of late 2008 still a dominant concern, cat bond pricing was in some cases up nearly 50 percent relative to early 2008, remaining elevated relative to both historical precedent and the traditional reinsurance market.



Source: Guy Carpenter & Company, LLC

In the third and fourth quarters, pricing declined 25 percent to 40 percent and, depending on transaction features, is now tracking with 2007 levels. Drivers for this market reversal include: stabilizing financial conditions generally; elevated pricing in the first half, forestalling planned issuances (as some sponsors were reluctant to issue into a distressed environment); cat bond maturities and net new inflows to the asset class generating investable cash; and the acknowledgment by market participants that the spread levels of early 2009 were unsustainable when ample traditional reinsurance capacity remained available at far cheaper pricing.

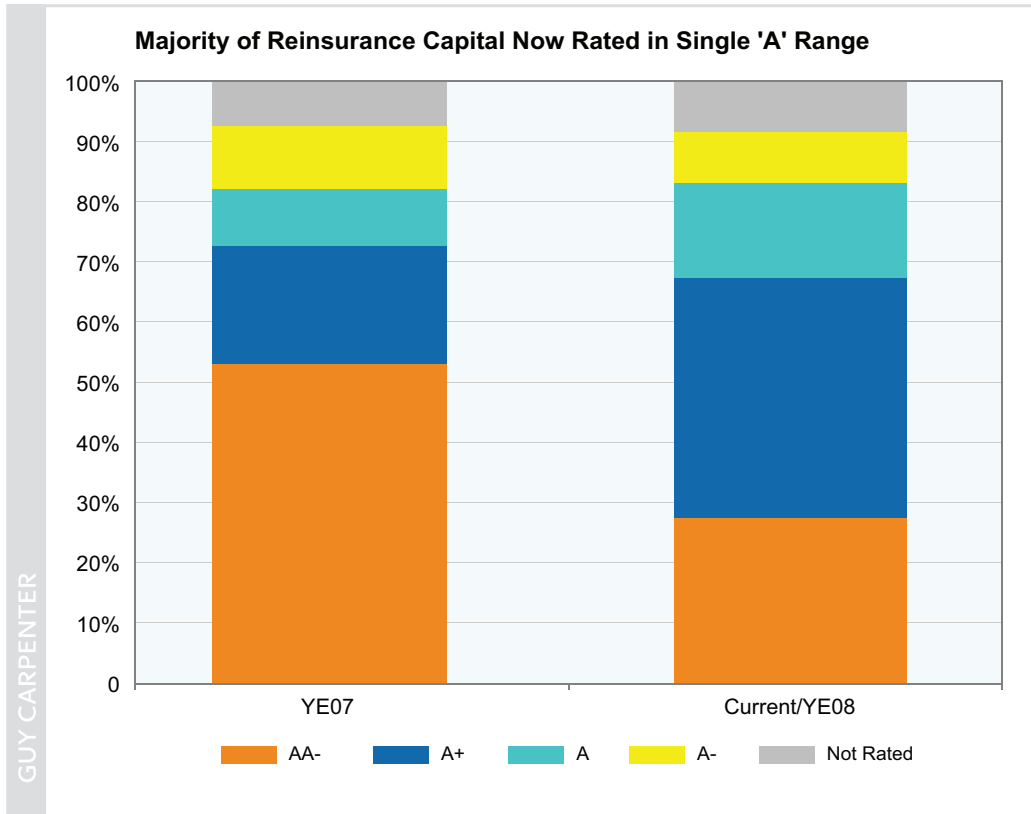
Heading into 2010, the catastrophe bond market continues to provide an increasingly attractive and worthwhile supplement to sponsors' risk transfer programs. Aside from what could potentially prove to be attractive levels to lock in fixed pricing on a multi-year basis, other transaction features such as trigger mechanics and choice of collateral solution (among other features) continue to progress and offer greater value to protection buyers and sellers. The market also remains focused on further reducing transaction costs and transaction time requirements in order to improve the overall efficiency of catastrophe bond risk transfer solution.

Macroeconomic Trends

Macroeconomic trends had an outsized effect on reinsurance capital and pricing, with asset-side movements and investment returns the greatest drivers of sector profitability and capital adequacy in 2009. The environment in which reinsurers operate will continue to be influenced by global economic conditions as much as by underwriting.

