January 18th, 2011

2011 Reinsurance Renewal Rates: United States Property

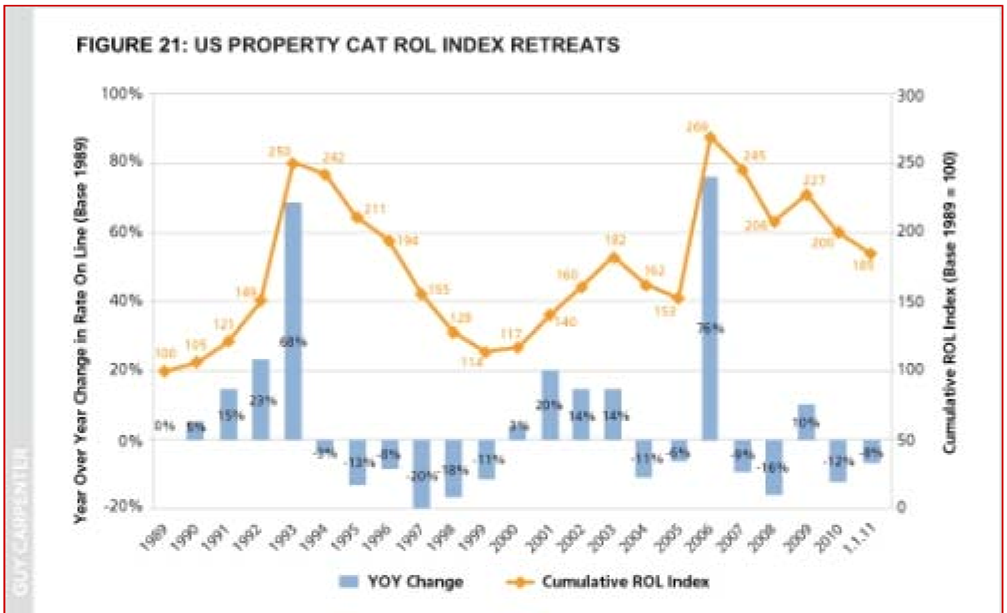
Posted at 1:00 AM ET

GC Editor

Property Catastrophe Market

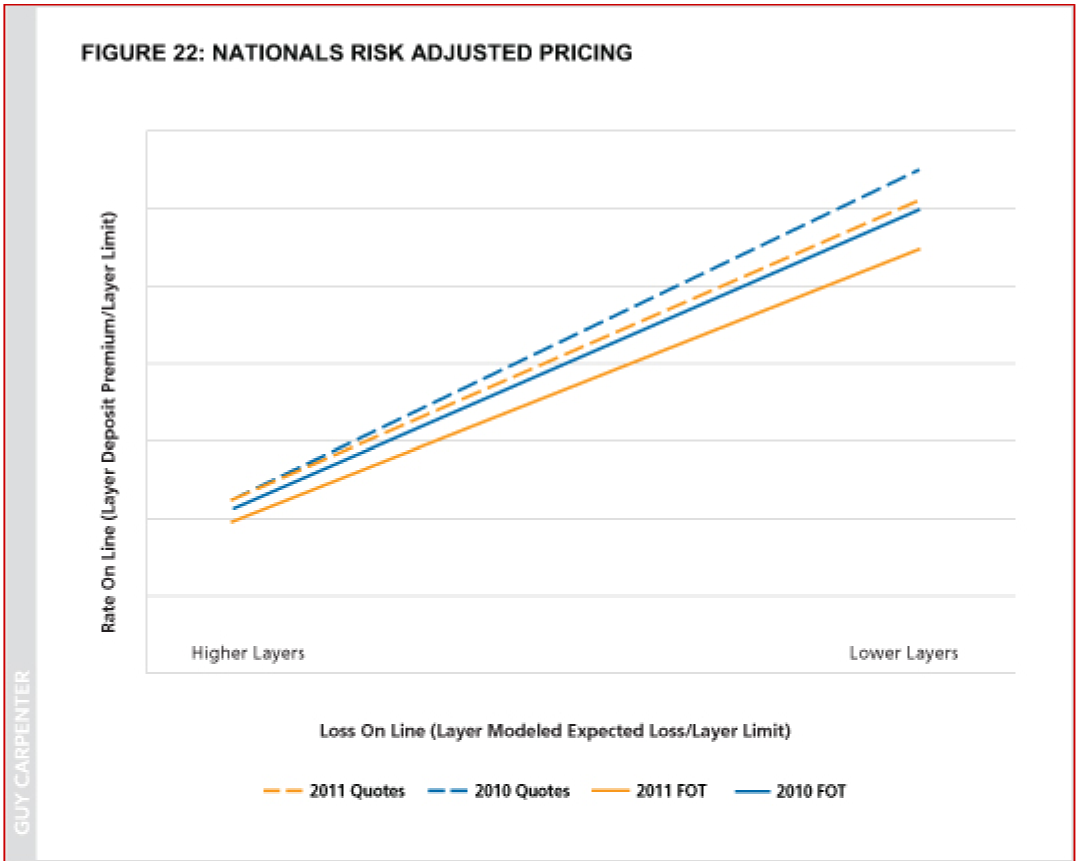
Rates on line decreased by an average of 7.5 percent on US programs, but there were significant variations depending on cedents' results, regional characteristics and coverage.

Catastrophe activity started off strong in 2010 with overall global losses in the range of double the average amount for the first half loss average since 2000. This activity included significant weather events in many parts of the United States. Even with these occurrences, rates declined through the July 1, 2010 renewals, primarily as the result of excess capital. As noted earlier this fall, this decreasing price trend was unlikely to change going into 2011 without a significant catastrophe event impacting the second half of the year. This did not occur, and as expected pricing decreased at the January 1, 2011 renewal on average at a risk adjusted rate of down 6 percent to down 10 percent.



Source: Guy Carpenter & Company, LLC

On a risk adjusted basis, measuring the relationship between the rate on line (the amount charged) and the loss on line (the amount of risk) for both the January 1, 2010 renewals and the January 1, 2011 renewals, the comparison indicates a decrease of between 6 percent to 10 percent in the amount charged per unit of exposure. Reviewing this relationship in the chart below, it is apparent that the amount of downward movement in pricing was not as significant in upper layers with low loss on line. This is in part due to minimum capacity charges.

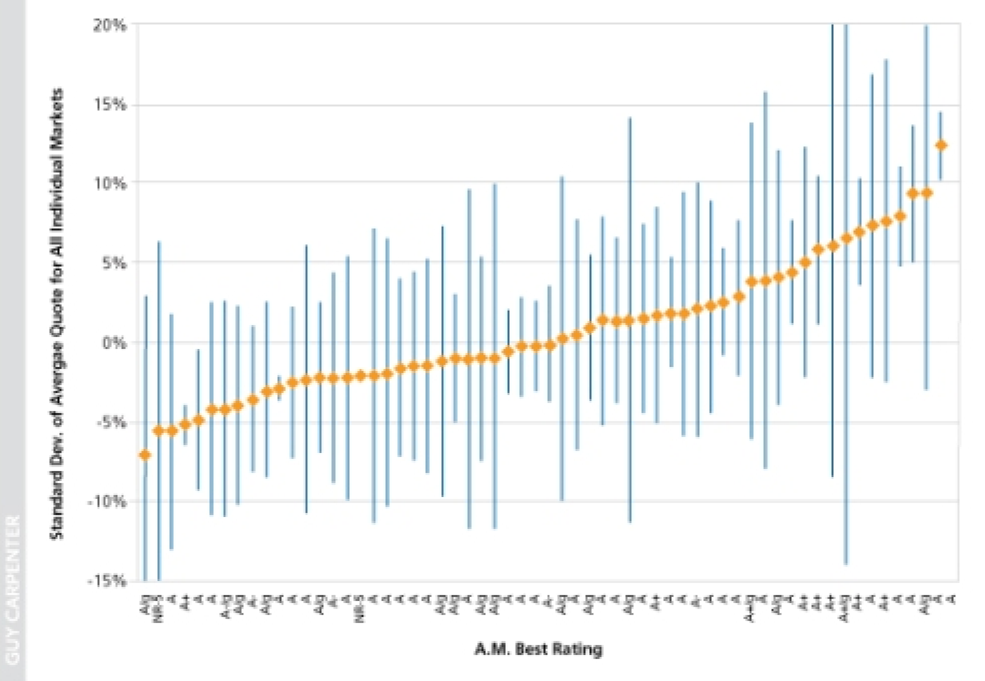


Source: Guy Carpenter & Company, LLC

2011 quotes were on average 3 percent higher than 2010 firm order terms (FOT) but 5 to 8 percent lower than 2010 quotes. Overall, 2011 firm orders were approximately 90 percent of reinsurers' average quote on a given program. Limits and retentions were relatively stable.

In reviewing how markets quoted relative to each other, the range around the average quote narrowed slightly from a year ago from up 10 to down 10 at January 1, 2010 to up 10 to down 5 for 2011 renewals. Market quoting behavior is similar to prior years, with similar markets providing the lowest quotes and similar markets providing the highest quotes.

FIGURE 23: PROPERTY CATASTROPHE REINSURER QUOTING COMPETITIVENESS



Source: Guy Carpenter & Company, LLC

While substantial reinsurance capital continues to drive market behavior, there are factors that may begin to mitigate these current conditions, including continued pressures on earnings from low investment returns, diminishing reserve releases, inflation concerns and the impacts of Solvency II implementation, which may erode some available capital.The largest impact may still occur in response to catastrophe model changes.

Impact of Model Version Changes

Both AIR and RMS have introduced or will introduce new model versions significantly impacting US hurricane results. AIR released v12 in June 2010. RMS is due to release its v11 model update in February 2011. However, many reinsurers assessed changes to their pricing approach based on the RMS pre-release indications.

In the AIR v12 release, multiple components of the model were revised, creating a broad impact on results depending on the characteristics of the individual portfolio. Across Guy Carpenter's book of business renewing at January 1 the average annual loss impact ranged from a decrease of 21 percent to an increase of 62 percent.

TABLE 5: IMPACT OF AIR MODEL VERSION CHANGE

	AAL		1 in 100		1 in 250	
Peer Group Region	Weighted Average Change	Range of Changes	Weighted Average Change	Range of Changes	Weighted Average Change	Range of Changes
Gulf	+3%	-4% to +44%	+3%	-10% to +58%	+18%	-15% to +81%
Midatlantic	+7%	-10% to +62%	+3%	-18% to +92%	+5%	-6% to +50%
National	+16%	-5% to +46%	+7%	-10% to +43%	+8%	-3% to +35%
Northeast	+5%	-21% to +25%	+8%	-13% to +48%	+2%	-12% to +52%
Super Regional	+1%	+1% to +1%	+8%	-8% to +10%	+8%	+1% to +9%

Source: Guy Carpenter & Company, LLC

While RMS is not due to release v11 until February 2011, this represents the largest version change in their history. Several reinsurers have advised that they are incorporating some adjustment for the new model output into pricing, before the model release. While no primary carrier, broker or market has a "beta" copy of the software, nor will any actual portfolio losses in the new version be provided by RMS before the model is released, RMS has provided indications of changes.

