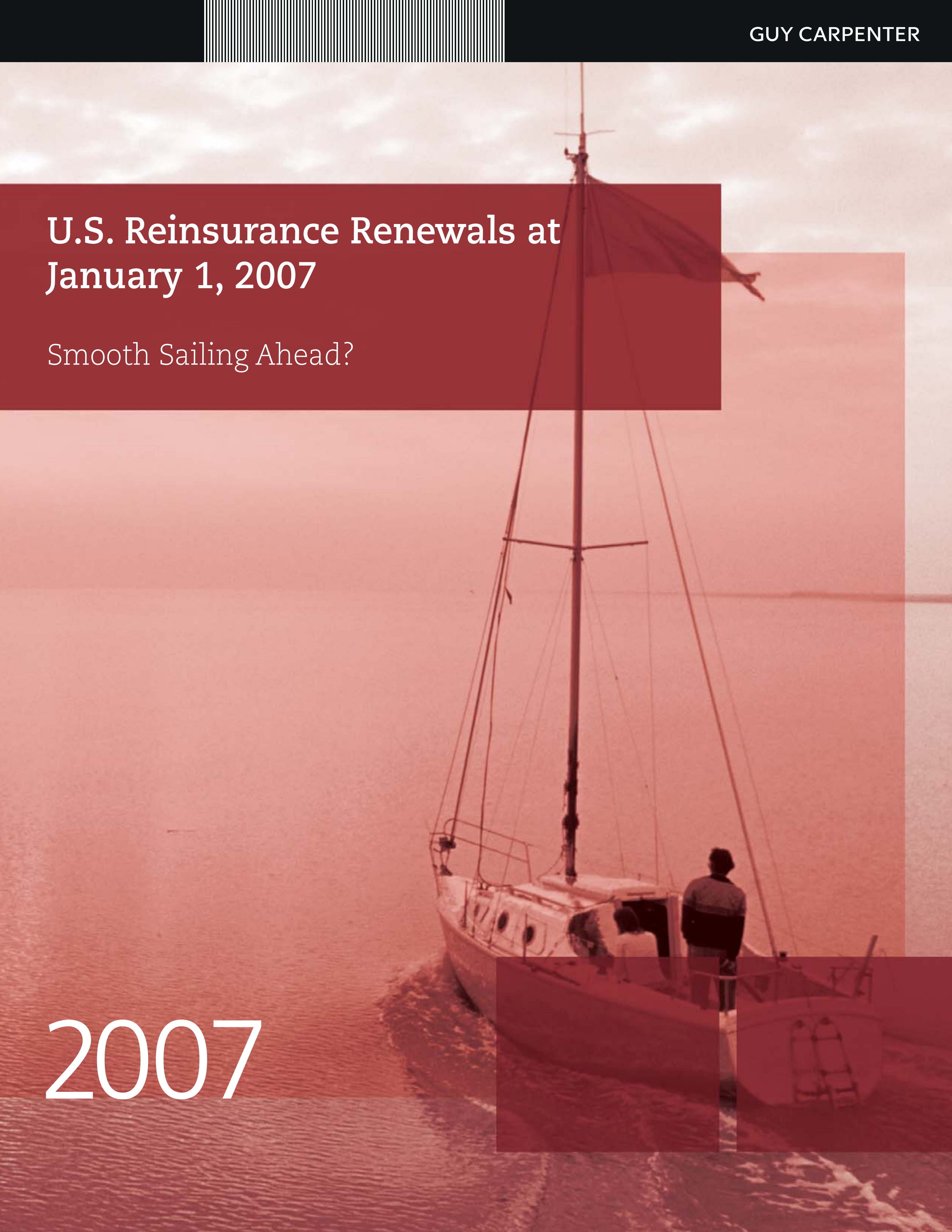
GUY CARPENTER
U.S. Reinsurance Renewals at January 1, 2007
Smooth Sailing Ahead?
2007

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Introduction

Smooth Sailing Ahead?

There have been very few typical year-end renewals in the new century, given the stock market collapse, the terrorist attacks of September 11, 2001, the stock market recovery, the record typhoons of 2004 and the North Atlantic storms of 2004 and 2005. All of these factors have meant that there has been little normalcy in reinsurance markets. But for those who prefer a quieter life, renewals at January 1, 2007 may be the sign of a more placid reinsurance environment.

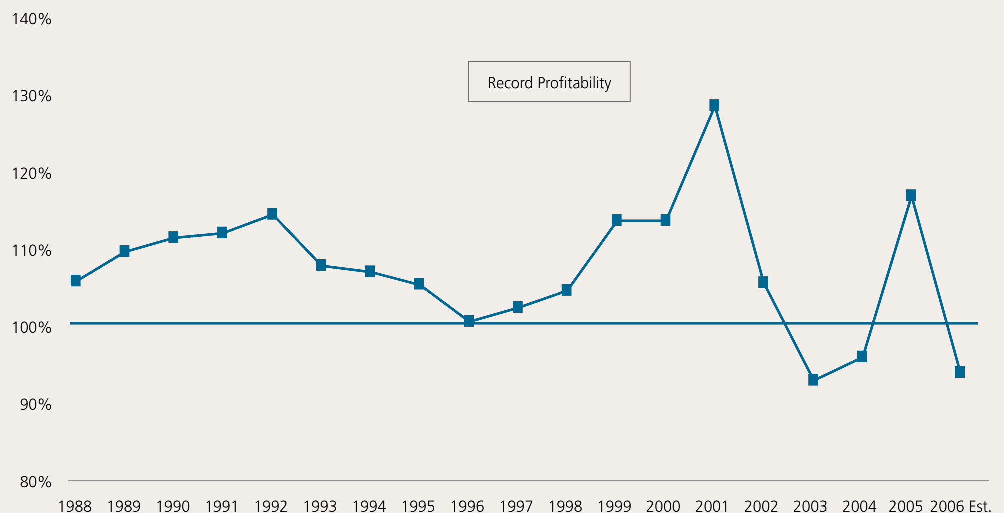
The prominent factors at work at 2007 renewals seem pedestrian relative to the mega-events listed above. These factors include:

- Recapitalization from internal profits plus inflow of new capital to the reinsurance industry.
- Disparity between continued hard conditions for U.S. coastal exposures and soft market conditions elsewhere.
- Divergent trends between pricing in primary markets (soft) and pricing in reinsurance markets (firm), particularly in casualty lines.

Increased Capital to the Reinsurance Industry
Due to significant rate increases and a benign loss season, 2006 is likely to be a record year for industry profitability.

Global Reinsurance Industry Profitable

Combined Ratio



Source: Standard & Poor's and Guy Carpenter

For the past year as a whole, the combined ratio for the global reinsurance industry is likely to drop below 90, and operating income is likely to exceed the prior record of $26 billion in 2003. Profits for 2006 are quickly helping to replenish whatever capital was extracted from the reinsurance market in 2004 and 2005. In addition to record profitability, the infusion of new capital into the business through outside investment helped to bolster capacity in the marketplace. In 2006, $17 billion of new capital entered the reinsurance space, consisting of $5.3 billion to existing reinsurers, $7 billion for new ventures, including sidecars, and $4.7 billion for new catastrophe bond issues. This added capital was in addition to the $21 billion raised in 2005 after Hurricane Katrina.

U.S. Coastal vs. Most Other Regions

Following the record-breaking hurricanes of 2004 and 2005, reinsurers took a long, hard look at their potential exposures to tropical storm losses in North American coastal regions, ranging from Mexico to Maine. This reassessment, reinforced by increased projected losses from the major modeling firms, and higher standards for catastrophe exposures by rating agencies, led to a severe shortage of capacity allocated to United States and Mexican coastal exposures. However, the market was very discriminatory. Property lines in countries outside North America experienced minimal increases in 2006, and, in general, recorded decreases at January 1, 2007 renewals. Further, as detailed in the casualty section of this report, casualty lines in the United States continued to experience soft market conditions.

Divergent Trends in Pricing

In a number of casualty lines, ranging from casualty facultative to directors and officers, the primary and reinsurance sectors appear to be out of phase in terms of the pricing cycle. Soft market conditions prevail in the primary market, while the reinsurance market has been relatively firm. A number of factors appear to be at work, including:

> A more conservative approach to underwriting and pricing by reinsurers, reflecting the general fact that they have less spread of risk in their portfolios compared with their brethren in the primary sector.

> A number of primary carriers appear to believe that their current rates are more than adequate, a view not fully shared by their reinsurance partners.

> Reinsurers participating on an excess basis are more exposed to severity increases than cedents and are therefore more cautious about favorable reports of improving tort or workers compensation environments.

> Reinsurers are more exposed to clash risks such as pandemics or acts of terror, and hence more cautious as long as such fears are realistic.

