GC Briefing

GUY CARPENTER

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Wide Range of Outcomes Seen in June 1, 2011, Florida Reinsurance Renewals

The June 1, 2011, renewals took place against the backdrop of record first-half catastrophe losses and uncertainty surrounding the release of version 11 of Risk Management Solutions' (RMS) U.S. hurricane model. The heavy international natural catastrophe-related losses that occurred during the first quarter of 2011 – combined with the multi-billion dollar losses from tornadoes in the United States in April and May – have added to significant loss activity over the past 16 months, culminating in insured losses of close to USD100 billion.

Catastrophe activity and two major catastrophe model revisions (RMS v11 this spring, which was preceded by AIR v12 last fall) led to a volatile renewal.

Guy Carpenter estimates that 2011 reinsurance sector losses are already more than double reinsurers' natural catastrophe budgets for the year. Nevertheless, the industry remains adequately capitalized heading into the 2011 hurricane season, due in part to strong capital growth in 2010. Despite the difficult start to the year, Guy Carpenter estimates that there is still approximately USD10 billion of excess dedicated reinsurance capital. Moreover, we estimate dedicated reinsurance capital currently stands between USD165 billion and USD175 billion.

With the number of changes in the marketplace since June 2010, measuring the change in pricing is not necessarily a straightforward exercise. Depending on the method used, the price change in Florida could be reported anywhere from down 15 percent to up 10 percent. Using last year's RMS model version as a stable baseline to calculate the amount of risk in both this year and last year's programs, and measuring the price change by unit of exposure to mitigate the impact of exposure changes, pricing shifted up 5 percent to 10 percent on average, with a wide range of outcomes for individual programs.

This briefing examines the latest renewal season in Florida and provides an update on the property retrocession and industry loss warranty (ILW) markets.

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Dedicated Reinsurance Capital Still Adequate

At the January 1, 2011, renewal, Guy Carpenter estimated that the global reinsurance sector's dedicated excess capital position was about USD20 billion. At that time, global property catastrophe rates on line (ROL) were down 7.5 percent, and it was estimated that about USD50 billion in insured losses this year would have been necessary to give the sector "pause for thought." With up to USD70 billion in large insured loss estimates in 2011 prior to the hurricane season, and accounting for premiums, attritional losses, expenses, investment income and dividends in the reinsurance sector this year, we now estimate that the reinsurance sector's excess capital position has roughly halved, to about USD10 billion. This is still a significant excess capital position and must be considered within the broader context of overall dedicated reinsurance capital totaling USD165 billion to USD175 billion. Indeed, the reinsurance sector remains fully solvent, fully liquid and easily able to pay claims.

Florida Reinsurance Renewals Highlight an Unsettled Market

With the start of the wind season and the inception date of the Florida Hurricane Catastrophe Fund (FHCF) falling on June 1, 2011, the vast majority of property catastrophe renewals occurring on this date are for companies with significant Florida exposure. There was clear evidence of a transition in the market starting in April and May, with the continuing buildup of losses (including the Tohoku earthquake in Japan) and the long-awaited RMS v11 release.

The catastrophe model version changes and substantial global losses since last year's June renewals have impacted each reinsurer's capital position and view of pricing adequacy differently. Due to the number of changing factors in 2011, there were even notable differences in how the market measured pricing movement. There are several ways to assess risk adjusted price change, and, as noted above, the range for this year's pricing compared to last year's could be calculated anywhere from down 15 percent to up 10 percent. Understanding how the factors are being measured is critical to understanding this year's pricing movements.

Significant Volatility Is Evident in Pricing Behavior

Analysis of June 1, 2011, quoting behavior reveals a significant change in the once cohesive view of Florida pricing, reflecting markets' varied responses to the current environment's pressures. Over the past two years, variation from the average quote for Florida renewals has consistently fallen within a range of down 3 percent to up 3 percent from the average. In Figure 1, the 2010 average quote across all programs is represented by the line at 0 percent, while the red dots indicate the reinsurers' distances from the average across all the programs that they quoted. The size of the line represents the variability from the average for all quotes provided by the reinsurer. Each reinsurer is represented across the bottom of the chart by its A.M. Best rating.

