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GUY CARPENTER
MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

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Reinsurance Renewal July 1, 2010: Capital Cushion Continues to Impact Pricing

Introduction

Further erosion of rates was evident at the July 1, 2010 reinsurance renewal. Property rates were down by as much 15 percent despite substantial catastrophe loss activity in the first half of 2010. Heavy losses from the Chilean earthquake were insufficient to turn prices outside the areas immediately affected by the earthquake, despite the announcement of large increases in estimates from the largest European reinsurers. In the energy and casualty sectors, conditions were flat or down, but the Deepwater Horizon rig disaster may exert upwards pressure as more information emerges. Excess capital remains available to absorb losses as evidenced by continuing share buy-backs and the substitution of equity capital with less expensive debt.

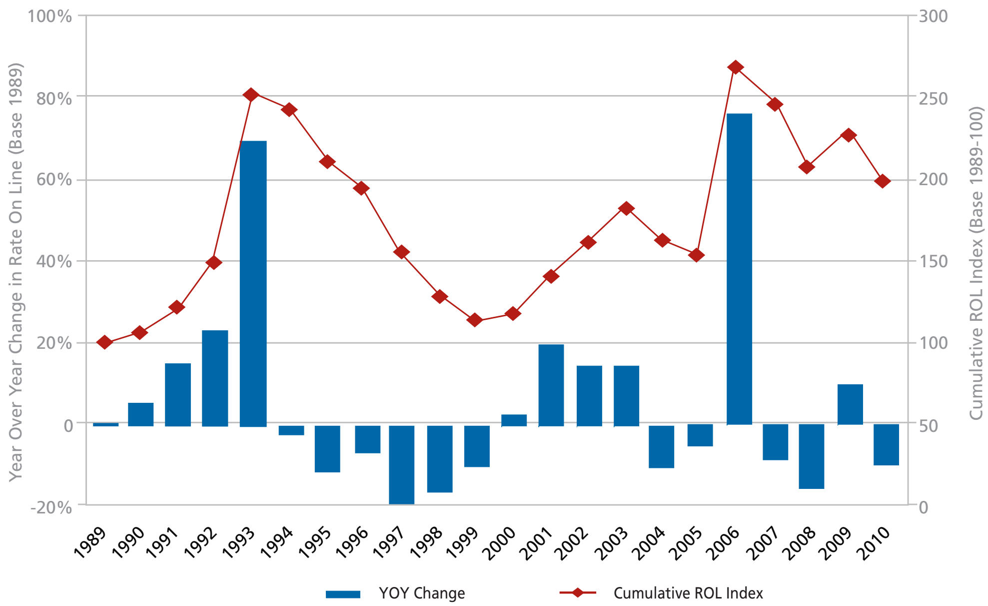
The market's direction for the remainder of the year is more difficult to forecast. Excess supply continues to depress pricing, but the substantial depletion or even exhaustion of reinsurers' catastrophe loss budgets in the first half of 2010 may help to stabilize the market. For the medium term, pressures on earnings from low investment returns, diminishing reserve releases, inflation concerns and, in Europe, Solvency II continue to build. Consolidation would be a logical response, but depressed price-to-book values are an impediment. Increased volatility in the investment markets, widening credit default swap spreads and European sovereign debt worries also point to wider economic concerns. Meanwhile, the hurricane season is predicted to bring elevated storm activity. If these forecasts are right there is an even greater chance that the marketplace will look very different at the January 1, 2011 renewal.

Property

US Property Catastrophe

The rate decreases seen were as expected across the July 1 renewals. Preliminary analysis of the renewal data shows that pricing was down in a range equal to earlier renewals on a risk- adjusted basis, decreasing 10 percent to 15 percent. Overall, pricing for the year ended down 12 percent.