As the financial crisis unfolded in 2008 and in the first quarter of 2009, almost all reinsurers experienced significant capital stress. Asset-side volatility in the eighteen months leading to the January 1, 2010 renewal arguably had a greater effect on reinsurance balance sheets in aggregate than all underwriting losses combined. Initially, asset prices were severely impaired by spread widening, equity market losses and structured write-downs as growth deteriorated in 2008 and the first half of 2009. The capital of the Guy Carpenter Reinsurance Composite was affected by this movement, with shareholders' funds for the composite falling 18 percent in 2008 before almost fully recovering in 2009.

Commercial rating agencies reacted to the initial capital write-downs with downgrades to insurer financial strength ratings, significantly changing the credit profile of the reinsurance industry. The following chart shows the shareholders' funds of the Guy Carpenter Reinsurance Composite by Standard & Poor's rating. Where the bulk of reinsurance capital was rated in the 'AA' range at the end of 2007, the majority was rated in the 'A' range at the end of 2009. This has had significant implications for reinsurance buyers worldwide, many of whom had required 'AA' ratings for certain classes of business previously.



Source: Guy Carpenter & Company, LLC

Although asset-side losses were initially significant, the speed at which balance sheets recovered was also remarkable. Asset prices and spreads on corporate and government bonds anticipated the economic recovery that began to take place late in 2009, driving balance sheets higher. By the end of 2009, industry capital positions were nearly as high as at the end of 2007, a time when industry capital levels were historically high. This had important implications for the supply of available capital, and in turn, for the demand for reinsurance. In historical terms, industry capital levels at the end of 2009 were, to the surprise of many, as healthy as at any time in the last ten years.

This was the environment in which the events leading up to the January 1, 2009 renewal took place. Although carrier balance sheets were adversely affected at the time, the significant capital impairment was insufficient to drive up reinsurance rates to the same extent as experienced after Hurricane Andrew in 1992 or Hurricanes Katrina, Rita, and Wilma in 2005. Nevertheless, given the sharp decline in capital, higher rate increases had been expected. The property and casualty sector's capital position mitigated reinsurance property-catastrophe rate on line movements at January 1, 2009 to an increase of 8 percent.

