



Aon BENFIELD

# Reinsurance Market Outlook

Partnership Renewed  
January 2011

reDEFINING

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# Executive Summary — Partnership Renewed

The partnership between insurers and reinsurers has been renewed. Reinsurers are now lowering rates at the same, or faster, pace than insurers—their cedents—are lowering rates. The partners enjoy fully recovered balance sheets but quite limited growth in demand for their products. With major developed markets like the U.S., Germany, France, and the U.K. facing their second or third year-on-year non-life market-wide premium declines, even as gross domestic product returns to sequential growth, the partners need to turn their efforts to generating demand from new products or innovations on existing ones. Until the partners' efforts start to show traction in reasonable levels of new demand, the reinsurance market outlook will continue to reflect a global softening.

Our outlook for renewals at important April, June and July 2011 dates is for softening at a pace similar to what we observed during the January 2011 renewals. The January 2011 renewals softened at the high end of the rate of change we projected in our Fall 2010 Reinsurance Market Outlook. Following a U.S. hurricane season with no land-falling events and high investment valuations, reinsurers lowered rates at a pace less than the decreases in January 2010 renewals. U.S. catastrophe programs that include hurricane exposure—the peak reinsured global peril—fell by 5 to 10 percent. Reinsurance for property and casualty per risk and per occurrence programs also got cheaper. These programs already reflect the price decreases taken by insurers but they still saw terms and conditions, including ceding commissions and aggregate deductibles, changed to reflect a net price decrease of a further 5 to 10 percent.

Reinsurance is a form of underwriting capital and it is now substantially cheaper—more accretive—than equity capital. Many insurers are trading below book value and have the ability to act on substantial value-enhancing share repurchases if additional working capital from reinsurance structures are planned and executed. Reinsurance partnerships are powerful, even in soft markets.

Record high reinsurance capital, driving supply and stable to weak growth in reinsurance demand has driven, and will continue to drive, softening in the global reinsurance market.

**Exhibit 1: Key Factors Impacting Reinsurance Supply and Demand in the Global Market**

Global Factors Influencing Reinsurance Supply	
+	Record reinsurer capital
+	Extremely light hurricane losses
+	Growth in investor interest for catastrophe bonds
+	Continued favorable casualty reserve development
+	Declining quality of Florida homeowners insurers as they struggle to profit with inadequate rates and survive sinkholes
+	Low exposure growth
-	Moderate non-peak catastrophes in Chile and New Zealand
-	Eroding returns on nearly every line
-	Increased catastrophe model estimates for peak U.S. hurricane PMLs
-	Poor reinsurer market valuations leading to accretive share repurchase math
-	Uncertainty over reinsurer solvency standards
=	<b>High reinsurance supply, even in peak regions, struggling to find suitable returns for taking risk</b>

Global Factors Influencing Reinsurance Demand	
-	Near record insurer capital
-	Budget pressure from declining insurance pricing and exposures, especially in commercial and specialty lines
-	Continued favorable development on casualty lines that had previously been heavily reinsured
-	Continued disconnect between reinsurer loss ratio assumptions and cedent views of the original insurance business
-	Low volatility of insurer's declining earnings
-	Limited interest from insureds in new liability limits despite significant actual events
+	Reasonably high regional catastrophe losses
+	Increased catastrophe model estimates for peak U.S. hurricane PMLs
+	Poor insurer market valuations leading to accretive share repurchase math
+	Uncertainty over insurer solvency capital standards
=	<b>Stable to weak growth in reinsurance demand</b>

Source: Aon Benfield Analytics

## Expectations for Upcoming U.S. Property Catastrophe Renewals

Our outlook for the Spring/Summer renewal season reflects our expectation that the pace of the reinsurer capital growth will decrease, due to share repurchases and more stable investment prices. However 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. Because the United States represents the reinsurance industry's peak aggregation, for both hurricanes and earthquakes, we provide our views on how the reinsurance market is likely to continue throughout the 2011 U.S. renewals.

### Exhibit 2: United States: Property Catastrophe Spring/Summer 2011 Expectations

	ROL Changes	Capacity Changes	Retention Changes
Personal Lines National	-10% to -5%	+10%	+5% to +10%
Personal Lines Regional	-10% to -5%	+15%	Stable
Florida Homeowners Specialists	-10% to -5%	+10%	Stable
Standard Commercial Lines	-10% to -5%	+15%	Stable to +10%
Complex Commercial Lines	-10% to -5%	+15%	+5% to +10%

Assumptions: No changes in insured catastrophe exposures. Rate of change measured from the expiring Spring/Summer 2010 terms.

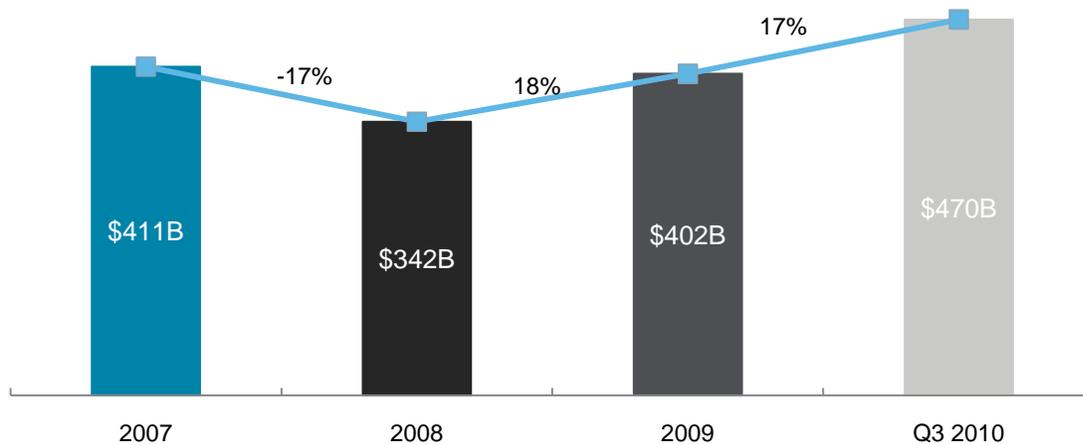
Source: Aon Benfield Analytics

These expectations represent our views of broad market trends. Individual client placements are represented by professionals from our firm who understand the unique underwriting processes, class choices, original exposures, data quality, aggregations of catastrophe exposures, loss history, program structure, capacity needs, catastrophe model change portfolio impact, expiring technical margins, and varying security requirements of each client. Our professionals work closely with clients to properly differentiate their individual placements within the dynamic marketplace. 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.

# Reinsurance Supply

Reinsurer capital increased 17 percent in the first nine months of 2010, to surpass 2007's prior peak capital level. Capital increased seven percent in the third quarter alone. Despite continued share buybacks and increased dividend payments, reinsurer capital remains in excess of demand for capacity.

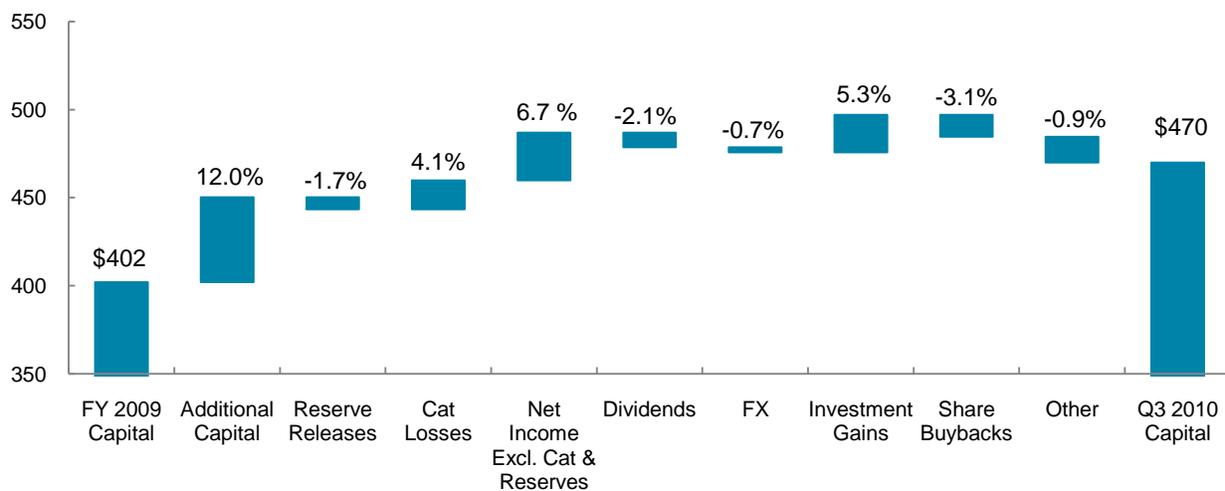
**Exhibit 3: Change in Reinsurer Capital**



Source: Aon Benfield Analytics

Realized and unrealized investment returns accounted for a significant portion of the capital increase. The contributors to the increase in global capital through Q3 2010 are outlined in Exhibit 4.

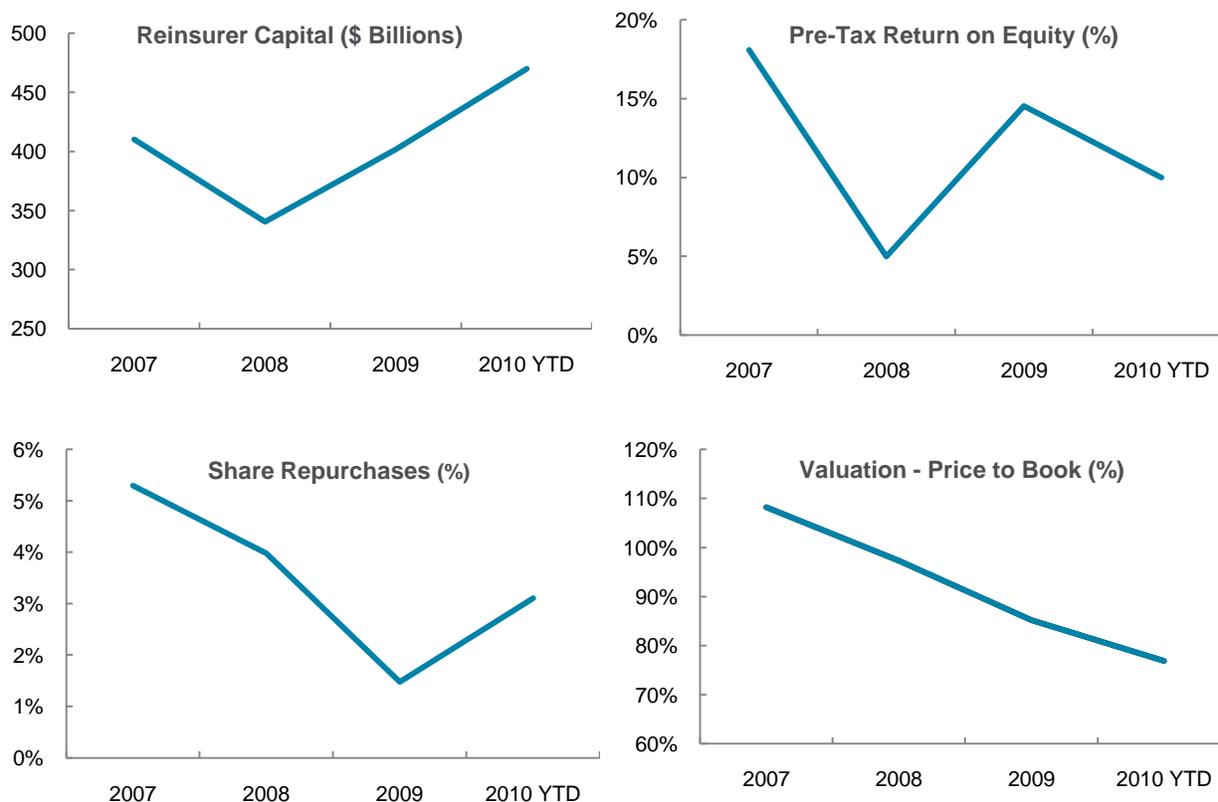
**Exhibit 4: Change in Capital in Billions (FY 2009 vs. Q3 2010)**



Source: Company Data, Aon Benfield Research

Reinsurer capital was at a low point in 2008 due to the financial crisis and share repurchases were largely stopped. As capital returned to near record levels in 2009, share buybacks resumed. Over this same period ROEs dropped off in 2008 in tandem with the financial markets crisis, and improved in 2009—though not to prior 2007 levels—due to low catastrophic losses, a rebound in the financial markets and effective capital management across the reinsurance industry. During 2010 as capital increased and ROEs declined once again, share repurchase programs increased across the industry. Throughout this entire period price to book valuations continued to decline.

**Exhibit 5: Reinsurer Capital, ROE, Share Repurchases, and Valuation**



Source: Aon Benfield Research

**Exhibit 6: Reinsurer Financial Trends 2007 through Q3 2010**

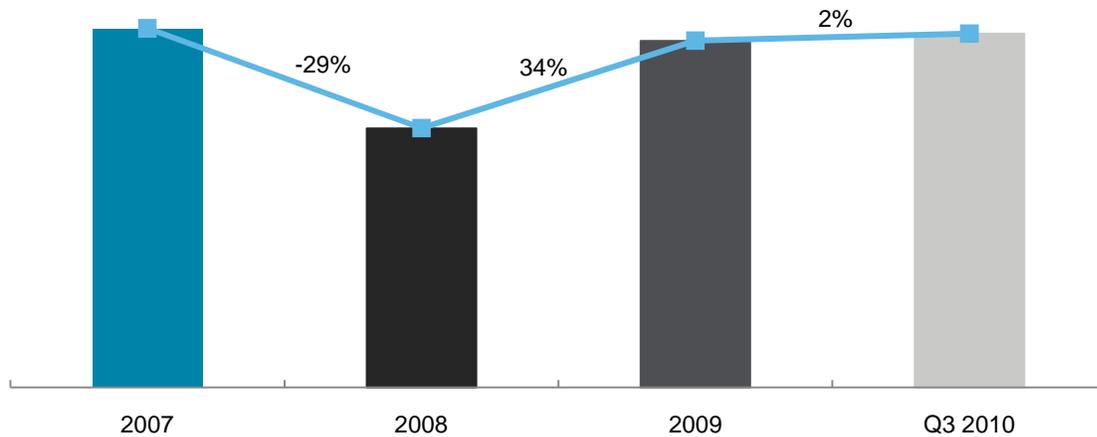
Driver	Change	Share Repurchase Impact
Capital	Increases	Increases
Valuations	Decline	Increases
ROE	Decline	Increases

Currently the reinsurance industry is in a period of increasing capital, declining valuations and declining ROEs, all of which improve the calculus for additional share buybacks in 2011. We anticipate that without the occurrence of significant catastrophic events, reinsurers will repurchase between USD4 and USD10 billion of their shares in 2011. In Q4 2010 alone, Bermudian reinsurers repurchased an additional USD1 billion of shares.

# Reinsurance Demand

In contrast with reinsurer capital, insurer capital increased by only two percent throughout the first nine months of 2010 reflecting the continued soft market and a difficult investment environment for insurers.

**Exhibit 7: Change in Insurer Capital**

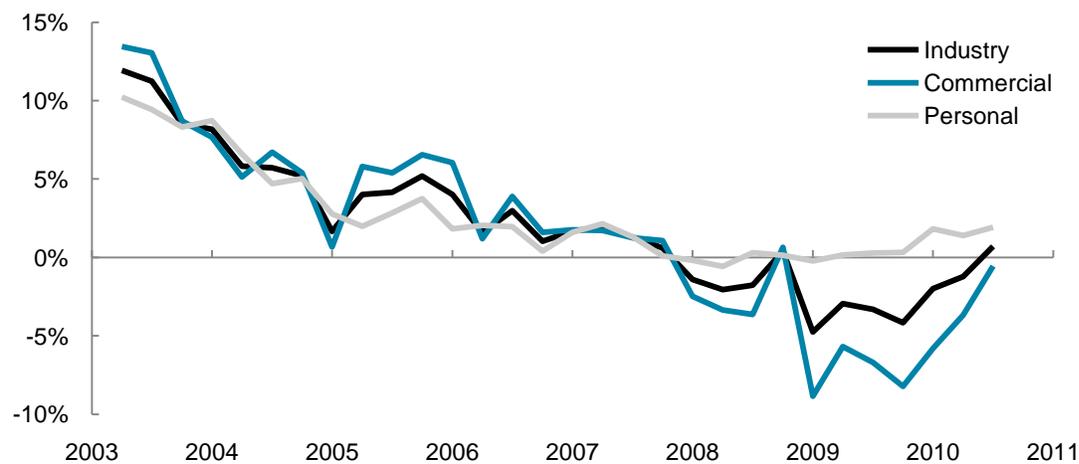


Source: Aon Benfield Analytics

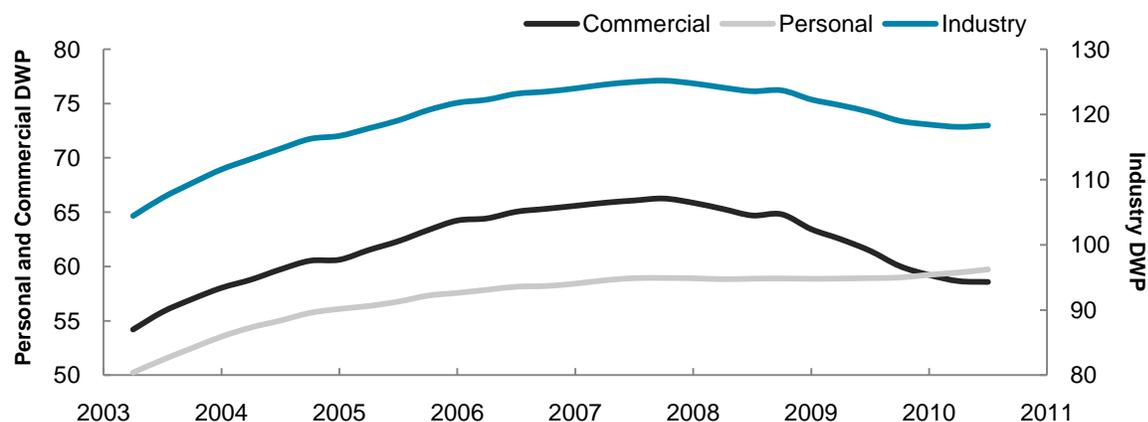
## U.S. Commercial Insurance Market

After two consecutive years of almost 10 percent premium decreases, the U.S. commercial insurance premium stabilized in 2010 at flat to down one to two percent. The softening in the rate environment is driven by intense price competition and rationalized in part by stable to declining frequency and moderate severity trends.