The range of change provided by RMS is based on its industry exposure database, not actual portfolios. When reviewing actual client portfolios, the change in loss can vary by over 100 percent. In addition, RMS has not completed testing, and the model does not yet meet quality standards for individual portfolio analysis. For these reasons, making assumptions before running the actual model is risky. RMS has indicated it will be providing greater directional detail in January when it is further along in the testing process.

Guy Carpenter has discussed the AIR and RMS changes with reinsurers and has learned that their approaches differ. Each reinsurer's approach is heavily influenced by its own concentrations, the type of business it favors and the adjustments it was building into its previous pricing approach. Many reinsurers agree that several of the factors influencing increased modeled results have already been incorporated into their pricing methodology.

Analysis of the model version change shows a limited impact on the January 1 renewals. For RMS, reinsurers indicated they were building in adjustments before the version release demonstrated pricing behavior that was still largely in line with the rest of the market.

That said, due to the extreme difficulty in estimating changes to a given book of business, reinsurers have a very limited view of how their own PMLs will be impacted by the RMS v11 release. This, coupled with the potential need for some companies to evaluate the purchase of additional limit once they are able to assess their own new results, could result in a scenario with greater demand and less supply through the first half of 2011.

A.M. Best has indicated in a recent conversation that they will not grant a grace period in dealing with companies at risk when the impacts of the model version changes are calculated. AIR results have been available for some time, and RMS has provided the industry with enough information to shed light on the regions and types of business that will be impacted by the new version. A.M. Best expects that affected companies should anticipate the potential impact as they renew their 2011 catastrophe protections. In addition, these companies should be prepared to discuss with A.M. Best any risk management changes they have made in the event they have a meeting or call with their analysts prior to running RMS v11.

Click here to read the Executive Summary of Guy Carpenter's report: Global Reinsurance Outlook: Points of Inflection; Positioning for Change in a Challenging Market >>

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Category: Property
Tagged: Catastrophe, Models, Property, Reins Markets, reinsurance rates, renewal, ROL, US

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December 30th, 2010

Global Reinsurance Outlook: Points of Inflection, Positioning for Change in a Challenging Market: Executive Summary

Posted at 1:00 AM ET

GC Editor

2011 Renewal Rates Reflect Continued Softening

Early predictions that January 1, 2011 reinsurance renewal rates were likely to fall have been proven correct. The Guy Carpenter Global Property Catastrophe Rate on Line (ROL) Index lost 7.5 percent - the second consecutive annual decline. Contributing to this move has been a combination of factors, including moderate loss activity and abundant levels of industry surplus.

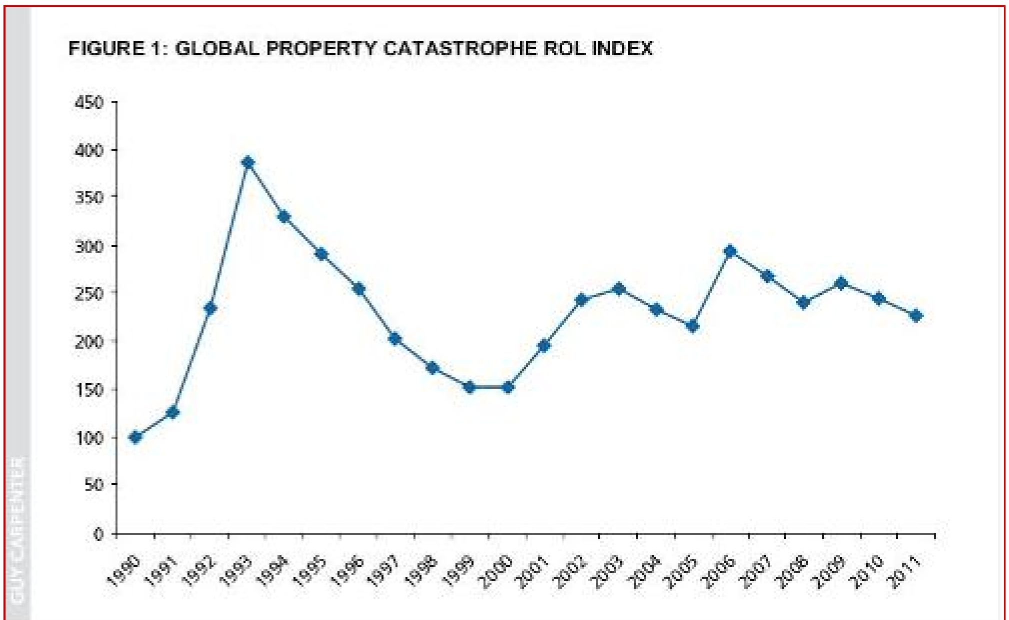

FIGURE 1: GLOBAL PROPERTY CATASTROPHE ROL INDEX

Source: Guy Carpenter & Company, LLC

The decline in rates on line at January 1, 2011 takes place following a year that began with significant catastrophe activity. Losses in the first half of the year were well above average and included Windstorm Xynthia, the Deepwater Horizon oil rig loss and the Chile earthquake. However, despite the New Zealand earthquake in the second half, the year finished with relatively low insured catastrophe losses - owing in large part to an unexpectedly low-loss hurricane season. Subdued losses, combined with unrealized investment gains, led to record levels of capital, which in turn drove reinsurance pricing lower at the renewal. Structures have not changed significantly: Cedents are buying similar amounts of cover to last year, with purchasing appetite helped by attractive pricing.

As shown in Table 1, 2011 renewal rates varied widely by business segment - yet most trended overall flat to negative to their levels last year. The only sectors with a clear upward bias were Marine & Energy and Credit, Bond & Political Risk.

TABLE 1: TYPICAL RATE CHANGES

Business Segment	Price Change
Global Property Catastrophe Reinsurance	Down 6% to 10%
Global Marine & Energy	Up 25% to down 5%
Global Aviation & Aerospace	Up 5% to down 10%
Global Credit, Bond & Political Risk	Up 25% to down 20%
Global Property Retrocession	Flat to down 10%
Global Life/PA Catastrophe	Down 8% to 10%
US Property Catastrophe Reinsurance	Down 6% to 10%
US Casualty Clash	Flat to down 5%
US Workers Compensation Catastrophe	Flat to down 12%
US Directors & Officers	Up 5% to down 5%
US Medical Professional Liability	Flat
US Surety	Flat to down 10%
US Agriculture	Down 10% to 15%

Source: Guy Carpenter & Company, LLC

Outlook 2011: Identifying Forces for Change

While soft market conditions show no immediate signs of reversing, we note an increasing number of latent factors which - alone or in combination - could at some point precipitate a meaningful change in the market's direction. Depending on loss experience, these factors could begin to coalesce around renewals later in the year.

As always, a major catastrophic event of sufficient size could reverse the direction of rates. We estimate that a USD50 billion insured loss event would stem the decline of property catastrophe reinsurance rates for at least one year in the current, capital rich environment. At USD100 billion, we believe "outlier" reinsurance entity failures could occur, while a USD150 billion insured loss event would create a decided and sustained market turn.

Reserves also bear watching. As reserve releases continue unabated, we question whether the sector has entered the 'cheating phase' and how much longer favorable development can be expected to prop up calendar year results.

US P&C sector underwriting cash flow has also turned marginally negative, and we note that the last hard market was accompanied by significant underwriting cash flow shortfalls.

Finally, persistent low sector valuations could themselves prove to be a catalyst for change by precipitating industry consolidation in the form of share repurchases and increasing the potential for mergers and acquisitions (M&A) - both of which could serve ultimately to restrict the supply of reinsurance capital.

It is not clear which of these factors will emerge to affect the direction of the industry, in what combination or when. But there are enough potential catalysts to serve as a potent reminder that the status quo in the industry is not permanent.

Industry Grapples with Regulatory Changes

While the direction of the reinsurance industry in 2011 is uncertain, it is very clear that regulatory issues will be high on the agenda of virtually every participant. At the top of the list is Solvency II, which is set to be implemented in 2013. While nominally European in scope, it is sure to have a significant impact on the entire global industry for years to come.

We note that Solvency II is not only a change in risk management practices but also in management information systems - with a substantial burden resulting from documentation, transparency and disclosure requirements. As a result, the resource costs associated with Solvency II's implementation are putting significant pressure on companies at a time when market conditions and underwriting results are less than optimal. Smaller companies and niche players will be most at risk, and it is crucial that these companies take the right steps now to optimize their performance under the new regime.

Other issues we expect to loom large among reinsurers and the insurance industry in the year ahead include a potentially busy hurricane season and a continued focus on developing and obtaining terrorism risk transfer mechanisms. With regard to hurricane risk, Colorado State University is calling for an above-average hurricane season for the sixth year in a row with 17 named storms, nine hurricanes and five major hurricanes predicted.

In all, we expect 2011 to be a challenging year both in terms of the underwriting environment and underlying macroeconomic issues. But it is also likely to be a year of opportunity, particularly if we see catalysts emerge that begin to change market fundamentals. In any case, firms armed with the best insight, tools and analysis will be those most prepared to position themselves for the inevitable changes to come.

The report is available exclusively to Guy Carpenter clients. Clients are encouraged to contact their Guy Carpenter broker to receive a copy of the report.

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MARSH GUY CARPENTER
MERCER OLIVER WYMAN

GUY CARPENTER

WORLD CATASTROPHE REINSURANCE MARKET REVIEW

September, 2011

MARSH & McLENNAN COMPANIES

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1 EXECUTIVE SUMMARY

2011 has been another challenging year for the (re)insurance sector. The sector is in a period of heightened market uncertainty as it begins to focus on the 2012 renewals. The devastating earthquakes in New Zealand and Japan, along with damaging tornadoes and floods in the United States and Australia, have resulted in insured losses of around USD70 billion so far this year.

Elevated global catastrophe activity, combined with the challenging macroeconomic environment, has seen pricing pressures build in catastrophe-exposed markets as global reinsurance capital growth has moderated. According to the Guy Carpenter Global Property Catastrophe Rate on Line (ROL) Index, rates were flat to up 10 percent year-on-year as of July 1, 2011. However, widespread hardening in the broader reinsurance market has not materialized as rates in non-catastrophe lines remain flat to down.

It is important to stress that despite the difficult start to the year, the reinsurance sector remains adequately capitalized with a significant excess capital position. Furthermore, the quality and liquidity of overall dedicated reinsurance capital remain strong. Yet the sector faces several headwinds in the run-up to the 2012 renewals. The macroeconomic environment remains challenging, as subdued economic growth and low interest rates continue to depress investment returns. There is also a growing concern over the sovereign debt crisis in Europe and the economic consequences following the downgrade of the United States' credit rating.

Adding to the pressure on the market has been the impact of major catastrophe model releases, particularly for earthquake and wind risks. These model changes have been disruptive to the industry and significantly altered risk perceptions and unexpectedly changed calculated loss amounts. (Re)insurers face a significant amount of work between now and the January 1, 2012 renewals in order to gain a better understanding of how the revisions will affect their business.

All of these factors have resulted in an uncertain market as the sector begins to focus on next year's renewals. Market conditions at the January 1, 2012 renewals will be influenced by loss experience in the remainder of 2011, and by the hurricane season in particular. A quiet hurricane season with no damaging landfalls could enable reinsurance capital to resume growth, while a busy season with at least one significant landfall will put additional strain on the sector's capital position.