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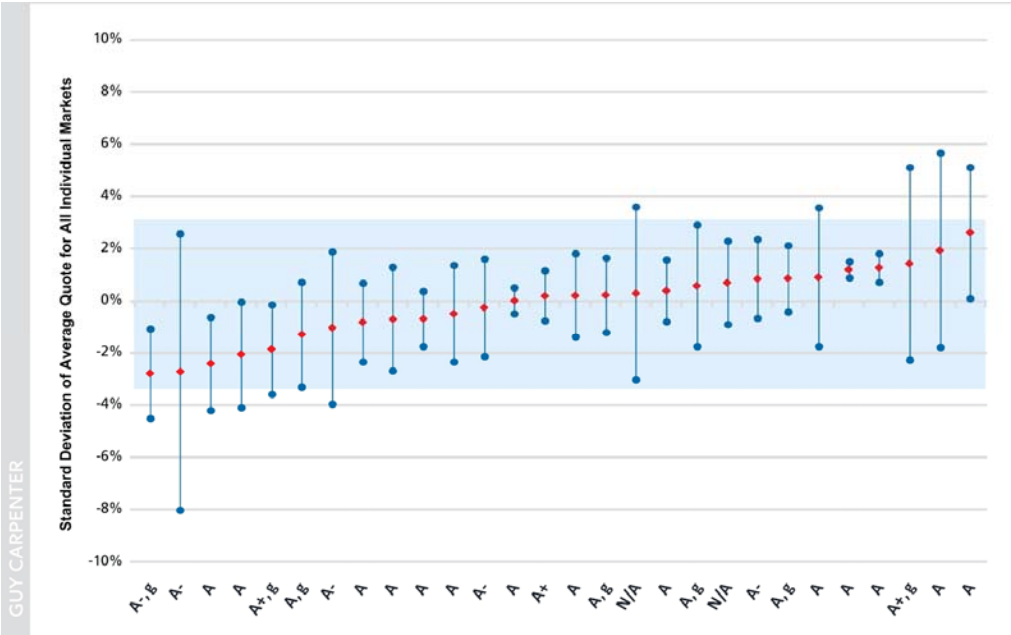
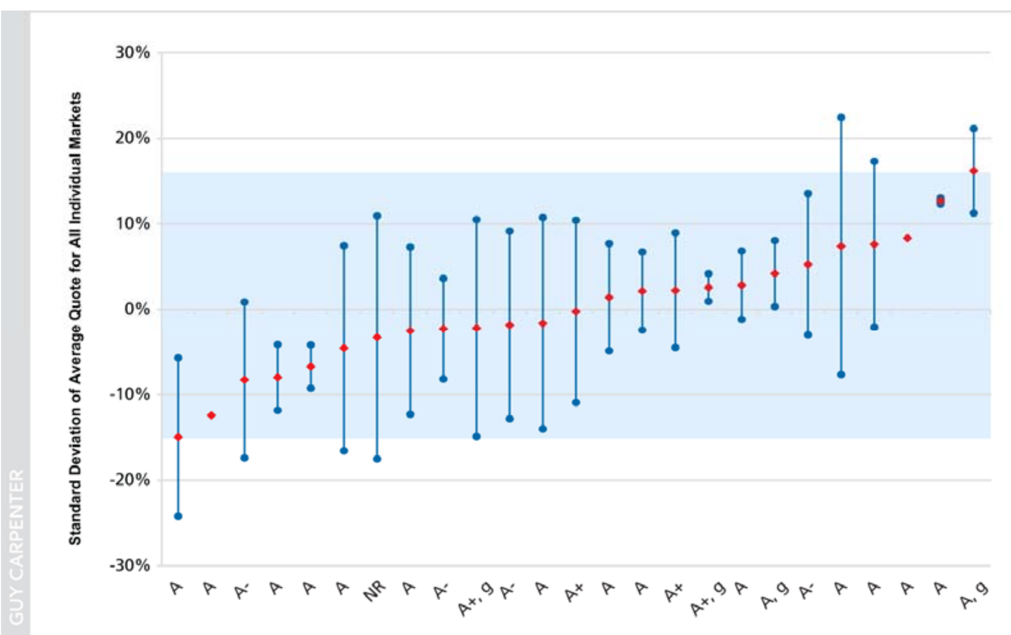
Figure 1: 2010 Florida Renewal Reinsurer Quoting Behavior – Quoting Range of Down 3 Percent to Up 3 Percent



The analysis of quotes on individual Florida programs received in 2011 reveals that the range has increased five-fold versus the past two years, from 15 percent below the average to up to 16 percent above the average (Figure 2). This quoting volatility does not specifically indicate increasing or decreasing pricing; it simply illustrates how far from the average many individual reinsurers were, highlighting the divergent views regarding the calculation of an adequate price.