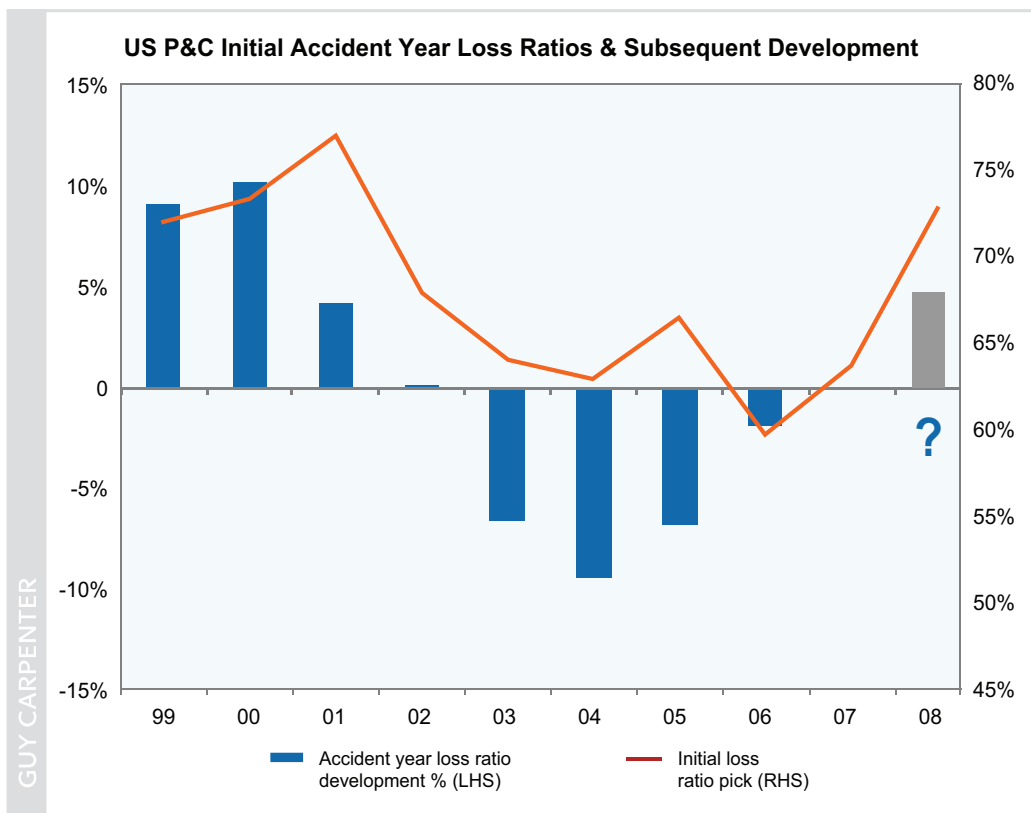
Earnings Pressure

Following two years in which asset-side movements have been the dominant drivers of reinsurance sector capital and earnings, the focus may revert to insurer profitability in 2010. There are several factors that could affect earnings and valuations in the next few years.

Reserves

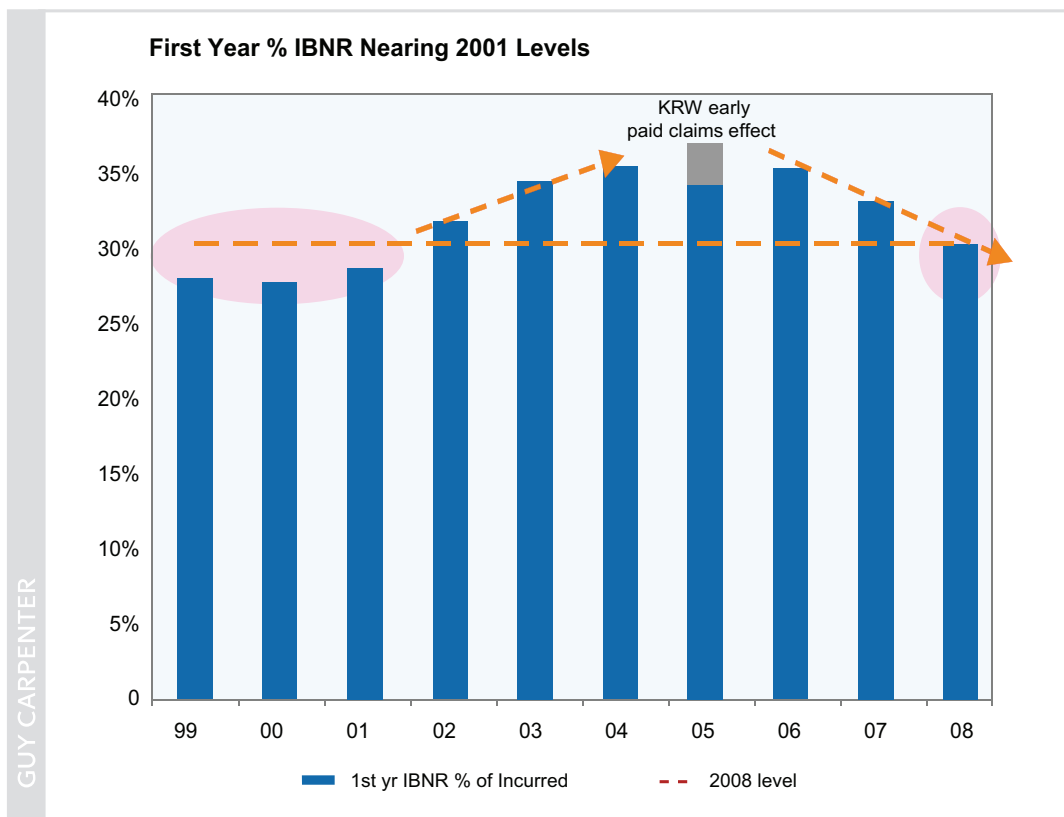
In the years since 2005, most carriers' earnings have been enhanced by reserve releases, particularly on accident years since 2002. For example, in 2008 and in the first nine months of 2009, the Guy Carpenter Reinsurance Composite experienced a 7.1 percentage point benefit to its calendar year combined ratio due to prior year reserve releases. This high level of reserve releases is not expected to continue, and several indicators point to a declining benefit from this source of earnings in the future.

