

STATE OF THE REINSURANCE MARKET 2010 Overview¹

Despite the tumultuous financial markets in 2008 and early 2009 and approximately \$23 billion of insured losses in the first half of 2010, the global reinsurance industry continued to provide needed capital and risk transfer capabilities to the U.S. market, including the U.S. catastrophe risk market. Despite these losses, U.S. catastrophe risk continues to be viewed as an essential component of reinsurers' diverse assumed risk portfolios.

- **Reinsurance supply is abundant**, resulting in a continuation of the **downward trend in reinsurance catastrophe pricing since 2007**.
- **Brokers reported price decreases of 5% to 25%**, on a risk adjusted basis, for U.S. hurricane and earthquake exposed treaties renewing at January 1, April 1 and July 1, **and 10% to 25% for June 1 Florida business**.
- **Despite losses from the Chile earthquake and European windstorm Xynthia, reinsurer capital positions are largely restored to the robust levels** that existed prior to the near collapse of the financial markets. The **low 2009 catastrophe losses**, coupled with an **increase in asset prices** for corporate and government bonds late in the year, led to an improvement in insurer and reinsurer balance sheets.
- With their balance sheets revitalized and with **capacity exceeding demand** for reinsurance, reinsurer **competition** resulted in lower risk adjusted pricing for insurers.
- The **catastrophe bond market has also recovered** from the demise of Lehman Brothers. Insurance linked securities now account for **nearly 10% of the property catastrophe reinsurance** protection in place.
- Typical insurance and reinsurance cycles involve temporary increases in pricing, followed by new market participants, leading to increased competition and price moderation.
- Reinsurance is a sophisticated business decision for insurers and their **reinsurance costs are impacted by how much and at what layers they buy it, if at all**, within their financial model for handling risk.

¹ **NOTE:** The RAA does not collect rate or market information from underwriting reinsurers. The comments contained in this document are based on published reports in the trade press, from investment bankers and reinsurance companies and brokers.

September 2010 – Traditional Reinsurance

Aon Benfield “Reinsurance Market Outlook - Abundant Capital to Cultivate Growth” September 2010:

Reinsurance capacity is at an all-time high. Capacity continues to grow more quickly than demand despite solid capital management actions and some reinsurer consolidation. Our **clients will continue to benefit from a softening reinsurance market** should these conditions persist through the end of the 2011 negotiation, quoting and renewal season.

Our outlook for January 2011 renewals reflects our expectation that, **absent significant reinsurer losses** during the remainder of the year, growth in reinsurer capital and capacity will exceed client demand. As a result, **market forces will drive a global softening** of rates, terms and conditions in the reinsurance market. **The reinsurance market will provide cedents their most accretive capital source in 2011 and beyond.**

In its September 12, 2010 press release, Aon Benfield noted that:

[D]espite regionally significant catastrophe events thus far in 2010, **the supply of reinsurance capital continues to grow at a faster rate than insurers’ demand** for capacity.

This imbalance means that **reinsurance will be the most accretive form of underwriting capital** for insurers in 2011, and will be a **primary capital management option** for insurer chief financial officers as they manage cycle risk and increasing regulatory and rating agency capital requirements.

Guy Carpenter “World Catastrophe Reinsurance Market, September, 2010”:

According to the Guy Carpenter World Rate on Line (ROL) Index, global catastrophe **reinsurance rates fell by 6 percent** on average through the 2010 renewal season.

Guy Carpenter estimated that the sector was overcapitalized by as much as USD20 billion, or 12 percent, at the beginning of 2010. Although the overcapitalization fell back to around 8 percent by the end of June, the surplus capital among reinsurers remained the driving factor at the 2010 renewals.

July 2010 – Traditional Reinsurance

Aon Benfield “Reinsurance Market Outlook, July 1, 2010 Update”:

Catastrophe reinsurance **pricing decreased moderately more aggressively** for higher margin U.S. business than witnessed at January and June renewals. Catastrophe **program costs decreased by 10 to 20 percent in the U.S.** and were generally softening elsewhere in the world where loss experience was not present.

