GC Briefing

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April 1 Reinsurance Renewals

The April 1, 2011 renewal once again demonstrated the reinsurance industry's ability to operate during trying times. The renewal, which is dominated by business in the Asia-Pacific region, followed just a few weeks after the devastating 9.0Mw Tohoku earthquake struck off Japan on March 11. The earthquake and subsequent tsunami caused a humanitarian disaster, and the widespread damage to property and infrastructure is likely to make the event the most expensive insured loss outside of the United States, in history. Current modeled estimates predict an insured loss of between USD12 billion and USD30 billion for the event. This, along with other catastrophic events in Australia and New Zealand, resulted in a very challenging first quarter for the industry.

The loss in Japan, combined with flooding in Australia, Cyclone Yasi, a 6.3Mw earthquake in New Zealand and political unrest in North Africa and the Middle East, meant reinsurers experienced the most costly first quarter on record. It remains too early to assess what impact these losses will have on dedicated reinsurance sector capital for the full year 2011. However, it is important to remember that the reinsurance market was well capitalized at the January 1, 2011 renewal. Guy Carpenter's Global Business Intelligence Team estimated dedicated reinsurance sector capital was USD19 billion above trend, given risks assumed.

Taken in isolation, the effect of the Tohoku earthquake and tsunami would therefore have been unlikely to significantly impair the sector's excess capital position. However, the cost of the earthquake and tsunami comes on top of an estimated USD15 billion to USD20 billion in insured losses incurred in the first quarter prior to the earthquake. Consequently, many reinsurers' 2011 natural catastrophe budgets have already been exhausted and a portion of the sector's excess capital has been absorbed. Clearly, any additional large losses incurred in 2011 will put additional strain on reinsurers' capital. Nevertheless, the industry is well positioned to deal with such a scenario. Guy Carpenter's Global Business Intelligence Team estimates total dedicated reinsurance sector capital currently stands at between USD160 billion and USD180 billion.

The implications for the June and July reinsurance renewals later this year are unknown at this time. In the short term, we, at the very least, would expect to see increased demand for reinsurance cover. At the same time, share repurchases are likely to be scaled back or suspended until a clearer picture emerges.

At the April 1 renewal, the U.S. property catastrophe market showed signs of being in transition, with renewal pricing roughly flat. Timing of these events in the marketplace

helped create a status quo renewal environment, with reinsurers generally renewing at expiring terms.

The heavy catastrophe losses incurred over the past twelve months in the Australia and New Zealand region led to some rate increases for loss-affected programs, although the introduction of annual aggregate deductibles and higher retentions offset part of the rise.

Korea witnessed rate increases in excess of 15 percent for many large property per event programs. In contrast, the majority of per risk treaties continued to secure rate reductions, with renewals in the range of flat to down 5 percent.

Japan

Earthquake Lines

The Japanese market buys considerable amounts of earthquake reinsurance – both pro rata and excess of loss. Companies were able to renew unchanged capacity for pro rata treaties at the April 1, 2011 renewal, despite the occurrence of the Tohoku earthquake at a time when the renewal process was only partially completed. Typical ceding commissions for this kind of business have ranged between the low and high teens over the past few years. In most but not every case, these commissions were reduced by up to 3 percent in order to achieve placement goals. Many reinsurers also looked for greater detail on primary underwriting practices.

In addition to its purchase of pro rata, the Japanese insurance market buys significant quantities of excess of loss protection. The largest proportion of these is on an earthquake only basis with the remainder on a combined peril (earthquake and typhoon) basis. For these covers there was more of a mixed picture. Each buyer acted in a way that best suited its own circumstances, the result of which was that many of the larger programs, in particular the large mutuals, opted to extend their programs for up to 3 months while the remainder opted for 12 month renewal, as usual. Rates for renewing treaties varied between increases of 15 percent and 50 percent and were dependent on individual circumstances.

Windstorm Excess of Loss

The quoting season for windstorm business started just prior to the Tohoku earthquake. Lead reinsurers quoted for modest increases in expectation of the usual negotiation process, with a widespread expectation that small reductions would ultimately be available. Following March 11, insurers were not able to press for reductions and most elected to take up quoted pricing. The result was that windstorm rates for those programs increased by 3 percent to 10 percent. There is limited data for programs priced after March 11, but rate increases for these buyers were undoubtedly greater than for those that went earlier. Capacity remains tight for this line of business.