The following chart shows initial accident loss ratio picks for the US property-casualty industry in aggregate and its subsequent development. The line represents the initial loss ratio pick, while the bars represent subsequent development. The analysis seems to support the old adage that "good years get better, and bad years get worse." The troublesome years of 1999-2001 experienced significantly higher initial loss picks than subsequent years that experienced reserve releases. In accident year 2008, the initial loss ratio pick ticked up noticeably. This does not necessarily portend an industry reserves deficiency, but it may suggest that more recent accident years may be less generously reserved.



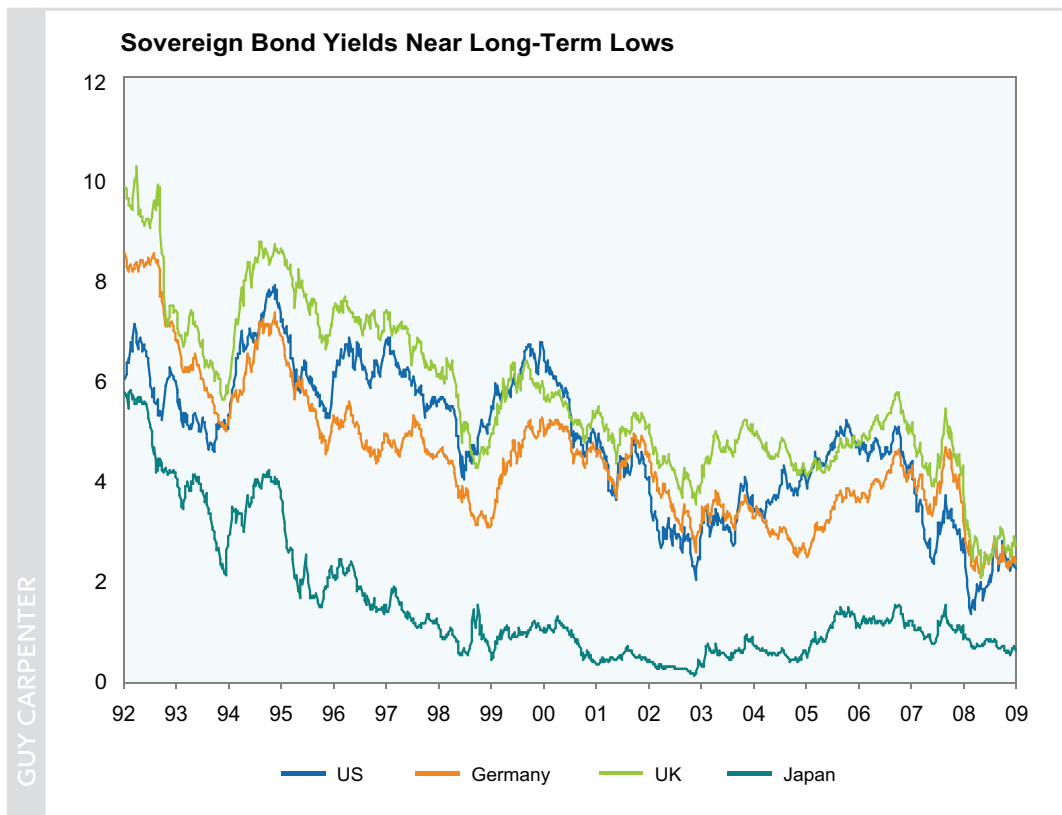
Source: Guy Carpenter & Company, LLC

Another indicator that may point to a less conservative reserving strategy is the first-year IBNR as a percentage of incurred losses. When used on an aggregate basis, this can be seen as a broad measure of conservatism in setting reserves (all other things equal). The following chart shows first-year IBNR levels over the last decade to 2008. Again, it is apparent that reserving policies were, in aggregate, less conservative in the accident years prior to 2002, evidenced by levels of first-year IBNR below 30 percent of incurred losses. During the so-called liability crisis, IBNR as a percentage of incurred losses increased substantially and probably would have peaked in 2005 were it not for early paid claims from Katrina, Rita and Wilma. The trend has decreased in every year since 2005, and it is noteworthy that for accident year 2008, US P&C aggregate IBNR as a percentage of incurred was set at almost exactly 30 percent. Whether or not this trend continues in 2009, it is clear that recent reserving policy has been less conservative on this measure than it has for most of the decade. Both indicators suggest that reserve releases cannot be considered as reliable a source of earnings in the future as they have been in recent years.