**Exhibit 8: Quarter over Quarter Change in DWP through Q2 2010**



Source: Aon Benfield Analytics

**Exhibit 9: U.S. DWP by Type (Rolling Four Quarter Averages in Billions)**

Source: Aon Benfield Analytics

Personal lines premium has held up much more strongly than commercial lines, and for the first time now accounts for more than 50 percent of total P&C premium in the U.S., as shown in Exhibit 9.

Companies continue to release significant amounts from prior year reserves. As of year-end 2009, Aon Benfield estimated that the insurance industry was USD21.9 billion redundant, with USD14.2 billion in the commercial casualty lines. Despite these fundamentals, the demand for reinsurance has been stable—an overwhelming majority of January 1, 2011 renewals were at expiring retentions for cedents. However, as insurers continue to see downward pricing pressure and release more of their redundancies—USD11.6 billion of which has been released through third quarter 2010—the demand for reinsurance could increase.

**Exhibit 10: Aon Benfield Reserve Study, U.S. Statutory Industry**

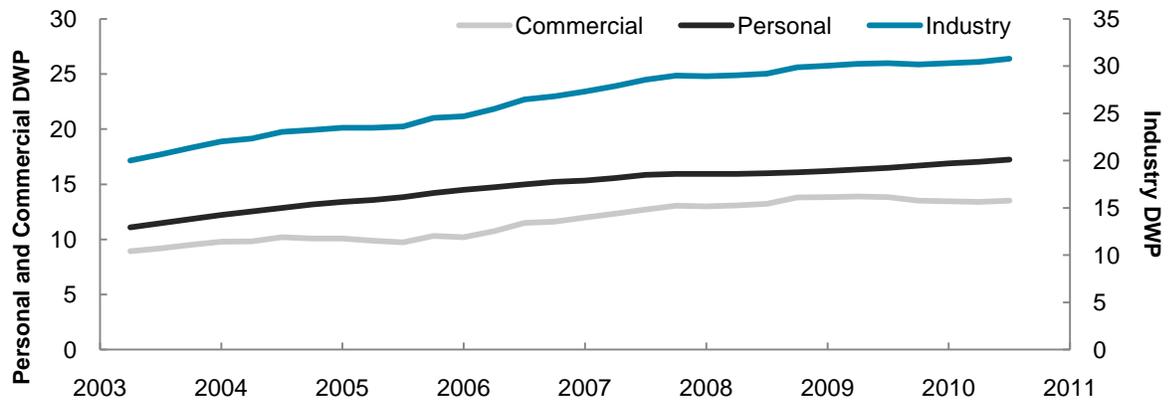
Reserve Summary (USD Billions)									
Line	Est. Reserves	Booked Reserves	Favorable / (Adverse) Development				Remaining Redundancy	Years at Run Rate	2010 Development
			2007	2008	2009	Avg			
Personal Lines	123.0	129.0	5.9	5.4	5.8	5.7	6.0	1.1	
Commercial Property	37.9	41.7	1.7	2.6	2.4	2.2	3.8	1.7	
Commercial Liability	223.1	237.3	1.0	5.2	3.8	3.3	14.2	4.3	
Workers' Compensation	114.8	114.0	1.0	1.1	(0.5)	0.6	(0.8)	n/a	
Total Excl. Financial Guaranty	498.7	522.0	9.5	14.4	11.5	11.8	23.2	2.0	
Financial Guaranty	34.1	32.8	(1.2)	(12.6)	7.0	(2.3)	(1.4)	n/a	
<b>Total</b>	<b>532.9</b>	<b>554.7</b>	<b>8.3</b>	<b>1.7</b>	<b>18.6</b>	<b>9.5</b>	<b>21.9</b>	<b>2.3</b>	<b>11.6</b>

Source: Aon Benfield Insurance Risk Study, 2010 Edition

## U.S. Property Insurance Market

In contrast to the decline in casualty premiums, property premiums have continued to steadily increase throughout the prior eight years.

Exhibit 11: U.S. Property DWP by Type (Rolling Four Quarter Averages in Billions)

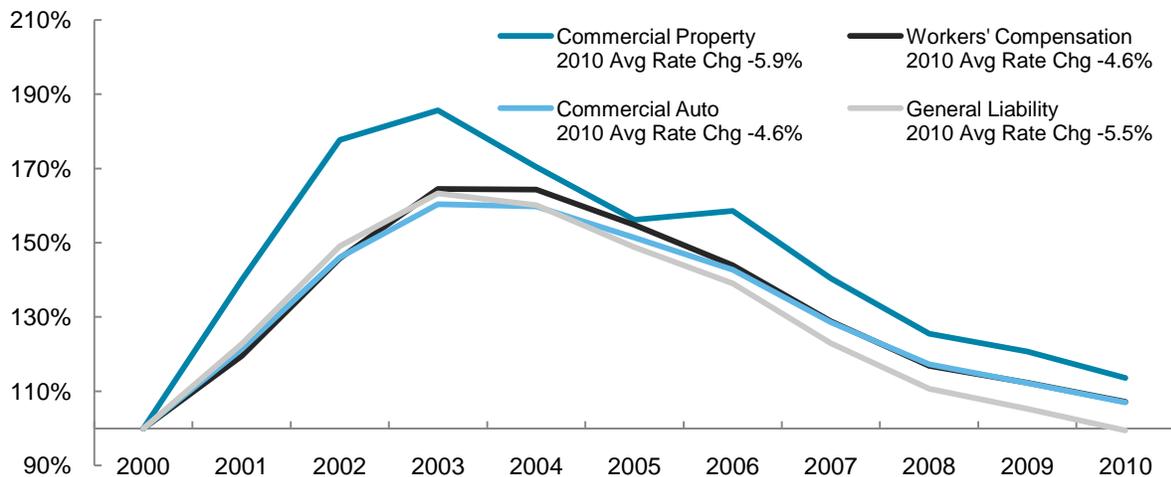


Source: SNL

## Primary Rates Still on the Decline

Through Q3 2010, rates continue to decline approximately five percent year-on-year in major commercial insurance.

Exhibit 12: U.S. Primary Pricing Trend Through Q3 2010

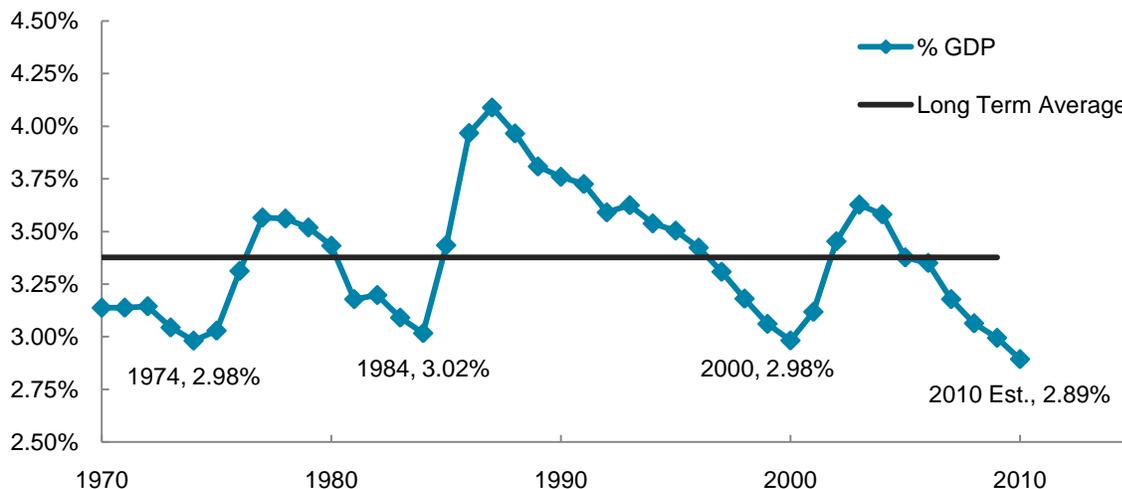


Source: Council of Insurance Agents & Brokers

### NWP Percent of GDP Suggests a Hard Market May Begin

During the 40 year period since 1970, soft markets have ended when U.S. industry Net Written Premium (NWP) as a percent of GDP fell below three percent. Based on a projected increase in GDP and a slight increase in NWP we forecast that the ratio will be 2.9 percent in 2010—the lowest ratio since 1970. We are seeing in part the influence of a very benign claims environment across many lines allowing companies to report calendar year underwriting profits despite rates at historically low levels.

**Exhibit 13: NWP as Percent of GDP**



Source: Aon Benfield Analytics

## Merger and Acquisition Trends

M&A activity picked up dramatically in 2010 from the very low levels of 2008 and 2009. Activity was driven by the stabilization of the financial markets which allowed buyers and sellers to more rationally evaluate the risks and rewards of a transaction, the continued soft market conditions which have pushed some to pursue acquisitions rather than more costly organic growth and the persistence of low valuations which have forced sellers to adjust their expectations to more realistic levels.

### Activity in 2010 Was Driven By Reinsurance Consolidation and Specialty Company Diversification

Transactions completed in 2010 were centered on the consolidation of reinsurance companies and the acquisition of monoline companies by multi-line specialty companies' intent on expanding their lines of business and in some cases add new distribution channels. Of particular note, three monoline workers' compensation companies were purchased by specialty companies.

**Exhibit 14: M&A Activity Since July 2008**

Buyer	Target	Announce Date	Equity Deal Value	Equity Value / Tangible Equity	Sector*
United Fire & Casualty Company	Mercer Insurance Group, Inc.	12/1/2010	191.5	1.09x	RC
CNA Financial	CNA Surety Corporation	11/1/2010	381.8	1.11x	SI
Fairfax Financial Holdings Limited	First Mercury Financial Corporation	10/28/2010	294.5	1.22x	SI
Elliott / Wand Partners	ICAT	10/21/2010	na	na	L
RSA Insurance Group plc	GCAN Insurance Company	10/4/2010	411.7	1.76x	SI
Apollo / CVC	Brit Insurance Holdings NV	9/18/2010	1,364.1	1.00x	L
ACE Limited	Rain and Hail Insurance Services, Inc.	9/14/2010	1,375.0	1.59x	SI
ProAssurance Corporation	American Physicians Service Group	8/31/2010	233.0	1.42x	MM
Donegal Group Inc.	Michigan Insurance Company	7/16/2010	39.0	1.00x	RC
ProSight Specialty Insurance Holdings	NYMAGIC, INC.	7/15/2010	221.7	0.99x	SI
Markel Corp.	FirstComp Insurance Company	7/14/2010	135.0	2.55x	WC
Doctors Company, An Interinsurance Exchange	American Physicians Capital, Inc.	7/8/2010	395.3	1.69x	MM
QBE Insurance Group	Secura NV	7/5/2010	339.2	1.3x	R
First Mercury Financial Corporation	Valiant insurance Group, Inc	7/1/2010	55.0	1.00x	SI
Canopus	KGM	7/1/2010	na	na	L
Old Republic International Corporation	PMA Capital Corporation	6/9/2010	229.0	0.59x	WC
National Interstate Corporation	Vanliner Group, Inc.	4/26/2010	128.0	1.00x	SI
QBE Insurance Group, Ltd.	NAU Holding Company, LLC	4/16/2010	565.0	2.60x	SI
Max Capital Group	Harbor Point Re	3/4/2010	1,521.0	0.93x	R
Fairfax Financial Holdings Limited	Zenith National Insurance Corp.	2/17/2010	395.4	1.49x	WC
Tower Group, Inc	OneBeacon – Personal Lines Division	2/2/2010	179.7	na	PL

Buyer	Target	Announce Date	Equity Deal Value	Equity Value / Tangible Equity	Sector*
Fairfax Financial Holdings Limited	Odyssey Re Holdings Corp.	9/18/2009	1,008.1	1.03x	R
Fairfax Financial Holdings Limited	Advent	7/17/2009	154.0	1.06x	L
Validus Holdings, Ltd.	IPC Holdings, Inc	7/9/2009	1,781.9	0.88x	R
PartnerRe Ltd.	Paris Re Holdings Limited	7/4/2009	2,081.3	1.04x	R
Tower Group, Inc.	Specialty Underwriters Alliance, Inc	6/21/2009	107.0	0.80x	SI
Farmers Group, Inc. - Zurich	ALG – Personal Lines Division	4/16/2009	1,700.0	0.86x	PL
Muenchner Ruechversicherungs	HSB Group, Inc.	12/21/2009	666.0	1.25x	SI
State Automobile Mutual Insurance Company	Rockhill Holding Company	11/17/2009	246.5	2.13x	SI
Flagstone	Malborough	10/17/2008	na	na	L
Max Capital Group	Imagine Group	7/24/2008	200.2		L
		Mean	754.2	1.35x	
		Median	367.2	1.09x	

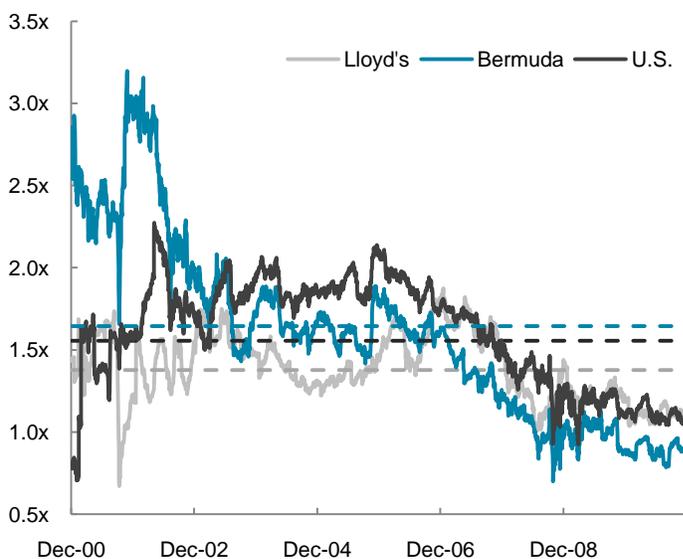
\*L – Lloyd's, MM – Medical Malpractice, PL – Personal Lines, R – Reinsurance, RC – Regional Commercial, SI – Specialty Insurance, WC – Workers' Compensation

Source: SNL, company filings, Aon Benfield Securities analysis

## Valuations Remain Low

While valuations have rebounded in recent weeks due to strong underlying global equity markets and increased industry M&A activity they remain at historically low levels and for good reason: insurance company returns on capital have been awful over the past 10 years.

Exhibit 15: Ten Year Price to Book Value Ratios



Source: SNL Data

## The Strongest Motivators for Buyers Were LOB and Distribution Channel Diversification

The chart below outlines the contributing motivating factors behind the M&A transactions that were announced since July 2008. These include diversification by type, financial engineering, whether or not the transaction involved a specialty company and whether or not a private equity fund was involved as buyer or seller. Please note that these factors were determined by the Aon Benfield Corporate Finance team by interpreting publicly available information. While the data is only from recent activity and some factors were determined by relatively subjective means, the conclusions are instructive: 1) Buyers seemed to pay larger premiums for diversification rather than consolidation; 2) The vast majority of transactions involved a specialty lines company as a buyer or seller and 3) Private equity firms seem to do a good job buying low and selling high.