The Outlook

As the property section of this report indicates, rates at January 1, 2007 renewals for U.S. property catastrophe were **below** the levels of July 1, 2006 renewals. Given that nearly all other lines are experiencing rate decreases or renewing at expiry, we can now conclude that the U.S. reinsurance market overall has entered the soft phase of the cycle. If history is a guide, we can expect soft market conditions to persist for many years. This will be the “normal” state of the market.

However, as we go to press with this report, two developments have occurred that each have the potential to disturb the stability of the reinsurance marketplace. First, the fierce European Windstorm Kyrill is expected to cause insured losses between EUR4 billion and EUR8 billion ($5.2 billion to $10.4 billion). Severe winter storms pummeled the western and central parts of the United States, causing more than 50 deaths and widespread economic loss, including most of the citrus crop in California. Insurance losses already exceed $250 million in January alone. This is hardly a good harbinger of things to come.

Waves from Florida Legislation

Another development that likely will have an important impact was legislation passed in Florida, directed at fulfilling campaign promises to reduce rates by the governor and recently elected members of the legislature. The bill's main feature is the expansion in cover provided by the Florida Hurricane Catastrophe Fund (FHCF) from the current ceiling of an industry loss of $16 billion to a loss of $28 billion. Insurers will be charged rates at the average annual loss cost, a figure that is well below market rates. Insurers then will be required to file rates including the impact of the savings due to the expanded cover.

The act allows Citizens Property Insurance Corporation ("Citizens") to be more competitive in the marketplace by allowing it to charge "actuarially sound" rates, as opposed to the current rule of "no lower than the top 20 insurers."

The bill is long – more than 174 pages – but many of the measures (licensing of building inspectors, higher construction codes for the Panhandle and an "oath of truth" in rate filing) are likely to have minor impacts.

The legislation raises a number of troubling issues. The FHCF, apart from premium income, will be supported by the issuance, post-event, of bonds. This "play now, pay later" runs counter to the basic premises of the insurance and reinsurance system, namely spreading the risk now of future events. There is also concern that the Florida plan may be expanded to other states, leading to a major contraction of insurance and reinsurance markets.

Analyst VJ Dowling estimates that the expansion of the FHCF will reduce reinsurance premiums by between $1.5 billion to $2 billion. As reinsurers seek to deploy their capital, more competition can be expected in practically all reinsurance lines.

Florida may have inflicted a long-term wound on itself, as it pursues a strategy of lower rates and ignores the realities of the cost of risk in a flat, sub-tropical peninsula. Time will tell how serious this issue will be for insurers and reinsurers.

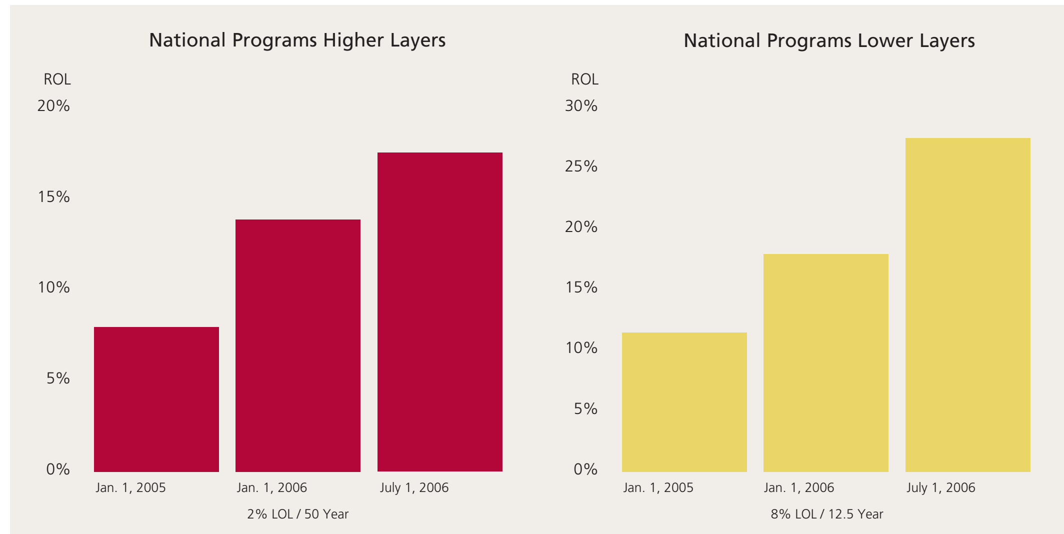
While this has not been a promising way to start a "normal" year in the reinsurance industry, let's hope that these latter events turn out to be mere speed bumps and that the rest of our journey this year is smooth.

Property

Property Catastrophe

Twelve months ago, the year-end renewal season for property catastrophe reinsurance was out of sync with the holiday season. Optimism and good cheer were extremely rare commodities. Following the industry's largest loss on record – Hurricane Katrina in August 2005 – capacity was tight and reinsurers' appetites for catastrophe-exposed business were greatly constrained. As the year progressed, things went from bad to worse as insurers and reinsurers came to grips with new realities of higher predicted storm activity in the North Atlantic, increased modeled losses and higher requirements for capital adequacy imposed by the rating agencies. The result: a near-horror story for summer renewals, with cedents in coastal-exposed regions vying for a limited supply of catastrophe capacity, and pricing for peak zones heading into the stratosphere.

ROLs Are Steadily Marching Upward From 1/1/2005 Through 7/1/2006



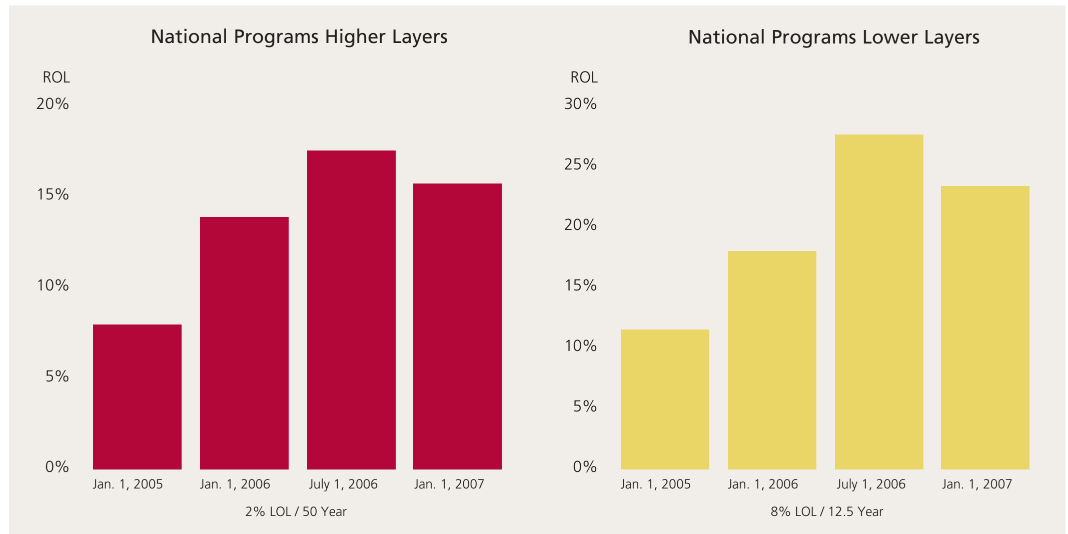
Note: LOL is model generated expected loss divided by reinsurance layer limit. We have chosen 8 percent and 2 percent as they approximate low and high reinsurance layers. We have also "equalized" modeled losses to enable comparison between different model versions.

Despite the difficult 2006 rate environment, as preparations began for upcoming January 2007 renewal activity, there were some very positive factors that gave rise to some optimism for the landscape to improve. Due to significant rate increases and a benign loss season, 2006 is likely to be a record year for industry profitability, and the industry benefited from an inflow of close to $40 billion since Katrina in 2005.

These factors converged to bring an extremely quick turn to the market that became apparent by the third week in December. After a brief stand-off with reinsurers who were holding onto their budgeted estimates for the January 2007 rates to mirror June/July 2006, the market acquiesced. Firm order prices that were between 5 percent and 20 percent below average quotations were being fully supported with authorizations that were significantly higher than the prior year.

As shown in the following charts, the program pricing for national companies declined from the July 2006 market peak. On average, the lower layers (8 percent LOL) reduced by 17 percent and the higher layers (2 percent LOL) reduced by 14 percent. Prices from the prior year are up (lower layers increased from January 1, 2006 by 28 percent and higher layers by 9 percent), but pricing is moving off the June/July peak as the exposure-adjusted pricing trend is clearly downward.

For January 2007, The Trend Turns



Note: LOL is model generated expected loss divided by reinsurance layer limit. We have chosen 8 percent and 2 percent as they approximate bottom and top reinsurance layers. We have also "equalized" modeled losses to enable comparison between different model versions.