Fire Pro Rata and Excess of Loss

These treaties exclude Japanese earthquake and generally enjoyed a smooth and stable renewal with stable pricing. There was no shortage of capacity. As usual, reinsurers were willing to look at each pro rata treaty based on its recent experience and there were some examples of modest commission adjustments to reflect good or

bad results where appropriate. Per risk excess of loss treaties renewed smoothly with broadly stable rates.

Other Non-Marine Lines

Personal accident excess of loss reinsurance in Japan includes earthquake. These covers are not expected to be significantly impacted by the Tohoku event, although some smaller mutual programs may be affected. Rates for renewal were flat to increasing 15 percent. There was no shortage of capacity.

General third party liability excess of loss covers were not affected by the recent events and enjoyed a renewal with stable capacity and flat pricing.

Credit and bond treaties renewed with plenty of capacity available. Structures were unchanged and there was opportunity for cedents to make modest increases to commission levels.

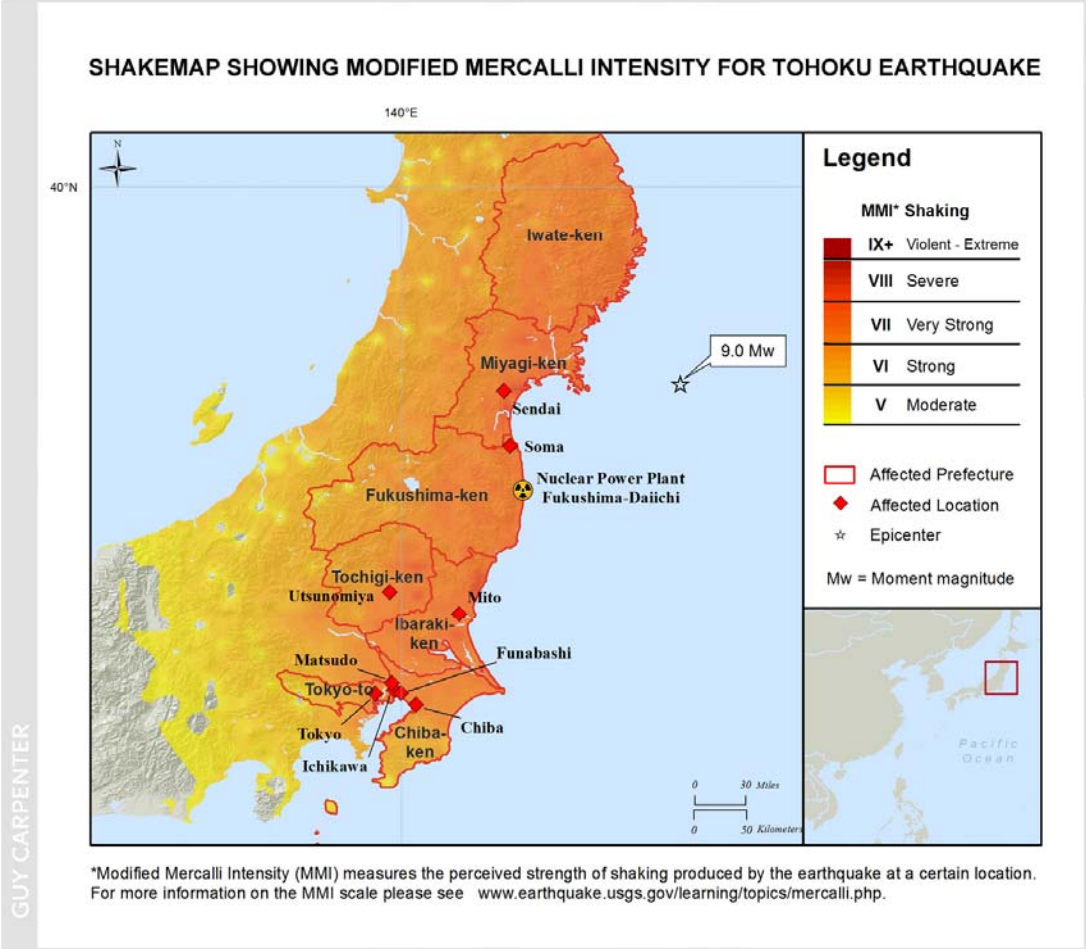
Engineering pro rata treaties enjoyed a smooth renewal. These treaties do include earthquake cover, but are normally placed on a long term relationship basis and reinsurers were generally willing to renew as before.

