

STATE OF THE REINSURANCE MARKET 2010

Overview

Despite the tumultuous financial markets in 2008 and early 2009, the global reinsurance industry continued to provide needed capital and risk transfer capabilities to the U.S. market, including the U.S. catastrophe risk market. U.S. catastrophe risk continues to be viewed as an essential component of reinsurers' diverse assumed risk portfolios.

- Reinsurance **supply is abundant** once again and the **downward trend in reinsurance catastrophe pricing since 2007 has resumed**.
- **Brokers report price decreases of 5% to 15%**, on a risk adjusted basis, for U.S. hurricane and earthquake exposed treaties renewing at January 1.
- The **low 2009 catastrophe losses**, coupled with an **increase in asset prices** for corporate and government bonds late in the year, led to an improvement in insurer and reinsurer balance sheets. By year end 2009, **reinsurer capital positions were largely restored to the robust levels** that existed prior to the near collapse of the financial markets.
- With their balance sheets revitalized and with **capacity exceeding demand** for reinsurance, reinsurer **competition** resulted in lower risk adjusted pricing for insurers.
- The **catastrophe bond market has also recovered** from the demise of Lehman Brothers. Insurance linked securities now account for **nearly 10% of the property catastrophe reinsurance** protection in place.
- Typical insurance and reinsurance cycles involve temporary increases in pricing, followed by new market participants, leading to increased competition and price moderation.
- Reinsurance is a sophisticated business decision for insurers and their **reinsurance costs are impacted by how much and at what layers they buy it, if at all**, within their financial model for handling risk.

NOTE: The RAA does not collect rate or market information from underwriting reinsurers. The comments contained in this document are based on published reports in the trade press, from investment bankers and reinsurance companies and brokers.

January 2010 – Traditional Reinsurance

AonBenfield Reinsurance Market Outlook, “Remarkable Recovery,” January 2010:

The **remarkable recovery of both insurer and reinsurer capital** translated into a catastrophe reinsurance renewal market for January 2010 that was **focused on rate decreases in all peak zones** of the market. ... **Rate decreases, adjusted for changes in exposure, for the peak zones of U.S. hurricane and U.S. earthquake ranged from minus 5 to minus 15 percent.** At the mean, the ROL decreases ... were very **similar in magnitude to the rate increases taken on January 2009 business.**

Global reinsurer capacity is driven by capital. ... capacity for the global catastrophe reinsurance market has been restored to near its all time December 2007 peak and it is meaningfully higher than witnessed throughout the January 2009 renewal season. Reinsurers ... were more focused on gaining the largest possible signings on their program authorizations rather than on rate. **The market is again price competitive as capacity growth outpaced demand growth. ...**

Aon Benfield believes that **reinsurers will not be able to deploy all their capital** and, as a result, we project \$10 to 15 billion in significant reinsurer share repurchases during the year. The **growth of government-sponsored insurers and reinsurance-like entities** continues to erode the opportunities for private reinsurers to deploy capacity. **Reinsurers have the capacity or could maintain higher levels of capital if reasonable demand were present. ...**

Our outlook for the April, June and July renewal seasons reflects our expectation that the pace of reinsurer capital growth ... is still likely to outpace the growth in insurer demand for reinsurance. Therefore **we expect continued softening over these upcoming renewal periods. ...**

These expectations represent our **views of market trends. ... Actual rate on line, capacity and retention changes are carefully considered and tailored to each client and can vary** materially from the expectations for the broad market set forth above.

Guy Carpenter CapitalIdeas.com – “Rates Retreat as Capital Rebounds: Global Reinsurance Renewals at January 1, 2010”:

Reinsurance rates for most lines of business decreased at the January 1, 2010 renewal. ...

Risk-adjusted catastrophe prices in the United States decreased by an average of 6 percent. This **picture is somewhat complicated by adjustments to the vendor catastrophe models** that have decreased predicted losses for earthquake and wind perils. **By applying the 2010 modeling assumptions retrospectively to 2009, the**

revised impact is a reduction of as much as 11 percent on average. Meanwhile, the great majority of risk covers (especially the larger ones) renew at mid-year.

Willis Re 1st View, January 1, 2010 Report – “Orderly Softening”:

As widely predicted, the 1 January 2010 renewal season has seen a softening in pricing, largely driven by three key factors: (1) 2009 is likely to close as one of the more **profitable underwriting** years the global reinsurance industry has enjoyed for a number of years. (2) Most **reinsurers’ balance sheets have recovered** from losses suffered in the second half of 2008, following the recovery in global investment markets during 2009. (3) The wide disparity between reinsurers’ results and that of their primary insurance company clients continues, as primary companies, whose underwriting performances are not exemplary, are struggling to obtain premium growth in the face of the global recession. This lack of premium growth is putting considerable **pressure on primary companies’** expense ratios, particularly in mature markets, and this pressure is **feeding through to their reinsurance cost budgets.**

By and large, **reinsurers have maintained a responsible underwriting attitude towards their own capital suppliers, as well as towards their clients’ requirements** over the 1 January renewal season. **The rate reductions they are supporting are reasonable, and in the majority of cases, maintain some relationship to the risk exposure they are accepting.** This disciplined rating approach is underpinned by reinsurer concern that the excellent 2009 underwriting results are not so much due to attractive pricing, but to a below average pattern of natural catastrophe and man-made losses. ...