The national companies did not make dramatic changes to their programs at this renewal period. The following chart shows that aggregated limits were up 12.5 percent and aggregated retentions increased by 15.1 percent. Despite these dollar increases, the model version changes actually drove program structures lower from a return period perspective. Average attachments reduced from one in 17 years to one in 10 years. Average program limits reduced from one in 86 years to one in 54 years.

Programs Shifted Up On A $ Basis But Not On A Modeled Basis

NATIONAL COMPANIES		
	2006	2007
Limit*	100%	112.5%
Attachment	100%	115%
RP Attach**	17.05	10.05
RP Exhaust**	86.72	54.71

**2007 increases indexed to 2006.*
***RP Attach/Exhaust in RMS 5.0 for 1/1/06 and in RMS 6.0 for 1/1/07.*

Each company included in the national account subset is engaged in a coastal exposure reduction campaign. Through policy cancellations and a host of underwriting actions, the main objectives of these campaigns are to reduce loss potential from hurricanes as expeditiously as possible. One of the reasons that limits did not increase as dramatically as might have been expected is the fact that companies have been diligent with these underwriting actions and expect their loss potential to be markedly lower at the start of the 2007 wind season than it is today, and more importantly than it was in 2005.

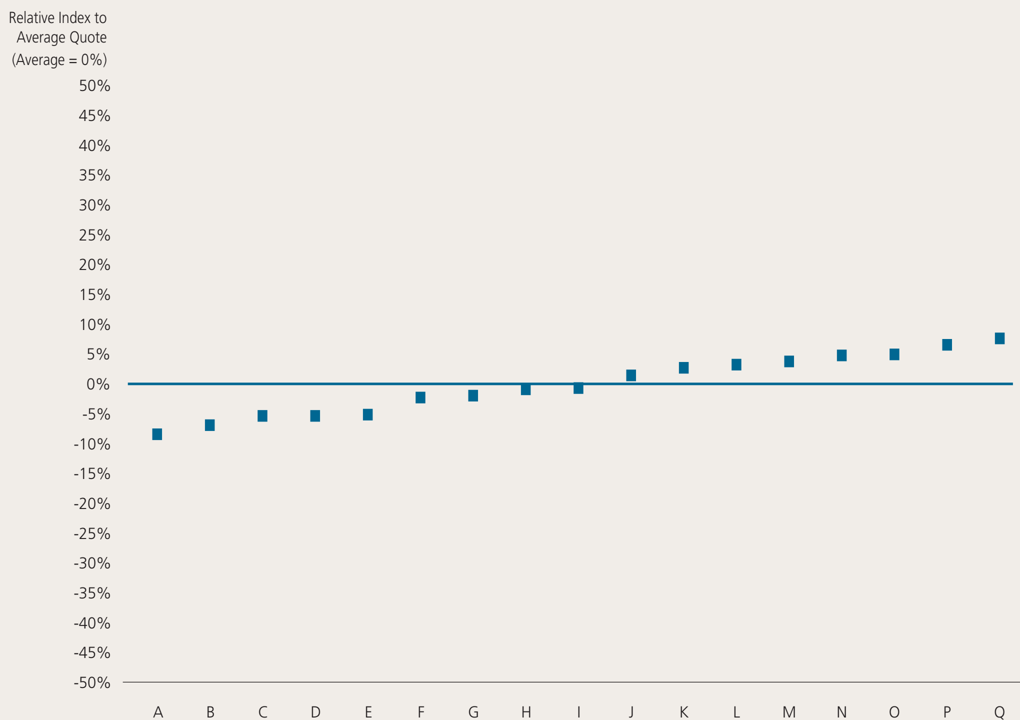
It will be important to monitor this activity as it is certainly conceivable that if some of the exposure reduction efforts stall, companies may return to the market to “top up” existing placements.

Reinsurers Quoting Behavior

A hallmark of a more stable market can be seen in the reduction in the disparity in reinsurer quotations. The wide range of quotes in January 2006 made it nearly impossible to draw any reasonable conclusions. The confusion over pending model changes and the anecdotal information about upcoming rating agency action meant that quantifying underlying loss expectancy and the capital required to support risk assumption was a matter of guesswork. All of this culminated in a very wide distribution of quotes around the mean. The following chart shows how order and consistency returned at January 1, 2007 renewals.

The chart ranks the average quotes of the most active quoting top reinsurers labeled A to Q. For each reinsurer, we have taken the average of their quotes for overall programs. We then compare their quotes to the market average for quotes from all reinsurers. Finally, we normalize the average market quotes to zero percent.

Average Quotes by Leading Reinsurers, 2007



Where a reinsurer, say reinsurer A, has tended to issue a quote below the average of the market, we get a negative average for this reinsurer. For reinsurers that tend to bid high, their average is above the line. The average quotes of each reinsurer were within 10 percent of the market average, a much tighter result than we observed last year.

On average, for Guy Carpenter's clients renewing at January 1, 2007, firm order terms represented 89 percent of the average of the quotations collected. In other words, firm orders were discounted 11 percent from the average of the quotations collected. In 2006, discounting from average achieved little response from reinsurers. It is important to bear in mind that even at these levels, capacity was plentiful enough to fill every order.

Authorized Capacity: What Reinsurers Gave This Year?

Not only did exposure-adjusted pricing soften, but capacity materialized in a very meaningful way, as shown in the following chart.

National Capacity Study Maximum Line Authorized by Region 2006 and 2007

MARKET	JAN 06	JAN 07	% CHANGE
Bermuda	628,410,000	794,884,500	26%
Foreign	177,075,000	183,450,000	4%
London	116,600,000	123,876,300	6%
U.S.	231,500,075	202,000,000	-13%
Hedge Fund	137,500,000	155,000,000	13%
Direct	59,500,000	75,000,000	26%
TOTAL	1,350,585,075	1,534,210,800	14%

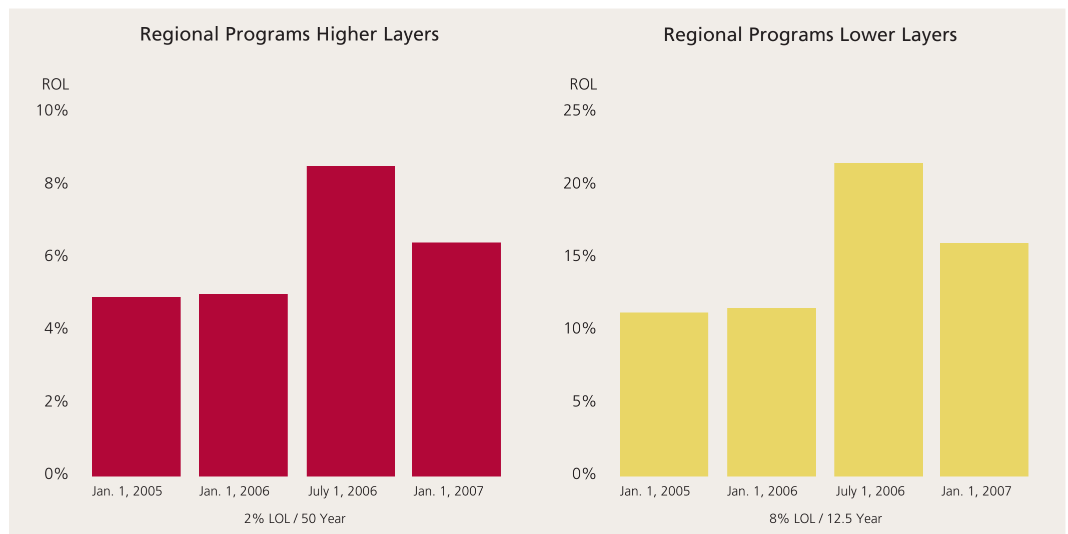
Maximum lines authorized increased by 14 percent over the past twelve months. Of note, more than 90 percent of the increase in line capacity came from Bermuda-domiciled reinsurers.

Bermuda represents almost 53 percent of the total limit for Guy Carpenter's January placements. That figure has grown from 45 percent in 2006. The U.S. based capacity appeared to have borne the brunt of that capacity shift as its share of the Guy Carpenter client portfolio reduced from 17 percent to 12.5 percent.

The growth in Bermuda placements reflects in large part the fact that Bermuda is the main beneficiary of the inflow of new capital into the industry post Katrina.

The story for the regional renewals was very consistent with the national accounts. The following charts track the pricing history of the Guy Carpenter regional portfolio. This subset includes business in wind-exposed territories, but not the Florida-only account.