Guy Carpenter is actively engaged in helping our clients navigate this challenging market through superior placement and portfolio management services, industry-leading advisory and analytics, actuarial expertise and leading-edge business intelligence. The purpose of this report is to give you superior insight in this dynamic environment. We hope you will find it timely and informative.

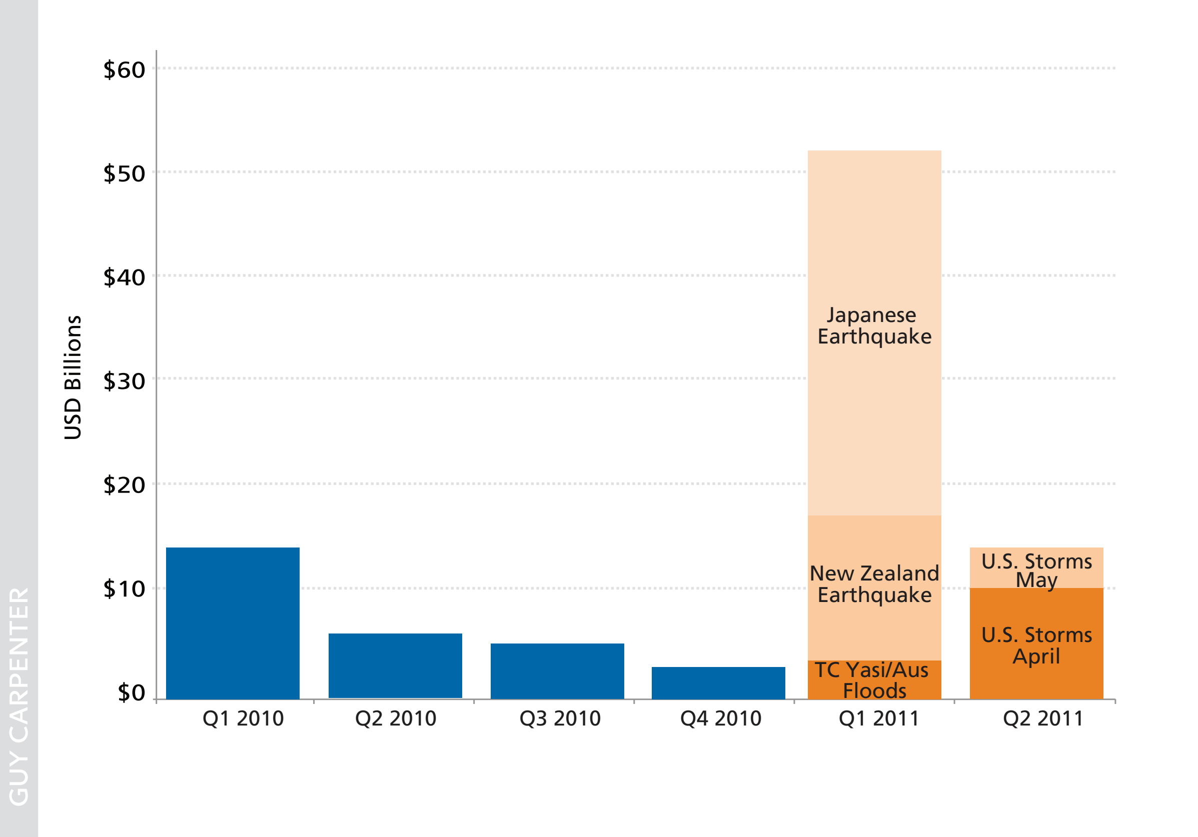
CATASTROPHE ACTIVITY

RECORD BREAKING GLOBAL LOSSES

The first six months of 2011 saw heavy losses from an exceptional accumulation of global natural catastrophes. A series of powerful earthquakes in New Zealand and Japan, combined with multi-billion dollar payouts from tornadoes and floods in the United States and Australia, meant the (re)insurance sector experienced the most costly first half on record in accident-year terms. Insured losses of around USD70 billion are estimated for the period, which is more than five times higher than the first-half average for the past ten years and second only to the full 12-month loss of 2005.

Figure 1 shows the significant catastrophic losses that have affected the (re)insurance industry over the last 18 months. The losses sustained in the first half of 2011 have already surpassed those recorded in 2010 and 2009 combined.

FIGURE 1: SIGNIFICANT CATASTROPHIC LOSSES - 2010 TO Q2 2011



Source: Guy Carpenter & Company, LLC

SIGNIFICANT INSURED LOSSES

At least nine natural catastrophes resulted in insured losses of more than USD1 billion during the first half of 2011. Five were related to tornadoes and severe weather in the United States, causing a combined insured loss of more than USD14 billion. The La Niña climate phenomenon helped create the necessary conditions for tornado formation (warm/humid air and strong south winds near the surface, with colder air and strong westerly winds in the upper atmosphere). A very strong jet stream also contributed to the favorable conditions. If considered a single event, the tornado losses in the second quarter would have ranked as the fifth most expensive disaster in U.S. history, according to the Insurance Information Institute.

EXPENSIVE TORNADO OUTBREAKS

The 2011 tornado season in the United States broke several records. More than 540 storm-related fatalities have been recorded in the United States so far this year. According to preliminary reports from the National Weather Service, April saw the most tornadoes ever reported in a single month – 875. There were a record breaking 226 tornado touchdowns in a single day – April 27. Around 1,600 tornadoes had been recorded by the end of June. Six of these are estimated to have reached EF-5 status (with winds exceeding 200 mph), tying 2011 with 1974 for most top-end tornadoes in one year. In addition to the tornadoes, there were more than 7,200 hail events and 11,300 wind damage reports during the first half of the year.

Two tornado outbreaks caused widespread damage in the United States during the second quarter. The first occurred between April 22 and April 28, damaging thousands of buildings in southern regions. Around 320 people were killed on April 27 alone, the second deadliest single day tornado outbreak in U.S. history. Alabama was badly hit by the outbreak, with insurable damage in the cities of Birmingham and Tuscaloosa alone expected to total around USD2 billion. Property Claims Services (PCS) has estimated an insured loss of more than USD5 billion for the entire outbreak, making it the most expensive tornado event in U.S. history (see Table 1).

TABLE 1: FIVE MOST EXPENSIVE U.S. TORNADO OUTBREAKS FOR INSURERS BETWEEN 1990 AND 2011 YTD

Date	Affected States	Insured Loss (USD Million)
April 22-28, 2011	AL, MS, TN, GA, VA, plus 8 others	5,050
May 20-27, 2011	MO, OK, IA, WI, MN, plus 14 others	4,900
May 2-11, 2003	OK, MO, KS, TN, IL, plus 13 others	3,800*
April 6-12, 2001	MO, NE, TX, KS, IL, plus 10 others	2,710*
May 3-7, 1999	OK, KS, TX, TN, GA, plus 13 others	1,660*

**Losses adjusted to 2010 dollars*

Source: Guy Carpenter, Swiss Re, Insurance Information Institute

Another devastating tornado outbreak hit the United States between May 20 and May 27. Missouri was particularly badly affected during this event, as a single EF-5 tornado flattened parts of Joplin City. The tornado killed more than 150 people and injured 900 more. Overall, this tornado outbreak is estimated to have caused an insured loss of USD4.9 billion.

CLUSTER OF COSTLY INTERNATIONAL LOSSES

Despite the record breaking tornado outbreaks in the United States, the vast majority of the loss activity so far this year has occurred outside of the country. The losses sustained in Australia, New Zealand and Japan have accompanied rate firming in other parts of the property catastrophe reinsurance market, breaking the historical trend of U.S.-based events dictating global pricing movements.

Australia sustained two major losses when floods submerged parts of Brisbane City in January and Cyclone Yasi made landfall in northern Queensland the following month. These events were also strongly influenced by the La Niña event. The floods in Queensland started at the end of 2010, but the worst of the damage occurred in January 2011 when parts of Brisbane City were inundated. Although floodwaters in Brisbane peaked one meter below the level reached during the devastating floods of 1974, thousands of buildings were inundated, and insured losses totaled around USD3 billion. Queensland's misery was compounded when Cyclone Yasi made landfall on February 3 with sustained winds of around 150 mph, making it one of the strongest cyclones to ever hit Queensland. Although the cities of Cairns and Townsville were spared the worst of the stormy weather, smaller communities suffered severe wind damage while the agricultural sector also reported heavy losses. Estimates suggest Yasi's insured loss cost is likely to exceed USD1.2 billion.

EARTHQUAKE DEVASTATION

However, the heaviest losses of the year so far were triggered when two of the most damaging earthquakes in recent times struck Japan and New Zealand. More than 23,000 people lost their lives or were left missing in Japan after a 9.0Mw earthquake struck off the country's northeastern coast in March. The event caused severe shaking along much of Japan's eastern coastline and triggered a massive tsunami that devastated coastal communities. Tens of thousands of buildings were destroyed or damaged by the Tohoku earthquake, which was the most powerful to hit Japan since modern instrumental recordings began 130 years ago. Industry losses related to the earthquake and tsunami are currently estimated at more than USD30 billion.

In New Zealand, meanwhile, thousands of buildings were destroyed in the country's second largest city of Christchurch after a shallow 6.3Mw earthquake hit the area in February. The event was classified as an aftershock of the 7.0Mw Canterbury earthquake that shook the region in September 2010. Despite being of a lower magnitude than that of the Canterbury earthquake, the Christchurch event hit closer to the city's central business district, where many buildings had already been weakened by the earlier quake. Recent estimates suggest insured losses from the event will exceed USD12 billion.

Although it is still too early to calculate a final insured loss figure for both the Tohoku and Christchurch earthquakes, current estimates suggest the events are set to become the first and third most costly earthquakes on record, respectively. The second on record is the Northridge earthquake of 1994, which cost the industry an inflation-adjusted USD22 billion. Furthermore, the Tohoku earthquake is the biggest loss ever to occur outside the United States. There remains considerable uncertainty over what the ultimate cost to the (re)insurance market will be, as earthquake losses historically take longer to develop when compared to typical wind losses.

HURRICANE FORECASTS FOR 2011

It was against this uncertain backdrop that the industry faced the 2011 hurricane season. Although cyclone activity in June and July was limited, with little damage from the four tropical storms that developed, most meteorologists continue to predict an above-average season with an increased risk of hurricane landfalls in the United States. The most recent forecasts for the 2011 season are outlined in Table 2.