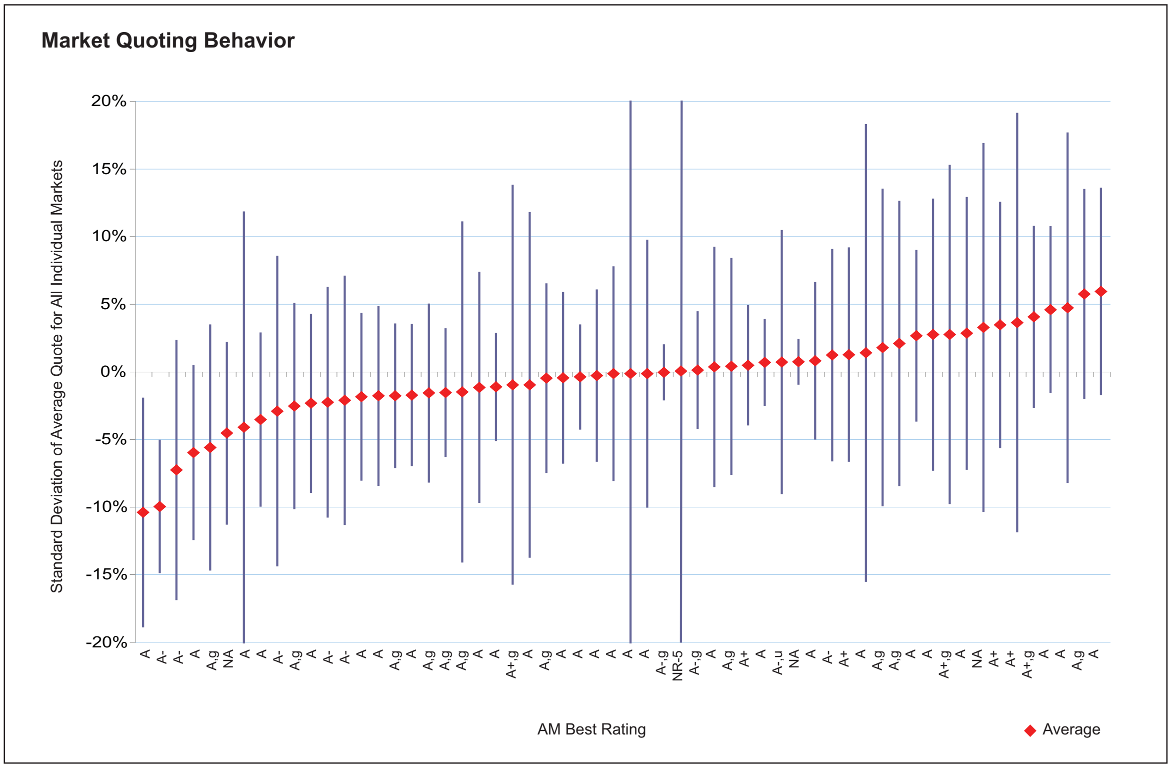
US Property Cat ROL Index



Source: Guy Carpenter & Company, LLC

Market behavior is similar to earlier patterns. Overall 2010 quoting behavior was less volatile than 2009 with average quotes in the range of declines of 10 percent to increases of 10 percent versus 2009 when the range was declines of 15 percent to increases of 15 percent.

Reinsurers have continued to present the position that those companies that are more highly rated should seek to have that financial strength recognized by commanding a higher price. However, until this year, we have not seen strong evidence for their attempting to achieve this outcome in the quoting behavior. Throughout 2010 there is more evidence of a relationship between reinsurers' rating and their average quotes than previously displayed. The following chart shows overall quoting behavior through 2010 with reinsurers represented by their A.M. Best ratings.



While catastrophe losses in 2010 have had only a very localized impact on pricing, storm activity is up and January 1 market conditions will be influenced by the amount of reinsurer capital eroded by loss activity through the rest of the year. The predictions for a very active hurricane season appear to have had a slight impact on June and July renewals with quoting behavior firmer than expected and some mention of wind aggregates filling up. While there is still an abundance of reinsurer capital, there is clearly weight being given to the potential for large hurricane losses this season and possible firmer pricing opportunities in the aftermath.

One significant unknown is the impact the oil from the Deepwater Horizon event will have on losses from storms in the Gulf. Preliminary analyses from various sources suggest that it will be necessary to better understand the applications of the covered cause of loss determination and existing pollution or contaminant language.

US Property Risk

Risk renewals have reflected individual treaty experience in 2010 with loss-affected renewals experiencing firmer pricing. Overall, risk treaties have seen pricing shifts in a smaller range than property cat, having not experienced the level of increase due to financial market conditions in 2009 and also seeing less of a decrease in 2010.

For those treaties not experiencing loss activity, pricing on a risk adjusted basis decreased 5 percent to 10 percent on average. Risk programs having a loss at least into the second layer saw firmer pricing with an average increase of 2 percent to 7 percent.

Latin America and Caribbean

In the Latin America and Caribbean region excluding Chile, terms and conditions in the property excess of loss and prorata lines were unchanged at the July 1 renewal.

Readily available capacity combined with new market entrants continued to put downward pressure on rates. The Chilean earthquake losses, however, had somewhat of a mitigating effect on this pressure on rates and on terms.