Regional Programs See Reductions at 1/1/07



The average exposure-adjusted rates on line almost doubled in the first six months of 2006. This increase was compounded by the fact that regional companies were largely immune to the pricing change from January 2005 through January 2006. Reinsurers appeared to have made dramatic adjustments from January 2006 to July 2006. The program pricing for regional companies declined from the July 2006 market peak. On average, the bottom layers (8 percent LOL) reduced by 30 percent, and the upper layers (2 percent LOL) reduced by 29 percent. Despite this decline of the last six months, program prices relative to the prior year are up 29 percent at the bottom and 22 percent at the top.

Where Are We Headed?

For most parts of the globe, cedents of property catastrophe covers in 2007 should face a softening marketplace, assuming the Europe winter wind season leaves them relatively unscathed. The exceptions will be insurers with significant U.S. coastal exposures. In this market, the battle lines have been drawn between reinsurers and their brokers pushing for year-over-year rate decreases, with reinsurers looking to hold the line and, at worst, maintain the current rate levels.

For the remainder of the year, clients will recalibrate their renewal prices relative to the January 1, 2007 levels. This will become the starting point for negotiations. The question to be answered is whether reinsurers will be pushed to reduce rates even further to become year-over-year rate negative. For the most distressed markets of 2006, like Florida, we certainly expect that prices will come down from their June 2006 peaks. However, for the rest of the U.S. hurricane-exposed business, reinsurers likely will fight dearly to hold the line. Guy Carpenter continues to expand and improve the tools that we offer clients, enabling them to continuously refine their portfolios and reduce catastrophic loss potential as well as improve the transparency of their exposures to reinsurers. It is through these efforts that meaningful rate reductions may be achieved.

Property Per Risk Market

Year-End Summary at January 1, 2007

Unlike the turmoil and rate fluctuations of the property cat market, the per risk market has been very stable. Reinsurance pricing is directly linked to experience and exposure, so any movements can largely be anticipated. The December/January workload continues to be weighted towards smaller regional companies. The majority of clients' programs renew in the middle of the year.

Price

Exposure rates are again largely unchanged for non-catastrophe-exposed programs, but most have taken rate on line increases largely resulting from higher original premiums. Those companies with significant exposure to windstorm have seen some modest rate increases of up to 10 percent. Occurrence limits that generally were reduced at the previous renewal have remained unchanged this year.

Poor experience continues to be the main contributor to any substantial price increase. Some companies have taken increased retentions in order to control their reinsurance costs.

Capacity

There has been no identifiable reduction in capacity for the smaller programs. Retrocessional capacity remains scarce, expensive and increasingly restrictive, and most markets readjusted their portfolios to compensate for this at January 2006 and July 2006. As a result, we have seen little change in capacity this year. The total limit placed at year end 2007 is almost identical with that placed this time last year.

Terms and Conditions

Through 2006, there was some suggestion that exclusions for natural catastrophe perils might be imposed. This has failed to materialize, however, and there appears to be no immediate pressure from reinsurers for further coverage restrictions. It is conceivable that some cedents will agree to the exclusion of critical catastrophe coverage from their per risk treaties. Provided that they receive the appropriate price discount, and assuming that catastrophe excess of loss capacity is ample, cedents will evaluate the cost benefit of this trade-off. One thing that is here to stay is the requirement for detailed catastrophe aggregate data. Reinsurers are requiring model-produced exposure information, enabling them to model the exposure to per risk programs more accurately. Many cedents also have reduced their own sublimits for “critical cat,” meaning that higher layers are often in excess of these limits.

Markets and Orders

The majority of markets held maximum lines at expiring levels.

Orders have held up very well, with at least expiring capacity utilized. At renewals, we experienced several examples where London orders have been increased either to cater for withdrawals by domestic or Bermudian markets or because clients have cut shares from markets whose ratings have decreased.

Proportional Reinsurance Market

Compared to excess of loss business, it is harder to make generalizations about pro rata business, as a wide variety of terms exists within territories. It is not uncommon for major supporters of this business to view their proportional treaty support with reference to an overall assessment of the offering of the cedent.

In terms of the numbers of supporting participants, proportional treaty protection is a much less popular, and declining, line of business than excess of loss. Nevertheless, capacity for the business is sometimes provided in large shares from the major supporters. In the United States, where pro rata treaties are most likely to be used to protect against catastrophe perils, results have been good due to the absence of such losses during 2006. Despite these good results, there is very little additional capacity available in the peak zones, especially in Florida.

Commissions

Terms and conditions on pro rata treaties generally are decided on a treaty-by-treaty basis according to recent results and perceived profitability over the long term. These treaties are often seen on a more long-term basis than their excess of loss equivalents, and in most cases, movements in terms therefore tend to be limited. Reinsurers thus were willing to grant commission increases where warranted by results but conversely looked to tighten terms following poor experience.

Event Limits

In general, event limits remained unchanged. The method of calculation of event limit varies according to the custom and practice of each territory. In some cases, key zone aggregates are used and the event limit is based on a probable maximum loss (PML) calculation. In other cases, the limit is expressed as a multiple of ceded income.

Markets

The traditional pro rata market is generally the domain of established players whose capacity tends to remain stable from year to year.

There are few new entrants to the market, with the London and Bermudian markets tending not to view pro rata business as particularly attractive. The possible exception to this rule is on catastrophe-exposed treaties, where sufficient premium can be generated to enable these reinsurers to view the business on an ROL basis (in a net premium to event limit calculation). Examples are treaties covering coastal business in the United States or Caribbean accounts.

As property insurance rates remain at historically high levels for catastrophe-exposed business, there is a growing level of interest from reinsurers to evaluate pro rata relationships. Their strategy is to pick partners that are key players in a certain market segment in hopes that they can share in the expected profits. The negotiations have largely centered around the amount of catastrophe protection that is provided. Cedents are not inclined to give away expected profits without a meaningful amount of catastrophe protection. We have seen this trend surface in the Northeast personal lines market.

Property Retrocession Market

The hurricanes of 2004 and 2005 hit the retrocessional market hard, and conditions for the traditional retro product continue to be tight. However, a number of developments have occurred in the past year or so that have alleviated some of the strain in this marketplace:

> Reinsurers have taken an aggressive approach toward reducing their need for retro cover by reducing their aggregate exposures in peak zones.

> Reinsurers have made increasing use of industry loss warranties (ILWs). An ILW is a financial instrument designed to protect reinsurers from losses for significant defined events, typically natural disasters. Payouts under these index-based instruments are triggered when the level of industry-wide insured losses for a particular event exceeds a pre-defined threshold.

> Sidecars, which are entities set to share insurance or reinsurance risks, also have played a role in allowing reinsurers to expand their capacity.

> Newer index products, such as SelectCat, created by Guy Carpenter, have provided capacity to reinsurers. The Guy Carpenter product is a customized index product based on a reference portfolio that represents the client's entire portfolio.

SelectCat is an index-based protection where the pricing and loss index is developed from a synthetic layer. This layer is structured for a basket of programs, which the client "selects," that acts as a proxy of the portfolio that they wish to protect.

This customized index approach adds value to the property catastrophe insurance/reinsurance supply chain in several key ways:

> Retains the indemnity feature of insurance protection.

> Allows the buyer to actively manage its portfolio.

> Brings transparency of data and better exposure control for the seller.

> Gives capital markets the comfort level to write a portfolio that fits their risk appetite, through the resemblance of CDO (Collateralized Debt Obligation) to how SelectCat is structured.

Casualty

Casualty Catastrophe and Clash

Pricing for casualty catastrophe and clash covers was relatively stable at January 1, 2007 renewals. Reinsurers continue to have a super-regional preference and less interest in national account business, especially with regard to professional liability exposures. Average market capacity is also stable at around $5 million, with both larger and smaller exceptions up to $35 million. Estimated market capacity remains around $200 million, without Berkshire Hathaway.

Casualty catastrophe and clash business has not been an area of expansion or of interest to new market entrants and existing players. However, there are a handful of reinsurer exceptions that are actively pursuing new business in this area. Overall, this area of reinsurance remains relatively stable. We have seen a slight increase in insurers' interest in purchasing this product, especially for professional liability exposures.

During 2006 a survey conducted by Guy Carpenter provided the following market indicators:

> 75 percent of the reinsurers will consider including terror in regular contracts. Generally, reinsurers prefer to exclude nuclear, biological and chemical, but may cover radiation.

> About 50 percent of the reinsurers will consider providing sunrise coverage, but usually on an exceptional basis.

> Nearly 50 percent of the reinsurers will consider covering a property extra-contractual obligations/excess policy limits (ECO/XPL) loss.

Contract wording is a very important part of securing appropriate cover. There are almost always some issues with the standard clash type wording of “series of events arising from a common cause.” Alternatively, there is the wording where the cedent is a “sole judge,” which is clearly much better but difficult to secure in the current market.