TABLE 2: SUMMARY OF HURRICANE FORECASTS FOR 2011

	Total Named Storms (>39 mph)	Hurricanes (>74 mph)	Major Hurricanes (>111 mph)
Average storm development (based on data from 1950 – 2009)	10	6	2
AccuWeather (released June 4)	15	8	4
Colorado State University (released August 3)	16	9	5
National Oceanic and Atmosphere Administration (released August 4)	14-19	7-10	3-5
Weather Services International (released July 27)	15	8	4

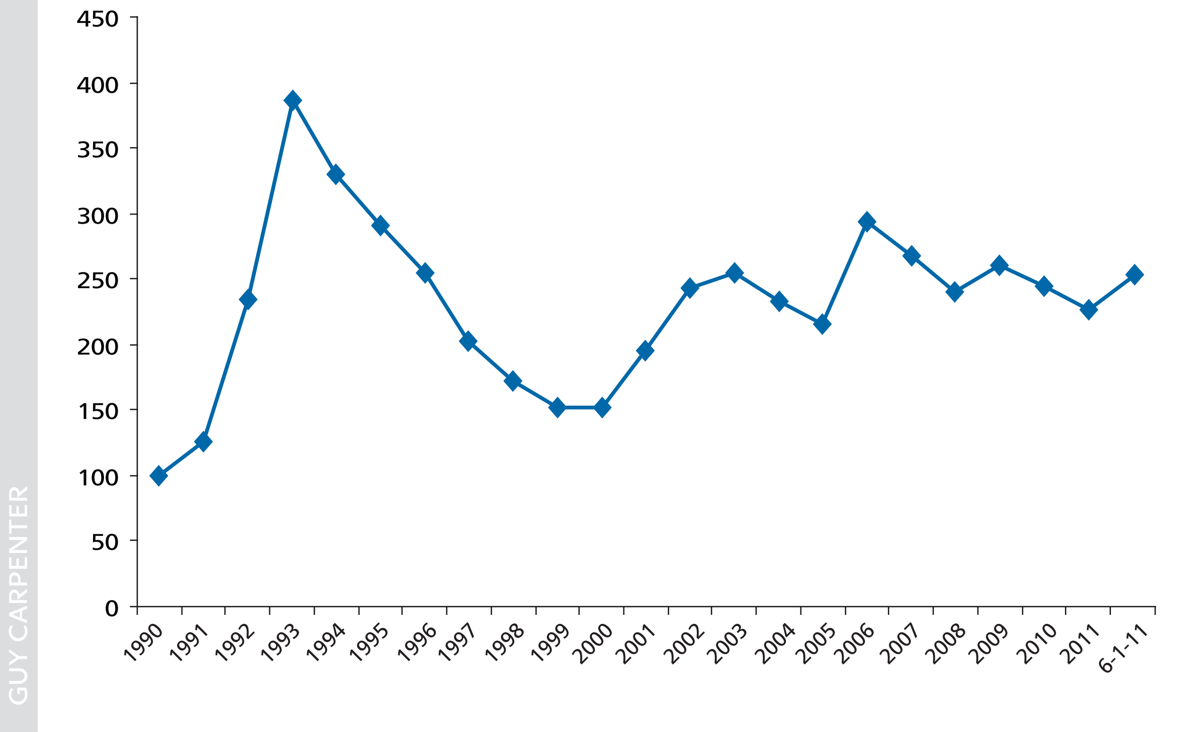
Sources: AccuWeather, CSU, NOAA, WSI

Historically, it is unusual for the (re)insurance industry to experience such heavy losses before the onset of the hurricane season. All eyes are now firmly fixed on the North Atlantic as loss activity through the rest of the year will play an important role in determining the direction of the reinsurance market.

LOSSES EXERT UPWARD PRESSURE ON PROPERTY CATASTROPHE PRICING

The high catastrophe losses sustained in the first half of 2011 have already had an impact on capital and pricing in the reinsurance market. Since the January 1, 2011 renewal, the decline in the capital positions of some reinsurers has exerted pricing pressure on catastrophe-exposed markets. Indeed, according to the Guy Carpenter Global Property Catastrophe ROL Index, rates were flat to up 10 percent year-on-year as of July 1, 2011 (see Figure 2). However, rates in non-catastrophe lines continue to experience downward pressure.

FIGURE 2: GLOBAL PROPERTY CATASTROPHE ROL INDEX[1]



Source: Guy Carpenter & Company, LLC

1 *All renewals shown in Figure 2 are at January 1 of the indicated year, except the date labeled June 1, 2011. As the relationship between exposure and rate-on-line differs from January to June renewals, the final data point represents a best estimate of the sequential change in the cost of property catastrophe cover.*

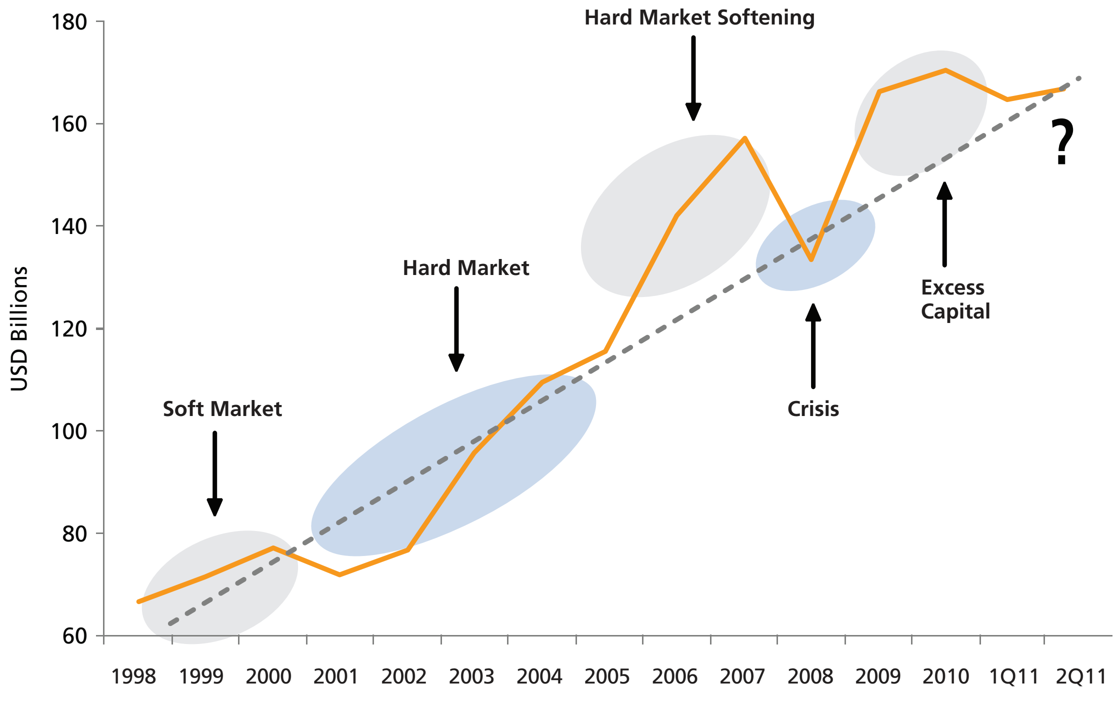
SECTOR CAPITAL POSITION

The first increase in global property catastrophe pricing since 2008 has been driven by a range of factors, from the elevated global catastrophe activity outlined above to a moderation of global reinsurance capital growth. At the January 1, 2011 renewal, Guy Carpenter estimated that the global reinsurance sector's dedicated capital position was about USD20 billion above historical averages, given risks assumed. Since then, the catastrophe losses of around USD70 billion, when offset against premiums, investment income and other factors, have resulted in the reinsurance sector's excess capital position roughly halving to about USD10 billion.

Figure 3 shows historical capital levels for the Guy Carpenter Global Reinsurance Composite beginning in 1998. From a pricing perspective, rates tend to rise when capital levels in the sector tighten. Conversely, reinsurance rates on line often fall when capital levels are above trend. The decline in capital growth witnessed so far this year goes some way towards explaining the building pricing pressures seen in property catastrophe lines.

GUY CARPENTER

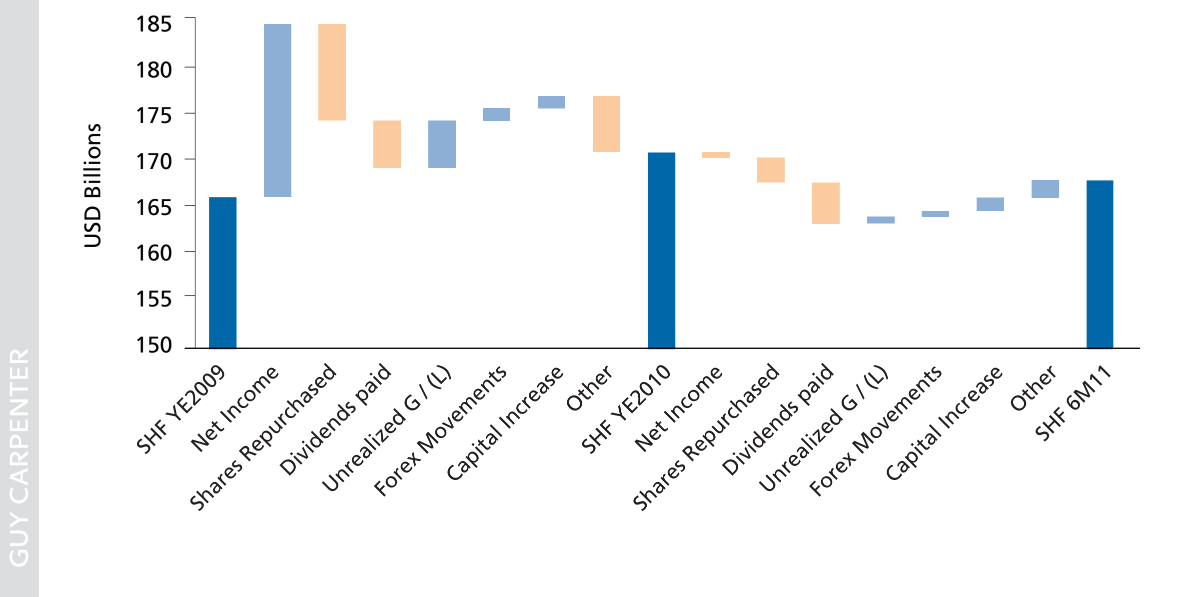
FIGURE 3: HISTORICAL CAPITAL LEVELS OF GUY CARPENTER GLOBAL REINSURANCE COMPOSITE



Source: Guy Carpenter & Company, LLC

It is important to stress that, despite the difficult start to the year, the reinsurance sector remains adequately capitalized with a significant excess capital position. Furthermore, the quality and liquidity of overall dedicated reinsurance capital remain strong. During the first half of 2011, the Guy Carpenter Global Reinsurance Composite's dedicated capital position fell by only 1.8 percent to around USD168 billion (see Figure 4). This occurred as the decline in net income was mitigated by a significant cut in share buybacks and dividend payments.

FIGURE 4: EVOLUTION OF GUY CARPENTER GLOBAL REINSURANCE COMPOSITE'S SHAREHOLDER FUNDS



Source: Guy Carpenter & Company, LLC

IMPACT OF CATASTROPHE MODEL UPDATES

Adding to the pressure on the market was the impact of a new U.S. hurricane model release by Risk Management Solutions (RMS). The launch of RMS version (v)11 in February created uncertainty. The upgrade resulted in inland risk estimates rising substantially due to slower dissipation rates for hurricanes and heavier damage for lower wind speed events. There has also been some debate on the storm surge component of the model[2]. Combined with the high global losses and their impact on reinsurers' balance sheets, this had an effect on U.S. catastrophe pricing through the renewal season.

Although the market has yet to determine fully how it will integrate RMS v11, it is expected that some companies will see aggregate exposures rise due to increased risk perception. Some carriers will also need to hold more capital to cover the same level of catastrophe exposure, possibly prompting a rise in demand for reinsurance protection.