Tohoku Earthquake and Tsunami

The 9.0Mw earthquake that struck offshore of Japan's Tohoku region at 14:46 local time on March 11, 2011 caused widespread devastation across eastern regions of the country. Severe shaking near the epicenter region and the massive tsunami that followed the earthquake killed thousands of people and flattened several communities. There are reports that the death toll will ultimately exceed 25,000 people.

According to both the U.S. Geological Survey (USGS) and the Japanese Meteorological Agency (JMA), the earthquake's magnitude was measured at 9.0, making it the fourth most powerful earthquake in the world since 1900 and the largest in Japan since modern instrumental recordings began 130 years ago. According to the USGS, more than 73 million people lived in areas impacted by a Modified Mercalli Intensity (MMI) of V or higher. Several towns and cities, including Sendai City, experienced intensity VIII on the MMI scale, equivalent to severe shaking with the potential for moderate to heavy building damage, the USGS said. It added that Chiba and the capital of Tokyo were hit by MMI intensity of VII, very strong shaking that can cause moderate to heavy structural damage (see Figure 1).

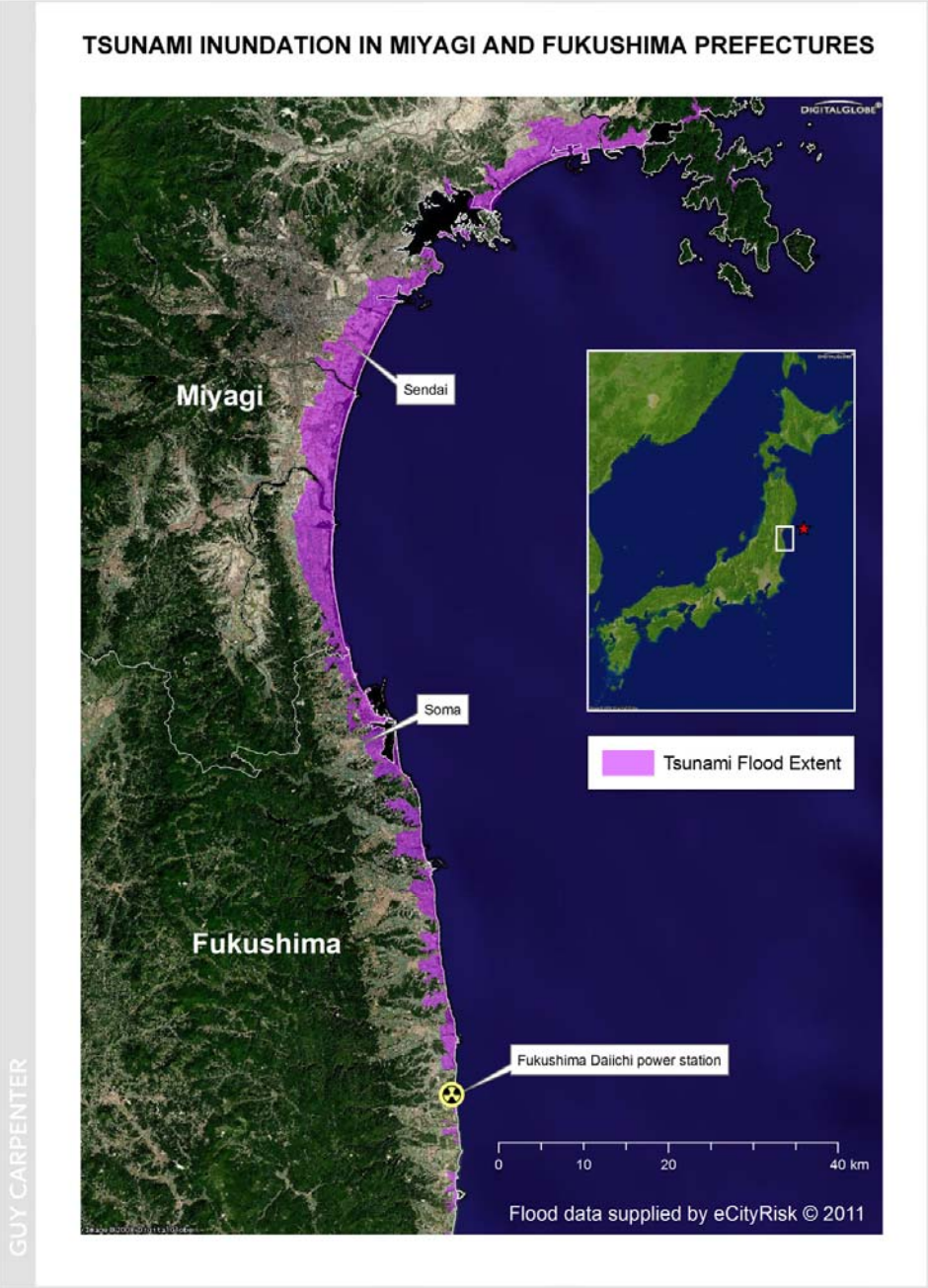
FIGURE 1:



Source: Guy Carpenter, USGS

The tsunami waves that followed the earthquake reached heights exceeding 7 meters (23 feet) along parts of Japan's eastern shoreline. Some reports said waves of 10 meters (33 feet) high hit Sendai City, severely damaging the city's port before sweeping up to 6 kilometers (4 miles) inland (see Figure 2). The tsunami waves caused widespread damage in the prefectures of Miyagi and Fukushima, with massive surges of debris-filled water sweeping away buildings, cars and ships. Reports said residents in Miyagi had just 15 minutes to evacuate before the tsunami waves reached the coastline.

FIGURE 2:



Source: Guy Carpenter, eCityRisk

Damage Extent

Extensive damage has been reported in dozens of towns and cities along the 2,100 kilometer (1,300 mile) stretch of Japan's eastern coastline. The Fire and Disaster Management Agency of Japan has reported more than 145,000 buildings damaged or destroyed so far, leaving about half a million people homeless.

The earthquake and tsunami also hit manufacturing output in Japan. Operations at several manufacturing facilities have been suspended, with plants in and around Sendai particularly badly damaged. Several car manufacturers, including Toyota, Honda and Nissan, have

suspended production. Operations at some electronics firms such as Sony, Canon and Panasonic remain shut down. Supply chain problems have also forced some undamaged manufacturing facilities inside and outside of Japan to slow production.

The earthquake and tsunami also caused an emergency at the Fukushima Daiichi nuclear plant. Three explosions and two fires damaged the facility a few days after the event, triggering a leakage of radioactive material. Hundreds of thousands of people living close to the plant have been advised or ordered to evacuate their homes as workers attempt to bring the situation under control. However, the incident at Fukushima Daiichi is unlikely to result in a significant direct loss for (re)insurers, as coverage for nuclear facilities in Japan specifically excludes earthquake shock, fire following earthquake and tsunami.

Loss Estimates

Japan's government estimates the total cost of the damage caused by the earthquake and tsunami could reach JPY25 trillion (USD310 billion). Although there is considerable uncertainty over the extent of the insured loss, early modeling estimates suggest the cost to the industry could be between USD12 billion and USD30 billion. EQECAT said insured losses are expected to be between USD12 billion and USD25 billion after estimating the effects of earthquake shaking, damage from the subsequent tsunami and fires, and losses to automobiles, marine, life and personal accident insurance lines.

AIR Worldwide, meanwhile, recently revised its initial loss estimate to a narrower range of USD20 billion to USD30 billion (from an initial estimated range of USD15 billion to USD35 billion). This estimate reflects insured physical damage to residential and commercial property resulting from shake, fire following and tsunami. However, the estimate does not factor in business interruption costs (direct or indirect), demand surge or any losses to casualty and life lines.

Earthquake Coverage

Due to the way the Japanese market is structured, insured losses are projected to be only a fraction of the overall economic loss. This is partly explained by the fact that Japan's residential earthquake risk is reinsured to the government through the Japan Earthquake Reinsurance Company (JER), reducing the total cost to private (re)insurers. The JER retrocedes a portion of the risk back to the non-life insurance sector while the bulk of the exposure is covered by the government. Japan's nuclear cover exclusions are also likely to see the government pay most of the costs from the fallout at the Fukushima Daiichi plant. However, much of the commercial and industrial losses, including business interruption claims, will be absorbed by international (re)insurers.

U.S. Property Catastrophe Market

Due to the timing of factors impacting the April 1 programs, many of these renewals have been finalized very late. While the renewal data is still being assessed our current analysis of the U.S. property catastrophe market showed signs of a market in transition at this April 1 renewal, with pricing roughly flat to slightly up, as compared to down 6 percent to 10 percent at January 1, 2011.

Factors affecting the April 1 renewals included the release of RMS's RiskLink v11 U.S. Hurricane model on February 28 and very heavy global natural catastrophe activity. Pre-release briefings on the RMS v11 model indicated the potential for material changes in results, and as the Tohoku earthquake in Japan occurred, many companies were in the process of assessing their firm order terms.