Global reinsurance capacity remains at record high levels and its growth continues to outpace the growth in demand from cedents.

Casualty reinsurance capacity is also plentiful as reinsurers continue to see decreasing demand for the product. Underlying casualty insurance results continue to be reported at levels that are far better than anticipated.

Guy Carpenter “Reinsurance Renewal July 1, 2010: Capital Cushion Continues to Impact Pricing”:

Despite significant catastrophe losses during the first half of 2010, including the Chilean earthquake, property rates **declined by as much as 15 percent**. U.S. property rates decreased by 10 percent to 15 percent, with **pricing for the year down 12 percent**.

Willis Re “1st View July 1, 2010: Running on Empty”:

The recent 1st June and 1st July renewals continued the pattern set at the 1st January and 1st April 2010 renewals, namely, a **continued gradual decline in pricing**, with only a handful of loss-driven classes and territories showing any pricing stability or upwards pricing pressure.

Buyers achieved significant rate reductions, particularly in Florida, where reinsurance markets treated the better capitalized and more geographically diversified accounts to **substantial rate reductions, as high as 25%**.

June 2010 – Traditional Reinsurance

Aon Benfield “Reinsurance Market Outlook, June 2, 2010 Update”:

Reinsurance pricing in Florida softened 10 to 15 percent ... However, **uncertainty associated with Florida** has meant that the **full benefit of the potential reinsurance price reductions** that may have otherwise been realized **were not realized**.

[D]espite the reinsurance recoveries paid as a result of the Chile Earthquake and Xynthia windstorm, reinsurer capital remains stable and capacity remains abundant.

Guy Carpenter CapitalIdeas.com – “June 1 Reinsurance Rate Decreases are one Positive Development for Florida Companies”, June 2010:

[R]einsurance pricing continued its 2010 trend of price declines and dropped year over year on a risk adjusted basis by **10 percent to 12 percent** on average. This drop returns pricing to a level close to that seen in 2008, particularly in upper layers.”

Consistently in 2010, **capacity has returned in abundance ...**

April 2010 – Traditional Reinsurance

Aon Benfield Reinsurance Market Outlook, “April 1, 2010”:

The April renewals were in line with the expectations we published following the January renewals ... with **renewal terms equal to the 5 to 15 percent reductions** witnessed for January 2010 renewals.

Catastrophe losses in the first quarter did not impact pricing or capacity in critical reinsurer aggregate zones. The impact of the losses in non-peak zones like Chile, will be minimal outside of Chile and even in Chile ... the impact is likely muted by the fact that the **earthquake risk was well understood ... and appears to be contained within reasonable loss expectations.**

Guy Carpenter CapitalIdeas.com – “April 1 Reinsurance Renewals: Rates Lower; Returns Under Pressure”:

Reinsurance rates in most cases continued the decline experienced at January 1, 2010 which occurred largely because of the effects of healthier (re)insurer balance sheets.

The large earthquake in Chile, and, to a lesser extent, windstorm Xynthia in Europe, ... cause pause for thought. There are **several significant renewals at April 1 in the U.S., which did not show signs of any impact from the recent global loss activity.**

Capacity continued to be plentiful, a critical element in companies' ability to secure favorable terms and conditions.

Willis Re 1st View, April 1, 2010 Report – “Calm Amid Calamity”:

Against [a] background of increasing uncertainty and the frequency and severity of loss activity, the reinsurance market has yet to react in terms of pricing, conditions and capacity. [T]he 1st **April 2010 renewals have continued the trend** seen at 1st January 2010.

We are still seeing **modest risk-adjusted reductions** and hardening only in specific territories and classes with consistently poor results.