Figure 2: 2011 Florida Renewal Reinsurer Quoting Behavior – Quoting Range of Down 15 Percent to Up 16 Percent



In addition to the wide disparity in reinsurers' views of adequate pricing, there was also a greater reluctance to deploy capacity. While overall capacity remains adequate in the sector, reinsurers are more cautious about using it as they continue to assess loss development on the recent catastrophes, the impact of the model version changes on their retained capital requirements and the possible impact of the new model versions in calculating pricing adequacy.

Noting the divergence in reinsurers' views of pricing and the somewhat more reluctant position to deploy capacity, firm order terms across all programs were issued at approximately 84 percent of maximum quotes and 94 percent of average quotes. In 2010, programs were placed at 87 percent of the average quote across all renewals.

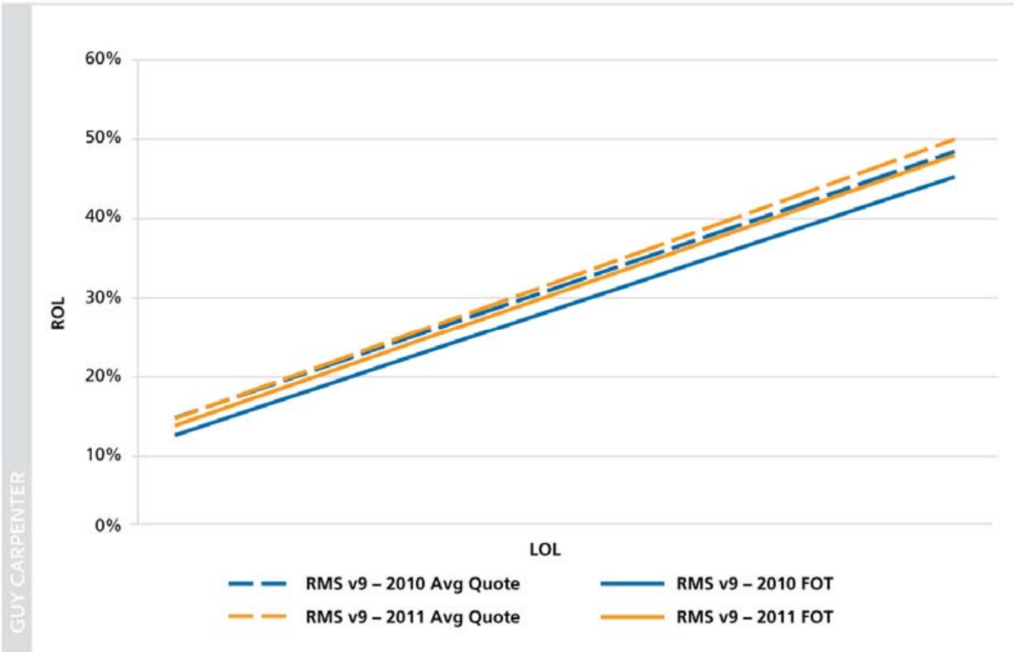
Is 2011 Pricing Up or Down?

Guy Carpenter's April 1, 2011, renewal briefing indicated that U.S. catastrophe pricing across a broad range of placements was flat to up slightly. At that time, the RMS v11 release and the Tohoku earthquake had just occurred. Through the June 1, 2011, renewal process, there has been more time to evaluate the impact of both the recent catastrophe activity and the new RMS and AIR model version releases. Companies are still working through analysis of the drivers of the RMS new view of risk, which has not been fully adopted by cedents or the market, and consequently this model result has not been fully integrated in the pricing process. Adding to the lack of clarity, the change in modeled results for individual companies varied widely: a small number of companies experienced decreases in their modeled losses, while the majority saw the loss expectation out of the model increase – by as much as 200 percent (or more) for some companies.