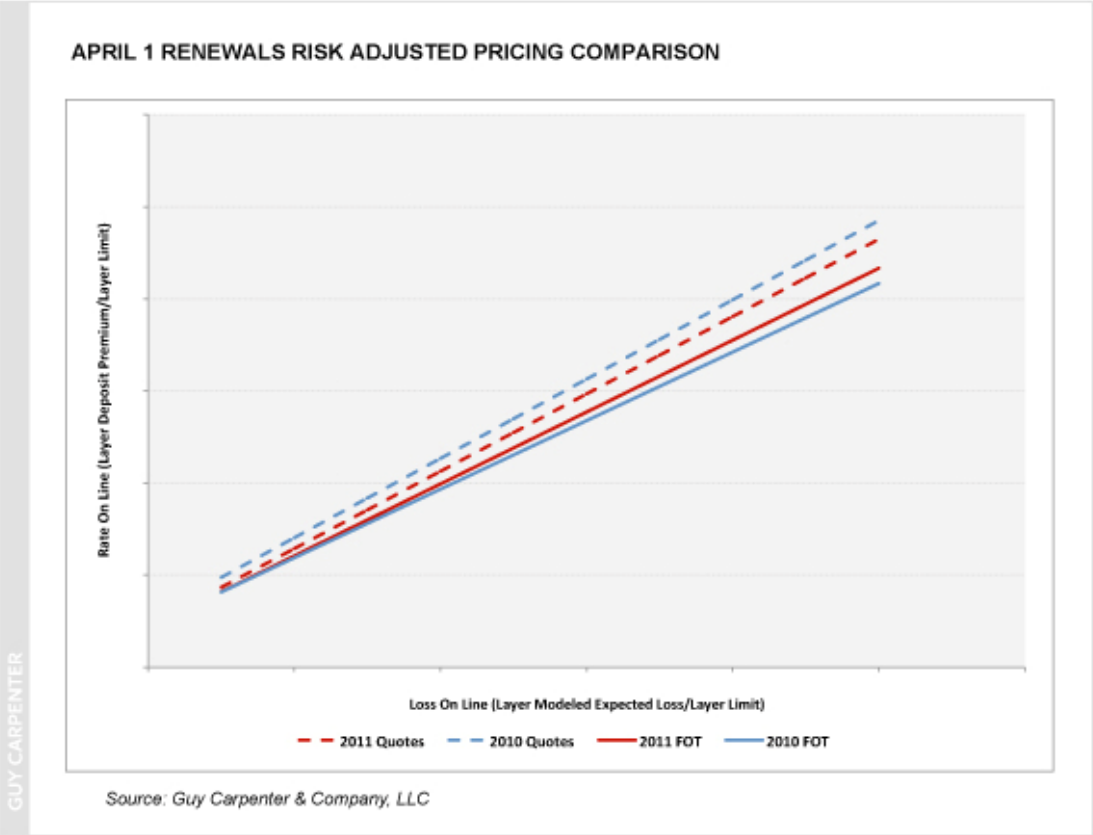
While it is still far too early to evaluate the ultimate impact of either of these factors, their occurrence during the renewal process led to a cautious marketplace. In general, as reinsurers have not yet had time to evaluate the impact of these events on their own capital, they have taken a position to renew at expiring terms.

Programs that were out early at terms measuring any notable price decrease were not supported at the lesser pricing, and a significant number of programs were repriced to reflect the changing circumstances. Capacity needs in excess of expiring were subjected to heavier scrutiny. Also, with the high level of uncertainty in the market, reinsurers were more willing to significantly cut back on their support of a program if pricing did not meet expectations.

In reviewing the relationship between the rate on line (the amount charged) and the loss on line (amount of risk) for the April 1, 2010 and 2011 renewals, pricing was flat to up very slightly.

The portion of Figure 3 showing the relationship between 2010 and 2011 quotes, tracks very closely with the January 1, 2011 renewal activity. The shift occurs in the firm order terms, where the spread between April 1, 2011 quotes and final terms is much tighter than in 2010 or at January 1, 2011. This leads to pricing being roughly flat as opposed to down as in the past several quarters.

FIGURE 3:



The number of renewals at April 1 is significantly smaller than at January 1, and individual company results vary based on their own given set of circumstances. Factors impacting individual renewal results include modifications in structure, changing risk profiles and loss activity. While many companies renewed their existing structures there was some appetite for increased limit. For the most part, retentions were stable.