Directors & Officers (D&O) and Financial Institutions Errors & Omissions (FI E&O) Liability

We saw relatively stable year-end renewals across the board in the D&O and FI E&O segments. Despite continued D&O insurance rate reductions, there were modest improvements for most programs. This took the form of increased ceding commissions, expanded loss ratio caps or the reduction of loss corridors. Relaxation of contractual exclusions or other underwriting restrictions was limited.

These improvements were earned based on reinsurers’ (mostly begrudging) acknowledgment of an improving loss picture for recent accident years, and not just on the dramatic reduction in securities class actions in 2006. The reduction in class action frequency was offset in part by the explosion of derivative litigation related to issues surrounding option pricing at more than 150 companies. More than 100 derivative cases have been filed so far, and while typical settlements are a fraction of shareholder class actions, there is some concern as to whether that will change and plaintiffs will become more successful in accessing the heretofore lucrative Side A insurance product. (Side A provides liability cover to directors and officers.)

FI E&O was not impacted by a systemic event for the second consecutive year, which drove reinsurers’ stable treatment of this business when on a standalone basis or blended in larger D&O and E&O treaties.

Notably, three major D&O and FI E&O cedents attempted material changes in structure. For the most part, the decisions were not driven by expectations of softening reinsurance pricing, but rather cedents' desires to consolidate lines of business or retain more premium. Two of the three were successful in restructuring.

While no new D&O reinsurance capacity is visible on the horizon, several existing markets authorized increased lines at January 1, 2007 renewals. We did not see a material pullback in capacity on any treaty or from any reinsurer.

The D&O and FI E&O reinsurance renewal season evolved as expected. The market is waiting for a major event to dictate a course for the future in the face of positive experience and negative insurance rate change.

Employment Practices Liability

Reinsurance terms for employment practices liability (EPL) did not change measurably at January 1, 2007 renewals. Most treaties were renewed as expiring, as long as results did not deteriorate over the past year.

This is particularly the case for cedents focused on the large employer segment (more than 7,500 employees), where older claims have begun to settle and new exposures are arising. Reinsurers are increasingly cognizant of not just primary rate levels, but also deductible levels being used and the jurisdictional exposures within a portfolio. The last point is especially true for multinational firms that have a significant U.S. employee presence and increasing exposures in foreign countries (United Kingdom and Continental Europe). Reinsurance capacity did not change in 2006, and we do not expect a change in 2007.

Cedents that target smaller insureds (fewer than 7,500 employees) continue to be treated favorably by reinsurers. While the vast majority of these cedents reinsure EPL within their larger professional liability treaties, reinsurers typically select a lower loss ratio (compared to public D&O) for this line. Accordingly, this lower loss ratio helps to improve overall treaty terms, particularly if the EPL line has meaningful premium volume. Capacity is certainly available and reinsurers are willing to write EPL on a standalone basis.

Errors & Omissions (E&O) Liability

At January 1, 2007 renewals, similar to the overall professional liability marketplace, E&O reinsurance terms and conditions improved incrementally. The main area of concern for reinsurers is the deterioration in original rates for small- to mid-sized insureds. This is being driven in part by the profitability of this segment over the past two years and by the increase in primary insurance capacity that is targeting these insureds. There are three sources for the increase in capacity:

- Current commercial writers looking to expand their own writings through entry into other E&O lines of business and new product development.
- New operations set up by a variety of London and/or Bermuda markets that have established or expanded their U.S. E&O operations.
- Increased interest in managing general agent (MGA) or managing general underwriter (MGU) produced E&O business.

While there has been increased competition in the E&O insurance marketplace, reinsurers have recognized that small and mid-sized accounts present different exposures than large accounts. That is why reinsurers continue to heavily scrutinize the lines of business and size of risk composition of each E&O treaty. There continues to be ample reinsurance capacity for E&O treaties comprised of small to mid-sized, less complex risks, whereas treaties with an overweight of large accounts and/or high hazard classes are viewed skeptically. E&O treaties comprised of small to mid-sized, less complex risks with quantifiable positive results continued to receive incremental improvements in terms and conditions at January 1, 2007 renewals.

Those E&O treaties comprised of predominantly large risk business and/or with material exposure to problematic E&O classes were renewed at per expiring terms. Problematic classes include law firms with more than 175 attorneys, Big Four and Tier Two accounting firms, actuarial and pension consultants, project A&E policies and large technology risks. The reinsurance structure and balance inherent in the portfolio also influence final reinsurance terms. Treaties in this category could have one or more of the following restrictions in place: limitations on the number of large limit policies that a cedent can write, minimum pricing requirements and/or attachment point levels and the size of insured restrictions for classes of business. Reinsurance capacity in this E&O segment remained available, but terms are tighter than for smaller account business.

Medical Malpractice Liability

Pricing

We observed flat to negative changes in reinsurance rates for physicians and hospitals, with the exception of accounts that experienced unusual loss development in the reinsurance layer.

Losses are benefiting from favorable frequency trends, which ranged from flat to slightly negative.

On the other hand, filed physicians' severity trends range from the mid- to high single digits and are slightly higher for hospitals. Reinsurance pricing contemplates the higher end of the severity trend range for hospitals. In some jurisdictions, pricing has forced physicians to purchase lower limits or go without coverage. This has given some insurers concern about possible increased hospital exposure and may be reflected in pricing.

Retentions and Limit/Capacity

Perceived profitability and reserve adequacy has led some insurers to increase their retentions. In some cases, insurers have increased their gross capacity and benefitted from renewed reinsurer interest in medical malpractice.

At January 1, 2007 renewals, some existing reinsurers expanded their lines. In addition, there were other reinsurers that, while not historical participants in the medical malpractice market, are now in the exploratory mode.

The alternative market has grown significantly since 2002. Reinsurers continue to be very interested in supporting large physician and hospital groups that have opted to self-insure through an alternative risk vehicle. There is less capacity for start-up risk retention groups without a sponsoring insured group. Consequently, it is incumbent on these organizations to exhibit a superior business model.

Changes in Terms and Conditions

Overall, terms and conditions remain relatively stable for the 2007 renewal season. However, there has been some liberalization in reinsurers' requirements for loss ratio caps and extended reporting period limitations.

Batching separate patient claims under the same loss event (e.g., bacteria in the pediatric ward infecting multiple babies) is an emerging coverage issue for hospitals, physician groups and their insurers. With significantly increased retentions, batch claims can result in a catastrophic event.

Occurrence form capacity remains available for legacy writers but not for insurers looking to buy their way into a new market.

Other Comments

For long-term care business and managed care liability, there continues to be an increased reinsurance appetite for these formally "taboo" segments.

For excess hospital placements, this past year has witnessed greater pressure to liberalize the retentions towards aggregated underlying amounts coupled with unaggregated maintenance deductibles. Reinsurers continue to closely watch this development.

Continued reinsurer appetite, terms and capacity will be dependent on two key developments during 2007. The first is the underlying pricing/terms for the ceding companies. While most of the market has recognized that the primary medical malpractice market is softening, the real question is how much and how fast. To the extent the primary market can adequately hold rate and terms, reinsurer appetite should continue to expand.

The second development relates to the significant amount of tort reform passed at the state level since 2003. Reinsurers have minimally contemplated tort reform in their pricing. To the extent that tort reform is upheld judicially (pending cases in a number of states), we believe reinsurers will fully integrate the reform impact into their pricing. If reforms are not upheld, the expectation is that the immediate impact on reinsurance terms will not be severe, given that the reforms have not been given full credit to this point.

Workers Compensation

Primary Market Conditions

Primary rates for workers compensation continued to soften in 2006. According to a recent Council of Agent and Brokers Study, about 70 percent of policies renewing in the first three quarters of 2006 received rate decreases. However, a robust job market and wage inflation offset the rate decreases. The result was an estimated 5 percent growth of total workers compensation premium in 2006 to approximately $40 billion.

Experience continues to be good, with reforms in key states and continuing positive trends in loss frequency contributing to improving accident year and calendar year loss ratios over the past four years. In 1997, the Bureau of Labor Statistics reported 7.1 injuries per 100 full-time employees. The most recent study reports 4.8 injuries per 100 full time employees. Many in the industry felt the decrease in frequency was limited to the smaller claims that typically would fall below the working layer reinsurance retentions. Enhanced safety measures, the export of manufacturing out of the United States and full employment are likely all contributors to this decrease. In 2006, the National Council of Compensation Insurance (NCCI) reported that the drop in overall claim frequency was observed in medium and large claims across all employment categories.

While the current workers compensation market is showing favorable results, there are several factors that contribute to the uncertainty of continued profitability:

> renewal of the Terrorism Risk Insurance Act.

> medical inflation and utilization.

> increased competition within the line.

> pushback/erosion of reforms.

> aging of the workforce.