**Exhibit 16: Characteristics of Selected Recent M&A Transactions**

Sector*	Buyer	Target	Equity Deal Value	Equity Value / Tang. Equity	Contributing Motivation Diversification							Private Equity*	
					Consolidation	Geography	Line of Business	Distribution	Financial Engineering	Motivated Seller	Specialty		
RC	United Fire & Casualty Company	Mercer Insurance Group, Inc.	191.5	1.09x	x	x		x					
SI	CNA Financial	CNA Surety Corporation	381.8	1.11x	x							x	
SI	Fairfax Financial Holdings Limited	First Mercury Financial Corporation	294.5	1.22x			x					x	
L	Elliott / Wand Partners	ICAT	na	na								x	xb
SI	RSA Insurance Group plc	GCAN Insurance Company	411.7	1.76x		x	x	x				x	
L	Apollo / CVC	Brit Insurance Holdings NV	1,364.1	1.00x					x	x		x	xb
SI	ACE Limited	Rain and Hail Insurance Services, Inc.	1,375.0	1.59x	x				x			x	
MM	ProAssurance Corporation	American Physicians Service Group	233.0	1.42x	x	x						x	
RC	Donegal Group Inc.	Michigan Insurance Company	39.0	1.00x	x	x					x		
SI	ProSight Specialty Insurance Holdings	NYMAGIC, INC.	221.7	0.99x					x	x		x	xb
WC	Markel Corp.	FirstComp Insurance Company	135.0	2.55x			x	x	x			x	
MM	Doctors Company, An Interinsurance Exchange	American Physicians Capital, Inc.	395.3	1.69x	x	x						x	
R	QBE Insurance Group	Secura NV	339.2	1.3x		x					x		

Sector*	Buyer	Target	Equity Deal Value	Equity Value / Tang. Equity	Contributing Motivation Diversification							
					Consolidation	Geography	Line of Business	Distribution	Financial Engineering	Motivated Seller	Specialty	Private Equity*
SI	First Mercury Financial Corporation	Valiant insurance Group, Inc	55.0	1.00x			x		x	x	x	
L	Canopus	KGM	na	na			x			x		
WC	Old Republic International Corporation	PMA Capital Corporation	229.0	0.59x					x		x	
SI	National Interstate Corporation	Vanliner Group, Inc.	128.0	1.00x	x		x			x	x	
SI	QBE Insurance Group, Ltd.	NAU Holding Company, LLC	565.0	2.60x			x	x			x	xs
R	Max Capital Group	Harbor Point Re	1,521.0	0.93x		x						xs
WC	Fairfax Financial Holdings Limited	Zenith National Insurance Corp.	395.4	1.49x			x				x	
PL	Tower Group, Inc	OneBeacon – Personal Lines Division	179.7	na			x		x			
R	Fairfax Financial Holdings Limited	Odyssey Re Holdings Corp.	1,008.1	1.03x	x				x			
L	Fairfax Financial Holdings Limited	Advent	154.0	1.06x	x					x		
R	Validus Holdings, Ltd.	IPC Holdings, Inc	1,781.9	0.88x	x				x			xb
R	PartnerRe Ltd.	Paris Re Holdings Limited	2,081.3	1.04x	x	x	x					xs
SI	Tower Group, Inc.	Specialty Underwriters Alliance, Inc	107.0	0.80x					x	x	x	
PL	Farmers Group, Inc. - Zurich	AIG – Personal Lines Division	1,700.0	0.86x	x			x		x		
SI	Muenchner Ruechversicherungs	HSB Group, Inc.	666.0	1.25x			x			x	x	
SI	State Automobile Mutual Insurance Company	Rockhill Holding Company	246.5	2.13x		x	x	x			x	xs
L	Flagstone	Malborough	na	na		x	x				x	
L	Max Capital Group	Imagine Group	200.2			x	x	x		x	x	
		Number of Transactions			12	11	14	7	10	12	20	8
		Average Price / Tangible Book (x)			1.2	1.4	1.6	1.8	1.2	1.0	1.4	1.0

\*b – buyer, s – seller

# Insurance Linked Securities Activity Update

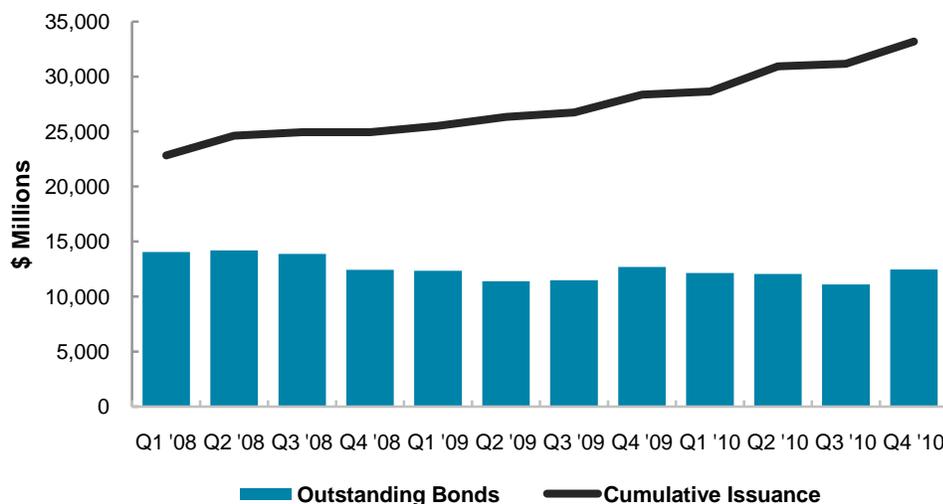
The 2010 calendar year was characterized by a return to strength for the insurance linked securities (ILS) sector. Twenty-three catastrophe bond transactions closed in 2010, totaling USD4.9 billion in notional issuance volume, readily exceeding both the number of deals (18) and the issuance volume (USD3.4 billion) observed in the 2009 calendar year.

While the first half of 2010 consisted largely of U.S. hurricane-exposed cat bonds (10 of the 11 cat bonds issued during the first half contained U.S. hurricane), the second half, particularly the fourth quarter, gave rise to a much more diverse offering of cat bonds. This provided investors with a welcome opportunity to invest in other perils and re-balance their existing portfolios by geography and peril.

The fourth quarter itself was capped by a flurry of transactions, concluding with 10 cat bonds covering USD2.0 billion in volume. During this quarter, a handful of sponsors decided to access the capital markets again with take-down issuances using established shelf programs following earlier issuances. With the issuance of various diversifying non-peak peril transactions and the passage of a relatively loss-free 2010 Atlantic Hurricane season, these sponsors sought to secure additional capital markets capacity for U.S. peak perils as investors' capital inflows surged.

Outstanding catastrophe bonds ended the year at approximately USD12.5 billion, about even with last year. Refer to the following exhibits.

**Exhibit 17: Outstanding Catastrophe Bond Volume by Quarter**



Source: Aon Benfield Securities

**Exhibit 18: 2010 Catastrophe Bond Market League Table**

Bank	Notional Amount (USD Millions)	Number of Deals	% of Notional Amount	% of Number of Deals
Aon Benfield Securities	2,964.5	12	66.6%	60.0%
GC Securities	1,252.6	6	28.1%	30.0%
Goldman Sachs	1,220.0	5	27.4%	25.0%
Swiss Re	1,216.3	5	27.3%	25.0%
DB Securities	1,086.6	3	24.4%	15.0%
BNP Paribas	875.0	2	19.7%	10.0%
Munich Re	401.0	2	9.0%	10.0%
Natixis	381.6	1	8.6%	5.0%
BofA	185.0	1	4.2%	5.0%
USB	185.0	1	4.2%	5.0%

Note: Excludes proprietary deals Source: Aon Benfield Securities

**European ILS**

2010 closed with EUR525 million of new Europe Windstorm issuance from six transactions. These diversifying non-U.S. peril transactions were well received by investors, having generated strong order books. Calypso Capital 2010-A, Atlas VI Capital 2010-1 and Green Fields Capital 2011-1 each was upsized and priced at the low end of the indicative price guidance.

Most of the new Europe Windstorm issuance used industry loss indices, optimized with payout factors at CRESTA zone and line of business level. The growing acceptance of industry loss indices generated from information provided by PERILS AG or Paradex will assist sponsors in mitigating the basis risk in a non-indemnity transaction. As the scope of coverage from these two firms expands, this will encourage new sponsors to consider accessing the capital markets for capacity on their Europe Windstorm catastrophe risk and will potentially result in the end of pure parametric solutions for this peril.

**Secondary Market**

As noted in our last review, investors have been actively looking for diversifying perils to add to their portfolios. During the fourth quarter, U.S. wind capacity continued to rebound, leading to heavy secondary trading volumes across all perils and successful placements of new issues on the primary market. Secondary prices for bonds increased in the beginning of the fourth quarter as investors looked to deploy capital. Later, those gains were given back as focus shifted to the primary market at year end, causing pricing to finish relatively flat as compared to the prior quarter.

**Outlook**

With the re-emergence of the cat bond sector in 2010, Aon Benfield Securities expects the 2011 issuance calendar will continue to be robust with issuance volume picking up in the first half of 2011 where the previous six months ended. As the broader reinsurance markets continue to experience price softening, we see the capital markets increasingly providing sponsors globally with viable risk transfer alternatives at competitive terms using fully collateralized multi-year fixed-price protection. We expect a trend towards more top layers or aggregate covers and low expected loss transactions as minimum pricing declines.

Investor inflows are predicted to be very strong as we head into 2011. Several existing ILS funds are expecting increased investment into the new year from both new and current investors. Feeding investor interest is a strong performance from the ILS sector throughout the past couple years, despite challenges in the broader market. In addition, there are a number of bonds maturing throughout 2011 which will likely lead to continued reinvestment.

## Solvency II: Current Trends and the Impact on Reinsurance

Solvency II, the new risk based regulatory framework for Europe, is now entering the final stages of implementation, with a proposed start date of January 2013. Throughout 2010, insurers who operate in Europe have been testing the proposed capital rules by participating in the Fifth Quantitative Impact Study (QIS 5). The industry has invested significant resources into risk management functions, building up large teams of actuaries, risk managers and IT specialists. CEIOPS, the Committee of European Insurance and Occupational Pensions Supervisors, announced mid-December 2010 that 70 percent of all relevant (re)insurers across Europe participated in QIS 5. An important positive aspect of the Solvency II project is to incentivize a culture of risk management in the insurance industry, encouraging business strategies that target greater risk-adjusted reward and greater portfolio diversification. Realizing these benefits requires a close alignment of regulatory capital to economic fundamentals, helping demonstrate to senior managers across the industry that Solvency II is a valuable initiative.

Solvency II provides two approaches to setting regulatory capital: the standard formula and the internal model. The capital requirements obtained from the standard formula under QIS 5 should reflect a 1 in 200 year confidence level and are deemed to be equivalent with a BBB rating. Current results show a capital requirement that far exceeds those of existing BBB rating agencies requirements suggesting that the calibration of the standard formula in QIS 5 is inconsistent with economic principles. Furthermore, the alternative internal model approach is regarded as cumbersome for any size of (re)insurance company due to very onerous requirements. Moreover, significant questions are currently being raised about the practicalities of internal model approval by 2013—particularly given the limited resources of local supervisors in many regions. It is noteworthy that the Swiss regulator, FINMA, with a team of about 40 actuaries, has yet to fully approve a single internal model under the Swiss Solvency Test prior to its implementation date of January 1, 2011.

The problems surrounding internal models is worrying and suggests the standard formula will be the main measure of regulatory capital in the early years of Solvency II for most of the industry. It is therefore highly likely that Solvency II will follow the example of Basel III and introduce transitional measures to gradually phase in the new capital rules. We expect that this will be part of the new regulation (Omnibus II) that will amend the original Solvency II Directive. It is also possible that following publication of the QIS 5 results in February 2011, the European Commission will choose to revise the rules of the standard formula to be closer to economic principles calibrated to the 1 in 200 year confidence level. It is clear that significant uncertainty remains as to the final form of the European regulatory environment.

While the overall impact of Solvency II on the insurance landscape is still unclear, several early indicators can be drawn.

- The effects of Solvency II are global: a trend of regulatory harmonization is emerging, with other territories aspiring to achieve regulatory equivalence to Solvency II through the adoption of risk-based regulatory frameworks. Switzerland, Bermuda and Japan will all be considered for equivalence in the first wave of assessments.
- Smaller insurers, such as captives and mono-lines, are at a significant disadvantage under Solvency II, as the standard formula penalizes those writing less diverse portfolios—both geographically and in terms of class of business. We might see an increase in M&A activity as smaller undercapitalized insurers struggle to raise additional capital and become acquisition targets for larger, more adequately capitalized, diversified insurers.
- Catastrophe risk is a key concern within the Solvency II standard formula. This is a particular issue since (partial) internal models might not be approved before January 2013. Local catastrophe scenarios under QIS 5 often lead to materially higher PMLs than the commercial catastrophe models used by most insurers to manage catastrophe risk and structure reinsurance. The standard formula completely ignores granular data, creating huge discrepancies compared to current industry best practice.
- Overall we expect an increased demand for reinsurance, driven by the need to seek capital relief under the more onerous regulatory requirements. We already see greater demand for aggregate covers and more specialized reinsurance products in order to reduce earnings volatility. This trend will continue as companies aim to optimize the use of their capital under Solvency II. However, this increase in demand may be partially offset by the effect of consolidation, since larger insurers are often better capitalized and diversified, requiring less reinsurance than the sum of their parts.
- Reinsurers are well placed for the transition into Solvency II. Their businesses are diverse and the majority already utilize internal models for setting economic capital. We do not expect Solvency II to have a material impact on the supply of reinsurance.
- The capital charges for counterparty default risk will drive a flight to quality for reinsurance counterparties. We expect the majority of reinsurance placement in a post-Solvency II world to be with reinsurers rated A+ or higher. This may therefore drive reinsurers with lower credit ratings to raise additional capital or consider mergers. In addition, cedents will be looking for a more diversified book of reinsurers.
- An unexpected consequence of Solvency II may be dislocations in the financial markets. Insurers will be significantly penalized for holding longer duration corporate bonds of a lower credit quality: for example, under QIS 5 a BBB rated corporate bond of 10 year duration attracts a 25 percent capital charge. (For perspective, Solvency 1 did not include asset risk charges, and the equivalent charge under S&P is 5.3 percent, so the change is meaningful). Since insurers are major participants in the bond markets, this could have a significant impact on new issuances.

Our expectation is that 2011 will be the year where many uncertainties around Solvency II will be resolved and it will become a key consideration in business strategy. For insurers that have shown technical deficiencies under the QIS 5 exercise, this will be a critical time period to identify possible remedies ranging from capital raising, reinsurance solutions to investment strategy. The insurance industry should continue to identify and report areas in which Solvency II has become disconnected from economic fundamentals. If Solvency II remains in its current form insurers could be forced to make business decisions driven by non-economic idiosyncrasies of the standard formula that will be detrimental to shareholders and ultimately to policyholders through increased premiums.

## Florida Market Turmoil Continues

With the peak reinsured peril in the world still U.S. hurricane and many of those occurrences affecting Florida, the actions of the State of Florida have a particularly important impact on the entire reinsurance market. For example, in 2007 when the already significant Florida Hurricane Catastrophe Fund (FHCF) was changed by the Florida legislature to provide an additional USD12 billion of unfunded low-priced capacity that insurers were essentially (through rate making requirements) required to buy, a significant portion of the over USD30 billion of capital raised from investors in the wake of hurricane Katrina needed to be returned to investors. This move by the Florida legislature stifled the development of an efficiently priced, competitive reinsurance market for all insurers in Florida and other hurricane exposed states.

A lesser discussed but more devastating change to the potential to attract private insurers into the market was the conversion of Florida's controlled residential and commercial residual market into a competitive insurer with dramatically inadequate rates. This change is having significant negative consequences for all privately-funded homeowners insurers. Several have either failed or are headed for failure. Their financial statements have been ravaged, not by hurricanes but by a well-intentioned yet poorly planned set of required mitigation credits, reopened hurricane claims with perverse incentives for public adjusters, expensive claims adjustment procedures and claims for potential and actual sinkhole losses.

The change in state governor presents a new opportunity to work through the very tough issues of ensuring that financially sound insurers make residential insurance available and that the market is transitioned to premium levels that reflect the risk and the cost of insuring substantial volatility. With such a difficult legacy, quick action by the legislature will be required for those currently financing private insurers to continue to hold their stakes. Reinsurers today have difficulty sorting through potential cedents to find those with a good chance of surviving beyond the very short-term foreseeable future.

### Financial Challenges Still Persist

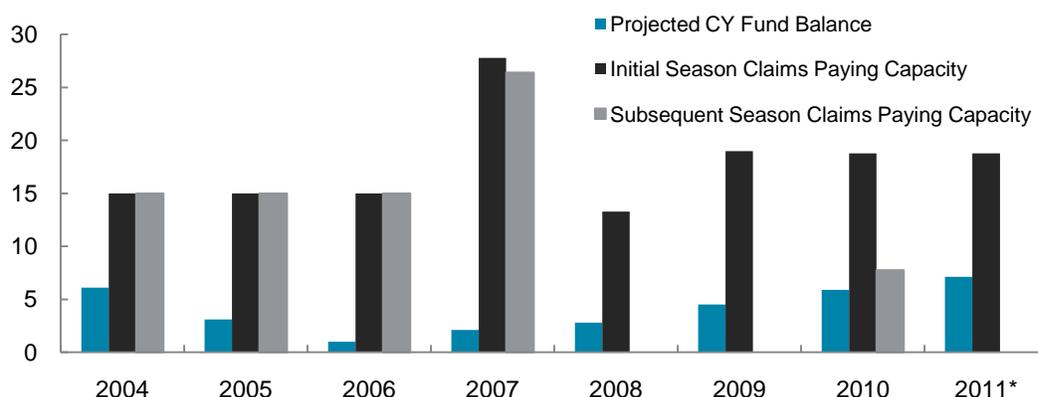
As depicted below, despite more than USD120 million of capital contributions, the capital position for Florida property insurers is flat from the beginning of the year. These capital contributions have been offset by USD138 million net loss through Q3 2010. Given the lack of storm activity, coupled with the benefit of rate increases and reduced reinsurance costs, the net loss for the market is disappointing and speaks to continued challenges of the Florida property market. In 2010, many companies have been impacted by escalating sinkhole claims, leading to material adverse loss development. Since Q1 2010, the Florida property market has recorded USD23.5 million of adverse loss development mostly related to sinkhole claims. In November 2010, the Florida Office of Insurance Regulation (OIR) released a report on sinkhole claim activity based upon data call results received from insureds for activity from 2006 to 2010 (as of September). The findings confirmed that "problems of sinkhole activity in Florida had increased in both frequency and severity" and it specifically noted an "increase in reported sinkholes in the parts of South Florida where sinkholes traditionally have not been an issue." Demotech has also expressed concerns regarding loss development trends related to the Florida market.