Near-Term Yields

Yields on government securities, which comprise a significant proportion of almost every carrier's balance sheet, have fallen to period lows. Investors have been more risk-averse in the last two years, increasing the demand for and price of safer government-backed securities, thereby lowering yields. Governments have also contributed to lower yields in an attempt to ease lending by lowering interest rates. This has reduced investment income for insurers with large holdings of low-risk securities. In the near future, low-risk securities are likely to continue to produce low yields, further pressuring earnings of carriers. Guy Carpenter estimates that for a typically leveraged insurer, one percentage point of investment yield can generate over two percentage points of return on equity – so the effect is not insubstantial. However, a rise in interest rates is not all good news, as the market value of the securities will decrease in response with a concomitant effect on the balance sheet.

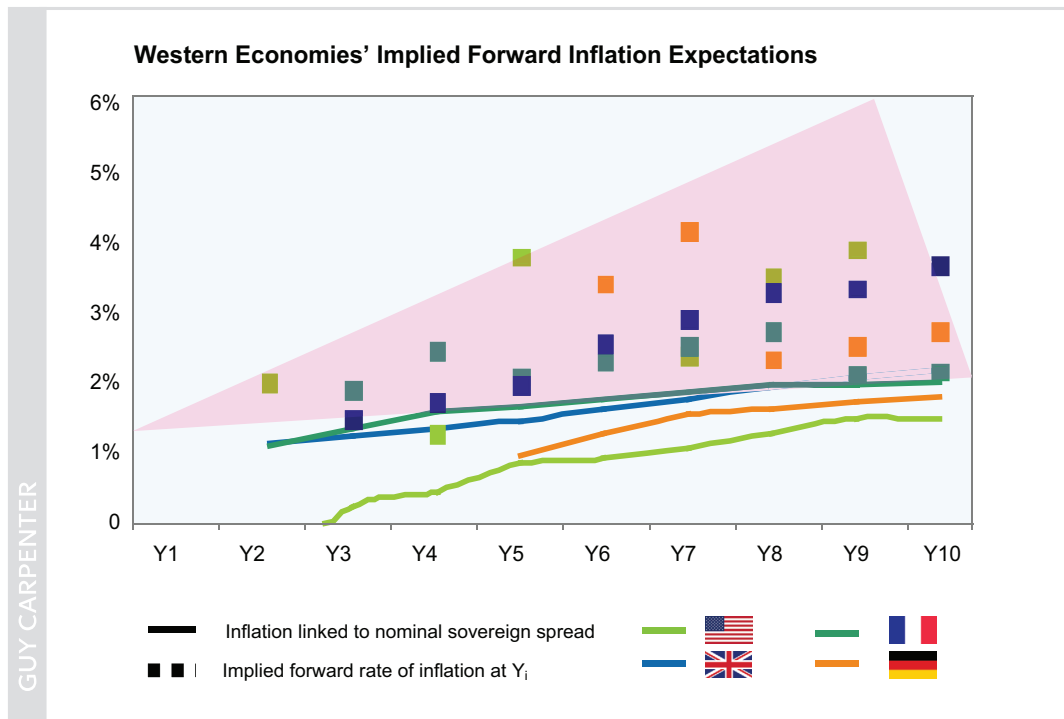


Source: Guy Carpenter & Company, LLC

Inflation

One factor that could influence company earnings in the longer term is inflation. Although inflation expectations are currently subdued by historical standards, it is worth noting that forward expectations (as measured by the bond market) are higher in future years. The following chart attempts to