We saw rates increase in Chile for treaty excess of loss and facultative risks in the range of 50 percent to 70 percent. Reinsurers have been attempting to acknowledge recent increases in Chilean earthquake provisions from Munich Re and Swiss Re, but most have built their own loss estimates around a sensible market loss range. Specific factors relating to individual primary insurers will ultimately determine pricing. These determinants include: loss experience; transparency in reporting the earthquake loss and to what extent their losses have been inspected and adjusted; face to face approach with reinsurers; size of their programs and their portfolio.

There were likely a number of corrections on the proportional side (where cedents encountered the greatest resistance from reinsurers):

- Contracts with more strict co-insurance clauses, limiting the share each insurer can take of a shared risk
- Lower event limits
- Reduced ceding commissions for earthquake
- Minimum earthquake rates, and more reinsurer involvement in original policy terms e.g. deductibles.

It appears that the Chilean earthquake has finally enlightened reinsurers to the fact that Chile is a very seismically active country, which requires a different (more serious) approach to natural perils than other countries in the region.

Property Retrocession

The July 1 renewals for catastrophe retrocession transactions have a smaller deal flow than those earlier in the year, but are an important indicator, occurring at the start of the Hurricane Season. However, we did see inquiries in the London and Bermuda marketplaces and several placements reached completion, characterized by modest reductions in prices. Many markets were approaching full for US wind capacity, but there was still some capacity available. Whatever view was taken of pricing seen at the Florida June 1 renewals, it did not appear to divert any significant capacity to retrocession. Terms and conditions remained fairly stable from those seen in the early part of the year.

Investors in hedge funds with more insurance linked securities (ILS) orientations that also write traditional covers seemed to have had concerns. The concerns reflected the various forecasts reports for a hurricane season with above average activity. They may have been sitting on capacity that they had available. Whether this was a prudent attempt to avoid what may have been seen as an increasing risk, or perhaps "keeping the powder dry" for a post event rationale for raising rates, remains to be seen.

One area where we saw interest among active buyers and sellers was for covers excluding the United For accounts with losses from the Chilean earthquake, prices increased in line with expectations. Buyers also showed an interest in buying down their retentions to protect against more attritional-type losses which might have damaged their results but not to a level that would have impacted prices.

Many reinsurers, including those based in Bermuda, were active in placing inquiries this year. We believe that this level of interest may have been caused by concerns about the potential capital impact of some of the large loss events in the first half of the year. Reinsurance as a capital solution is still perceived to be attractive. Index products, such as Guy Carpenter’s CWIL, received much interest in the London market, but there were also opportunities for placement of traditional business at acceptable terms.

Industry Loss Warranties

Loss events in Chile, Australia and the Gulf of Mexico have impacted (re)insurers' appetites to retain loss. Buyers began looking to the industry loss warranties market in April and May to enhance those reinsurance protections already in place, resulting in an increase in traded volumes and terms hardening following a period of sustained softening that began in early 2009.

Compounded by forecasts of an active hurricane season, available capacity has contracted quickly in the last days and weeks. We are witnessing something of a crunch for US nationwide wind with pricing increasing sharply as a result.

Marine & Energy

At the July 1, 2010 renewal, territories and marine classes that were unaffected by losses have seen rates remain stable. We have also witnessed a slowing in the decline of rates. The Deepwater Horizon Gulf of Mexico loss did not cloud reinsurers' judgments when quoting international placements and each account was underwritten separately based on specific account losses and exposures.

Marine excess of loss pricing is expected to increase substantially for reinsurance purchasers with exposures to energy risks. Increases of greater than 10 percent were seen for deepwater drilling risks similar to those of the Deepwater Horizon disaster. However, regional markets are still looking to compete with Lloyds for this business.

Reinsurers continued to look for diversification into areas with less volatility and fewer losses. Significant rate increases were being imposed on energy-affected accounts as many reinsurers reviewed the basis of their involvement in energy reinsurance contracts. Potentially the Deepwater Horizon loss is a market changing event, although it is geared principally towards energy and liability exposures. Reinsurers will have difficulty justifying to clients who are writing traditional cargo/hull accounts that they should pay rate increases because of the Deepwater Horizon loss. Underwriters remained flexible in negotiating terms and conditions on placements.

Capacity remained plentiful for marine classes that had been unaffected by losses. Quota share capacity for energy business was generally tight.