Reinsurance Pricing

Reinsurance industry catastrophe losses from 2005 did not result in significant workers compensation reinsurance rate increases in 2006, as threatened earlier by several reinsurers. In fact, many clients saw their reinsurance rates and/or the corresponding rate on lines decrease throughout the 2006 renewals.

Client subject premium estimates for 2007 tended to be increased for regional and specialty insurers and flat to down for larger and national carriers. Carriers with significant historical California exposures have experienced rates decrease by approximately 50 percent in the last three years, resulting in subject premium decreases due to both the rate decreases and increased competition.

As detailed below, the options for workers compensation reinsurance programs have increased in the past three years. There are very few programs that have remained unchanged in the last three renewals, which would be necessary in order to gauge the pure changes in reinsurance pricing. It generally is felt that catastrophe pricing continues to decrease, and at the same time, clients have an increased ability to enhance terms and conditions. Where clients projected moderate subject premium increases, the ROLs lowered slightly or at a minimum remained constant, corresponding to a reinsurance rate decrease. Several programs received ROL indications at or below 2 percent for upper catastrophe layers, which in previous years had been deemed the “floor.”

Reinsurance layers that respond to single claimant losses are often referred to as “working layers.” Where there are 10 to 15 potential lead catastrophe reinsurers, the number of lead working layer reinsurers has been limited to five or six in recent years. The 2007 working layer renewals benefited from reinsurers’ increased interest in working layers, which is likely a result of a combination of:

> improved direct loss ratios for workers compensation.

> improved investment returns (which are key in working layers).

> reinsurer diversification strategies.

Capacity

Standard workers compensation reinsurance market capacity for catastrophe programs is in excess of $1 billion. While this would suggest that this market is saturated with reinsurers, it is not that the number of reinsurers has increased significantly in recent years as much as the individual capacity for each reinsurer has increased. About 90 percent of the total ceded workers compensation reinsurance premium (through Guy Carpenter) is ceded to 20 reinsurer groups. A limited number of the new (post-Katrina) reinsurers are actively participating in the workers compensation reinsurance market. As these new reinsurer platforms continue to develop, we expect a few additional reinsurers to actively enter the workers compensation reinsurance market.

As mentioned earlier, there is a welcome increased interest of reinsurers in working layer reinsurance. Start-up and small- to mid-sized insurers should benefit from this increased interest. Working layer structures may incorporate aggregate deductibles, annual aggregate limits and other features that are incorporated to concentrate the transaction on the more significant volatility within the layering.

The ability to measure the cost benefit/efficiencies and create a distribution of potential outcomes in working layers has been enhanced in recent years with the addition of exposure-based analysis through the use of models, including the Reveal™ model, developed and maintained by Guy Carpenter.

With the tools to measure volatility, a stable primary market and a reinsurance market more willing to deploy, we expect to see an increase in the number of bound working layer agreements in 2007.

Limit and Retentions

Workers compensation reinsurance limit and retention strategies tended to fall into two categories:

- Increased retention and the use of savings to purchase increased limits.

- Stable or minor adjustments in retention and limits, based on market pricing, and improvement in terms and conditions.

Clients that historically have focused their reinsurance strategies on retention levels are widening their focus to include the overall limits purchased. Improved exposure accumulation data sets and the use of workers compensation catastrophe models (natural hazard and terrorism) are gaining more acceptance. The rating agencies are also requiring additional details regarding exposure to catastrophes and reinsurance limit purchasing strategies.

Total reinsurance program limits will continue to be reviewed (and adjusted) as exposure data develops and catastrophe model adjustments/refinements are made. Companies will need to be able to readily track and access this information throughout the year.

Terms and Conditions

The most significant development in workers compensation reinsurance programs over the past few renewals are the options for terrorism coverage. A majority of the 2002 reinsurance renewals were subject to an absolute exclusion for terrorism. As the Terrorism Risk Insurance Act deductibles increased and the uncertainty of TRIA continued beyond the original three-year term, insurers and reinsurers found middle ground, and coverages developed.

Today, there is still limited (and expensive) capacity for nationwide terrorism coverage, including nuclear, biological, chemical and radiation (NBCR). However, capacity for limited geographical footprints for NBCR losses is gaining momentum, and several clients sought NBCR options from reinsurers at January 1, 2007 renewals. The number of bound transactions, including enhanced terrorism coverages, and the number of reinsurers supporting the programs increased at January 1, 2007 renewals. Terrorism coverages either were incorporated into existing catastrophe structures or placed in separate terrorism towers.

Workers compensation catastrophe agreements include a maximum any one life (MAOL) limitation/warranty. Typical MAOL warranties in catastrophe programs have been $5 million or less. Over the last few renewal seasons, reinsurance capacity for increased MAOLs ($7 million and $10 million) has increased at a price acceptable to clients.

Outlook

Early indications are that the 2007 primary workers compensation insurance market will show good overall results and likely will attract attention from carriers seeking to increase their participation in the good results. However, the cyclical nature of workers compensation, the long tail of the claims/exposures and various factors that produce uncertainty within the line will be constantly monitored by insurers and reinsurers to evaluate the state of the market.

Advancements in medical technology also can cause an upward spike in workers compensation costs. An example of such may appear from rapid development (and funding) of the next generation of artificial limbs and developments in treatment of head injuries, both tied to the injuries sustained in Iraq and Afghanistan. Where traditional healthcare programs have the ability to control some of these potential increased costs, the workers compensation system is not as well equipped to control access to the new technology (and likely increased costs of treatment).

There is also an emerging discussion surrounding pandemic and workers compensation exposures. Workers compensation statutes vary by state, and compensability for pandemic losses will need to be evaluated and reinsurance solutions investigated.

Casualty Facultative

Buying Habits

The ongoing trend is for fewer facultative purchases by carriers, as they increased retentions on what they believe are profitable rates. When they do purchase fac, they predominantly are not motivated by price. Instead, purchases reflect more traditional concerns on exposures and accumulations.

Line of Business

Auto Liability

In general, renewal pricing ranged from flat to 5 percent to 10 percent reductions. On large trucking risks, ceding companies were willing to reduce rates even further for favored accounts. The broker fac market typically is supportive of small rate reductions but occasionally will support more dramatic reductions for the “right” account.

General Liability/Products Liability

Increased market capacity here allows more aggressive pricing. Excess and surplus (E&S) marketplace rates are down 5 percent to 15 percent on average.

Workers Compensation

There is an increasing disconnect between primary market and reinsurers. Statutory rates are down significantly in certain areas, but the fac market is reluctant to follow. The middle market is becoming increasingly competitive with more liberal use of dividend plans. Larger, risk management-type accounts can be renewed at a flat to 5 percent reduction under the right circumstances.

Professional Liability

Rates are continuing to drop as much as 20 percent in certain cases, although for the most part, facultative reinsurance support remains.

Attachment Points

There is a continuing upward movement as cedents become increasingly comfortable with larger retentions. More and more placements are above $2 million on all lines. The $500,000 x $500,000 layers still were placed but with decreasing frequency.

Reinsurance Capacity

Workers compensation capacity is shrinking, particularly in larger layers. Auto liability capacity in longer layers (e.g., $3 million xs $2 million) also was reduced, particularly by direct reinsurers.

General Liability

Bucking trends, there was additional general liability/product capacity from the facultative market. Many reinsurance markets perceived profit opportunities in this line.

Professional

There was greater interest from markets, with several broker fac markets setting up dedicated professional underwriting units.

Umbrella

There was little to no additional capacity, with the most activity in leading layers of $5 million to $10 million.

Reinsurance Rates

For auto liability renewals, a flat to a 10 percent reduction was typical. However, for the "right" account (e.g., with good experience and no hazardous goods hauled), rate reductions of about 20 percent have been supported by certain reinsurers.

The mid-market often experienced greater price competition. In workers compensation, there was a disconnect between the primary and the fac reinsurance market, with reinsurers holding their ground on this line more often than the primary market.

Umbrella renewals were mostly flat. There was more general liability capacity from reinsurers, allowing rate decreases if desired by ceding companies, since they have more reinsurance support.

Summary

The pricing disconnect between the primary market (softening) and fac reinsurers (firm to hard) remains in most cases. This increases the likelihood that ceding companies will increase their net retentions, as reinsurers are unwilling and occasionally unable to support primary market pricing.

The casualty facultative broker market is starting to accommodate some price reductions, although not on a wholesale basis. These price cuts were more account-specific. Companies and reinsurers are more competitive on a relative basis on new business than renewals. Carriers rarely are requiring fac support as a condition precedent to pursuing an account. Cedents are much more willing to bind an account and then see if casualty fac support can be retrofitted or backfilled.