The capital contributions noted above were mostly intended to strengthen capital bases following 2009 results, when companies were impacted by mitigation credits, re-opened claims prompted by public adjusters, higher reinsurance costs and increased fraudulent activity related to a poor economy. For 2009, 17 of 55 (31 percent) Florida property companies that we identified reported a risk-based capital (RBC) score below 300 percent. A score below 200 percent can trigger regulatory action. This is in contrast to the rest of the U.S. market in which only three percent of homeowners insurers had a 2009 RBC score below 300 percent. These relatively low RBC scores led to capital infusions in 2010 for many companies, while others made adjustments to their financial projections to satisfy rating agency or regulator concerns. Despite the 2010 capital contributions, many companies may need to contribute additional capital (again) in 2011 to fill-in the hole generated from 2010 results. The continued surplus drain from poor operating results and the need for more capital contributions will invariably lead to Demotech questioning the viability of some business plans, which may lead to increased M&A activity for the market.

### FHCF Financial Stability Increases

With a lack of any major hurricanes during the last five seasons and the decline in coverage available and elected for TICL capacity, the financial stability of the FHCF is poised to be significantly better in 2011 than it has been for the past five seasons. Capacity for the mandatory layer will remain the same as in 2010 at USD17 billion and it is reasonable that elections for the TICL layer will remain at or below the current levels of USD1.4 billion. While the pricing decisions vary due to the portfolio dynamics of each individual insurer, the elections have trended downward in the last two contract years (USD5.5 billion, or 55 percent of the USD10 billion elected in 2009; USD1.4 billion, or 17.5 percent of the USD8.0 billion elected in 2010). Coverage for some companies will remain cost effective compared to the traditional market, especially when factoring in the drop down feature of the TICL layer to provide protection for multiple occurrences. Exhibit 19 shows the estimated level of capacity covered by the fund balance for the 2011 season. This, along with the USD3.5 billion of outstanding pre-event funding, provides liquidity for more than 55 percent of the capacity estimated to be provided in the 2011 season.

**Exhibit 19: FHCF Fund Balance and Claims Paying Capacity**



\*Note: 2011 does not contemplate subsequent season capacity  
 Source: Aon Benfield Analytics

The resolution of pending legal actions dealing with attorney fees being covered by the FHCF regarding claims filed for 2005 will provide more definitive answers for the industry, presumably in the first half of 2011. A decision for either party may also result in changes in practices by the FHCF.

### Significant Implications for Florida Insureds Remain in a Major Event

Although the FHCF's position is better than it has been in many years, a significant event exhausting the capacity would still require more than USD11.6 billion of funding through bond issuance that is financed through assessments for the FHCF alone should a loss occur that exhausts the full limit. Should this loss also cause 100-year events in both the HRA and PLA/CLA accounts of Florida Citizens, we estimate an additional USD10.1 billion would need to be financed, for a total of USD21.7 billion. By comparison, the assessment base of Florida in 2010 is expected to be USD33.3 billion.

### U.S. Earthquake Risk Remains Largely Uninsured

As a product of the U.S. housing collapse and financial crisis of 2008, Freddie Mac and Fannie Mae, two massive U.S. government-sponsored mortgage financing enterprises, saw their financial position fall under extreme duress with a USD116 billion drop in combined GAAP equity. Both companies reported negative GAAP equity for 2008 (deficits of USD31 billion and USD15 billion, respectively). This precarious spiral led the U.S. Government to place both companies into conservatorship run by the Federal Housing Finance Agency (FHFA). Under conservatorship, the FHFA assumed power of the Board and management and this control enabled political support for further government financial backing. The future status of Freddie Mac and Fannie Mae is uncertain. While the Dodd-Frank Act does not detail modifications to Freddie Mac and Fannie Mae, it states that efforts to regulate residential mortgage credit would be incomplete without significant structural reforms of these two entities. As required by the Dodd-Frank Act, the Treasury is conducting a study, due January 31, 2011, on ending the conservatorship of Freddie Mac and Fannie Mae. They are reviewing multiple scenarios, including gradual run-off and liquidation, privatization, absorption of the functions into one Federal agency, dissolution into smaller entities, or any other suitable solutions.

While losses related to the financial crisis were devastating and foreclosures continue to impact financial statements, there remains another looming exposure that Freddie Mac and Fannie Mae assume everyday—earthquake risk. Unlike hurricane risk in high risk areas, Freddie Mac and Fannie Mae do not require homeowners to insure mortgaged homes against earthquake exposure. Currently, there is only an approximate 12 percent take-up rate for earthquake insurance across the U.S. in exposed regions. The estimated industry 1 in 250 year PML from an earthquake event is around USD109 billion. With only a 12 percent take-up rate, USD95.9 billion of this exposure is retained by the property owners and mortgage holders. Freddie Mac and Fannie Mae are estimated to have a combined market share of 50 percent of mortgages.

As depicted in the table below, if homeowners' equity is approximately 30 percent, then Freddie Mac and Fannie Mae's estimated exposure to a 1 in 250 earthquake event is approximately USD33.6 billion. Many of the largest reinsurers manage their catastrophe exposure to approximately 20 percent of GAAP equity, which implies a capital base of USD167.9 billion needed to support this exposure. This implied level of capital need makes Freddie Mac and Fannie Mae the largest catastrophe reinsurer by more than six times.

**Exhibit 20: Analysis of Freddie Mac and Fannie Mae Earthquake Exposures**

USD Billions	100 Year	250 Year
Gross Loss	63.3	109.0
Insurance Take-Up Rate	12%	12%
Uninsured Risk	55.7	95.9
% of Homeowners Equity	30%	30%
Loss of Homeowner Equity	16.7	28.8
Mortgage Exposed Value	39.0	67.1
Freddie + Fannie Market Share	50%	50%
Loss of Mortgage Value	19.5	33.6
PML Tolerance	20%	20%
Implied Capital Need	97.5	167.9

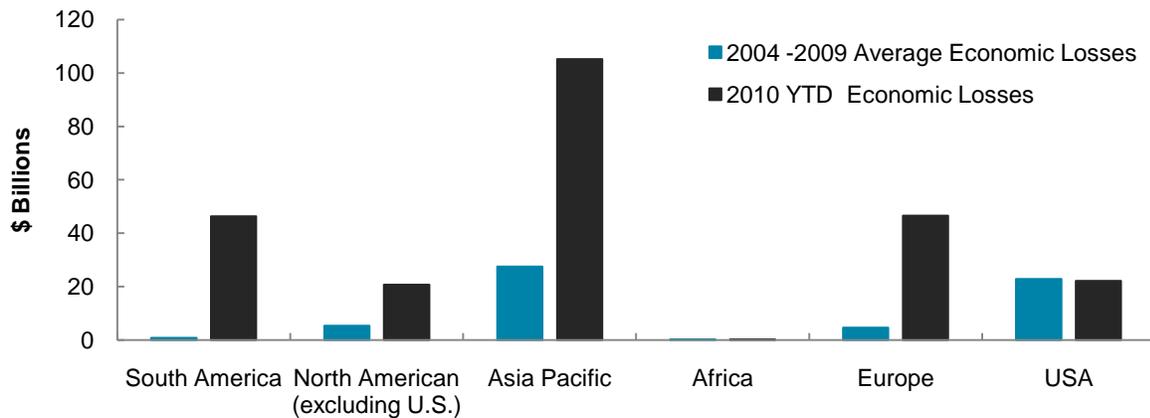
Source: Aon Benfield Analytics

We anticipate that if (or when) Freddie Mac and Fannie Mae's roles in the mortgage market are reduced the successor lender based mortgage market will require its collateral to be insured for earthquakes. The impact on Florida is that any changes in mortgage requirements will begin to allow for diversification against U.S. hurricane risk. This transition is likely to take some of the reinsurance cost burden off of Floridians.

# Property Catastrophe Activity Update

Increased estimates on prior loss activity and additional events that occurred following our September *Reinsurance Market Outlook* have resulted in USD75 billion of additional economic losses from catastrophes outside the U.S. in 2010. Despite approximately USD22 billion total economic catastrophe loss for the U.S., in line with average loss activity since 2004, global losses totaled more than USD250 billion as depicted by region in Exhibit 21.

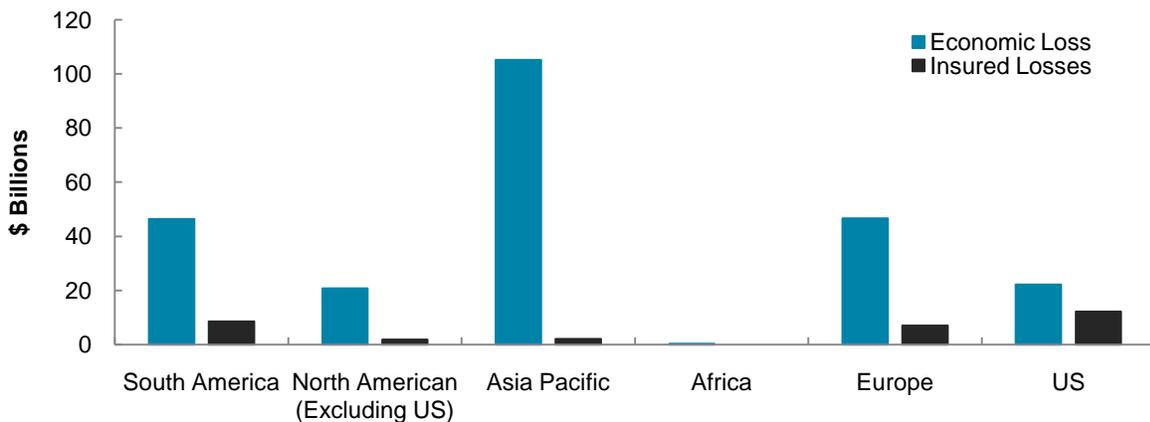
**Exhibit 21: Economic Losses from Catastrophe Events by Region**



Source: Impact Forecasting

Low insurance penetration in the regions with significant economic losses has mitigated the total loss to the insurance industry to USD37.6 billion to date (or 15 percent of the total economic losses). Exhibit 22 demonstrates the significant differences between insured and economic loss in each region.

**Exhibit 22: 2010 Economic vs. Insured Losses by Region**



Source: Impact Forecasting

Further analysis of the non-U.S. loss activity by peril highlights that flood losses have comprised more than USD118 billion of the total in 2010 despite a six year historical average of contributing USD8 billion to the economic catastrophe losses. Other major events including the Haiti, Chile and New Zealand earthquakes and Russian wildfires served to increase the total non-U.S. losses to almost six times the average yearly loss activity for the prior six years and to more than double the individual year average in 2008 at USD103 billion.

Top losses contributing to this year's non-U.S. activity on an economic and insured basis through December 13, 2010 are provided below.

**Exhibit 23: Top Five Non-U.S. Economic Losses**

Rank	Description	Value (USD Billions)
1	Pakistan Flood (7/21-7/29)	30
2	Chile Earthquake (2/27)	30
3	China Flood (7/1-7/31)	25
4	China Flood (6/13-6/30)	15
5	Russia Wildfire (7/1-7/31)	15

**Exhibit 24: Top Five Non-U.S. Insured Losses**

Rank	Description	Value (USD Billions)
1	Chile EQ (2/27)	8.50
2	Windstorm Xynthia (2/27-2/28)	3.65
3	New Zealand Earthquake (9/4)	3.05
4	Australia Severe Weather (3/22)	1.06
5	Victoria Severe Weather (3/6)	1.02

Source: Impact Forecasting

In the U.S., despite an average total economic loss year, a higher level of losses emanated from severe weather (USD15.6 billion compared to an average of USD5.9 billion) and winter weather (USD3.7 billion compared to an average of USD0.9 billion). Additional years like 2010, with lower severity and higher frequency, will force insurers to evaluate the benefit of catastrophe aggregate versus per occurrence protection.

## Rating Agency Perspective on Catastrophe Model Changes

AIR released an update to its U.S. Hurricane model in August 2010 and RMS is set to release an update to its U.S. Hurricane model in February 2011. Both materially increased PMLs over their previous versions based on recent Hurricane activity, particularly in the Gulf of Mexico regions. Historically the Hurricane models had been under-performing, as actual losses were on average one-and-a-half times to double the observed modeled losses. Therefore, the recent model changes are an attempt to rectify this model miss, and better align modeled PMLs with indications based on recent actual losses.

For a nationwide portfolio under AIR, the average change at the 100 year return period for residential lines is down 8 percent while commercial lines are up 45 percent. Losses in the Gulf region increased 56 percent for commercial lines and remained flat for residential, with non-coastal losses increasing much more than coastal losses. RMS has indicated the typical range of sample portfolio increases is anywhere from +20 percent to +90 percent at the 100 year return period, driven by changes in the Gulf; however, there are extreme outliers below and above this range. Our expectation is that RMS will have larger increases in inland losses than observed in AIR. Although the underlying science and supporting theories for the changes in both models are very similar, they are starting from very different points and thus the impact of the change can be very different. Under both AIR and RMS, model changes will be unique to individual companies based on business mix and regional concentrations.

It should further be noted that the current estimated changes to RMS do not include impact of secondary modifiers or storm surge, and both factors could dramatically change results. Findings from more detailed testing of the model will be released in January 2011, including the impact of storm surge.

Given these changes, many (re)insurance companies are wondering how the rating agencies will react and the impact on reinsurance buying decisions for 2011. As the AIR model has been available since August 2010, companies who have historically used AIR to calculate their PMLs and manage their reinsurance will have incorporated the new model into 2011 financial pro-formas and reinsurance buying decisions. And although a number of companies use AIR, we are finding that the greater majority of companies use RMS or a blended approach. Therefore, even though the industry has had time to incorporate the impact of the AIR model changes, many companies have not yet reacted since decisions had previously been based on RMS. The pending RMS changes are receiving much more attention given the potential magnitude of the changes, the model's greater prevalence across the industry, and the fact the impact was essentially delayed one year for companies who renew their catastrophe reinsurance at January 1 due to the timing of RMS' release compared to AIR.

The catastrophe model changes are different than the model changes introduced in 2006. Those model changes established the new concept of a 'near-term' frequency view, and, given the unprecedented frequency and severity of storms that occurred in 2004 and 2005, the rating agencies quickly adopted the concept and applied it immediately for all companies. However, when there has been a model change in terms of updating a catastrophe modeling firm's vulnerability and hazard assumptions, rating agencies have generally allowed companies a short amount of time to absorb and manage the impact of new model results.

Each of the major rating agencies had similar responses regarding this topic. The key takeaways are as follows:

- Rating agency expectations generally allow for an approximate 12 month implementation period from when the model changes are released. The grace period is meant to give companies time to re-underwrite portfolios and absorb model changes within their reinsurance and overall capital management strategies.
- We expect certain companies will be afforded less time to respond given the nature of their risk profile and the relative weakness of their catastrophe risk management practices. This also occurred after the previous round of material model changes following the 2004/2005 hurricanes.
- Companies using AIR will have to report their PMLs based on the new model in 2010 year-end rating agency questionnaires such as the A.M. Best SRQ, the S&P Property/Casualty Insurance Survey and Demotech's data call. Companies with strong capital adequacy and who had previously been contemplating model miss in their risk management and reinsurance strategy will likely have some grace period to address the model changes. Conversely, for a company with weak capitalization or an undefined strategy to address the higher PML results, we expect the rating agencies will be quicker to change the rating outlook to negative or downgrade the company.
- Companies using RMS will likely not have to report their updated PMLs in the 2010 year-end rating agency questionnaires due to the anticipated release date of the new model. Realistically companies will not have sufficient time to re-run their PMLs in between February (expected release of the RMS model) and the due date of the questionnaires. Nonetheless, when companies are meeting with the rating agencies for their annual rating meeting they should be prepared to discuss the impact of the new model change and communicate their strategy for managing the increased PMLs.
- For companies whose catastrophe reinsurance renews at May, June or July, the rating agencies will give less leeway in the grace period for incorporating the updated model results as these companies will have sufficient time to adjust their reinsurance strategy. Again, based on risk management, capital adequacy and historic consideration of model miss this will vary by company, but companies who renew after the updated model is available should not expect a full rating cycle to make all necessary changes.
- Most importantly, there is no expectation that rating agencies will adjust their return period thresholds. Companies whose capital adequacy is at or near minimum levels using the current modeled will have to explore capital alternatives once the updated modeled PMLs are incorporated into the capital calculations as overall requirements will not change.
- Companies who have previously used AIR for reinsurance buying decisions and who reported AIR to the rating agencies in the respective questionnaires in the past cannot arbitrarily change to RMS this year to delay the impact of the model changes. While rating agencies accept model results from various vendors, they are also very cognizant of the temptation for 'model shopping.'

To illustrate this, below is a catastrophe stressed A.M. Best's Capital Adequacy Ratio (BCAR) analysis for a Texas property company based on a composite of several standard Texas property writers assumed to be 'A-' rated. A.M. Best will generally use the catastrophe stressed BCAR in lieu of baseline BCAR for companies with significant property catastrophe exposures.

- Baseline BCAR, which is a company's published BCAR score, includes a reduction from capital for the first event Net PML (Net PML is defined as the largest net 1 in 100 occurrence-based hurricane or wind or 1 in 250 earthquake; net PMLs include reinsurance recoveries and reinstatement premiums, and are net of the company's statutory tax rate).
- The catastrophe stressed BCAR is meant to represent what the company would look like the day after a major catastrophic event occurs.
- The catastrophe stressed BCAR assumes that the first event Net PML is fully paid from surplus.
- In addition, it assumes a second event Net PML is probable and therefore is reduced from surplus—the second event Net PML is defined as the largest net 1 in 100 occurrence-based PML and calculated in the same manner as the first event Net PML.
- Further, 40 percent of catastrophe reinsurance recoveries are added to the credit risk portion of the BCAR and 40 percent of the net retention is added to the reserve risk portion of the BCAR. A.M. Best assumes that companies will collect 60 percent of its recoveries and pay 60 percent of its losses fairly quickly. The 40 percent charge represents the portion not collected/paid within the first year.
- A company's catastrophe stressed BCAR should not fall more than 30 points below the company's minimum BCAR score (in most cases the minimum BCAR for the rating category).
- The PMLs in the illustration below are calculated using RMS.