The subject premium income base for marine risks did not show any signs of increase as the economy began to recover. The primary marine market remained soft and rates continued to decline further amid aggressive competition. Although economic conditions have improved in recent months the primary market was still aggressive on most marine classes. The reduction in marine trade and fall in insured values have also compounded the issue of falling premium income and led to further competition for the most attractive classes and accounts. Primary cargo insurance incomes have started to show very small signs of recovery, however, given the fact that current income levels are significantly lower than 18 months ago there is clearly still a "long way to go." There remains a general concern about the impact the current volatile European economy will have upon future trading levels. The marine cargo market was essentially flat with small reductions, depending on turnover and experience. Rate increases were seen on hull accounts with loss experience, but according to some underwriters, the increases were still not adequate. There were very clear signs that marine casualty rates may increase substantially (100 percent to 200 percent or even higher) for the upper layers of casualty programs.

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There will likely be greater demand from reinsurers for further transparency on future renewals. The reinsurance market will require much more information regarding the direct market's involvements in excess liability placements as these exposures accumulate with the physical damage policy due to syndicates' involvements with multi-assureds such as Transocean, Anardarko, MOEX and Halliburton.

The Deepwater Horizon loss has shown that a relatively small physical damage loss of approximately USD560 million can potentially escalate to USD2.5 billion to USD3 billion depending on where responsibility is apportioned and liability placements respond. Therefore, marine whole account top layers are potentially more exposed to single risk type losses. Reinsurers will likely look to address this with rate increases on excess of loss programs at the January 1, 2011 renewal.

Casualty

US Casualty

At the July 1 renewals the US casualty lines continued to demonstrate a soft pricing environment with few changes seen from the prior renewals in the year. The direct market showed a general improvement in profitability as underwriting results and net investment gains increased. This occurred as premiums declined, further impacting a soft reinsurance pricing environment. A recent development is a slowing in the decline of the subject premium base for many casualty lines. It appears to be stabilizing (even increasing in some lines) as a result of the recovering economy.

Little has changed in the workers compensation reinsurance marketplace since January 1. Capacity and competition remain abundant for both single claimant and catastrophe layers and thus rates for both remain soft.

There were no material changes from prior renewals for reinsurers in the umbrella and excess lines. The direct umbrella market was unchanged as well. Rates were flat to down where competition was introduced with the exception being a decreasing exposure base seeing a slight rate increase so that the premium does not follow it down dollar for dollar. The situation is similar in the automobile and general liability lines except that rates were flat to down regardless of the competitiveness of the situation. There are growing expectations that the Deepwater Horizon loss will have an effect on reinsurance pricing and capacity. Some direct umbrella insurers are evaluating the impact of their limited pollution wording related to the Deepwater loss. They may add exclusions on renewals where they received notice of loss under the previous policy.

There has been no change in pricing or capacity levels in surety since the year's prior renewals. Primary rates remained stable, while reinsurance pricing increased up to 7 percent compared to subject premium levels. Reinsurance pricing was driven by loss activity and expanded coverage.

Workers Compensation

Little has changed in the workers compensation reinsurance marketplace since the January 1, 2010 renewal. Capacity and competition remained abundant for catastrophe layers and adequate for single claimant layers. Rates for both remained at the same levels seen at the January 1 and April 1 renewals. Purchasers were able to secure rate on line (ROL) reductions for multi-claimant catastrophe layers up to 10 percent. Single claimant layers continued the trend of stabilization, with rate reductions only given to clients with excellent loss experience. A majority of single claimant layers were renewed at expiring rates.

With unemployment still at historically high levels, no signs of an economic recovery have shown up in the subject premium projections for our workers compensation clients. Many clients are projecting their 2010 subject bases will end up flat or down by 5 percent to 10 percent this year, with a few outliers seeing declines in subject base in the 20 percent to 30 percent range.

No major shifts in terms and conditions were noted, although the soft market atmosphere allowed for the elimination/softening of restrictions such as exclusions, employers liability policy limits and maximum any one life warranties. Clients were still increasingly investigating higher single claimant exposed limits (in excess of USD10 million), and for a few clients, there was an increased interest in the use of pure per person covers for higher layers.

Reinsurer merger and acquisition activity has had an effect on capacity in the last couple of years. “One plus one rarely equals two” when it comes to pricing support and capacity. We have also seen certain reinsurers restructure/retreat from larger stretch single claimant layers (USD9 million xs USD1 million). Both the merger activity and restructuring, which resulted in capacity reduction, are contributing to upward pressure on reinsurance rates.