U.S. – Regional Earthquake

- Due to absence of major earthquake activity and reduction in loss estimates from updated catastrophe models, **residential and commercial pricing for earthquake programs was down -10% to -15%.**

U.S. – Regional Wind ...

- **Firm orders were down -5% to -10% on a risk adjusted basis for loss-free programs. Market support was strong, with no evidence of a shortage of capacity. ...**
- Significant interest in **weather aggregate frequency protection** from regional clients and **a stronger market** for these products.

In a related press release, noting that ceding insurers face stagnant premium growth and expense pressure, Peter Hearn, CEO Willis Re, said, **“Reinsurers have listened to these concerns and responded sensibly with measured premium reductions.”**

Hearn continued, “When many other financial markets were in turmoil over the past year, **the reinsurance industry managed to meet its client requirements in virtually every case.** The disciplined actions taken by reinsurers at the January 1 renewals reinforce the fact that **the market will continue to provide clients with secure long-term support in the years to come.”**

January 2010 – Catastrophe Bonds and Insurance Linked Securities

AonBenfield Reinsurance Market Outlook, “Remarkable Recovery,” January 2010:

Catastrophe bond issuance resumed after the first quarter of 2009. **Total catastrophe bond capacity on risk at year end of 2009 is \$13.0 billion** due in large part to the significant issuances in Q4 2009. The **Insurance-Linked Securities (ILS) sector continues to gain momentum** with fixed income investors and with new sponsors issuing in 2010 despite the financial market disruption. We expect the capacity on risk to continue to grow through 2010. ...

Developing analytics, a growing investor base, and structural innovation all play a role in further developing ILS as **a seasoned alternative asset class**. ILS returns have **demonstrated a lack of volatility in contrast to the correlation** that high yield bonds exhibited with broader financial markets. Combined with consistent economic benefits for portfolio managers, this lack of correlation will compel them to consider adding to their ILS holdings. In addition, **changes to collateral standards following the bankruptcy of Lehman Brothers** have reduced investor’s reliance on counterparties. These factors all bode well for the market in 2010 as more than \$2 billion of currently outstanding bonds are expected to mature in the second quarter of 2010 alone. ...

With \$13.0 billion of capacity on risk at year end, the ILS market represents almost 10 percent of the total capacity provided to cedents for property catastrophe reinsurance protection. While the index basis of some bonds presents hurdles to certain sponsors, **pricing** of occurrence based U.S. bonds at various expected loss levels compared to traditional reinsurance **continues to suggest catastrophe bonds can be an effective and complementary method of securing reinsurance capacity.** Sponsors of catastrophe bond transactions tend to be among the top consumers of traditional catastrophe reinsurance capacity. Most sponsors have taken maximum program participations from individual reinsurers and seek high quality capacity near the top of their programs. **Pricing is now reasonably, but not directly, comparable to traditional reinsurance.** ... Catastrophe bonds cover only modeled perils, do not include reinstatement premiums or limits and are collateralized. The all-in costs of transferring catastrophe risk to investors in the form of catastrophe bonds are therefore not directly comparable to traditional reinsurance ROLs.

Guy Carpenter CapitalIdeas.com – “Rates Retreat as Capital Rebounds: Global Reinsurance Renewals at January 1, 2010”:

Despite the challenging financial conditions of late 2008 and early 2009, **the catastrophe bond market continued to play a critical role for both sponsors and investors over the past 12 months.** ...

In the third and fourth quarters, pricing declined 25 percent to 40 percent and, depending on transaction features, is now tracking with 2007 levels. ...

Heading into 2010, the catastrophe bond market continues to provide an increasingly attractive and worthwhile supplement to sponsors' risk transfer programs. ... The market also remains focused on further reducing transaction costs and transaction time requirements in order to improve the overall efficiency of catastrophe bond risk transfer solution.

Willis Re 1st View, January 1, 2010 Report – “Orderly Softening”:

The market conditions for catastrophe bond issuance in 2010 are expected to be very favorable.

- Insurance Linked Securities funds and multi-strategy investors are demonstrating **abundant new and revitalized interest in this uncorrelated asset class**; recent deals have been **oversubscribed**.
- The catastrophe bond market closed out 2009 with eighteen new P&C issuances, for a total of \$3.4 billion in new catastrophe bond capacity; yet, demand continues to outpace supply.
- Catastrophe bond sponsors and investors are comfortable with new catastrophe bond collateral arrangements, many of which utilize government-guaranteed paper, and all of which include significantly increased transparency.

Attractive catastrophe bond pricing.