We analyzed a 'low' model change and a 'high' model change scenarios. RMS published some initial guidance on the range of changes in loss costs by county for Texas wind losses between the current wind model and the upcoming version. Each county was given a range of factors by which the current model loss costs will be increasing in the new version. For example, RMS shows that loss costs in Harris county could increase by a factor of 2x to 10x, so our low end estimation considers a factor of two for Harris County and our high end estimate uses a factor of five, recognizing that this factor could be as high as 10.

Baseline BCAR, including a first event 1 in 100 occurrence-based Net PML, for this composite is 182.1 percent and the catastrophe stressed BCAR is 169.0 percent. The minimum and median BCARs for each rating category are listed in the table below, noting that this composite company is above the minimum capital requirements for its 'A-' rating but well below the median.

**Exhibit 25: A.M. Best's Capital Adequacy Scale**

Rating	Minimum	2009 Median
A++	175	304
A+	160	293
A	145	300
A-	130	255
B++	115	230
B+	100	194

Source: A.M. Best

When considering 'low' model change, the catastrophe stressed BCAR declines to 114.7 percent and *negative* 123.9 percent when considering 'high' model change. This company could likely not maintain its current A.M. Best rating assuming the low model change, and would fall well below minimum capital requirements assuming the high model change. Therefore, the company would need to explore capital alternatives. The company could either raise additional capital or purchase additional reinsurance cover. Under the low scenario, the company could buy an additional USD80 million at an average four percent ROL and achieve the same BCAR. Under the high scenario the company would have to buy USD580 million to keep BCAR relatively flat.

#### Exhibit 26: Sample BCAR Impact Analysis

	Current PMLs	Low Estimate	High Estimate	Ceded ROE
Catastrophe Stressed BCAR	169.0%	114.7%	-123.9%	
PML/Surplus	7.3%	22.9%	98.1%	
Additional \$80M of reinsurance		168.6%		2.3%
Additional \$580M of reinsurance			164.4%	2.1%

Source: Aon Benfield Analytics

The model changes will impact states in the U.S. beyond Texas; Texas was used for illustrative purposes only. Further, ratings implications will be similar for all rating agencies globally whenever a change in the models becomes available.

Catastrophe models are a valuable tool in helping companies measure and manage their catastrophe exposure, but they are only a tool, and company management must supplement this with additional analysis. Aon Benfield's model miss studies have provided evidence that catastrophe models have underestimated losses since 2006. This model change will work to close the gap between historic actual losses and modeled losses. Insurers who historically considered 'model miss' in their risk management and catastrophe reinsurance purchasing decision typically bought above rating agency standards, and will be well positioned to successfully manage the year over year change in modeled losses.

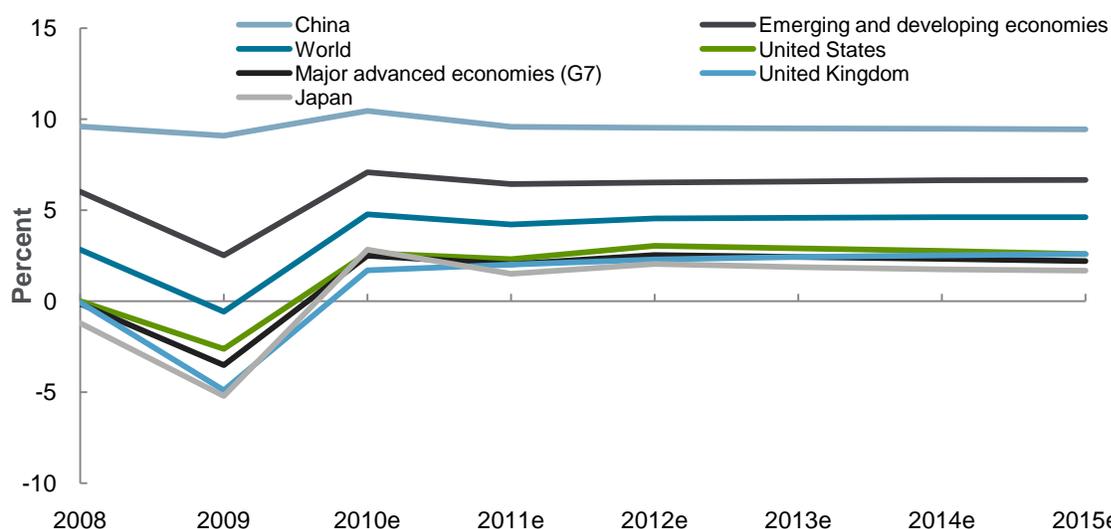
Companies who have historically disclosed risk tolerance targets in terms of capital or earnings at risk driven by a PML need to be mindful of the impact of model changes, even if they think they have sufficient capital to absorb the increased PML. Risk tolerance targets should remain relatively stable year over year. Increasing the stated tolerance, either by allowing a higher percentage of capital at risk or by looking at a shorter return period, will be frowned on by the rating agencies, especially if seen as an expedient reaction to model change.

While capital adequacy is just one component of rating agency analysis, it generally sets the ceiling for a company's rating and is a useful metric for comparing and contrasting companies' relative capital strength.

## Economic and Financial Markets Update

The global economy posted a moderate recovery during 2010 in response to the stimulus from governments around the world. Emerging market countries continued to perform well, in part driven by strong growth in China where the economy was only minimally impacted by the global downturn in 2009. Asia performed well reflecting the strength of growth in China and India supported by high growth in other regions. Growth was hampered in many industrial nations with the ending of fiscal policy incentives and relatively high rates of unemployment. Steady economic growth is forecast in the coming years.

**Exhibit 27: Real GDP Growth Percentage Change**



Source: IMF World Economic Outlook Database, October 2010

Forecasts appear to represent a relatively benign scenario, but this could be threatened by several factors:

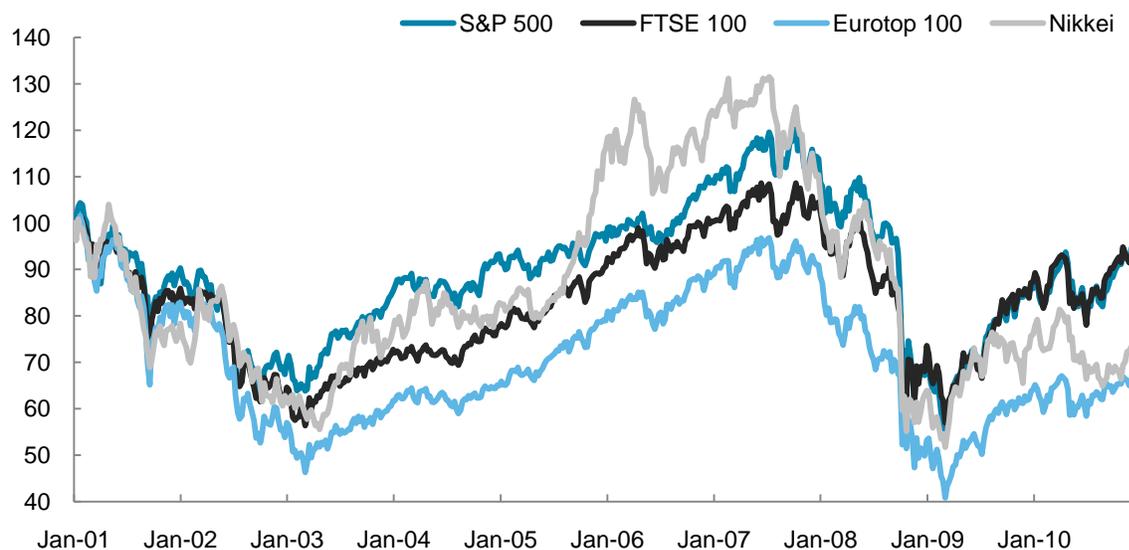
- Financial assistance was provided to the governments of Greece and Ireland during the second half of 2010. However, many European banks are exposed to the sovereign debt of countries such as Greece, Ireland, Portugal, and Spain—all of which are perceived as weaker economies—and economists fear another financial crisis should major restructurings of the debt of other countries become necessary.
- Fiscal tightening already implemented in Europe could choke off recovery, and provoke a period of stagnation.
- Conversely, there is concern that current fiscal tightening might be insufficient, particularly in the U.S. A consequent weakening of the U.S. dollar could then provoke a spike in interest rates resulting in a slowing of global economic growth.
- Growth in European and North American economies could slow if unemployment rates remain high.

Governments around the world have targeted low interest rates as a key policy measure to promote economic recovery and this has recently been emphasized by the resumption of quantitative easing in the U.S., which is intended to keep long term interest rates down. A consequence of this is to exert downward pressure on the dollar exchange rate.

Low interest rates have important consequences for insurers and reinsurers. Initially, balance sheets have benefited as the rise in market value of government and corporate debt holdings has boosted capitalization and solvency and this has been an important contributor to the apparent capital surplus reported by many companies. However, this may be illusory as the pull to par means that unrealized gains presently reported will disappear as the bonds approach maturity, and a rise in interest rates would erode much of the unrealized gains. A second consequence is that low interest rates translate into very low investment returns on new cash inflows, putting additional pressure on underwriting. The geared nature of the non-life (re)insurance industry's balance sheet means that for every percentage point reduction in interest rates the combined ratio has to be cut by almost two percentage points to generate the same return on equity.

World stock markets broadly fell in the early months of 2010 but staged a recovery during the second half of the year. The U.S., represented by the S&P 500, ended the year up 10.3 percent at 1,243. In Europe, the Eurotop 100 index closed up 5.6 percent at 5,886 and the U.K.'s FTSE100 index rose 8.6 percent to 5,886. In Japan, the recovery in the Nikkei in recent months was not sufficient to offset earlier falls, so the index ended down 1.8 percent at 10,304.

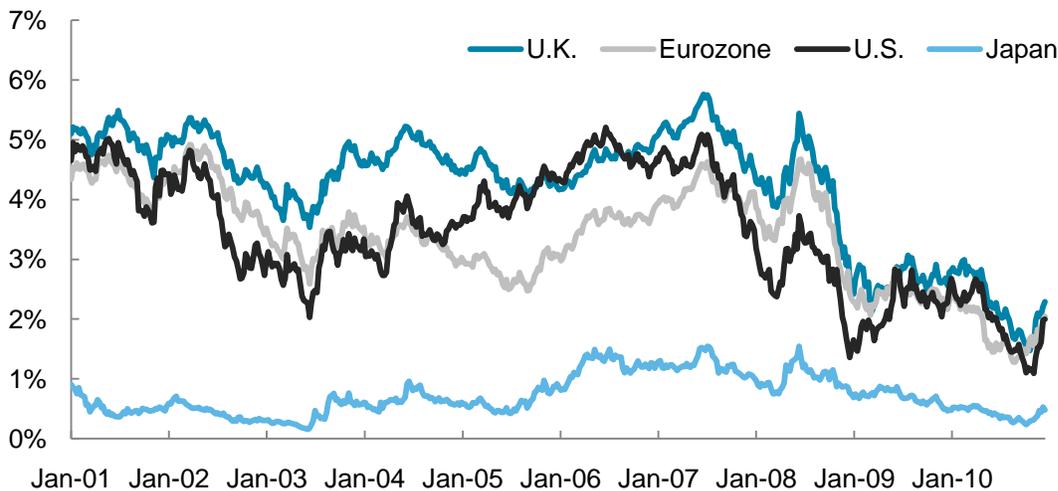
**Exhibit 28: Equity Markets Index**



Source: Bloomberg

Government bond yields drifted down for most of the year, although there has been an uptick in recent weeks. Nevertheless, yields were down year-on-year falling by 0.5 percentage points in both the U.S. and the U.K. to 2.0 and 2.3 percent, respectively. The fall in the Eurozone was 0.3 percentage points to 2.1 percent. In Japan, the yield ended the year unchanged at 0.5 percent.

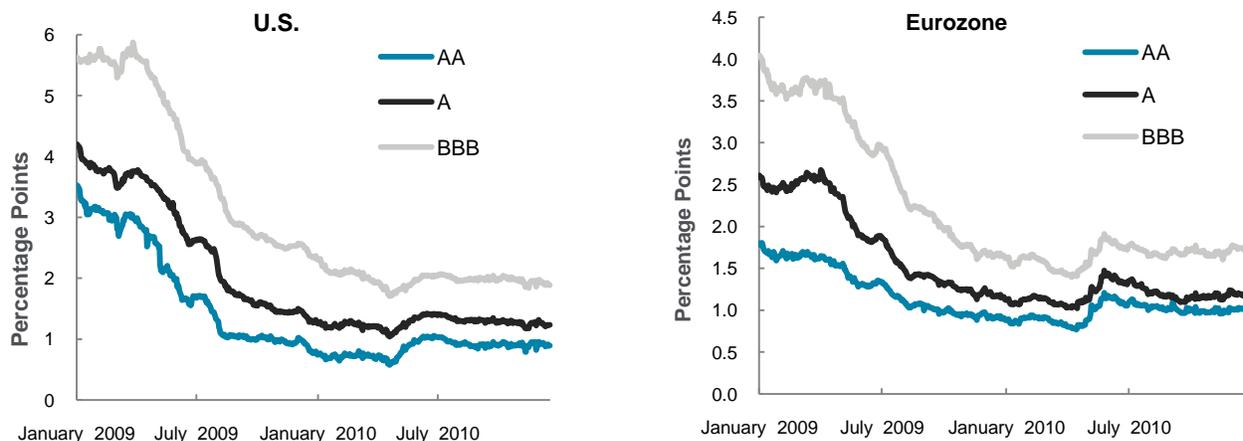
**Exhibit 29: Five-year Government Bond Yields**



Source: Bloomberg

The corporate bond markets stabilized in 2010 with the yield spread over government debt substantially below the levels at the start of 2009 in the peak of the credit crisis. The tightening of spreads through 2009 and into the first part of 2010 was reflected in a recovery in the market value of corporate bond investments held by insurers and reinsurers and has been a significant contributor to the sector's recapitalization. Spreads have remained relatively stable during the second half of 2010 and are now lower than pre-crisis in the U.S. but still somewhat higher in the Eurozone.

**Exhibit 30: Five-year Corporate Bond Spreads Over Government Debt**



Source: Bloomberg

Data as of December 17, 2010

# Sector Analysis By Geography

The following sections provide an update on significant reinsurance market segments by region.

## Asia Pacific

### Australia and New Zealand

The Darfield Earthquake that struck New Zealand on September 4 is estimated by the NZ Reserve Bank to have caused economic losses of NZD5 billion (USD3.8 billion). This loss added to an already active year for Australian and New Zealand catastrophes with the earlier storms in Melbourne and Perth. Notwithstanding this loss activity, capacity remains abundant across a range of classes of reinsurance. Pricing in all classes is very much loss experience driven and pressure on retentions remains isolated only to specific cases. Programs that did not cede losses to the market renewed with flat pricing year over year.

Adding to the supply of capacity, a number of reinsurers have been opening offices in Singapore with focus on the region. Singapore has now become a significant market for Australian/NZ business.

In September, the Australian Prudential Regulation Authority (APRA) began discussions around changing the Concentration Risk Charge for insurers. APRA is in the process of consulting with the industry on the topic; however, their intentions are for insurers to hold capital to limit the impact of retained losses within retention levels from multiple events in a given year. This change in approach has the potential to alter the way that insurers buy their catastrophe protections in Australia. Implementation of any new regulation is expected in 2012 and depending on the final outcomes, changes could start to impact reinsurance purchasing in 2011.

### China

The Chinese non-life insurance industry is growing strongly with total gross written premium of RMB263 billion (USD84 billion) in the first eight months of 2010, up 33 percent compared with the same period last year, according to the Chinese Insurance Regulatory Commission (CIRC). Peoples Insurance Company of China, Ping An and China Pacific remained the top three non-life insurers, with 66 percent market share in terms of premium income by the end of August this year. These three insurers achieved premium growth of 23, 59 and 46 percent respectively.

Generally, original rates for property are stable with some increases for engineering.

The heavy rainstorm in Southern China this year is not likely to impact China insurance community appreciably, but it will raise awareness for extreme weather loss scenarios and the increased need for catastrophe protection. In the absence of a large insured catastrophe loss, property catastrophe excess of loss treaty pricing will continue to soften but overall spend will appear to increase due to continuous increase in exposures and fast growing net retained premium income.

Reinsurers continue to show consistent interest in China. Capacity is generally increasing, with new Bermuda entrants and Lloyd's entrants setting up operation in Singapore.

Due to the positive performance of Non-Marine proportional treaty business in 2009 and 2010, ceding companies are looking for improvements in renewal terms and conditions, in particular financial terms to reflect the encouraging development of the treaty performance. Ceding companies continue to increase retention levels correlated to increases in paid up capital and to minimize reinsurance spend.

Property risk excess of loss treaty business is under heavy pricing pressure, in particular for loss free programs due to the strong availability of capacity in the market.

Renewals in China mirrored many other regions with major renewals entering the market very late and completing placement in the last days of 2010.

### **Hong Kong**

Hong Kong remains a developed property and casualty insurance market with premium of HKD23 billion (USD3 billion) in 2009. There are over 140 registered P&C companies; however, only 70 of them are active. Market concentration is regarded as low—market share of the top five insurers together is less than 35 percent.