2 *Full details of all recent significant catastrophe model changes can be found in Section 4 of this report.*

DISJOINTED MARKET

All these competing factors resulted in wide-ranging rate movements across the reinsurance market through the 2011 renewals, with only certain regions and lines of business experiencing rising pricing trends. Pricing for property lines varied depending on region, catastrophe exposure levels and loss experience. Though the picture was complicated in the United States by the RMS model change, Guy Carpenter estimates U.S. property rates during the June and July renewals increased in the range of 5 percent to 10 percent on a risk adjusted basis, as measured by RMS v9[3]. However, incorporating a view of risk using RMS v11 saw risk adjusted pricing fall 15 percent. As illustrated by the wide disparity in quotes during the renewal process, the market has yet to develop a consensus on the adoption of RMS v11. But, we expect companies to have fully digested the changes by January 1, 2012, as they gain a better understanding of how the revisions will affect their business.

Loss-affected areas in Asia saw dramatic rate increases in property lines in response to the earthquakes in Japan and New Zealand and the severe weather in Australia. However, rates were flat to down elsewhere in Asia, particularly in countries unaffected by catastrophe losses. The market has been more stable in Europe, where pricing pressures continue to be subdued.

Despite significant rate increases seen in markets exposed to property catastrophe losses, widespread hardening in the broader reinsurance market has not yet materialized. Market conditions for property programs that do not have significant catastrophe exposure continue to be competitive. Pricing also remains generally soft in longer tail casualty lines, with rates flat to down. The perception of adequate sector capital and intense competition continues to prevent market hardening. These factors, along with future catastrophe activity and the wider macroeconomic environment, will be among the most important drivers in determining the direction of the market.

PROSPECTS FOR THE MARKET

In addition to the record breaking loss activity so far in 2011, the current macroeconomic environment continues to be challenging for the reinsurance industry. Subdued economic growth and low interest rates have seen investment returns remain at low levels through 2011. Coupled with poor underwriting results, the reinsurance sector's non-technical income could be under pressure for some time to come if the current expansionary monetary polices in the United States and elsewhere remain in place.

In recent years, several reinsurers have offset accident year losses with the release of prior-year reserves on the back of favorable results for accident years 2003-2007. However, following deteriorating accident-year results and rising inflationary trends in subsequent years, many now question their sustainability. Indeed, there have been instances of companies reporting adverse reserve development for recent accident years, raising concerns over reserve adequacy and prompting some reserve additions. We continue to question how much longer reserves can be expected to bolster earnings.

There is also concern over the sovereign debt crisis in Europe. Yields on "safe" government bonds are at or near thirty-year lows, while spreads on peripheral sovereign European securities have reached or approached Euro-era highs. Recent events in the Eurozone have fueled fears over the threat of debt contagion. In an effort to stop the contagion spreading to other European economies, a new bailout plan for Greece was agreed upon in July, with private sector investors asked to accept a 21 percent loss, or 'haircut,' on certain Greek debt positions. Such potential impairments to Greek bonds are expected to be manageable for most reinsurers, given their limited exposure. However, should the crisis spread to larger economies, such as those of Spain and Italy, the impact on the industry would take on a new significance.

3 *RMS v9 was used to provide a consistent measure of the level of risk from 2010 to 2011.*

Peripheral European sovereign risks are not the only concern for the industry. Although the United States avoided defaulting on its debts with a last minute agreement to increase its debt ceiling and cut government spending, S&P subsequently downgraded the country's credit rating from AAA to AA+ and maintained its negative outlook. The downgrade could ultimately have broad economic implications, resulting in higher interest payments. The downgrade, together with downward revisions of economic forecasts, has already played a role in driving significant capital market volatility. The implications for carriers worldwide are mixed. Most (re)insurers' risk-adjusted capital positions are unlikely to be impacted significantly by the downgrade. However, long-term effects for companies with relatively high exposures to U.S. Treasury securities could become significant if the situation continues to deteriorate.

All of these dynamics have combined to create a difficult operating environment for the reinsurance sector. The lack of clarity around Solvency II's implementation is an added complication at a time of general uncertainty over capital requirements. How these factors develop over the coming months will play an important part in determining the direction of the reinsurance market as the industry begins to focus on the January 1, 2012 renewal.

2012 RENEWALS

Market conditions at the January 1, 2012 renewal will be influenced by loss experience in the remainder of the year, and the 2011 hurricane season, in particular. A quiet hurricane season with no damaging landfalls could enable reinsurance capital to resume growth, while a busy season with at least one significant landfall will put an additional strain on the sector's capital position.

Any adverse development in the macroeconomic factors identified above could also have an effect on the market. How companies integrate the various new cat model releases into their business will also have an impact. As the industry absorbs several major model updates in the remaining months of the year, we expect to see increased demand for reinsurance cover and further pockets of price firming during the 2012 renewals.

4 CATASTROPHE MODEL DEVELOPMENTS

MODEL UPDATES CAUSE UNCERTAINTY

Over the past 12 months, the three main catastrophe modeling companies, AIR Worldwide (AIR), EQECAT (EQE) and RMS have updated many of their products or launched models for additional countries. The changes relate to earthquake, wind and flood risks. Some of the updates have created uncertainty within the market, and their longer-term implications are not fully known at the time of writing.

Guy Carpenter has carefully considered the merits of each model change. For the first time, our model validation conclusions have resulted in recommendations for our clients that are not consistent with the vendors' recommended best practices. Going forward, Guy Carpenter clients should expect specific advice from us regarding every significant model update. In this section, we examine several significant model changes and assess their implications.

NORTH ATLANTIC HURRICANE

All the major catastrophe modeling companies have reset their view of U.S./North American hurricane risk in the past year. Revisions to storm characteristics have been the key component of change for AIR, EQE and RMS. Many users have been frustrated by the lack of regard for risk management implications as some vendors packaged several significant U.S. hurricane changes into their releases. Below we provide an overview of the significant changes to U.S./North Atlantic models over the last 12 months and give our view on each update.

AIR CLASIC/2 v12

AIR's v12 was the first of the new hurricane models, released in the second half of 2010. The updated model introduced a new basin-wide stochastic catalog that included the United States, Caribbean and Mexico. It also expanded its historical catalog to include the 2008 storms of Ike, Gustav and Dolly, while the three states of Missouri, Illinois and Indiana were added to allow for the extension of hurricane tracks further inland. Several changes were made to the model's vulnerability module, and the year of construction was used in vulnerability calculations for all hurricane states. There were marked changes in personal lines vulnerability (almost uniformly upward) for structures built prior to 1995 (except in the Florida counties of Broward and Miami-Dade). Vulnerability functions were updated for various construction types, particularly commercial structures of reinforced concrete, steel and reinforced masonry.

AIR CLASIC/2 v13

AIR only made minor updates to its U.S. hurricane product in 2011, but its tropical cyclone hazard and vulnerability model for the Caribbean underwent more significant change. This, the first Caribbean update since 2003, added 17 new countries and enabled users to model wind and precipitation-induced flood separately. The changes resulted in an estimated 20 percent to 50 percent increase in insurable losses across the new countries.

GUY CARPENTER PERSPECTIVE ON AIR HURRICANE MODEL UPDATE

The release of AIR v12 was expected to result in modest loss decreases in personal lines, while increasing commercial lines in lower return periods and average annual losses (AAL). However, changes in loss results were not uniform across portfolios and were often seen to move in directions unexpected by the AIR guidance. For residential classes in Florida and Texas, for example, AIR guidance indicated that double-digit decreases in AAL would be expected. However, based on actual client data, there were very few instances of pure model change decreases for residential lines in either state.

The model change impact of v12 for commercial portfolios was more consistent with AIR guidance, in that the direction of loss estimates (almost always upward) did prove to be correct. But, client portfolios saw increases that were considerably higher than the AIR guidance had suggested. Such inconsistencies suggested that AIR's industry database was not adequately representative to anticipate how the model update would impact insurer portfolios. When AIR's industry exposure data was updated from v11 to v12, the assumption that the newer building stock in v12 would result in some industry loss decreases did not materialize for the majority of insurers.

RMS RISKLINK V11

RMS released their much anticipated North American hurricane model in February 2011. This new model takes into account observed inland losses from Hurricane Ike (2008) that were not available previously. Other significant changes included:

- Decreased filling rates at which storms dissipate after landfall
- Reset of frequency rates by region and storm category
- Increased vulnerabilities at lower wind speeds
- Increased vulnerabilities of commercial risks
- Decreased impact of secondary modifiers
- Updated regional building practice considerations
- Decreased hazards for some coastal areas
- Remodeled storm surge with revised hazard and take-up rate assumptions for the National Flood Insurance Program

GUY CARPENTER PERSPECTIVE ON RMS HURRICANE MODEL UPDATE

Since 2006, RMS has recommended their medium term rate (MTR) view of risk for near-term risk management. However, recent Guy Carpenter research and sensitivity testing calls this recommendation into question. Our advice to clients is to review each component of model change and make educated choices regarding best settings for their portfolios rather than a wholesale adoption of vendor recommended best practices. Rating agencies are careful not to require a specific view of risk when modeling but expect all companies to provide supporting documentation validating their choice of model settings.

Losses in the new model are generally much higher than expected for most users, based on the RMS guidance. The RMS changes also develop losses that are generally higher than AIR v12. Guy Carpenter believes there are a number of factors leading to a disconnect between actual insurer portfolios and the RMS industry loss summaries provided pre-release. One such reason is the use of an industry exposure database that apparently does not adequately represent the insured industry, as demonstrated by the low number of insurers that observed changes in loss estimates anywhere close to the RMS guidance.

This leads us to question the accuracy of the industry databases typically used to derive industry change numbers between models. For Florida in particular, the amount of coastal exposure skewed the "industry" guidance, even though it was also well known that inland losses would be increasing. Many Florida insurers maintain some inland exposure to balance their coastal writings, so guidance geared towards an "industry loss" view in Florida was virtually worthless to most insurers.

The storm surge component of the model can also have a substantial impact on results, with estimates varying widely due to minor differences in the data on number of building stories. Furthermore, insurers with inspection data for coastal risks that include base flood elevation often have documented elevation heights that vary significantly from the RMS hazard lookup data.

Across the U.S. insurance industry, there has consistently been more interest in reviewing two or more perspectives of modeled loss estimates, and blended model answers are becoming more common.

EQE WORLDCAT ENTERPRISE V3.16

EQE's North American hurricane updates were the last to be released and, generally, had the least impact on loss results. The new version contains hazard and vulnerability updates and an upgrade to its storm surge and demand surge components.

GUY CARPENTER PERSPECTIVE ON EQE HURRICANE MODEL UPDATE

Both long-term and near-term losses have decreased about 15 percent as a result of changes in EQE windfield modeling. Commercial and industrial lines experienced larger decreases than residential lines. As EQE had already adjusted its hurricane model prior to 2010 to take into account claims data from hurricanes Katrina and Rita, along with updated frequency and demand surge modeling that had resulted in loss increases, the relatively minor 3.16 update is not surprising.

Some increases were observed, however, with rises in the District of Columbia, New Jersey, Pennsylvania and Vermont. The Bahamas had the greatest increase in loss estimates at 15 percent to 20 percent, while losses for Caribbean hurricane ranged between down 10 percent to up 10 percent.