U.S. – Nationwide and Regional Property

- **Firm orders were down -10% to -15% on a risk adjusted basis for loss-free regional programs and -5% to -10% for nationwide programs.**
- **Market support was strong, with no evidence of a shortage of capacity.**

[A]bsent any other major losses, **buyers who will be renewing loss-free programs later in the year can continue to budget for stability or modest reductions in their reinsurance costs.**

July 2010 – Catastrophe Bonds and Insurance Linked Securities

Aon Benfield “Reinsurance Market Outlook, July 1, 2010 Update”:

There were **nineteen transactions** placed in the market during the 12-month period ending June 30, 2010, totaling **\$4.4 billion**. Bonds on risk at June 30, 2010 totaled \$12.0 billion, up from \$11.4 billion the prior year. In all, the ILS market has seen \$30.7 billion of cumulative issuance since 1997, demonstrating its importance as a strategic and cost effective risk management tool for sponsors.

April 2010 – Catastrophe Bonds and Insurance Linked Securities

Guy Carpenter & GC Securities Briefing, “Cat Bond Update: First Quarter 2010,” April 2010 (Guy Carpenter CapitalIdeas.com):

Catastrophe bond issuance conditions saw sustained improvement in the first quarter of 2010, reflecting the increase in prominence of the insurance linked securities (ILS) asset class.

Despite the continued improvement in market conditions, however, **catastrophe bond issuance relative to the first quarter of 2009 was lighter** than might have been expected.

Sponsors posted two catastrophe bond transactions during the first quarter of 2010, resulting in \$300 million of risk capital issued.

Taking all factors into consideration, **the second quarter of 2010 should prove significantly more active** than the first, with the **potential for 5 to 10 transactions**, while total issuance for the year is expected between US\$3 billion and US\$5 billion.

January 2010– Traditional Reinsurance

Aon Benfield Reinsurance Market Outlook, “Remarkable Recovery,” January 2010:

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

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

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

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

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

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

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

Risk-adjusted catastrophe prices in the United States decreased by an average of 6 percent. This **picture is somewhat complicated by adjustments to the vendor catastrophe models** that have decreased predicted losses for earthquake and wind perils. **By applying the 2010 modeling assumptions retrospectively to 2009, the revised impact is a reduction of as much as 11 percent on average.** Meanwhile, the great majority of risk covers (especially the larger ones) renew at mid-year.

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

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

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

U.S. – Regional Earthquake

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

U.S. – Regional Wind ...

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

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

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

January 2010 – Catastrophe Bonds and Insurance Linked Securities

Aon Benfield Reinsurance Market Outlook, “Remarkable Recovery,” January 2010:

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

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

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

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

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

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

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

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

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

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

Attractive catastrophe bond pricing.

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

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

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

Historical Market Review

In 2005, the United States sustained record hurricane losses (Katrina, Wilma and Rita) and the global reinsurance market paid 61 percent of the \$72.7 billion in losses. The aftermath of those unprecedented hurricane losses, gave rise to an increase in the cost of reinsurance. Additionally, several factors external to the reinsurance market affected the cost. Demand increased in some peak zones at a greater rate than the supply increased due to: rating agencies requiring more capital of insurers and reinsurers to support catastrophe risk; catastrophe risk modeling firms increasing loss predictions; and insurance company managements purchasing more protection.

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

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

The Florida Hurricane Catastrophe Fund

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

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

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

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

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

Due to the size of its potential bond offering and events in the bond markets, beginning in late 2008 and into 2009, the FHCF advisors reported that the catastrophe fund would not be able to

borrow sufficient funds should it have to pay its obligations in full – a potential shortfall of \$14 to \$18 billion.

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

Based upon the most recent post-event bonding capacity estimates in May 2010, the FHCF projects that it could raise the approximately \$16 billion needed to pay its claims after a large storm.

While the FHCF now projects that it will be able to borrow enough money meet its contractual obligations, **the borrowed money will have to be repaid and all Florida policyholders, including those not benefiting from the FHCF coverage such as commercial, charitable, and auto policyholders, will be taxed to repay the bonds that will be needed to satisfy the desire to set homeowners rates politically, instead of basing them on risk.**

In fact, Florida consumers are currently being taxed to repay bonds issued to cover losses incurred by Florida's government run insurer (Citizens) and reinsurer (FHCF) in 2004 and 2005.

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