This year we saw nine percent primary premium growth in the first nine months (year on year comparison) on all lines of P&C business due to the economic recovery. Yet keen competition exists among insurers and price decreases are being observed on policy renewals.

Hong Kong treaty arrangements are mainly on a proportional basis except for casualty lines.

As a result of low insured catastrophe loss activity, few insurers arrange catastrophe cover to protect their portfolios, particularly local companies. Fewer typhoons affected the area in 2010, but Super Typhoon Megi (Category 5) almost made landfall in mid-October. It would have been the first Super Typhoon on record affecting the Pearl River Delta, providing a good test for validation of existing typhoon models.

Retention and capacity levels are largely being maintained except for general third party liability policy where the maximum limit requested is above the current HKD50 million level.

Commission terms on proportional treaties for January renewals are increasing by 1.0 to 2.5 points for well performing treaties while others remain flat year over year. Excess of loss prices on both risk and catastrophe covers are dropping by 5 to 10 percent despite the soft market environment that has continued for a number of years.

### **India**

The majority of programs in India renew at April 1 as a result of the Insurance Regulatory and Development Authority encouraging all business be conducted in line with the Indian financial year.

Depressed original rates combined with a number of small to medium-sized losses, means proportional treaty renewals are expected to be the main area of concern for Indian insurance companies as many were already in a negative position. While primary prices on headline risks still appear to be declining, albeit at a slower rate, there are some indications that on small to medium sized risks rating levels are stabilizing.

With the depressed original market conditions, clients are under pressure not to spend more on reinsurance. The monsoon flooding in the north and west are not expected to significantly impact the Indian catastrophe programs. To date, there have not been any significant risk losses, although there have been a number of small to medium sized losses which may put some pressure on deductible levels.

### **Indonesia**

The Indonesian market is expected to continue to soften in 2011. The eruption of the Merapi Volcano was a timely reminder for the potential for catastrophic loss in Indonesia; however, it has yet to produce significant insured losses. With no further major catastrophes after the Padang Earthquake, excess of loss capacity in the International market remains competitive.

However, we are seeing a gap developing between the rate of decline in the original market and that being afforded by the reinsurance market. Continuing original rate reductions are now having a marked impact on pro rata results and this in turn is having an impact on domestic proportional capacity. Domestic reinsurance providers are now looking to switch their capacity to excess of loss.

The planned increases in minimum paid up capital (USD4.5 million 2010, USD7.8 million by 2012 and USD11.1 million in 2014) are still being pursued by the regulator and we expect this to start the drive for mergers and acquisitions within the near future.

### **South Korea**

The Korean market renews predominantly at April 1. During the last renewal season, the market enjoyed roughly 5 to 10 percent reductions on a risk adjusted basis. This trend is expected to continue in 2011, subject to no major loss.

Korea experienced its first catastrophe loss in seven years when Typhoon Kompasu made landfall September 2-3, and while this loss impacted many first layers, it was not a significant event for reinsurers following several years of good results.

In mid-July, the Financial Supervisory Service sent a letter to all local companies including Korean Re, Korea Insurance Development Institute and the General Insurance Association of Korea instructing them to evaluate the performance of their respective companies by measuring retained premium and profit rather than original premium. The intention is to force companies to concentrate less on turnover and short-term strategies. This instruction will be placed into effect in January 2011 for all non-life insurance lines other than long-term and motor policies.

The situation between South and North continues to be closely monitored following the recent escalation of activities but the current focus is more on broad economic issues rather than insurance related impact.

### **Singapore**

There remains an abundance of capital in Singapore resulting in ample capacity to meet treaty reinsurance demands. No significant property risk losses and a lack of perceived catastrophe exposure, coupled with profitability of the property market means property treaties rarely have event limits.

Volatility in the motor segment and resulting rate increases have been mitigated by the recent improvement in results and the impact of new entrants. Original pricing is likely to remain flat for the near future but trending down again throughout the latter part of 2011. Motor reinsurance continues to be predominantly purchased through excess of loss and prices continued to soften owing to generally positive reinsurance results.

Workers' compensation claims are trending upwards resulting in concern within the industry over rate adequacy. This, along with the potential spill over for medical expense cover being provided to foreign workers is being closely monitored.

Public liability limits for engineering business are commonly increasing to USD11.5 million up from USD7.6 million but this will be easily covered within most standard casualty programs.

### **Taiwan**

There have been no major catastrophe losses this year but a series of major fire and engineering losses have negatively affected the property and engineering market. Primary market pricing remains soft, though the trend is bottoming out and there are attempts being made within the market to introduce tariff pricing for natural perils for the larger property risks in 2011.

Catastrophe aggregate exposures have increased significantly for a number of companies due to the soft state of the primary market leading to increased levels of cover being quoted for 2011. However, most companies remain constrained by budgetary pressures due to inadequate levels of original natural perils pricing and as a result find it difficult to afford conservative levels of catastrophe reinsurance cover.

Reinsurance market pricing remains flat for most lines of business though abundant capacity and continuing competition for business is expected to result in modest technical softening of the order of 5 to 10 percent risk adjusted for accounts where the loss record has been good and exposures have increased—i.e. nominal pricing may not keep pace with underlying exposure increases. In contrast, for reinsurance programs negatively affected by losses, we expect to see price increases of up to 30 percent. This hardening of terms will apply to property and engineering pro rata and per risk excess of loss programs many of which have been negatively affected by a series of large single risk losses during the current year.

### **Philippines**

Super Typhoon Megi (Pagasa: Juan) struck the Luzon province of the Philippines on October 18, 2010. Despite sustained wind speeds in excess of 156 mph it appears to have caused little insured loss primarily due to the low insurance penetration in this northern region.

However the loss arising from Typhoon Ketsana (Pagasa: Ondoy), which occurred on September 23, 2009 and impacted Metro Manila, continues to develop in size though 2010. Early estimates of Ketsana have been significantly increased as the extent of damage from the property and motor lines are reported. Flood damaged vehicles which were initially thought to be repairable have instead been written off as workloads to garages became overwhelming.

Many catastrophe programs were severely affected by Typhoon Ketsana and saw significant price increases—some as high as 40 to 50 percent—during the 2010 renewals. Reinsurance pricing for 2011 is expected to be relatively stable although programs where losses or aggregate exposures have further escalated since the last renewal may see some further price correction.

The tariff on earthquake and typhoon was ‘reinforced’ in early 2010 following the financial losses caused to insurers by the catastrophe claims. Despite this the direct market remains competitive for property business.

### **Pakistan**

Following minor floods in 2008 and 2009, in 2010 the Pakistani insurance market was badly affected by the floods that affected 20 percent of the country's land area. These flood losses have adversely affected the reinsurance results of the market and the 2011 treaty reinsurance renewal is therefore proving to be tougher than last year.

Increases in original rates for crop insurance are being discussed and the government is considering supporting the crop insurances for subsistence farmers and may subsidize the premium for small holding farmers.

Original property rates are still under pressure although the rate of decline has slowed and there is sufficient proportional capacity.

Property excess of loss capacity remains plentiful but prices are expected to increase 5 to 10 percent following the floods.

In line with the directions of the Securities and Exchange Commission of Pakistan (SECP) most of the insurance companies have, or will, increase their paid-up capital to PKR300 million (USD3.5 million) by 2011. However, the key concerns of the insurance industry are the macro-economic influences of law and order, introduction of new taxes and political instability resulting in an overall decrease in business activity.

### **Malaysia**

Following introduction of risk based capital at January 2009 the market has been through a period of consolidation which looks set to continue through 2011.

A profitable tariff property market means generally good results for clients and reinsurers alike although increasing competition and high commission levels are beginning to impact reinsurers' margins.

Risk adjusted excess of loss pricing for property is expected to reduce at least 10 percent for 2011.

Motor and third party bodily injury in particular continues to be a significant segment of the reinsurance buying landscape and pricing is loss sensitive with reductions available to better performing portfolio's.

Takaful is expected to grow faster than conventional through 2011 due to a combination of increased personal lines awareness coupled with increased pressure for Government related entities and industries to purchase from Sharia compliant providers.

## Vietnam

Vietnam continues to rely heavily on proportional reinsurance but with an abundance of capacity, the reinsurance market remains competitive and required increases in per risk or cession limits are not proving a problem. The market continues to perform well for reinsurers although ongoing rate competition is now squeezing margins in some instances when coupled with the historically high commission levels.

Co-insurance/inwards reinsurance acceptances continue to be a concern for some reinsurers and have caused loss accumulation via multiple acceptances.

Excess of loss capacity remains high and with the new entrants in the Singapore reinsurance markets and with an absence of significant insured catastrophe loss activity in 2010, rates are expected to fall 5 to 10 percent for 2011.

## Europe, Middle East and Africa

### Austria

After substantial catastrophe loss activity in prior years, no major local losses affected the Austrian market during 2010.

Reinsurance capacity remained abundant resulting in overall flat pricing on a risk adjusted basis in most cases. Few programs were restructured and some low layers experienced price increases. For nationwide Austrian programs, some price reductions were achieved for claims free programs. As expected, demand for frequency protection has increased resulting in new aggregate contracts for the January 2011 renewals.

Companies are still debating the calculation of the current standard formula approach of CEIOPS and are in disagreement with the results on natural catastrophe perils. In particular, for earthquake and flood, Aon Benfield's Impact Forecasting model makes use of a more detailed dataset and are widely accepted among clients and reinsurers. This is due to the fact that Impact Forecasting accounts for individual exposure evaluation in client's portfolios while the CEIOPS standard formula does not. On this basis, most of the Austrian programs already comply with the Solvency II requirement to cover the 1 in 200 year PML. For property, all proportional treaties continued to be under review by lead reinsurers, supporting the trend to seek additional non-proportional capacity.

As in other European countries, there has been a deterioration of results in the primary motor third party liability market and many insurers intend to increase their tariffs. That said, there has been minimal pressure on excess of loss reinsurance rates in this market segment. A few reinsurers even offered slight price reductions on small and medium-sized local Motor TPL programs.

Attachment levels mostly remained stable. For all other lines of business, we have seen stability in terms of pricing and capacity.

### **Belgium and Luxembourg**

Property renewals in the Belux market showed a modest softening for property catastrophe business despite an increase in demand due to the Solvency II 1 in 200 year cover as well as additional aggregate protection against frequency. On a risk adjusted basis, rates reduced approximately three percent for catastrophe excess of loss programs and limits were secured quite easily despite a series of minor natural peril events such as Xynthia, Olivia and the November floods.

Property per risk excess of loss remains attractive to reinsurers and most programs benefited from the diversification aspect as well as a benign year for large fire losses.

Renewal terms for motor and general third party liability programs are fully defined by the company statistics, which varied significantly from one company to the other during January 2011 renewals. In general, this line is benefitting from the insurance premium increases initiated by the major insurance companies.

Life, WCA, and accident programs remained competitive as results continue to be very positive for reinsurers.

### **Central and Eastern Europe**

The Central and Eastern Europe region was exposed to an unusual frequency of small to medium-size catastrophe losses in 2010. The major event occurred between May 13 and mid-June and brought flooding across four countries including Poland, Hungary, Slovakia, and the Czech Republic. Total insured losses are estimated at EUR516 million. Another flood event occurred between August 6 and 10, when local torrential rains caused flash floods in the north of the Czech Republic, southwest Poland and southeast Germany. This smaller scale event resulted in more than EUR140 million in loss to the insurance sector. Heavy snowing in the first half of January also had multi-country effects on the insurance industry impacting the Czech Republic and Poland. The subsequent snow pressure produced more than EUR 130 million of insured losses.

The catastrophe activity in the region resulted in an increased demand for frequency protection through catastrophe aggregate covers and increased pressure on loss affected layers. In some cases, this also resulted in retention levels of excess of loss programs being increased. Overall catastrophe capacity purchase in the region remains stable.

Based on preliminary results, pricing of loss affected layers increased by approximately 15 percent. At the same time there was a slight softening of around 2 percent on loss-free layers. On average, the market went up by approximately three percent.

Risk excess of loss rates in the region decreased slightly or remained unchanged, depending on the loss experience. Motor third party liability programs have seen slight decrease as well.

## France

Original rates for personal lines business in France are expected to increase by five percent for motor and property lines of business following difficult market conditions in 2008 through 2010.

Winterstorm Xynthia had an unexpected storm surge and was characterized by two loss types, each representing about 50 percent of the total. Xynthia caused reinsured wind loss and natural disaster loss as described in the natural disaster loss law that was enacted 1982, which created coverage for flooding, landslide, drought, avalanche, earthquakes, etc. Wind is not a covered peril under the natural disaster loss law and is reinsured separately in the market. Property catastrophe layers were mostly unaffected, with the exception of those layers that combined wind and natural catastrophe losses. Xynthia created a further focus on all peril aggregate covers by primary insurers, which generally benefit from the recoveries provided by property catastrophe programs, encouraging them to buy more limit in the aggregate covers than is already widely purchased. Catastrophe aggregate covers represent approximately 10 percent of the total catastrophe capacity purchased. The consequence of this focus is reflected in the fact that catastrophe aggregate covers were the only difficult renewals to place.

Several distinct effects were noted for the more traditional property cat programs—stable to decreasing total sums insured, which generated pressure from the cedent to achieve substantial decreases and an overall discipline from the market. Overall, the pricing trend is stable or slightly decreasing by less than five percent.

A more remarkable decrease was the one benefitting the terrorism Pool Gareat (around 10 percent) and consequently some personal lines terrorism covers.

Indications for motor renewals suggest an overall price increase between three and five percent following worsening development pattern and decreasing in the expected financial income.

Finally, it is important to note that so far Solvency II has had a limited impact on the reinsurance purchase in the French market.

## Germany

Property catastrophe excess of loss programs achieved small decreases on a risk adjusted basis (down four to five percent on average) with no major changes in other terms and conditions. Losses faced by the German insurance and reinsurance industry during the course of 2010 were relatively low, driven by the well-known foreign events and one bigger event –Xynthia. Windstorm Xynthia is estimated to have caused losses at around EUR 575 million for Germany and hit the reinsurance programs. The third quarter results of the major German reinsurance companies are dominated by healthy investment income and good underwriting results and raised profit targets can be expected for 2010.

The 2011 renewal is in line with the expectations and is characterized by stable individual reinsurance program structures. The impact of Solvency II and QIS 5 is moderate since many clients already secured additional capacity to deal with the future requirements, while other companies have elected to wait until closer to the implementation of Solvency II to secure protection to the 200 year level. Buying decisions in Germany remain driven by budget restrictions with continued pressure in the local market on original rates

Property per risk programs renewals were stable year over year and rates continue to be driven by the loss history of the programs. Contrary to prior years, no major fire loss affected the industry in 2010 resulting in a few new reinsurers being attracted to these programs in order to diversify their aggregates.

German motor insurance has become a very competitive market over the last few years. Increasing loss ratios resulting from higher loss frequency during the long winter period in 2009/2010 lead to deteriorating results and most market participants are beginning to increase the original tariffs. Both proportional and non-proportional reinsurance for motor business are under pressure for an improvement by the reinsurers and unchanged excess of loss rates and commissions are the exception.

Overall reinsurance capacity is expected to be more than sufficient. Reinsurers' balance sheets have been reinstated and supply exceeds demand. The existing and new capacity in Switzerland plays an increasingly important role in the German market.

### Israel

Property catastrophe reinsurance pricing decreased 5 to 10 percent on a risk adjusted basis compared to prior year renewals. While the Carmel forest fire is unlikely to impact catastrophe excess of loss programs, it will add a few percentage points to proportional treaty loss ratios.

In general, primary property rates are stable on residential and commercial business with some pressure on rates for large industrial business. Insureds are looking to decrease premiums through higher deductibles and the primary market remains quite disciplined.

The Israeli regulator will likely implement a version of Solvency II that could require an increase in capital for insurers in the region and a subsequent increase in reinsurance demand. Quality security and a diversified panel of risk-carriers will both be emphasized.

### Italy

In general, exposure adjusted reinsurance pricing remains stable, reflecting the fact that contract terms have virtually bottomed out in many cases in recent years. With no noteworthy catastrophe loss in 2010, renewals are largely proceeding at unchanged terms on a comparable basis.

Underlying direct rates remain stagnant and in some instances are decreasing. The exception would be motor liability, as negative results in the past two years have led to increased tariffs. In some instances this has had a bearing on the relevant excess of loss reinsurance pricing.

Certain ceding companies have shown a greater awareness of Solvency II requirements and the impact on reinsurance needs; while others have minimally adjusted their programs to fulfill the requirements. Some reinsurers have also been more rigid in their underwriting approach, a fact which might be attributed to their own Solvency II considerations.

## Netherlands

In general, renewals in the Netherlands were well managed with overall risk adjusted price reductions on property catastrophe programs of five percent on average, and ranging from 1 to 12 percent. Softening continues as a result of the surplus of global catastrophe capacity, the lower Dutch PML estimates from the new AIR model, and the minimum growth of aggregates in the Dutch market. Overall catastrophe capacity purchased reduced one percent for the first time in years as a result of increased retentions (+10 percent on average) and reduced modeled exposures. The RMS 1 in 200 year limit has definitely become the market standard upon which the average capacity is bought. Solvency II is increasingly playing a role in setting that standard.

On non-catastrophe programs, competition was healthy mainly driven by the diversification needed by reinsurers. Nevertheless the ultimate pricing of these programs remain more loss and exposure based rather than market price driven. In general property renewals decreased slightly and casualty renewals remained stable year over year.

The direct market, especially on the commercial and industrial property side continues to soften with renewals receiving 10 percent reductions, and even as high as 40 percent reductions in some cases. Motor business looks to be turning to a hard market as combined ratios well above 100 percent are being reported by some insurers.