In addition to a large increase in volatility around quoting behavior, there was also significant variation in the pricing result for individual clients at June 1 compared to last year. Many factors influenced the ultimate experience of an individual company, including the increase or decrease in model results based on the transition from the old to the new versions, as well as the magnitude of those changes, the perception of existing price adequacy and the company's own geographic exposure shifts or experience over the past year. Companies with the largest increases in modeled results experienced more sensitivity to price.

There are several ways to compare price change between years while removing the impact of a company's increase or decrease in exposure. In order to provide a consistent view of price change, Figure 3 compares the ROL (the amount charged) with the loss on line (LOL, the amount of risk) using RMS v9 for both 2010 and 2011 to calculate the amount of risk. This analysis does not take into account any increase in the perceived amount of risk from AIR v12 or RMS v11. Across all programs, the change indicated is up 5 percent to up 10 percent. Upper layers experienced more pressure on pricing and evidenced the largest average increases, whereas the indicated increase in the lower layers was less significant.

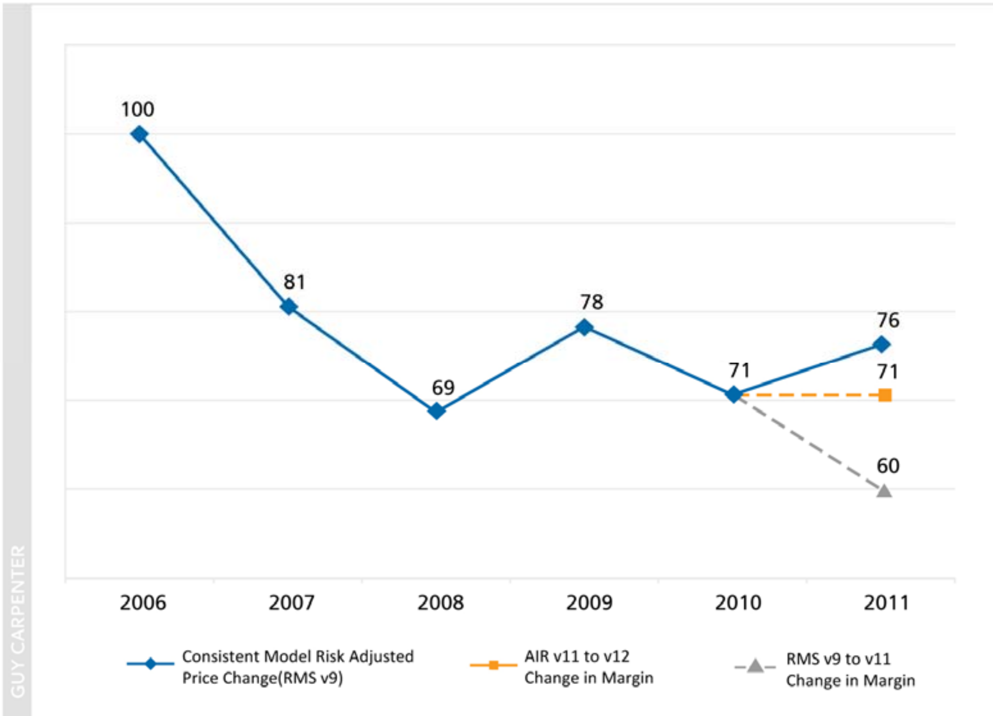
Figure 3: Comparison of 2010 and 2011 Florida Risk Adjusted Pricing Using RMS v9



While the new model versions, to some degree, reflect a changed perception of risk that reinsurers began incorporating into their pricing view in 2006 through the inclusion of additional risk charge, the extent of these adjustments varies by reinsurer. Incorporating a view of risk using AIR v12 or RMS v11 substantially changes the perception of a 2011 price increase. Assessing reinsurers' changes in margin using AIR v12 indicates pricing that is roughly flat, while applying RMS v11 results in a decrease of approximately 15 percent. To the extent that reinsurers were incorporating some measure of risk generated by AIR v12 and RMS v11, it is difficult to determine the definitive 2011 price change indication, although the market perception is that pricing has increased.

Taking a historical view of pricing in Florida, and using the RMS v9 results to represent the shift in pricing from 2010 to 2011, the overall result is that Florida pricing remains in the same band that pricing has fluctuated in for the previous four years (Figure 4). The chart below sets 2006 pricing equal to 100 with the adjustment in price in subsequent years represented as the change from this starting point. Including some weighting for the new AIR and RMS model versions in the analysis shifts the perceived price change significantly. This is represented on the chart by the dotted lines.