While factors in the marketplace have created an uncertain renewal environment at April 1, an abundance of reinsurance capacity was a critical element in companies' ability to secure favorable terms and conditions in the 2010 and January 1, 2011 renewals. Alternatively, constrained capacity going into the 2006 and 2009 renewal seasons contributed to the realization of rate increases at those renewals. The degree to which capacity is impacted by recent events ultimately will play a substantial role in the market's position in the coming months. To this point, the April 1 renewals provided no indication that there is currently a capacity issue for U.S. catastrophe placements, as reinsurers continued to provide substantial authorizations.

Australia/New Zealand

The April 1 renewal is not a major one for the Australia/New Zealand region, as most renewals are divided between January 1 and July 1. It has proven to be more significant this year, however, as a result of the natural catastrophe activity that has impacted the market over the past twelve months. During this time there have been seven events that have, on each occasion, resulted in insured losses in excess of USD1 billion. A large proportion of these losses have been passed on to reinsurers.

In Australia the most significant event has been the flooding that predominantly affected the state of Queensland. Separate events in December 2010 and January 2011 resulted in substantial insured and economic losses. These events have once again led to considerable debate regarding flood as a peril, with coverage definitions varying greatly between insurers. In light of these disasters, the Assistant Treasurer recently set up the National Disasters Insurance Review (NDIR), which is due to report back to the Government by the end of 2011.

In New Zealand, the city of Christchurch was shaken by a devastating 7.0Mw earthquake in September 2010 that resulted in insured losses of approximately USD4 billion. An aftershock measuring 6.3Mw struck on February 22, 2011. This time the epicenter was much closer to the city and the damage sustained was much greater. With close to 200 fatalities, this second earthquake also caused significantly more building damage. Early estimates put the insured loss as high as USD12 billion.

With the majority of reinsurance programs having been affected by multiple events over the past year, reinsurers have been signaling double digit-price increases. They also have been looking for cedents to again raise their catastrophe retentions – this was also a theme at January 1. The market norm of pre-paid reinstatements was also coming under pressure, especially at the lower end of programs.

For loss-affected programs renewing at April 1 this translated into rate increases on a program-wide basis. However, the introduction of annual aggregate deductibles and higher retentions helped keep the increases at a reasonable level. While capacity remained more than adequate, reinsurers' approaches to the renewal were largely uniform as they sought to achieve a better return for the capacity they were deploying.

The much larger June 1/July 1 renewal season will be a better guide as to how much the frequency and severity of natural catastrophe events over the past year have moved the market.

Republic of Korea

In 2010 Korean property programs were impacted by Typhoon Kompasu, which hit the northern regions of South Korea in early September 2010. Most insurers suffered losses to the first layers of their property catastrophe excess of loss treaties and in some cases the claims ran into subsequent layers.

For the largest companies in the Korean market, retained natural perils growth was fairly stable, ranging from an increase of 10 percent to a decrease of 10 percent, with an average increase of only 2 percent to 3 percent. In spite of this low aggregate growth, many of the large per event programs saw rate increases in excess of 15

percent. Model changes had a small impact on rate increases in the lower layers of programs. The driving factor in the rate movements appeared to be twofold:

1. Prior year rate reductions. Although rates have been decreasing steadily since 2004 following significant increases in the aftermath of typhoons Rusa (2002) and Maemi (2003), the rate of decline had been even more pronounced since 2007, following several years without catastrophe loss activity.

2. Overseas exposures. Non-domestic coverage is a common feature of the non-proportional treaties of the larger insurers that have branches located overseas. In 2011, increasing reinsurer focus has been placed on the aggregate growth in these regions as well as on the inclusion of non-Korean interests abroad under domestic treaties.

Additionally, some of the largest reinsurance purchasers in the Korean market increased maximum risk retentions and, as result, purchased higher limits for both per risk and per event treaties. Deductibles, for the most part, remained unchanged from 2010.

In contrast to the rate movements of the property per event programs, the majority of per risk treaties continue to secure reductions in rates, with renewals in the range of flat to down 5 percent. It is worth noting, however, that in some instances where increased retentions have led to increases in estimates of net retained premium income, these rate reductions still result in significant premium increases in monetary terms.

For property proportional treaties, renewal terms have been relatively unchanged from the prior year, although there also have been some requests for small improvements in terms such as increased event limits and commissions.

In addition, there also were some noteworthy shifts in lead reinsurers throughout the course of the 2011 renewal. This was in no small part due to the disturbance in renewal negotiations caused by the earthquake and tsunami in Japan. These events slowed the quotation process and impacted reinsurers' expectations to vastly different degrees.

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