## Nordic Countries

Property catastrophe capacity purchased has remained stable for 2011. Modest losses from summer flooding and winter freeze affected some first layers and pricing was adjusted accordingly. Otherwise further portfolio improvements played through in the final pricing, although reductions achieved were modest. Reinsurer capacity remained stable.

For property risk, some fairly significant fire losses affected some programs. Pricing was adjusted to reflect experience, but rate reductions were possible on clean programs.

Most Nordic casualty treaties have not reported any major changes in loss pattern this year or since the financial crisis so renewals in this segment were stable.

There were no extreme catastrophe losses to the Nordic market in the motor third-party liability sector, with the exception of the train loss in Sweden. It is too early to tell the impact of this claim. We anticipate stable to slightly decreased prices and thus stable retentions with more discussions about frequency protections following the hard winter in 2009/2010. Green card exposures of the Baltic accounts are significantly reduced as a consequence of the economic downturn.

For the accident and health market, no major catastrophe losses and more new reinsurers with experienced underwriters entering the market has put further pressure on rates.

## Portugal

The 2011 renewals in Portugal were unusually late this year as many cedents negotiated improved terms beyond prior discussions with the market.

Some proportional programs looked for significant increases in capacity for fire and allied lines. Other improvements, such as a more generous co-insurance clause or some limited increases in property commissions, have been requested as well. Neither traditional reinsurers nor the available alternative markets have been willing to completely agree to this term, forcing both cedents and reinsurers to meet in the middle. Other proportional treaties covering engineering, transportation and bonds have renewed at stable terms and conditions.

2011 renewals saw continued migration of personal accident and third party liability insurance from historical proportional programs into excess of loss during this renewal period. As a result, most of the market now has non proportional personal accident and third party liability protection although exceptions do exist.

Pressure from cedents for a reduction of rates in property catastrophe excess of loss reinsurance resulted in some companies electing to buy a little less coverage at the top of the program. Results from the commercial models continue to vary widely, resulting in differing opinions of exposure throughout the market.

Motor and workers' compensation experienced no major changes in capacity, conditions, or price for January 2011 renewals.

## Spain

Results for 2010 have been generally positive in most lines of business with solid margins continuing for reinsurers in motor, liability lines, engineering and credit where experience has improved in the last few years following the losses of 2008.

For many insurers, property classes have shown negative results due to large risk losses in Spain and the impact of natural catastrophe losses in Latin America which continue to affect Spanish interests in the region. Price increases of 10 to 30 percent were experienced for treaties with loss activity. That said, capacity is abundant and there is little movement in reinsurer panels or room for reinsurers interested in entering the Spanish markets.

Pricing in the insurance market remains soft with heavy competition in large risks where reductions of 20 percent are common. Despite this, primary results remain positive.

## Switzerland

Reinsurers continue to open offices in Switzerland as a result of the friendly tax environment and the desire to increase their Swiss and continental European business. While the former remains a benefit, it may be difficult for reinsurers to achieve additional market share in the area since Swiss cedents do not tend to make big changes on their reinsurance panels if content with their reinsurance partners.

With no significant catastrophe losses for Switzerland in 2010, the current catastrophe market situation is still relatively soft and risk adjusted price decrease of approximately five percent were achieved for earthquake exposures. Motor liability rates remain more or less unchanged and slight increases were seen in GTPL business. Property per risk rates decreased by 5 to 10 percent.

Regarding the primary market, cost pressure is still very high and rates are still decreasing on the original side.

### **Turkey**

Exposures increased for most Turkish insurers partly as a result of organic growth but mainly due to the Turkish Lira appreciation against the Euro. This resulted in more cover purchased although retention levels remained the same.

While exposure change in euro terms differs by reinsurers directly resulting from the high volatility in the rate of exchange during the last renewal, a common rate of exchange on like for like business implies a 10 to 15 percent reduction in Turkish catastrophe excess of loss renewals.

Property pro rata placements were straight forward and renewed near expiring terms with some new comers in the market.

### **U.K. and Ireland**

U.K. property catastrophe renewals have seen prices continue to soften throughout 2010 due to excess reinsurer capacity. Prices at January 1 decreased 5 to 10 percent on a risk adjusted basis. Additional cover has been purchased to reflect growing exposures while retention levels have reduced on a relative basis. With excess capacity still evident, we expect this trend to continue into 2011. Original rates for personal lines property business have hardened slightly. Commercial lines remain competitive.

Poor original market results in the U.K. motor market in 2008 and 2009 have led to a sustained increase in original rates that has in turn benefitted reinsurers who have secured a better rate per vehicle on virtually all portfolios. Reinsurers perceive that this is warranted due to the combined effect of:

- Periodical Payment Orders (PPO) which may increase the cost of claims and the period of time to final settlement.
- General bodily injury claims inflation
- Diminishing investment returns
- Increased cost of capital for reinsurers

In addition, concerns about both a possible review of the discount rate as well as the withdrawal of unlimited retro capacity by a significant reinsurer has led to further upward pressure on reinsurance rates. That said, at this juncture with ample capacity available, rates on income are flat with reinsurers only winning increased rates on programs with higher deductibles where volatility is a concern or where claims experience has deteriorated. In some cases, insurers who purchase at a lower deductible or are able to prove a de-risking of the portfolio have achieved rate reductions.

The original market for U.K. liability (public and employers) remains weak with reductions in rate being prevalent. Reinsurer capacity remains strong; reinsurance rates are generally flat with some small reductions where experience is good.

There is evidence that original rates are turning for the better in Irish motor business. Reinsurer capacity remains strong due to lower frequency and severity than the U.K. as well as the lack of PPOs despite recent discussions to adopt them. Reinsurance rates in the segment are generally flat on a risk adjusted basis.

Developments in the life reinsurance market around longevity risk have responded to one of the biggest challenges facing governments, corporations and individuals in the 21st Century. Many of the U.K.'s major insurers have reinsured their longevity risk on their annuity portfolios. However, the much larger U.K. pension fund market has significantly larger exposure. Recently, there has been a focus on longevity only risk transfer transactions. Reinsurance has been substantially the main risk provider for the BPS 6 billion of liability values that has been placed on this basis in the last three years.

### **Middle East**

The Middle East primary market has experienced premium reduction pressure, with rates slipping up to 10 to 15 percent. Focused efforts on writing premium over underwriting have led to a loss in profits with an average combined loss ratio of 95 to 105 percent. Many local companies are now starting to look outside the region to grow their business.

Reinsurance rates also remain soft despite continuing deterioration in loss experience. Certain reinsurance markets are reviewing who they now reinsure and which class of business they write. Specialized classes such as energy and aviation are also under pressure despite being a smaller reinsurance marketplace.

Life and medical insurance markets are seeing growth due to some governments applying compulsory medical insurance and group life insurance being bought by individuals and large companies. That said, medical loss ratios for some insurers have produced unattractive results.

Significant growth potential for insurance in the region remains as a result of the oil and gas industries, various government initiatives to fuel growth, and an increasing young and educated population.

Various country regulators including SAMA (Saudi Arabia Monetary Authority), DIFC (Dubai International Financial Centre), QFC (Qatar Financial Centre) & CBB (Central Bank of Bahrain) are applying greater regulatory pressure to insurers. Applying various licensing product restrictions, higher capital requirements, increased reinsurance limits, tougher financial accountability and compliance rules, insurers are becoming more accountable.

There seems to be real potential within the facultative market for 2011 with infrastructure projects for massive housing schemes, roads and general utilities to be underway by mid to late 2011. Expectations are that the announcement of Qatar hosting the World Cup for 2022 will spur on additional major projects around the region such as the Middle East Rail and Bahrain-Qatar Causeway.

## South Africa

Africa continues to attract international insurers and reinsurers due to its geographical diversification for the main insurance markets and lack of major catastrophes in the region. While earthquakes in the Maghreb region of North Africa, as well as Kenya and South Africa remain the most significant exposure to catastrophe loss, these areas have not suffered any major losses recently..

Aon Benfield together with a local university is at the forefront of research on natural perils and has recently developed a bespoke hail model specifically for crop and motor business in South Africa. The catastrophe modeling team has also enhanced its earthquake modeling capabilities significantly, with the release of the new Impact Forecasting Elements model. The team based in Johannesburg is willing to engage with both existing and potential new markets who wish to write business in the region to discuss their findings and assumptions utilized.

South African reinsurance programs have seen rate changes comparable to their international counterparts and these programs include a large participation from non-registered reinsurers domiciled outside the region. South African catastrophe rates continue to be stable with slight reductions of up to five percent where justified, depending on growth in underlying exposures given the lack of catastrophe losses in the market.

As regards Risk excess of loss treaties these are being renewed unaltered subject to loss experience. Proportional reinsurance is still utilized in the South African market, mainly in the property sector, with commission levels remaining stable (subject to favorable results) over this renewal.

South Africa is due to introduce SAM (Solvency Assessment & Management) in 2014 and the framework is likely to be based on Solvency II. This will impact the capital requirements for locally registered insurers and reinsurers, and the majority of companies are currently developing their own internal models to comply with this legislation.

For Africa outside of South Africa, the use of proportional reinsurance is still very much a feature of the placement in the region. These treaties, whilst being more volatile than their South African counterparts, are extremely profitable with relatively high ceding commissions being prevalent.

## Americas (Excluding U.S.)

### Canada

Canada experienced a significant reduction in reinsurance capacity secured due to continued movement from proportional reinsurance to excess of loss, mergers and acquisitions, and increased retentions. These factors set the stage for a competitive domestic reinsurance market with excess capacity available to deploy despite the fact that Canada experienced its second largest catastrophe loss in history during 2010.

Although reinsurers tried to maintain pricing discipline, the market supported single digit reductions in catastrophe prices on a risk-adjusted basis for loss free layers and programs. The pricing on layers that suffered losses during 2010 were subject to increased rate based on individual experience. Top layers saw minimal softening due to minimum ROL requirements.

Following two significant loss years property per risk covers saw a stable renewal after a benign 2010.

Proportional treaties generally saw a modest softening and clients with good results obtained slightly better terms at renewal.

Casualty and specialty programs experienced a relatively stable renewal with respect to both price and coverage. Reinsurers pushed (ultimately unsuccessfully) for additional rate on programs with Ontario Automobile exposure.

### Caribbean

Generally the outlook for the Caribbean for 2011 renewals is stable. Although a few markets withdrew from pro rata property business in certain islands, new entrants largely offset any reduction in capacity. Pricing in the region is generally flat despite the late season loss activity from Hurricane Tomas.

Property catastrophe programs renewed with pricing flat to down three percent with stable capacity and per risk programs achieved similar pricing reduction with the majority of programs renewing flat to down five percent with any discrepancy being driven by additional loss experience.

Motor and liability excess of loss programs renewed flat year over year adjusted for exposure.

## Sector Analysis By Specialty

This section provides an update on the following significant reinsurance lines of business: Global ReSpecialty, U.S. business segments and Facultative.

### Global ReSpecialty

#### Accident, Health and Life

Pricing trends on Accident, health and life catastrophe programs continued to follow the overall soft market conditions which have existed for the past several years. Rate decreases between 5 and 15 percent year-on-year were obtained for January 1, 2011 program renewals. Slightly larger reductions were obtained on some programs based on perils covered, locations of risks and the ability of carriers to provide good exposure details. The better exposure details and associated modeling reports have allowed reinsurers to determine the potential aggregation of exposures against the remainder of their portfolio and, in some instances, allow for greater pricing differentials. There has been an influx of new reinsurers into the accident, health and life catastrophe reinsurance market space that combined with increased lines from existing markets, has resulted in double digit percentage increases in available capacity. Absent any major catastrophic events and subject to continued stability in the financial markets, these pricing trends are expected to continue in the foreseeable future.

#### Aviation

Looking at the insurance market, the Air Transport Association (IATA) now forecasts 2010 airline net post-tax profits at USD15.1 billion, compared to original estimates of USD8.9 billion, on total industry revenues of USD565 billion resulting in an operating margin of 2.7 percent. Forecasts for 2011 are estimated to fall back to USD9.1 billion.

In 2009 travel within the Asia-Pacific region eclipsed North America as the world's largest aviation market and as a result, over half the 2010 profit (USD7.7 billion) comes from carriers in that region, with China being the main contributor.

Significant opportunities for future growth continues in the airline sector as the economies of China and India develop further. In the U.S. there are 3.0 aircraft seats per year for each of the 300 million residents. In comparison, China's population of 1.3 billion is served by only 0.3 seats per person and India's 1.1 billion population has only 0.1 seats available per person. It is estimated that the global air transportation industry will triple in size when Asian communities start to travel like those in the U.S.

Despite the world economic issues, the insurance industry is growing - hull insured values continue to rise and the 2010 passenger numbers per departures are expected to grow by approximately 10 percent overall. Underwriters have not been able to maintain rates despite the increased exposures. Therefore underwriters could experience the fourth consecutive loss year in the airline segment.

2009 airline incurred claims excluding attritional losses currently total USD1.6 billion (above the five year average of USD1.1 billion), whereas 2010 estimates are currently USD 1.2 billion with no single loss exceeding USD300 million.

Direct market over-capacity remains with approximately 180 percent capacity for a USD1.5 billion policy limit. One new entrant has commenced underwriting in Lloyd's but the business plan suggests a targeted and highly focused approach so this start-up will not have a destabilizing effect. No insurers left the market in 2010.

In 2010, the 30 largest insurers spent approximately USD350 million to protect excess of USD225 million up to the USD4.5 billion in original loss exposures. In comparison, they spent approximately USD400 million in 2009 but with increasing exposures, the balance between ceded and retained losses has shifted to favor buyers.

Unlike other specialty lines, January 1 is not a major renewal date for aviation. The majority of renewals occur at April, July, November, and December 1. At mid-year 2010, rates were unchanged unless an exposure adjustment was necessary. During the November and December renewals, pricing fell 7.5 percent to 12.5 percent. In January 2011, pricing is expected to follow the pattern set by the November and December renewals. Throughout 2011, rates are expected to soften further by about five percent.

There has been no significant change to overall reinsurance market capacity. However, written aggregate and premium have shifted considerably by reinsurer/region as several Lloyd's markets struggled to support reductions for late 2010 and January 2011 renewals. As a result of the shift in market capacity, a few companies were able to build market share considerably in 2010 despite being new to the market or previously affected by a rating downgrade.

Core retentions have remained stable as few buyers could present loss free renewals. With the majority not reaching income targets, reducing reinsurance spend as a percentage of income was the key driver. Sub-core layers are increasingly of interest on a sideways basis as many losses have fallen within underwriters' retentions. Vertical cover in general has not increased despite increases in potential liability awards since they fall well within RDS scenarios.

One major underwriting concern placed an all encompassing multi-class reinsurance program that resulted in their specific aviation program being withdrawn from the market.

Retrocessional pricing for ILW's and UNL cover remains firm and many believe present a better relative return than reinsurance excess of loss programs. That said, the market for both is small as approximately 50 percent of the excess loss market reinsurers run their portfolios net.

The USA General Aviation (GA) represents approximately sixty-five percent of worldwide of GA premiums and exposure. The insurance market remains very competitive, especially for the professionally flown corporate aircraft.

For many years, the large liability limits purchased by these corporations have been supported by reinsurers using risk excess placements. The Washington hangar collapse due to heavy snowfall in February 2010 has become the largest single GA loss because of the number of aircraft involved. The pricing expectations of reinsurers in this class are not being met due to an abundance of capacity and as a result reinsurers may reduce their exposures.

## Marine and Energy LMX and International

### *London Market Excess of Loss*

January is the first significant renewal for many reinsureds since the Deepwater Horizon incident in April. Although most, if not all of the interests involved in the loss are of a known quantity, there are still a number of factors that have shaped the 2011 renewal season:

- Price adequacy for Energy Casualty business
- Exposure accumulations between contractor and operators
- Nature of hold harmless agreements between operators and contractors
- OPA limitation of liability
- Impact of the US lawsuit

The disparity between client expectation and reinsurers has increased: although reinsurers have been measured in their reaction to retention levels, pricing has been revised to cater for previously unexpected risk accumulations. For clients with energy and energy liability exposures, increases in reinsurance spend have been about fifteen to twenty-five percent. For those clients which are standard marine programs, the pricing has remained stable, if not seen a reduction, as reinsurers seek to balance their portfolio with less volatile lines.

### *Gulf of Mexico Wind*

2010 was a benign windstorm season and as a result the sector continued to be profitable. More importantly the discipline of the revised product has remained stable although it remains untested. Despite the initial decrease in rating, the supply of Gulf of Mexico windstorm aggregate exceeded the demand. This was a result of a mixture of underwriting discipline and the reluctance of buyers to purchase a product deemed to be expensive and of limited responsiveness. Post Deepwater Horizon, a market that was prepared to give reductions in price consequently hardened.

The reinsurance market and buyers still struggle with the economics of the product and despite the similar levels of aggregate written in 2010 within the direct market, the volume of Gulf of Mexico stand-alone coverage bought decreased. Pricing remains flat; however cedants are able to achieve economies of scale by combining risk and cat coverage at more competitive levels.

### *Retrocessional Market*

A large proportion of middle market players rely on Retrocessional coverage to facilitate their portfolio. As a result of the loss activity in 2010, on average the retrocessional market has seen rate increases of twenty percent which is largely in line with the increases seen in the London market book. The increased rating has attracted additional capacity which has to some extent tempered increases in excess of twenty percent.

### *International*

International marine accounts can be seen as competitive for the renewal with a large variation in pricing due to the substantial capacity available and the loss records of each individual account.

There have been a considerable number of attritional losses this year which have not necessarily caused accounts to be in deficit, and these are being rated in accordance with the losses and income fluctuations.