Figure 4: 2006 to 2011 Florida Pricing Comparison



Non-Florida Renewals Also Tracking with Overall Market Behavior

While most placements at June 1, 2011, are primarily Florida-exposed, there were a handful of renewals that did not have Florida exposure. Reviewing quoting behavior and pricing on these accounts reinforces similar themes. Quoting behavior was widely varied, while pricing was roughly flat to up 10 percent, depending primarily on geography, model results and experience.

Property Retrocession

The early “loss-free” pricing reductions seen in the retrocession (retro) market during the January renewals generally stalled during the first quarter of 2011. The reductions were replaced by rate rises at April 1, 2011, renewals, with losses from the recent international catastrophe events and uncertainty over RMS v11 impacting retro rating decisions.

The January 1, 2011, pricing environment showed rates flat to down 10 percent for “loss-free” catastrophe retro and catastrophe on direct and facultative programs (loss-affected ex-U.S. or non-peak covers were an exception and experienced increases of up to, and sometimes beyond, 25 percent). However, mounting catastrophe losses in 2010 that included the Chile earthquake, the first New Zealand earthquake and flooding in Australia were compounded in the first quarter of 2011 by Cyclone Yasi, the second New Zealand earthquake, further flooding in Australia and the Tohoku earthquake. While the 2010 losses mostly affected cold spot covers, the 2011 losses have the potential to impact “core” programs. Average increases of 10 percent over January pricing were seen for programs already in the process of placement at the time of the Japan earthquake, as markets sought to

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price in some of their anxiety over the unfolding events. Pricing has become very loss-sensitive for subsequent placements.

This loss activity was played out against a background of increasing uncertainty over RMS v11, which we believe may have occasionally, but not always, contributed to price and attachment adjustment. Currently, the increased probable maximum losses (PMLs) that RMS v11 is producing have resulted, in most cases, in heightened buying activity, as some clients seek to pre-empt the effect of the change and protect themselves at the new return period levels. Prices are expected to rise to varying degrees on a year-on-year basis during the mid-year renewals, depending on the territories covered and the loss experience of the program. A recent influx of investor capacity has now come into the market, looking to take advantage of perceived hardening market conditions.

Overall, capacity remains robust. It contracted for new placements as an initial reaction to the Japan earthquake but was relatively stable for renewals. Currently, there is still an active retrocession market for both U.S. and ex-U.S. business, with an increase in investor money leading to increased capacity driven by several hedge funds and large (predominantly Bermudian) entities. It remains to be seen whether demand will exceed supply in the coming months.

Industry Loss Warranty Market

The ILW market has hardened in the wake of the heavy catastrophe losses and the RMS model change. However, new capacity potentially is entering the market, which could stabilize prices. This influx would be timely, as the market currently appears to be deploying capacity more carefully for first loss covers for the United States. Worldwide structures also would benefit from increased capacity. Significant ILW limits have now been triggered in 2010 and 2011, perhaps demonstrating the continued value of the product. In addition, there potentially is more capacity available on a frequency basis in the ILW market, as most cover is sold on a “one-shot basis” for the first event.

Looking Ahead

The same issues that have made the assessment of the June 1, 2011, renewal pricing particularly challenging – and resulted in the wide disparity – also complicate any attempt at predicting the future course of catastrophe rates. We expect to see clarity emerge later in the year as the new models (in particular, RMS v11) are integrated throughout the industry and a new equilibrium is established. While hurricane season is always fraught with uncertainty and any major event has the potential to affect pricing across the board, this year’s season could have a particularly acute impact, as a result of the extreme catastrophe-related losses of the past 12 months. We expect a substantial degree of uncertainty to persist at least until the 2011 hurricane season has passed.

How Guy Carpenter Can Help

Guy Carpenter is uniquely positioned to help clients navigate a changing and increasingly volatile reinsurance market. Our services and solutions through GC Analytics^{SM} include industry-leading proprietary catastrophe models, actuarial services and capital models. We encourage you to contact your Guy Carpenter representative to review and discuss your risk modeling and capital needs in more detail.

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