EUROPEAN WINDSTORM

AIR CLASIC/2 V13

AIR's European windstorm model underwent a major update in 2010. There were, therefore, only a few changes in the 2011 release, with an expansion in modeled countries to include the Czech Republic, Estonia, Finland, Latvia, Lithuania and Poland[4]. The historical storms of Janika (2001) and Xynthia (2010) were also added to the model's catalog.

RMS RISKLINK V11.0 (SP2)

RMS's European windstorm release saw more significant changes, requiring careful review and validation on a country-by-country basis. The new model expanded its territory reach to include the Czech Republic, Slovakia and Poland. An updated hazard module also resulted in increased hazard in lower return periods and decreased hazard in higher return periods. Depending on the portfolio chosen, these changes, when combined with updated vulnerability curves, can result in significant loss decreases for Austria, Belgium, Luxembourg, Netherlands, Norway, Sweden and Switzerland at a 100-year return period. Increases can also be observed in Denmark, France, Germany, Ireland and the United Kingdom for the same return period. Other notable changes from the model update saw increased annual aggregate losses arising from storm clustering in a single year, and there was a significant change to the industry exposure database.

4 *The research model domain has always included these countries. However, their exposure, vulnerability and loss information were not included in Version 12.0. The stochastic catalog has not changed between the versions and event IDs remain the same.*

GUY CARPENTER PERSPECTIVE ON EUROPEAN WINDSTORM MODEL CHANGES

In early testing of the RMS model, Guy Carpenter has been surprised by the extent of the vulnerability change for standard classes of occupancy and construction and the effect from storm clustering. In general, users have found the unforeseen magnitude of these changes to be confusing and time-consuming. Moreover, the changes communicated by RMS are based on a totally rebuilt industry database and not always in line with other test runs. Guy Carpenter has finished a comprehensive test project that will enable our clients to fully understand the changes in model components and the implications on the computed results.

Guy Carpenter urges greater transparency in disclosing the model components for users in order to evaluate the products more efficiently. We also anticipate greater industry collaboration for vendors who do a better job in disclosing their model assumptions.

EUROPEAN EARTHQUAKE

AIR CLASIC/2 V13

AIR updated its pan-European earthquake model in July 2011 to cover many new countries beyond core earthquake-prone countries in the region. In the event of an earthquake, the new model saw increased probability of magnitude 7 or larger events in most core countries (Greece, Turkey, Switzerland, Israel and Italy). There was also a general reduction in average annual event rates (although Turkey and Israel saw increases in magnitude 8 and above). The update also introduced a finer soil data resolution and an improvement in analysis resolution from 2-digit to 5-digit postal code for Turkey. Expanded vulnerability mapping for construction and occupancy and additional construction and occupancy mixes were also included in the new model.

RMS RISKLINK V11

RMS also made significant changes to its European earthquake model with coverage expanded to Bulgaria, Hungary, Romania and Slovenia. As part of the release, RMS introduced a major upgrade to the event catalog and hazard model for Greece and Turkey, and increased the resolution of geotechnical hazard data. The update also enhanced regional vulnerability curves to differentiate structural resistance to quake by geography and revised the understanding of local building stock and building code changes. Finally, RMS included a loss amplification analysis option in the release and increased the take-up rate to reflect the current portfolio of the Turkey Catastrophe Insurance Pool.

GUY CARPENTER PERSPECTIVE ON EUROPEAN EARTHQUAKE MODEL CHANGES

Pre-release documentation in the run up to AIR's update was unusually limited. In fact, users were only advised that the update would include more countries, adopt a technique to obtain an optimal sample of 10,000-year simulation events and use kinematic modeling to provide information on the size and return period of shallow and crustal earthquakes. AIR users were therefore surprised by the loss changes shown in the documentation made public on the day of the software's release. Given the lack of forewarning by AIR on the loss changes, users are playing catch-up to digest the factors leading to the results. This could slow its adoption for the 2012 renewal.

The scope of RMS's release was more limited. The upgrade was announced in 2010, and users anticipated the changes to modeled losses in Greece and Turkey.

ASIA TYPHOON

RMS RISKLINK V11.0 (SP2)

RMS launched its Hong Kong typhoon model several years ago and expanded its coverage to China in 2011. Unlike other vendor models, RMS's update offers modeling with demand surge and many secondary modifiers.

AIR CLASIC/2 V12.5

In late 2010, AIR released its Southeast Asia typhoon model covering wind and precipitation induced flooding in Hong Kong, Philippines and Taiwan. The model uses a single unified stochastic catalog with other countries modeled in the region – Japan, South Korea and China. Disaggregation of province level exposure data can now be done at a finer level than county in the new version.

EQE WORLDCAT ENTERPRISE V3.16

In 2010, EQE released its first basin-wide typhoon model for Asia. Previously, only country-specific models were available, and they did not produce flood losses. Vulnerability functions were also updated. In 2011, the updated model, v3.16, allows users to model wind with and without flooding for all countries. This option previously existed only for Japan in v3.15.

GUY CARPENTER PERSPECTIVE ON TYPHOON MODEL CHANGES

The most notable change is the emergence of the RMS model for China typhoon. The markets for Chinese-insured exposures generally use CATrader and CLASIC/2 to share analysis results. Our clients are interested in the new RMS modeled results, and, so far, we have seen higher loss results for return periods greater than 50 years

Reliance on modeled losses for China typhoon will be limited until the models are more mature. Some programs from this region have been priced based on claims experience, which are generally lower than the modeled results.

5 CATASTROPHE BOND UPDATE

Revisions to catastrophe models, combined with high industry losses, have led to mixed catastrophe bond issuance so far this year. As of August 5, ten non-life catastrophe bond transactions had been completed in 2011, with new bond issuance totaling USD1.907 billion. The market remains overweight to U.S. hurricane exposure relative to the historical average. This contributed to some second quarter U.S. hurricane exposed transactions pricing at or above the upper limit of initial guidance so that they could be completed. However, as additional investor cash inflows continue to enter the sector, the market remains particularly receptive to perils other than U.S. hurricane.

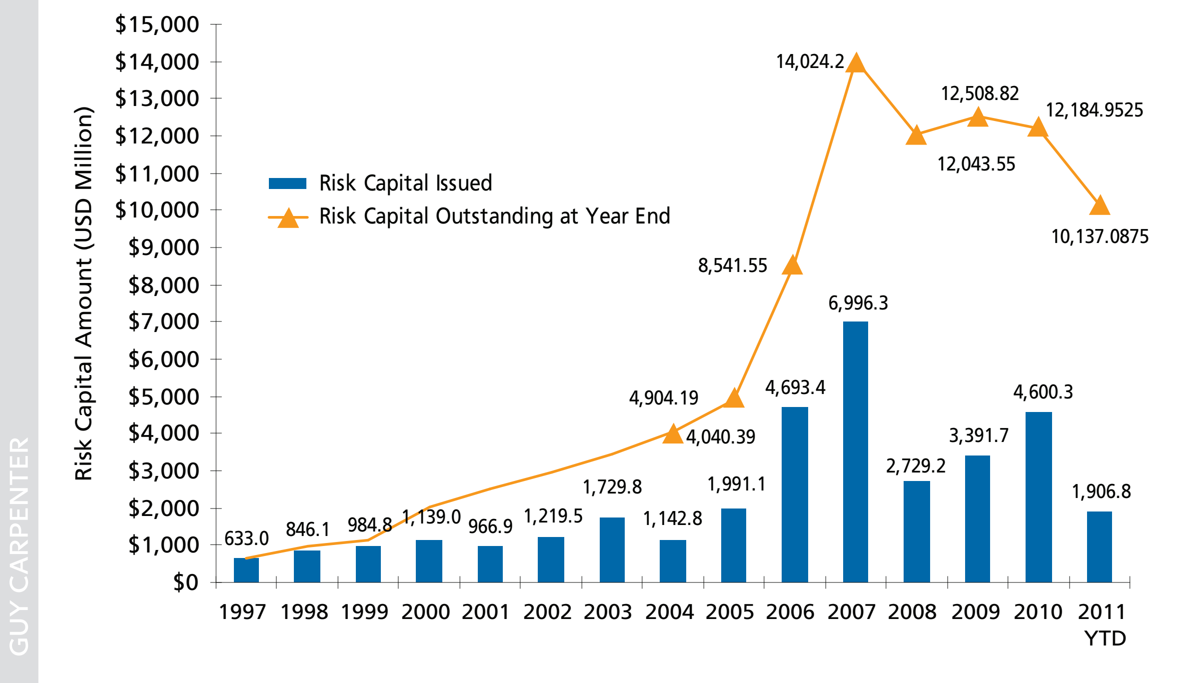
MARKET DIVERSIFICATION

In a break from the historical precedent, strong demand for diversifying peril-exposed transactions is contributing to a more active than usual third quarter for catastrophe bond issuance. Munich Re closed its USD150 million European windstorm bond on July 28 (with GC Securities* as sole bookrunner) with strong execution. The 1.95 percent expected loss transaction was priced at Treasury Money Market (TMM) + 4.75 percent (the initial price guidance was TMM + 5.25 percent to + 5.75 percent) and was concurrently upsized 200 percent from USD50 million. Embarcadero Re, a USD150 million transaction that provides the California Earthquake Authority (CEA) with earthquake protection, closed on August 1 and was reportedly over-subscribed. Subsequent CEA-sponsored transactions are expected in the future. Additionally, the EUR150 million Pylon II two tranche transaction that protects French utility company Electricité Réseau Distribution France against French windstorms closed on August 11. This transaction was also reportedly oversubscribed.

RISK CAPITAL OUTSTANDING

As of August 5, non-life cat bond maturities had outstripped new non-life cat bond issuance, resulting in the non-life cat bond risk capital outstanding decreasing from USD12.185 billion at year-end 2010 to USD10.137 billion (see Figure 5). Only four transactions with a new issuance total of USD592 million closed during the second quarter of 2011, making the period the least active second quarter in terms of primary new issuance since 2005. The RMS U.S. wind model update and a full loss suffered on the USD300 million Muteki cat bond transaction caused by the Tohoku earthquake in Japan were contributing factors to the low activity. It is important to note, however, that the catastrophe bond market continued to trade in an orderly and disciplined fashion in the aftermath of one of the largest earthquakes in recorded history. Moreover, as evidenced by continued net new cash inflows into the sector, capital market investors are continuing to make allocations to the catastrophe risk asset class.

FIGURE 5: RISK CAPITAL ISSUED AND OUTSTANDING 1997-2011 YTD



Source: Guy Carpenter & Company, LLC

Indeed, the first three months of 2011 was the most active first quarter in the history of the catastrophe bond market in terms of new issuance. In total, four transactions came to market, securing USD1.02 billion of new and renewal risk transfer capacity. This was a significant increase over the USD300 million issued during the first quarter of 2010 and even surpassed the previous first quarter high of USD615 million in 2008. Issuance was diverse in terms of risk profile and structure, though U.S. hurricane risk was a common theme in all four transactions. All transactions marketed during the first quarter of 2011 priced within or inside their initial spread guidance.

OUTLOOK FOR REMAINDER OF 2011

GC Securities expects issuance to strengthen during the second half of 2011 as the RMS hurricane model change becomes more fully integrated into cedents' risk management processes. This, along with any U.S. hurricane loss from the 2011 storm season, is likely to be a strong catalyst for issuance. Additionally, if the expected issuance increase of non-U.S. hurricane perils persists to the end of the year, investors should be better suited to take on more U.S. hurricane risk as their relative exposure to U.S. hurricane falls and demand for higher coupon transactions increases.