Reinsurers continued to support renewals even though pricing approached walk-away levels and oversubscriptions have been declining over the last 12 months. The previous absolute pricing floor for top layer multi-claimant layers of 2 percent gave way for ROLs approaching 1.5 percent. The single claimant layers were challenged by eroding primary market experience, increasing severity trends and threats of inflation increasing current reserves.

Recent National Council on Compensation Insurance (NCCI) reports showed that primary insurers’ average combined ratio increased 9 points in the last 12 months to 110 percent for 2009. This elevated combined ratio and economic recovery timing uncertainty are going to make primary workers compensation market profitability a major challenge.

International Casualty

Rates and capacity levels in the international casualty reinsurance marketplace remained relatively stable during the first half of 2010, leading into the July 1 renewal.

The classes most sought continued to be non-accumulative general liability and motor lines. Rate reductions in these classes remained possible, depending on individual account experience. This occurred in an environment of primary insurance rate increases on motor business and the benign loss experience on general liability accounts at levels that principally affected reinsurers.

Reinsurance capacity for most classes of long tail business remained plentiful. To a large extent this was a reflection of the general over-capitalization of the reinsurance market and was further fueled by a number of new entrants in the last 12 to 18 months.

Reinsurance competition was most prevalent on protections for pure UK portfolios. We also saw reinsurance competition for accounts that introduced territorial diversification.

Accumulative and systemic exposures inherent within professional liability lines proved the most challenging. Reinsurance rates were robust and capacity limited. Reinsurance support was only dispensed at sensible pricing for the most respected insurers. In-depth knowledge and understanding of the individual accounts to be reinsured was imperative if “commodity” pricing was to be averted. Retentions remained high and limits protected did not generally increase.

Financial institutions continued to be treated with caution with the economic climate, in particular sovereign debt, catching reinsurers’ attention. The Deepwater Horizon loss increased attention to side “A” directors and officers coverage and the potential costs that may be incurred from shareholder derivative actions.

The value of reinsurance for bodily injury exposures remains under scrutiny. Increased cost of claims at excess levels continues and insurers are also experiencing increased claims settlements on a structured basis, such as periodical payments in the UK. For these claims, coverage under reinsurance treaties is minimal with attachment level relatively high, indexed and ever increasing. In addition, periodic payments have introduced further uncertainty for both insurers and reinsurers alike. Political influences may also bear on the current economic environment, where cost of care is likely to increase from an insurance perspective. Current reinsurance arrangements do not bring certainty to insurers or reinsurers and compromise settlements continue to be the focus of attention.

Life, Accident & Health

Medical

The passage of health reform in the United States has put medical insurers in the challenging position of trying to understand how to manage unlimited lifetime claim maximums. In the short term, annual caps on payments are still allowed, easing the transition, but this change creates increased risk for insurers as volatility is increased and rate-making is necessarily based on assumptions rather than experience. We are seeing increased demand for high attachment medical excess reinsurance with high limits – many clients are looking for unlimited cover to match their required offering. This may create an excellent opportunity for reinsurers willing to step up to the challenge. Many are offering limits from USD10 million to USD20 million attaching at excess of USD5 million. A few reinsurers have come forward with unlimited coverage. Pricing is varying widely between carriers but should begin to converge for the very high attachments.

Overall, pricing for quota share and working layers held steady, indexing upward at near leveraged trend. We continued to see claims in programs attaching at USD1 million, making this more of a working layer than extreme event protection.

Personal Accident Catastrophe

This market dynamic includes factors which should suggest increased pricing -- flight accidents have increased with lower layers having claims in 2008 and 2009, exposures in international programs have increased significantly due to exchange rate movements and seismic activity highlights the potential for loss in high-risk areas. However, despite these and other factors to the contrary, pricing continued to be driven downwards as the market is flush with capacity. Quoted terms were down 6 percent to 10 percent, generally, with new markets offering 15 percent reductions or more to get onto programs. Cedents were aggressively looking for better pricing and while some markets blinked and backed out of very competitive programs, those programs were, in some cases, still oversubscribed by as much as 50 percent or more. Reinsurers had plenty of capital and seemed to be chasing business, aggressively allocating lines once firm order terms were set. This may be exacerbated as reinsurers look to make up for reduced spend as some major buyers have restructured their programs and are retaining more risk.

We also saw a continued trend in clients customizing their programs in order to buy the most appropriate coverage for their risk profiles. This movement has included lower layers specifically targeting certain quake risks, single-country covers and high-attaching nuclear, biological, chemical, radiological-only programs. These programs benefit from the overall reduction in price trend as well as eliminating layers or coverages that were deemed to have little value.

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Guy Carpenter Briefing

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