Accident and Health

Life and Personal Accident Catastrophe Reinsurance

Pricing

Since 2002, the life and personal accident catastrophe reinsurance marketplace has been inextricably linked to the property and casualty (P&C) catastrophe marketplace. With few exceptions, the same reinsurers that write life and accident catastrophe reinsurance also assume property catastrophe and workers compensation catastrophe risk. Accident and health and P&C writers often compete for finite earthquake and terrorism capacity, which places pressure on reinsurance premiums. Entering 2006, there was some concern that the 2005 hurricane season would cause upward pressure on life and accident catastrophe premiums. However, positive signs emerged over 2006, and reinsurers have shown they are willing to further differentiate between the more exposed P&C lines and life and accident lines. A more benign hurricane season in 2006 supported this trend.

Broadly, but not universally, catastrophe pricing decreased at the January 1, 2007 renewal season, especially for U.S. carriers. The largest pricing relief was experienced on U.S. full terrorism, including nuclear, biological and chemical (NBC) layers in excess of $50 million. Several programs experienced 10 percent to 20 percent rate decreases, as key reinsurers dropped their minimum ROLs for NBC on nationwide portfolios. This trend was supported by reinsurers' appetites for authorizing larger lines. Savings on layers under $50 million were less pronounced, with discounts on renewal generally less than 10 percent.

Reinsurers have become more sophisticated in their approaches to writing portfolios, translating into lower pricing for risks that are regional in nature and with no exposure to target terror cities or California earthquakes. Quality exposure data continues to differentiate insurers and increase transparency. Minimum capacity charges approached 1 percent ROL for pure U.S. NBC coverage and 0.80 percent for non-U.S. coverage. It should be noted, however, that the lower end of the NBC pricing scale generally is reserved for books considered less exposed (i.e., small group writers, individual life writers, low face amounts, non-terror- and earthquake-exposed regional writers and high excess layers).

Overall, ex-NBC programs experienced price reductions of up to 15 percent, although most were in the single digits. Generally, the higher the limit purchased, the less elastic the pricing, as overall capacity remained relatively tight. In general, pricing differentials for NBC and ex-NBC coverage illustrate an average NBC surcharge of an additional 1.8 percent to 2.5 percent rate on line.

Retention and Limit

In response to pricing after the terrorist attacks of September 11, 2001, insurers purchasing life and personal accident catastrophe reinsurance have become increasingly comfortable holding larger retentions. At January 1, 2007 renewals, however, most programs maintained expiring retention levels. Less than 10 percent increased their retention (but only slightly). Full terrorism program retentions average in the $15 million to $20 million range per occurrence, with the largest programs retaining in excess of $50 million. Programs that exclude NBC generally attach lower, in the $3 million to $10 million range. Retentions vary widely from program to program, reflecting the buyer's risk profile and portfolio characteristics.

In 2007, the average limit for ex-NBC coverage actually decreased as more companies shifted to purchasing NBC coverage. One-third of the companies that previously bought NBC coverage increased their limits purchased, taking advantage of additional capacity at reduced pricing. While a few insurers have expressed interest in obtaining limits in excess of $500 million per occurrence, including NBC coverage, the largest programs remain in the $200 million to $300 million range. In the United States, the average program size is approximately $80 million for NBC coverage and $50 million for ex-NBC coverage, with a wide range of limits purchased depending upon portfolio characteristics. More sophisticated methods of accumulation modeling, increased scrutiny from rating agencies and enterprise risk management also have stimulated interest in catastrophic protection.

Capacity

Capacity for both full terrorism and ex-NBC coverage has increased steadily since 2001. In 2006, several reinsurers continued the trend of 2005 and increased their maximum line size, with several now authorizing $20 million or more per program. The ongoing interest that the capital markets have displayed in reinsurance contributed to additional capacity. Total capacity is split fairly evenly between reinsurance markets in Bermuda, Europe, London (both Lloyd's and the company markets) and North America.

In 2006, we also saw the entry of some new traditional reinsurance capacity in North America, Bermuda and London. As these companies continue to build infrastructure and staff, their interest in alternative lines of catastrophe business, such as life/personal accident, is likely to increase. Capital markets also showed the willingness to provide significant capacity to Guy Carpenter's largest clients. In 2007, we expect up to $1 billion of capacity to be available for capital market transactions.

Terms and Conditions

Most programs have been successful in removing restrictive radius limitations in loss occurrence definitions that were present after the events of September 11, 2001. No other broad changes to terms and conditions were evident in 2007. Though some narrow and esoteric changes were observed, they generally are attributed to larger carriers enforcing corporate wording standards.

Pandemic

The potential for a pandemic outbreak, and the heightened awareness of the avian influenza in particular, created considerable interest on the part of life and health insurers in the last year. The U.S. Department of Health and Human Services estimates that 1.76 million U.S. residents could die from an avian flu pandemic. Standard & Poor's has predicted that insurance industry losses could reach $200 billion worldwide in a worst-case scenario. A recent report from the Congressional Budget Office suggested a pandemic would last for three months and 30 percent of the American workforce could become ill.

These alarming statistics are of concern to risk managers because traditional catastrophe reinsurance is intended to protect against sudden and accidental death, not death due to sickness and disease.

The number of reinsurers actively quoting pandemic catastrophic reinsurance has increased gradually over the past 12 months. In addition, the capital markets have taken a keen interest in supporting our clients' programs. Maximum reinsurance capacity is nearly $250 million per program, and capital markets capacity is approaching $1 billion. Pricing has fallen, as key lead reinsurers better understand the risk. Rate on line pricing has generally been in the 4 percent to 8 percent rate on line range, with some programs even more competitively priced. Guy Carpenter is pleased to be at the vanguard of reinsurance and capital market pandemic solutions and will look to drive convergence on pricing, terms and conditions in the year ahead.

Medical

Capacity and Pricing

The medical reinsurance market for both quota share and excess of loss reinsurance continued to remain stable over the past year and for the January 1, 2007 renewal season. One new medical reinsurer entered the market in 2006, and none have exited. Reinsurers continue to grapple with eroding margins resulting from poor experience and rate competition. This was especially true in the excess of loss segment of the business, where there was more account movement and competition between reinsurers.

The consistent state of medical reinsurance capacity has resulted in a relatively stable and competitive pricing environment. Although medical excess of loss reinsurance pricing became more competitive, it generally remains commensurate with ground up and leveraged medical trend. In addition to the usual low frequency, high severity claims (e.g., organ transplants, burns), the $1 million xs $1 million layer has experienced new loss activity generated from complications in newer treatments and procedures including gastric bypass surgery, diabetes and dialysis. The frequency of these claims continued to increase throughout 2006, and we may expect high medical excess layers to see significant rate increases in 2007.

Although catastrophic terrorism risk continued to be a concern for writers with heavy urban concentrations, very little occurred in the marketplace in 2006 with regard to actual programs purchased. Pricing and capacity for medical terrorism reinsurance remained competitive and stable. The potential for a pandemic outbreak, and the heightened awareness of the avian influenza in particular, has created considerable interest on the part of health insurers in the last year (see the "Pandemic" section on page 21). However, due to the lack of new developments over the past two migrations, the perception of the immediate concern has decreased to some degree.

Retention and Limits

Maximum treaty limits remain constant and reflect the lifetime maximums of the underlying policies. Excess of loss retentions continue to gradually increase as the underlying loss activity grows. In addition, many of the large insurers attached at higher levels, which provided them greater underwriting flexibility and thus created the opportunity to gain market share from smaller, less flexible MGUs. Quota share retentions remain fairly static, with reinsurers willing to consider 90 percent quota share arrangements.

Terms and Conditions
Terms and conditions for both excess of loss and quota share reinsurance remain reasonably constant. For MGUs, underwriting guidelines have stayed tight as they struggle to maintain premium volume year over year. Reinsurers continue to push for better notification of potential losses during the quotation process, especially on excess of loss programs. Lasering high-risk insureds remains to be a common practice for which additional pricing cannot compensate.

Disability

Pricing
Rates, terms and conditions continue to harden on both the primary and reinsurance sides of the disability business. These price increases, along with the tightening of contract terms, are the result of negative profitability trends. These trends are due to higher incidence, decreased terminations, lower investment income, the churning of existing disability business and limited reinsurance and retrocession capacity.

The group disability market is expected to continue producing ROEs in the mid-single digit range for the foreseeable future, considering current trends in the macro environment. Consequently, traditional disability reinsurance markets are likely to take a conservative approach to renewing in-force books of business. Additionally, demographic trends such as the aging of America, obesity and the shrinking skilled labor pool also are likely to present significant risk management challenges for all players in the disability insurance and reinsurance industries.

Retention and Limit
Maximum treaty limits remain capped at $25,000 to $30,000 per month per life. Retentions, on the other hand, are increasing for primary disability writers as a result of higher reinsurance renewal rates and tighter terms and conditions.