6 SOLVENCY II'S IMPACT ON THE REINSURANCE MARKET

CHANGING THE GAME

Changing regulatory requirements have remained high on the industry agenda this year, with particular attention focused on Solvency II. Despite its nominally European focus, Solvency II presents a wide range of considerations – and opportunities – to insurance entities worldwide. This new regulatory framework will enact a fundamental change in the way the European insurance industry looks at risk and risk management practices, mandating sweeping changes to capital requirements, corporate governance programs and disclosure practices. All businesses that have operations, subsidiaries or affiliates in Europe, write coverage in Europe or do business with insurers in Europe should be preparing now for these wide-ranging changes.

Market consensus holds that Solvency II will ultimately benefit reinsurers, as primary insurers, faced with higher risk-adjusted capital requirements, will turn to the reinsurance market as a relatively inexpensive source of additional capital and risk transfer. The consensus view further assumes that the additional revenue earned from the primary market – from mutuals and smaller carriers, in particular, that may need to add reinsurance to comply with Solvency II's capital requirements – will more than offset reinsurers' own additional investment costs and risk-adjusted capital constraints over the long run. While reinsurance will continue to be an attractive source of capital and a flexible risk management tool for many insurance carriers, Guy Carpenter believes that the simplistic assumptions noted above conceal the numerous challenges, and a few opportunities, Solvency II presents to the market.

Preparations for the new regulations are already a significant industry-wide burden, but Solvency II does promise to bring some genuine improvements to the market. Noting that the results of the fifth Solvency II Quantitative Impact Study (QIS 5) show that the primary insurance industry in Europe does not require a great deal of additional capital, and anticipating that the overall tenor of further changes to the rules will be dilutive, we perceive a number of positive developments from a cedent's perspective.

Below we review the key benefits and drawbacks to cedents of the new regime on the reinsurance market.

BENEFITS

GREATER TRANSPARENCY AND CONVERGENCE IN REPORTING AMONG SOLVENCY II AND EQUIVALENT REGIMES

In assessing the financial security of reinsurance counterparties, cedents often struggle to reconcile disparate accounting treatments across various domiciles. Disclosure requirements under Solvency II's Pillar Three and market consistent accounting standards will bring a high level of convergence to reports and accounts in Europe and equivalent jurisdictions. This will greatly facilitate the analysis of reinsurer financial strength.

There are some caveats, however. First and foremost, this benefit will take time to realize – perhaps up to ten years, under the phased-in implementation the European Commission (EC) suggested in its so-called Omnibus II directive. The directive constitutes a series of proposed amendments to Solvency II. The benefit may be further diluted to the extent that custom-built internal capital models diverge from the standard model defined in the Solvency II regulations. Market consistent accounting will also contribute to more volatile balance sheets and shorter underwriting cycles, once fully implemented, as noted below.

IMPROVED REINSURANCE SECURITY OVERALL

As the periphery of the market is gradually brought into the center by uniform capital, governance and disclosure requirements, some reinsurers will see capital requirements increase enough to facilitate a level of controlled consolidation and capital re-allocation. This ultimately will contribute positively to the overall health of the reinsurance market.

A STRONGER AND DEEPER INSURANCE LINKED SECURITIES (ILS) MARKET

As an often more flexible and longer-term source of capital than traditional reinsurance, the insurance-linked securities market may absorb some of the net benefit that larger traditional reinsurers expect to realize through Solvency II. This may work to the benefit of cedents as the capital markets compete more directly with traditional reinsurance to limit cost pressures.

While we do expect these benefits, the challenges presented by Solvency II will likely outweigh them. We discuss the key shortcomings and expected adverse effects on cedents and the reinsurance market below.

DRAWBACKS AND RISKS

CAPITAL REQUIREMENTS AND THE COSTS OF COMPLIANCE ARE DISCRIMINATELY HIGHER FOR SMALLER REINSURERS AND WILL FORCE SOME CONSOLIDATION

Large, diversified and highly-rated reinsurance groups with approved internal capital models will likely have materially lower capital requirements under Solvency II than they already maintain for their ratings. For these reinsurers, rating agencies will remain the final arbiters of capital requirements, while Solvency II will add administrative and regulatory cost and, perversely, encourage a lower standard of solvency. So far, rating agencies have resisted the demand to materially reduce capital requirements, with S&P granting only a limited weight to internal economic capital models in their assessment of risk-adjusted capitalization.[5]

Reinsurers of all sizes with material non-proportional books of business and/or material catastrophe exposure outside of Europe are essentially forced to apply for internal model approval. This is due to the seemingly high capital charge for this business contained in the standard formula. This increases the compliance costs for those companies that do not already use internal models. QIS 5 results show that progress on internal models has been slow as companies struggle with model construction and validation.

On the other hand, many smaller or unrated reinsurers assessed under the standard model will see capital requirements increase. We may see certain niche reinsurers withdraw from the market or combine with larger companies as a result. While some consolidation will improve the health of the reinsurance market, it may also pressure rates and eliminate some of the risk transfer options available to cedents. Longer-tail lines of business will be particularly prone to rate pressure as it becomes more expensive to match long-term liabilities with long-term assets.

SOLVENCY II MAY CONTRIBUTE TO MORE INTENSE AND VOLATILE UNDERWRITING CYCLES

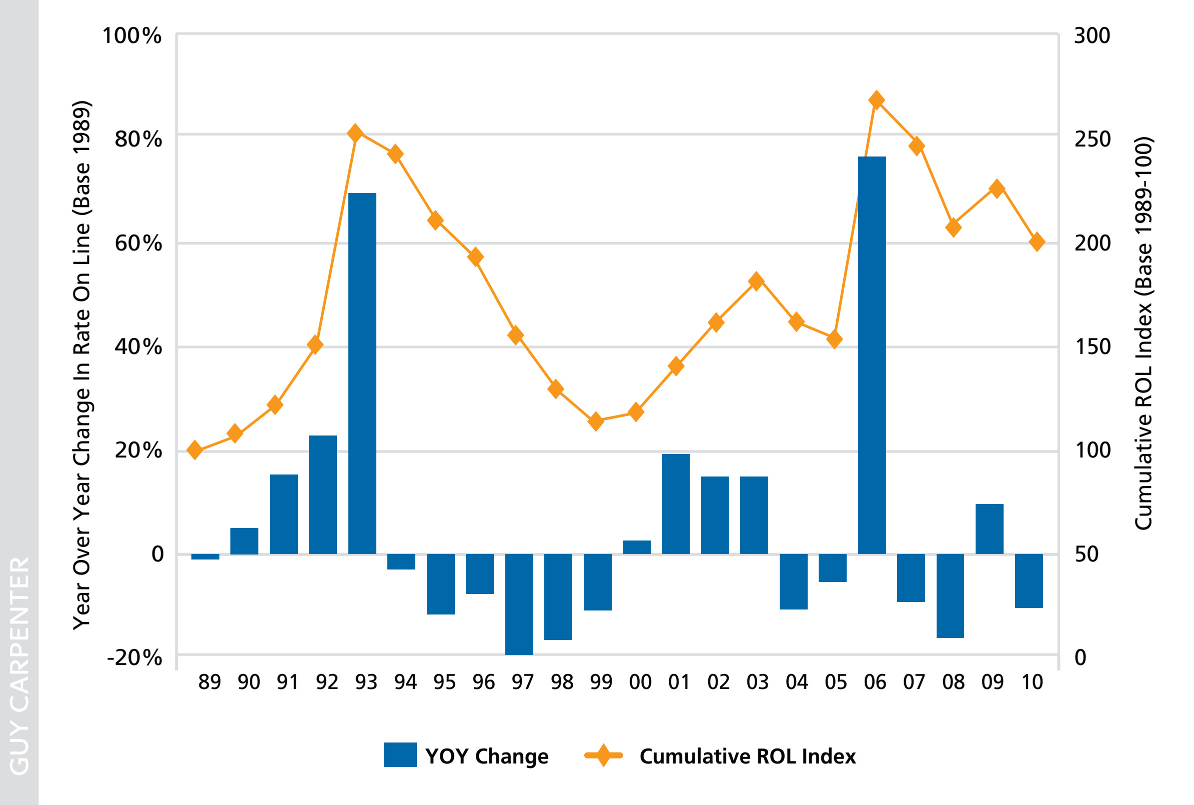
A more precise (or over-calibrated) measure of solvency is naturally more prone to volatility. The widespread use of the Solvency II standard model and internal capital models in conjunction with market consistent accounting of assets and liabilities could contribute to shorter, more volatile underwriting cycles. It could also drive more volatile earnings and balance sheets. Reinsurers, guided by economic capital models based on value-at-risk (VaR), may more actively shed assets and repurchase shares in soft markets, then seek to replace capital in hard markets. While this practice may appear to be sound

5 *Standard and Poor's,* Methodology: Assessing Insurers' Economic Capital Models, *May 15, 2008.*

capital management to investors and some managers, it tends to amplify the market impact of large losses while increasing reinsurers' cost of capital. It is also based on a potentially spurious measure of risk as it often overly simplifies an organization's exposure to tail risk as discussed below.

For example, Figure 6 shows the year-on-year rate change and cumulative rate on line index for the global property catastrophe business. The nearly 80 percent year-on-year average increase in pricing seen in 2006, following the shock losses of hurricanes Katrina, Rita and Wilma in 2005, was also preceded by reinsurers returning several billion dollars in capital to shareholders. This happened in response to relatively modest price declines in 2004 and 2005. Following these events, capital flooded into the reinsurance market in response to anticipated rate increases. The establishment of new markets and "side" "cars" benefited many cedents. However, several reinsurers that had been actively managing capital based on VaR and pricing trends found that they could not replace the capital that they had returned to shareholders only months earlier.

FIGURE 6: CUMULATIVE PROPERTY CATASTROPHE REINSURANCE PRICING, 1989-2010



Source: Guy Carpenter & Company, LLC

The Solvency Capital Requirement (SCR), the risk-based capital requirement for (re)insurers under Solvency II, is calibrated to a 99.5 percent VaR over a one-year period. Many internal capital models in use today also calibrate to VaR. There are a number of problems with the use of VaR as a measure of risk, many of which were illustrated over the course of the 2007-2009 credit crisis. For example, VaR is the foundation for risk-based capital requirements under Basel II, which not only failed to prevent bank failures, but arguably contributed to the crisis by providing a false sense of security around risky investments.