In general, there are reductions in the market place, especially for smaller well rated accounts with clean loss records. The pricing of larger programs has tended to be somewhat flat. Existing reinsurers seem to maintain leads even when under pressure from alternative markets.

#### *Sanction Limitation and Exclusion Clause*

The version of the Sanction Limitation and Exclusion Clause suggested by the Joint Cargo Committee has most commonly been applied, although this version has not been accepted by all cedants. This has become an emotive subject for cedants and reinsurers alike, with differing approaches and opinions from various legal teams, and there has not yet been a consistent approach.

## U.S. Business Segments

### Property Catastrophe

Property catastrophe programs with nationwide exposures in the U.S. renewed with risk adjusted rate decreases of 5 to 10 percent. Retentions and limits purchased in the U.S. remained relatively unchanged.

Results for regional programs were more varied. Southeast regional programs saw reductions similar to nationwide programs despite recent model changes in the region. Midwest regional programs that experienced significant losses throughout 2010 saw modest decreases to flat renewals on first layers and in some cases retentions or terms were changed in order to reduce upfront costs while still maintaining frequency protection.

### Property Per Risk

Exposure rates for per risk excess programs incepting in January of 2011 continued on a downward trend with an average reduction of 5 to 10 percent. Primary commercial rates have been flat to down since mid-year 2009 and are forecast to continue down modestly in 2011, resulting in reduced subject premium. This combination resulted in reinsurance rate reductions of approximately five percent. The degree of price change continues to be primarily influenced by loss experience and limits required for critical catastrophe perils. Retention levels have remained stable or increased over the course of 2010. Increases in retention were discretionary as some clients consolidated placements to take advantage of economies of scale.

Per risk reinsurance capacity remains plentiful. Clients with well-articulated underwriting plans, modest catastrophe exposures and good loss experience, will continue to have ready access to additional limits and should continue to achieve risk-adjusted rate reductions in excess of five percent.

### **Medical Professional Liability**

The Medical Professional Liability market remains stable at a 'soft' level. Primary physician rate levels were flat to slightly down during 2010; while hospital and facility primary rate levels have again decreased 5 to 10 percent over 2009 levels. Insurer combined ratios remain extremely favorable with major carriers posting results in the mid-80s to mid-90s. Historically low loss frequency and continuing prior year loss reserve releases are driving exceptionally good results. Loss severity continues to moderately increase.

Reinsurance rates during 2010 and for January 1, 2011 renewals were generally flat to decreasing with variances due to ceding company specific loss experience or risk characteristics. Coverage increases and improved terms and conditions were generally available for established insurers. Ceding companies continue to trend toward purchasing additional catastrophe type cover and less working layer coverage.

Reinsurance support remains abundant in the U.S., London, Europe and Bermuda, with a small number of new players and no major departures.

The outlook for 2011 for Medical Professional Liability remains stable, with the major challenges being premium growth, consolidation of physician groups and hospitals and the specific components of health care reform.

### **Lawyers Professional Liability**

Treaty reinsurance pricing is stable to slightly soft on an exposure neutral basis, with potential changes in rates driven by ceding companies' experience and risk profile. In some cases, reinsurance rate decreases were only achieved as a result of authorizations from new markets to the line of business. Existing reinsurance counterparties did not offer program improvements, but ultimately supported some improvements in terms and conditions on final contracts. This phenomenon existed through all of 2010.

Active markets in this segment remain the U.S., London, Europe, and Bermuda. Expectations are that pricing and capacity will remain stable for the foreseeable future into 2011, barring a catastrophe that would impact the market as a whole.

Facultative capacity remains limited, but in general both capacity and pricing have improved over the past several years. Financial results for primary companies continue to vary widely across the industry, with many of the poor performing companies plagued by increases in claim frequency in the real estate sector, and further exacerbated by pricing pressure due to significant competition.

Many companies have also been impacted by an increase in claim severity, which is driven to a great degree by increasing defense costs. While reinsurers and insurers continue to focus on residential real estate, there is also concern with the potential impact of the economy on financial institution, commercial real estate and transactional practices. In addition, significant competition in the primary market has created pricing pressure and in some cases, slight shift in market shares.

### **Directors and Officers Liability**

Pricing, terms and conditions for the D&O and professional liability reinsurance market are fragmented. During the later part of 2010 and into 2011 reinsurers have been looking to manage their overall portfolios by holding the line on renewal pricing as the underlying insurance market continues to soften under heavy competition. Modest improvements in overall terms and conditions were possible for certain insurers based on experience. However, in certain cases reinsurers have reduced shares or withdrawn support as a result of term improvements.

Treaties that are more structured in nature tend to receive favorable attention from the reinsurance market while treaties that are unlimited in nature and/or are more vulnerable to systemic losses (i.e. Financial Institutions) are being more heavily scrutinized. Commercial D&O, while still benefiting from good results, continues to be a concern for reinsurers due to continued rate deterioration as well as a number of new players entering into this soft market over the last year or so.

Over the 2011 renewal season, we anticipate that reinsurers will continue to require greater transparency with regard to loss and reserving positions of ceding companies as well as portfolio and price management.

Despite generally tighter terms and conditions for start ups, reinsurers are less attracted to additional entrants at this stage given overall sense of market saturation and rate decreases. Reinsurers have pulled back from the belief that the financial crisis would have reduced capacity or changed the market, therefore start up operations are finding it harder to attract reinsurance capacity unless there is a significant niche that is untapped or a compelling differentiator from what is seen in the current market.

The forecast for 2011 in supply and demand is stable, although supply will be influenced by the emergence of settlements of claims from the financial crisis, which generally have been developing slightly better than originally anticipated. That said this will be offset against continued softening in the underlying pricing in most lines and a continued reliance on underwriting profits versus investment returns. Reinsurers will continue to differentiate underlying portfolio mix, characteristics and historical experience to determine which carriers to support and at what cost.

### **General Casualty**

The environment for general liability and umbrella in 2010 has remained fairly consistent. Insurers and reinsurers are both conscious of the cumulative rate decreases since the market peak of 2004 and its potential impact on current policy year profitability. Calendar year and accident year results still indicate that many casualty portfolios remain at profitable levels although there is some indication of deterioration as we head into 2011.

Insurance rate levels continue to be flat to slightly down, with rate increases occurring mostly for insureds with loss activity or in classes such as energy liability where recent events have allowed for positive pricing movement. There remains a meaningful amount of both reinsurance and insurance capacity. Having said that, much of the reinsurance capacity is sitting on the sidelines waiting for an indication that the market will turn. Concerns regarding original rates, loss development and potential inflation that could significantly impact remaining loss reserves continue.

Reinsurers who support general casualty business are focusing on insurer's business plans and continue to support those clients that can demonstrate profit through actual loss experience and/or from a rating strategy that enables profit even in a challenging insurance market. Terms and conditions have remained stable in the reinsurance market as reinsurers are using capacity as a main topic for renewal discussion.

For 2011 we anticipate the market will continue on its current course unless loss emergence begins to develop for prior accident years.

### **Workers' Compensation**

As reported in September, the primary workers' compensation market continues to be competitive but recent reports on rates suggest the market may be stabilizing with recent rate decreases down only 1 percent. Industry calendar year results continue to outperform accident year results as carriers take down what appears to be the last of reserve redundancies for years 2007 and prior. Interest rates remain low to non-existent which will add pressure to risk selection and rate adequacy.

California, the largest workers' compensation state in the country, continues to deteriorate. Ultimate 2009 accident year loss ratio is predicted at 83.3 percent by WCIRB, up 53 points over 2005. This is a result of a period of rate decreases, erosion of previous reform, coupled with continued medical inflation and an annual uptick in severity. Over the past 10 years, declines in claim frequency have helped to mitigate medical inflation, however; the third quarter WCIRB projections indicate a 2.1 percent rise in frequency. This is only the second annual rise since 1993. If frequency continues to rise loss ratios will increase dramatically.

Reinsurance capacity remains sufficient with few shifts in market appetite. Rates on working and capacity layers tend to be flat to down 10 percent on a risk adjusted basis, with significant State specific differences. In 2011, we expect more attention given to portfolios with California and New York exposures. We continue to monitor recently published new loss elimination ratios and excess loss factors, as we see some substantial increase in factors excess of USD500,000. Certain reinsurers are beginning to raise the topic during placements.

The catastrophe multiple person layers continue to be soft, as capacity chases premium. Quoting markets are trying to hold the line, however; placements are being completed below market quotes. Some carriers have expressed interest in Industrial Accident only layers. Industrial Accident only layers range 25 to 50 percent below traditional pricing depending on the market and the portfolio exposures.

### **Surety**

The surety industry continued to produce better than expected results throughout 2010. The challenging economic environment, for construction in particular, has created significant anxiety over the future but surety companies remain focused on underwriting. Contractor failures continue to rise but many go out of business in an orderly fashion due to limited project opportunity and do not cause serious issues for sureties. Primary writers of this class remain cautiously optimistic they will be able to manage through the cycle. Primary pricing, as well as underwriting terms, remain fairly consistent compared to last year, even though revenues have fallen off significantly for most players over the last two years

Reinsurers continue to be attracted to this line as well. Retention increases over the past few years have placed reinsurers in a position to avoid much of the small frequency issues that currently bother the primary companies. Reinsurers are also beginning to recognize the reduction in actual exposure as contractor backlogs shrink and are reflecting this through rate reductions on January 2011 renewals of 5 to 10 percent. That said, while reinsurers recognize the reduced exposure due to the extended depressed economic conditions, they expect volatility to rise in 2011 and 2012 and therefore find it difficult to give full credit to the exposure reductions. Capacity remains adequate with excess of loss being the dominate structure in place. There seem to be a small handful of reinsurance markets ready to enter the space but most are taking a conservative position.

### **Terrorism**

The dynamics of the stand-alone terrorism reinsurance market remained unchanged in 2010. The supply of reinsurance capacity remains high relative to demand and it is underutilized. Reinsurers offering terrorism cover are attracted by the diversifying nature of the exposure.

On the demand side, there has been no catalyst for change in reinsurance buying appetite. Insurers, since the establishment of TRIA in 2002, have developed strategies for dealing with terrorism exposure with most avoiding the exposure or writing very limited amounts. In a limited number of cases, carriers have been able to leverage the benefit of the government backstop to write a portfolio of terrorism insurance.

For property exposures, traditional reinsurance provides some benefit as the product has not followed the 2007 TRIA revision in differentiating between domestic and foreign terrorism; acts of terrorism committed by 'domestic' agents are generally covered under mainframe reinsurances.

Coverage for terrorism in workers' compensation catastrophe covers is readily available. The facultative market remains fairly active, particularly in London, where clients can easily and cost effectively deal with terrorism exposures presented by an account or location.

Price, or more specifically value, remains the largest obstacle to a more robust stand-alone terrorism market. Without the ability to assign frequency to loss, the value of the reinsurance is difficult to quantify. Reinsurers will not part with aggregate and the capital needed to support risk below a minimum rate. Most reinsureds tend to see that minimum price as too high for an exposure they acknowledge is large but see as remote.

The stand-alone terror product has evolved over several years from a 'silo' approach, where property and workers' compensation exposures were treated separately to an aggregate all lines product in most cases. Pricing has reduced over the past several years from the low 20 percent ROL range to low single digit ROLs excluding nuclear, biological, chemical and radiological events. For coverage including NBCR, ROLs in the mid-single digits are achievable.

Events that could create need for clients in the future include changes in either the TRIA legislation or the rating agencies' treatment of terrorism exposure. Extensions of TRIA in the past have caused insurers to revisit terrorism exposure and evaluate reinsurance purchases and the same was true with the budget proposal from the Obama administration last year that including a scale back of TRIA. While it seems this is now unlikely prior to 2014, change in the federal backstop could impact the dynamic for coverage in the private market.

For several years, rating agencies have been requiring carriers to detail terrorism exposures. While the information provided does not currently factor quantitatively into ratings, demand for private terrorism cover will likely increase and market activity will pick up should this change in the future.

### **Reinsurance of Variable Annuities**

While sales of variable annuities in the US are rebounding compared to 2009 levels, they are still down over 30 percent from their peak in 2007. Products have been simplified with most carriers reducing or limiting the guaranteed benefits previously offered. Hedging strategies have become more sophisticated and pricing assumptions have become more realistic. Similar to the current direct insurance market, reinsurers have also reduced or limited the benefits they will accept with the most significant impact on living benefits. The traditional life reinsurers are still wary about taking market risk and policy holder behavior risk while reinsurers associated with banks are more receptive to market risk but typically look to retrocede the mortality risk to traditional outlets.

### **Facultative**

In 2010, global property facultative pricing resumed a downward trend, falling year-on-year for the seventh time out of the last eight years. Global property prices fell by seven percent, a significant turnaround from 2009 when the annual price index showed 1.5 percent increase over 2008, mainly due to certain heavy industrial risk sectors experiencing loss sensitive rate increases in the first quarter of 2009. The second half of 2010 showed property fac rate index decrease of seven percent versus a decrease of four percent in the same period in 2009.

Global liability prices fell for the eighth year in succession in 2010, showing a further 3.5 percent decline on top of the 3.7 percent reduction in 2009.

Excess capacity contributed to the rate decline in 2010 and absent a series of major losses in the facultative market, we expect our clients will find themselves in a strong position for rate negotiations during 2011.

Property rates are forecast to continue their steady decline in Q1 2011, down a predicted 5.75 percent (compared to a 6.5 percent reduction in Q1 2010). Latin American catastrophe rates remain the exception as a result of the February 2010 earthquake, and we estimate that catastrophe rates may increase by up to 10 percent domestically and in London.

Elsewhere the domestic markets will lead catastrophe pricing decreases in most markets with North America down four percent (London flat), Europe down one percent (London flat) and the Middle East down 15 percent (London down 10 percent). London and Asia Pacific catastrophe pricing is estimated to be closer than other markets with London down approximately eight percent and the domestic market down seven percent.

For non-catastrophe property business, the opposite is expected with London leading price reductions for North America at down eight percent (domestic down three percent) and in Europe down 10 percent (domestic down three percent). Asia Pacific reductions are forecast to be down 10 percent domestically and down eight percent in London. Latin American non-catastrophe rates are forecast to fall by five percent.

Liability rates will continue to fall in Q1 2011 by approximately five percent in domestic markets and three percent in London. Regionally, 10 percent reductions are expected across Asia Pacific and five percent reductions across EMEA and the North American domestic markets against the London market anticipated reductions of two percent for both Asia Pacific and EMEA business and five percent reductions for North American business.

# 2010 Property Catastrophe Renewals Recap

We are pleased to report that our efforts for U.S. catastrophe reinsurance clients at the January 1, 2011 renewal were at the top end of the reductions we projected for the light year estimates we published in September. Several factors for this outperformance have been mentioned in this report but a brief recap is (a) the light season scenario contemplated more ceded U.S. catastrophe losses than actually occurred—a lighter than light season, (b) reinsurer capital grew at a 17 percent rate for the year and we had anticipated a 12 percent growth rate net of share repurchases—more capital meant more competition than we anticipated, and (c) we anticipated that the catastrophe model increases that occurred and are still anticipated for U.S. hurricane would have made it tougher for reinsurers to accept lower prices than proved to be the case.

The table below sets forth our September predictions of -10 percent to Flat for all classes of U.S. property catastrophe business and we were able to achieve -10 to -5 percent for our clients.

**Exhibit 31: January 2011 Renewals**

	ROL Changes	Capacity Changes	Retention Changes
<b>Personal Lines National</b>			
Light	-10% to Flat	+5% to +10%	Stable to +10%
Medium	Flat to +10%	Stable to +5%	Stable
Heavy	+10% to +20%	-5% to -15%	-5% to -10%
<b>Personal Lines Regional</b>			
Light	-10% to Flat	+10% to +15%	Stable to +10%
Medium	Flat to +15%	Stable to +5%	Stable
Heavy	+15% to +25%	-5% to -10%	Stable
<b>Standard Commercial Lines</b>			
Light	-10% to Flat	+5% to +10%	Stable to +10%
Medium	Flat to +10%	Stable to +5%	Stable
Heavy	+10% to +20%	-5% to -15%	Stable to -5%
<b>Complex Commercial Lines</b>			
Light	-10% to Flat	+5% to +10%	Stable to +10%
Medium	Flat to +15%	Stable	Stable
Heavy	+15% to +30%	-5% to -15%	Stable to +20%

Assumptions: No changes in insured catastrophe exposures. Rate of change measured from the expiring January 2010 terms. Annual reinsurer catastrophe loss activity defined: Light means reinsurer capital decreases between zero and five percent from catastrophe losses. Medium means reinsurer capital decreases between five and ten percent from catastrophe losses. Heavy means reinsurer capital decreases between 10 and 20 percent from catastrophe losses.

Source: Aon Benfield Analytics

# Contact Information

**Bryon Ehrhart**

Chairman, Aon Benfield Analytics and  
Aon Benfield Securities  
+1 312 381 5350  
bryon.ehrhart@aonbenfield.com

**Stephen Mildenhall**

Chief Executive Officer, Aon Benfield Analytics  
+1 312 381 5880  
stephen.mildenhall@aonbenfield.com

**John Moore**

Head of Analytics, International  
+44 (0)20 7522 3973  
john.moore@aonbenfield.com

**Tracy Hatlestad**

Managing Director, Aon Benfield Analytics  
+1 952 886 8069  
tracy.hatlestad@aonbenfield.com

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200 E. Randolph Street | Chicago, Illinois 60601  
t: +1 312 381 5300 | f: +1 312 381 0160 | [aonbenfield.com](http://aonbenfield.com)

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