Capacity
Group disability reinsurance markets can be split into two general categories: private label/turnkey and automatic. Each segment is experiencing a retraction of capacity from both a lead and retrocessional reinsurance perspective, and the full impact of this trend will continue developing in 2007 and beyond. The shrinking of capacity and market consolidation will enable the remaining disability reinsurers to firm up pricing, terms and risk management parameters.

Terms and Conditions
Complex group disability market dynamics require disability reinsurers to design creative solutions to meet the needs of primary writers. Some of these reinsurance products include protracted reinsurance rate guarantees, market segment-specific arrangements, swing plans, structured reinsurance products, reserve buyouts and participating contracts. Traditional reinsurance markets historically have been slow to respond to these needs. However, some progress is being made.

Many disability reinsurers are moving away from a percentage of gross written premium pricing basis toward exposure, monthly indemnity and bifurcated SIC-based pricing to account for shifts in the primary writer's business mix. Increased data requirements for new pricing protocols are expected to result in an additional administrative burden for many disability insurers.

In addition to reinsurance price and market security, cedents have come to expect value-added services as part of the reinsurance partnership. These are including but not limited to actuarial, claims management, underwriting, product development, research and training services. Additionally, cedents are demanding guaranteed service days and web-based administration.

Product Development

Existing per person and excess of loss reinsurance treaties are not meeting the needs of some major long-term disability (LTD) writers. These companies are interested in earnings volatility protection. Guy Carpenter's Accident & Health Specialty Practice is working with industry partners to create reinsurance capacity and achieve convergence on such coverage.

Life and Annuity

Pricing and Capacity

Slowing improvements in mortality rates, increased expenses, adverse lapse results and a limited base of retrocessional reinsurance capacity have all contributed to increases in reinsurance rates for individual life and annuity insurers. Legacy reinsurers are wielding increased pricing power as the majority of in-force business ceded is now concentrated in the top five life reinsurance companies. The consolidation of reinsurers has presented a dilemma to some primary insurers. When two reinsurers in an existing pool merge or financial security issues arise with reinsurers, the cedent must choose between allocating a higher percentage to the combined entity and adding a reinsurer with potentially weaker market security or fewer services and capacity.

Despite hardening market trends, life insurers continue to utilize first dollar quota share reinsurance to meet capital needs resulting from Regulation XXX and AG 38 on level term and universal life contracts with no-lapse guarantees. Where unauthorized domestic reinsurers and offshore accredited reinsurers are used, a shortage of collateral capacity has kept pricing firm. The constrained credit markets may have difficulty supporting the future collateral needs of direct writers. U.S. and European regulators have discussed possible solutions, but most recognize that it will require a long and tedious process to bring meaningful resolution. Recent events around principle-based reserving are encouraging.

Although there is interest from the largest companies to utilize the capital markets, the cost, complexity and lack of flexibility relative to traditional reinsurance markets remains a barrier. Despite the growing use of capital market solutions, most direct writers may not find them feasible to deal with reserve strain. Some companies are internalizing the strain by raising retentions until changes in the reserving requirements are implemented.

Due to the low interest rate environment, there is little annuity reinsurance for fixed rate products. Variable annuity reinsurance for living benefits and guaranteed death benefits is increasing, although slowly and with limited coverage. Recent poor results in the variable annuity reinsurance market are still having a dampening effect on the entrance of new players.

Hardening life reinsurance markets have attracted competition, as evidenced by several new market entrants in the last two years. These new entrants compete on the basis of pure reinsurance capacity rather than the full-service platform that traditional markets have historically offered. Some reinsurers have recently offered more competitive pricing. These moves are likely the result of the reduction in primary demand for reinsurance (see the Society of Actuaries' *Survey of the Life Reinsurance Market 2006*) as well as the erosion of some reinsurers' market share in the last two years. As these trends continue, pricing may continue to become more competitive.

The potential for a pandemic outbreak and the threat of terrorism continues to loom over the industry, further inhibiting pricing relief (see the "Life and Personal Accident Catastrophe Reinsurance" section on page 20).

Retention and Limit
Life companies are increasing their share of proportional reinsurance retentions. This is primarily due to increased reinsurance costs but also because of their improved capital positions. As proportional retentions have risen, there has been a corresponding increase in the use of non-proportional reinsurance structures, such as stop loss protection, excess of loss coverage, catastrophe reinsurance and other financial risk management tools.

Terms and Conditions
Reinsurers continue to tighten terms and conditions and have attempted to insert more onerous clauses in new treaties. Realizing that underwriting guidelines have not been adhered to by many companies, reinsurers have moved from a guideline-based to a rules-based approach to underwriting, leading to more precise treaty provisions. Of particular concern are historical underwriting exceptions. Direct writers have seen more frequent underwriting audits, and in some cases, retroactive price increases have been enacted. In other cases, bound coverage has been denied.

U.S. Marine and Offshore Energy

Capacity and Pricing

The lack of hurricane activity in 2006 prevented any further general hardening of the U.S. marine reinsurance market. The renewal season can be characterized as stable and orderly, with many accounts renewing on an "as expiry" basis. Some modest rate reductions were achieved where results were profitable and aggregate exposures reduced. However, the market still sought increases where there had been any meaningful deterioration in experience. This principally affected accounts with energy losses from Hurricanes Katrina and Rita.

In cases where pricing was deemed to be adequate, there was an abundance of financially sound capacity and programs were oversubscribed. Despite everyone's best intentions to initiate the renewals process early, firm orders were not received until the end of December. Nevertheless, we did witness a very prompt response from almost all markets, and orders were completed on time. Reflecting the market's perception that primary rates are more than adequate, we noted an increase in the capacity of reinsurers to write pro rata treaties, particularly those which are energy-related. Many reinsurers offered substantially greater lines, but in the main were only able to keep their expiring percentage shares.

The energy market remains deeply concerned about its potential exposure to the Gulf of Mexico hurricanes. Although the original business is placed on far more limited and restrictive terms than a year ago, reinsurers have not been prepared to change their excess of loss pricing models significantly. As a consequence, several cedents have not bought protection at these prices.

During 2006, new capital was attracted to the marketplace, including the emergence of some sidecar vehicles. From the client perspective, the quality of security remains of paramount importance. Ratings and capital levels are monitored closely, and any negative change can lead to non-renewal or termination of relationships.

There has been no decrease in marine catastrophe pricing. The majority of reinsurers will not support top layer pricing unless it is at a rate on line of 5 percent or greater. By way of contrast, the offshore energy market continues to price "cat" layers at multiples of this marine rate. For example, those few reinsurers that are prepared to offer energy covers typically will not consider supporting those at any rate on line beneath 20 percent. In addition, many energy reinsurers are seeking loss additional premiums that are payable at the time of loss and range from 15 percent to 100 percent.

Marine reinsurance underwriters are now actively forced to compete with their non-marine colleagues for catastrophe aggregate. Catastrophe rates in the marine market remain comparatively cheaper but are increasingly coming under close scrutiny by management teams who seek to maximize their return on capital.

Both reinsurers and cedents continue to make greater use of catastrophe modeling tools in pricing the business. The monitoring and control of aggregate exposures is of prime importance, and reinsurers are constantly seeking to upgrade and improve their modeling capabilities.

Retention and Limits

There has not been any significant change in marine program structures. Many clients continue to differentiate between their risk and catastrophe retentions and have shown a willingness to increase catastrophe retentions in response to market conditions, but they have not changed risk retentions. Consistent with the overall theme of “as expiry” renewal, we placed the same limits of cover for most clients as at January 1, 2006 renewals.

There has been some improvement in offshore energy excess of loss business. With respect to lower layers of catastrophe covers, clients can now purchase Gulf of Mexico windstorm coverage without being subject to a first loss annual aggregate deductible. Some reinsurers will provide one reinstatement at additional premium. Others will only provide the cover for one limit and, as previously mentioned, will invariably seek some form of additional premium at the time of loss.

Terms and Conditions

There has been little activity to report. “The Contract at Placement” process has grown in acceptance and has gone more smoothly than a year ago when first introduced. Some reinsurers continue to focus attention on certain clauses that fall under the general heading of “corporate clauses” for most clients. However, there seem to be no specific “market” clauses that need to be addressed. It is noteworthy that some clients now require reinsurers to sign confidentiality agreements with respect to underwriting information. In some cases, reinsurers have refused to do so and, with more than adequate capacity existing in the marketplace today, clients have chosen to simply not transact business with these same reinsurers.

Summary

What a difference a year makes. It will be interesting to observe where this marketplace will go in 2007. If there is little or no windstorm activity in the upcoming year, and if capital must be put to use, then there likely will be significant downward pressure on prices.

Notes

Notes

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Questions or comments regarding this report should be addressed to:

Seán Mooney, Ph.D.
Chief Economist
Guy Carpenter & Company, LLC
917.937.3189
sean.f.mooney@guycarp.com

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