- **Rate-on-Line equivalents are down** well over 30% since mid-year.
- Reinsurance and Industry Loss Warranty price reductions, in combination with decreasing secondary ILS market spreads, presage continued price decreases for cat bonds into 2010.
- Narrowing spreads in the broader capital markets enhance the relative attraction of catastrophe bonds.
- Successful capital raises by insurance-linked securities funds will further increase the demand side.

Proliferation of sponsors, perils, and triggers anticipated in 2010.

- **The environment is very favorable for U.S. earthquake transactions, given investor desire for diversification and recent catastrophe model changes.**
- Pent-up demand for non-U.S. perils.
- Increased investor acceptance of indemnity-triggered cat bonds and introduction of creative hybrid triggers.
- New sponsor entrants will seek benefits of multi-year, collateralized catastrophe protection at attractive prices.

Historical Market Review

In 2005, the United States sustained record hurricane losses (Katrina, Wilma and Rita) and the global reinsurance market paid 61 percent of the \$72.7 billion in losses. The

aftermath of those unprecedented hurricane losses, gave rise to an increase in the cost of reinsurance. Additionally, several factors external to the reinsurance market affected the cost. Demand increased in some peak zones at a greater rate than the supply increased due to: rating agencies requiring more capital of insurers and reinsurers to support catastrophe risk; catastrophe risk modeling firms increasing loss predictions; and insurance company managements purchasing more protection.

The amounts paid by insurers for reinsurance increased significantly in areas exposed to hurricanes due to the combination of the increase in the amount purchased and the ensuing demand-driven increase in the price of windstorm catastrophe reinsurance. The capital markets responded to this demand, supplying approximately \$43 billion in new capital for catastrophe products, ending that cycle of demand-driven reinsurance pricing by mid-year 2007.

By January 2008 renewals, brokers reported supply exceeded demand, competition was working and, on average, U.S. national rates went down by 10 percent and U.S. regional rates were down by 12 percent. Mid-year 2008 broker reports showed a continuation, and in some markets, acceleration of the 10 to 15 percent pricing decreases in catastrophe reinsurance.

The Florida Hurricane Catastrophe Fund

Florida is the only state that has created a reinsurance catastrophe fund in the United States. The state-run Florida Hurricane Catastrophe Fund (FHCF) was formed in 1993 after Hurricane Andrew hit the state in 1992. In effect, the FHCF makes consumers the reinsurers for insurers.

The fund's solvency was not materially tested until the eight storms of **2004 and 2005**. **At that time, despite more than a decade to build up its financing, the FHCF exhausted its surplus funds.** The FHCF never purchased reinsurance or capital market reinsurance equivalents. There were concerns that it did not have enough money on hand to pay its claims before it was able to access bond funding. So, in 2006, the FHCF issued pre-event bonds to have cash on hand.

In 2007, the legislature expanded the FHCF by creating a temporary increase in coverage limit (TICL) layer solely to reduce consumer rates. The funding for the TICL layer was never assured. During the 2008 legislative session, some state leaders began expressing concerns about the impact of potential FHCF surcharges on Florida consumers.

OrlandoSentinel.com, "Florida Lawmakers, Worried About the Cost of a Monster Storm, are Rethinking Backup Coverage," February 9, 2008:

[Chief Financial Officer] Sink's office told the House Insurance Committee Friday that surcharges after **a mega-storm could cost every insured homeowner anywhere from \$11,000 to \$18,000 over 30 years.** Policies insuring autos and boats would be surcharged as well. **That doesn't include additional assessments the state-run Citizen's Property Insurance Co., Florida's largest home insurer, would have to levy to pay claims.**

Due to the size of its potential bond offering and events in the bond markets, beginning in late 2008 and into 2009, the FHCF advisors reported that the catastrophe fund would not be able to borrow sufficient funds should it have to pay its obligations in full – a potential shortfall of \$14 to \$18 billion.

Since that time, the estimates of the potential shortfall have been reduced. Among the reasons cited by the FHCF are: (a) legislative changes that will eliminate the \$12 billion TICL layer over six years – starting with a \$2 billion reduction in June 2009, plus the elimination of the never-used discretionary option for an additional \$4 billion of TICL coverage; (b) insurers declining to purchase the full TICL coverage offered; and (c) an increase in cash from premiums. The FHCF estimates that approximately \$6.4 billion of risk was returned to the private market in 2009.

Based upon post-event bonding capacity estimates that ranged from \$5 billion and \$20 billion, in October 2009 the FHCF projected that it could raise \$11 billion after a large storm. Using this mid-point estimate, the projected FHCF estimated claims paying capacity shortfall is approximately \$4.2 billion.

At the same time, the FHCF cautioned that the capital markets remain difficult and that it might not be able to bond to its statutory limit for an initial season.

The Reinsurance Association of America is the leading trade association of property and casualty reinsurers doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross border basis. The RAA represents its members before state, federal and international bodies.

<http://www.reinsurance.org>