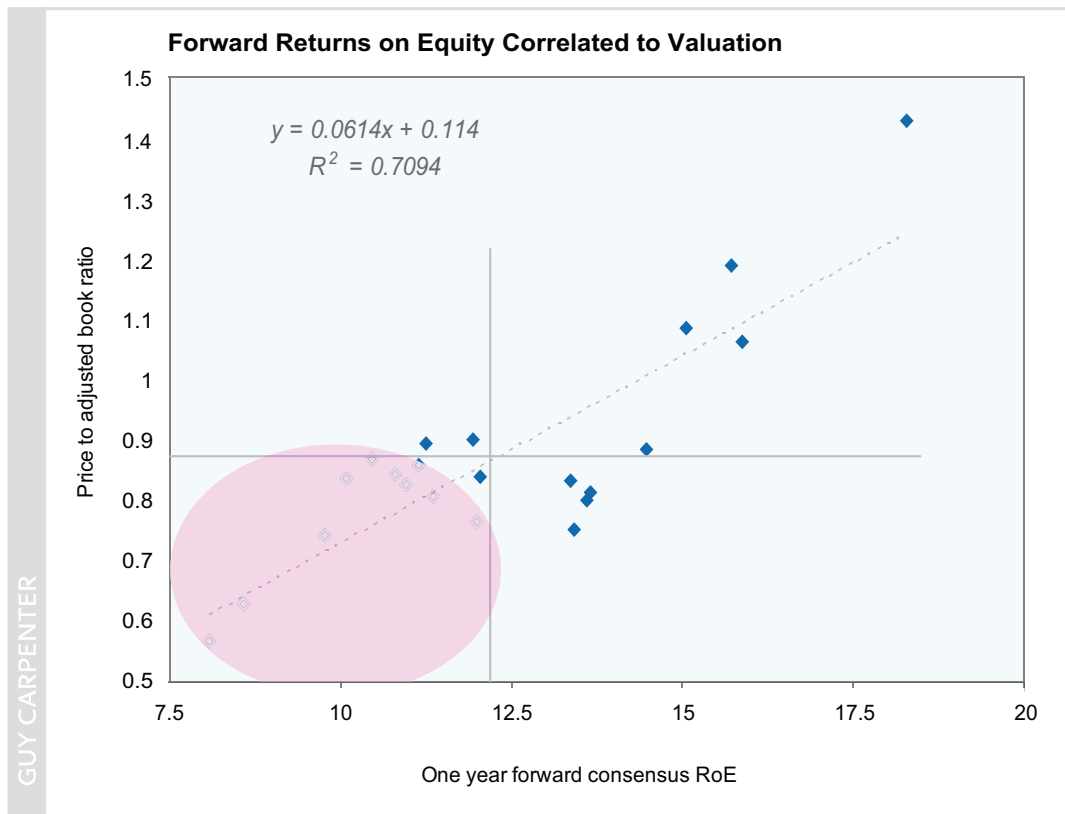
measure forward inflation expectations by using the break-even rate for nominal to inflation-linked government securities and computing a forward rate. Although future expectations remain subdued (peaking in six to eight years, at only 3 percent to 4 percent), long-term expectations have risen markedly over the past year. Inflation could become an issue, particularly for longer-tail writers whose premiums written today may be less able to cover inflated claims in the future.



Source: Guy Carpenter & Company, LLC

Valuation and Forward-Operating Conditions

All of the above factors may contribute to a more difficult operating environment for insurance and reinsurance carriers in coming years. The ability of the P&C industry to generate earnings has been impressive since the hurricanes of 2005, but this has been predicated, in part, on strong underwriting results bolstered by reserve releases and by relatively high yields. Since the beginning of the financial crisis, sector valuations have fallen considerably, with the average price to book ratio for reinsurance writers standing at 0.87x. This is as much reflective of lower perceived forward earnings potential as of bolstered capital positions. The following chart compares reinsurance company valuations with the one year forward consensus return on equity. Clearly there is a high degree of correlation between earnings expectations and valuations.



Source: Guy Carpenter & Company, LLC

As some traditional sources of earnings may become scarcer in the near future, carriers' ability to service costs of capital will be more dependent on accident year underwriting. To address this, some insurers are considering strategic growth into more profitable lines of business. Reinsurance is being utilized to enable cedents to focus on new areas where possible. In addition, some insurance groups are increasing the level of share buybacks, and others are considering inorganic growth.

Summary

The reinsurance market enters 2010 rejuvenated and with ample capacity. The weakening of pricing at the January 1, 2010 renewal reflected this, but the modest rate of decrease was essentially a return to the downwards trend established since 2006. Reinsurers will be faced with the choice of trying to protect or grow market share in a more competitive environment, considering M&A or returning capital to shareholders. Meanwhile, some longer-term clouds on the horizon in the form of rising accident-year loss ratios, diminishing releases from prior year loss reserves, inflation and (in Europe) increased capital demands from Solvency II may temper competitive conditions in time.

Guy Carpenter Briefing

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