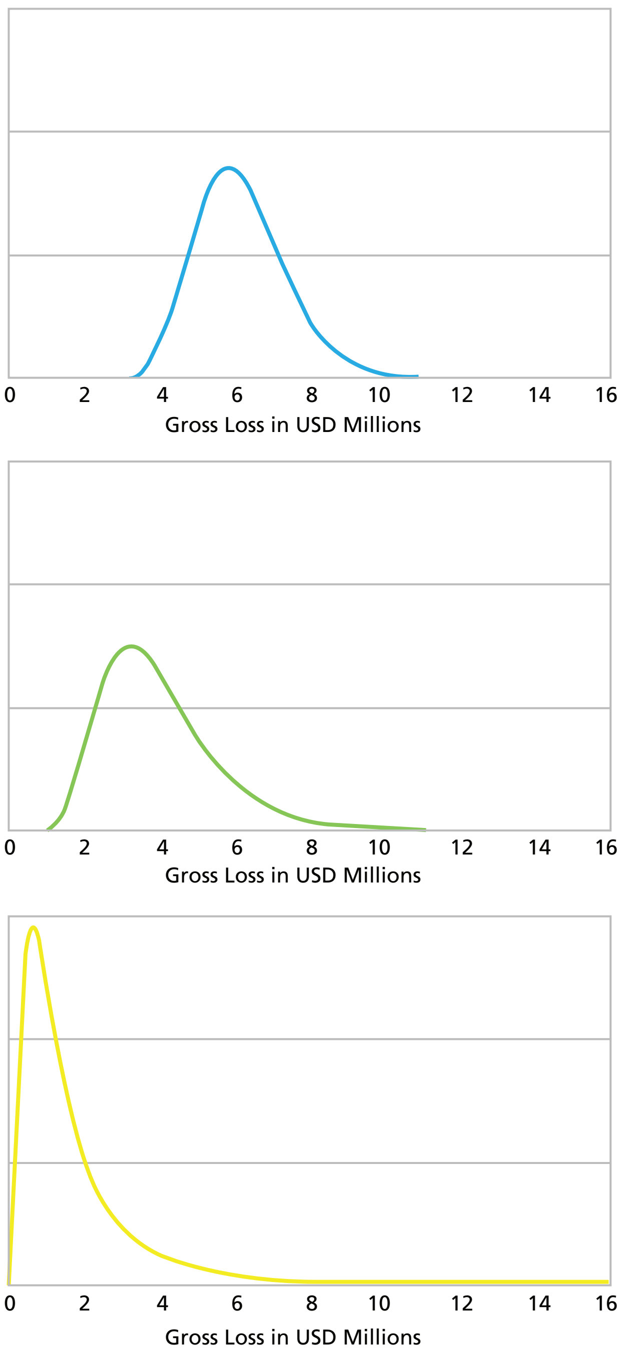
The three probability density function distributions shown in Figure 7 represent three reinsurance portfolios that all have the same VaR at 99.5 percent probability (the same level of confidence as the SCR under Solvency II). Yet, the risk profile of each is clearly different. The portfolio represented by the distribution in blue has the highest average expected loss but is actually the least risky, with its short tail. The portfolio represented by the distribution in yellow has the lowest average expected loss but is the riskiest because it has potential for much higher losses in its long tail.

While tail value at risk (TVaR) shares many of the same limitations as VaR and may also contribute to volatility when relied upon as the sole measure of risk, it can be a better measure of underwriting risk. In this example, the VaR at 99.5 percent probability is USD10 million for all three distributions. However, the TVaR at the same level of probability is USD10.7 million for the blue distribution, USD11.4 million for the green and USD13.4 million for the yellow.

The 2007-2009 credit crisis vividly showed that the simplistic use of VaR to manage risk may result in increased concentrations and gross underestimation of exposure to tail events. It can also give a false sense of security that can contribute to the overcorrection in risk appetite following unanticipated events.

It is clear that Solvency II will profoundly impact the reinsurance market – not only within Europe, but globally. Advances in disclosure and overall market strength will come with very real costs to both the industry at large and individual companies. It is imperative that any companies affected by these sweeping changes make preparations now to navigate this changing and increasingly volatile reinsurance market.

FIGURE 7: PROBABILITY DENSITY FUNCTIONS OF THREE (RE)INSURANCE PORTFOLIOS WITH THE SAME VaR



GUY CARPENTER

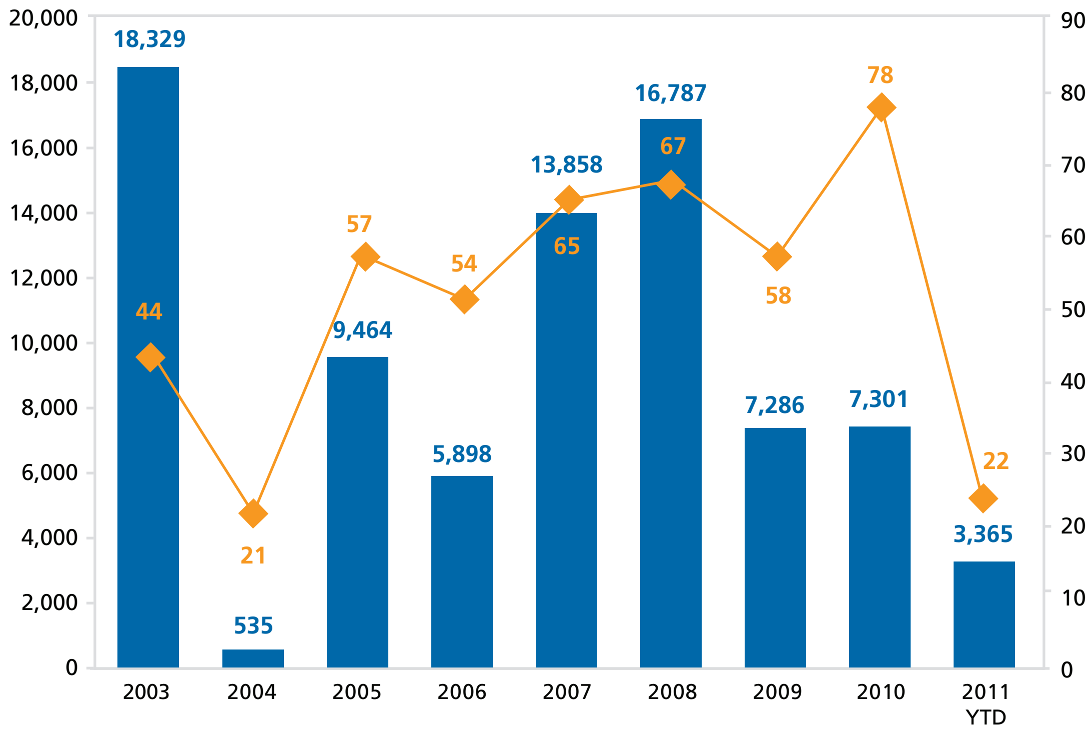
Source: Guy Carpenter & Company, LLC

7 MERGERS & ACQUISITIONS

SUBDUED MERGER AND ACQUISITION ACTIVITY

The recent volatility in the financial markets and the difficult operating environment in general, continue to stifle merger and acquisition (M&A) activity. Property-casualty M&A activity for risk-bearing entities in the first half of 2011 was at a level similar to that seen in the past two years. There were 22 announced and closed transactions with an aggregate deal value of almost USD3.4 billion during the first half of 2011 (see Figure 8). In terms of transaction value, this pace is on track to match the level seen during 2009 and 2010. In addition, industry reports indicated there were an additional 15 transactions that had been announced during the first half of the year, but not closed. If these deals were to close at their announced transaction values, this would add an additional USD1.8 billion in transaction value to 2011's total.

FIGURE 8: P&C INSURANCE M&A ACTIVITY 2003 TO PRESENT



Source: SNL Financial, all closed P&C deals through June 30, 2011

Two main, countervailing factors are affecting the current level of activity in the marketplace.

1. **Higher valuation levels in the first half of 2011:** Economic growth and the equity market's rise in 2010 and the first half of 2011 led to higher insurance company valuations – although this situation has now been mitigated by a broad market decline in response to negative economic growth estimate revisions. Prior to August 2011, with more companies trading close to book value than in the months following the financial crisis, prospective targets became more palatable to sellers' boards. In addition, the option of using stock as an acquisition currency became more attractive as equity values were boosted. This resulted in several high-profile takeover attempts in the quoted space.

2. **A recovering but still shaky economy:** Recent economic developments – such as the risk of the Greek economic crisis spreading to the rest of the European Union and the difficult employment and debt situation in the United States – are placing continued strain on the current macroeconomic environment. This, coupled with memories of the financial crisis in 2008, means boards and management teams continue to adopt a cautious stance.

Despite the uncertain macroeconomic picture, there are other leading indicators that will likely affect the level of P&C insurance M&A over the next 12 months:

1. **Solvency II:** European financial services companies will continue to analyze strategic options for insurance operations in the face of the coming regulatory changes. In particular, focus will likely be on non-core (re)insurance operations and alternative M&A transactions to clean up balance sheets, for example, the use of run-off sales.

2. **Turn in the market:** The unprecedented amount of catastrophes seen worldwide during the first half of 2011 has placed pressure on reinsurers. Many have exhausted their catastrophe budgets for the year. Should another major catastrophe strike, the tipping point from earnings event to capital event could be reached, thereby causing rates to increase. A hardening of the market would likely change insurers' focus away from growth via acquisition and back to organic growth.

3. **Pressure on Mutuals:** Many mutuals are facing downward pressure on their financial strength ratings, causing them to face headwinds on both the capital raising and divestiture fronts.

These factors, along with macroeconomic developments, will influence the level of M&A activity over the next 12 months. Although company valuations improved as equity markets rose in 2010 and the first half of 2011, the subsequent volatility in the financial markets has reinforced the cautious mood in the sector. A key factor in determining future M&A activity will be whether the recent financial volatility is a temporary blip or confirmation of a double-dip recession.

8 HOW GUY CARPENTER CAN HELP

Guy Carpenter is uniquely positioned to help clients navigate a changing and increasingly volatile reinsurance market. Our GC Analytics® team offers services and solutions that include industry-leading proprietary catastrophe models, actuarial services and capital models. We encourage you to contact your Guy Carpenter representative to review and discuss your modeling and capital needs in more detail.

Among the specific services we offer our clients are:

ALTERNATIVE CATASTROPHE MODELING

Guy Carpenter's Model Development Team, established in 2004, has developed a number of industry-leading proprietary catastrophe models for perils or regions where no other models exist, or where market-wide modeling technology is still not as advanced as Guy Carpenter's proprietary alternatives.

i-aXs®

Guy Carpenter's i-aXs data management platform provides a full suite of tools to help insurers translate their data instantly, allowing for faster and better informed decisions. The award-winning platform integrates sophisticated data analysis systems, cutting-edge technology and satellite imagery to provide more efficient management of exposure and loss data. It also provides data mining, analytics and real-time catastrophe information.

i-aXs allows users to select dozens of standard reports or create a custom view of their data. Exposure reports illuminate how and where policies are being written while a loss output view outlines what the models indicate about client exposures. Past and present data can be compared with ease, facilitating a web-enabled data warehouse users can access 24 hours a day, seven days a week. Clients can also visualize their geographic data with our integrated mapping platform so data can be transformed into fully interactive maps.

i-aXs can also assist insurers with accumulation management issues. Its unique accumulator tool calculates concentrations of exposure for perils such as wind, hailstorm and earthquake. Unlike other accumulation tools, output is instantly generated in both map and grid formats. Thematically shaded maps and satellite imagery, along with user-friendly reports, provide detailed accumulation information within a user-defined geographic range.

From an underwriting perspective, i-aXs helps clients assess new locations and combine them with existing portfolios to obtain estimates of probable maximum loss (PML) and AAL. RealCat reports (Patent #7,949,548), meanwhile, assist users in monitoring and evaluating potential losses to a portfolio as an event is unfolding. RealCat covers several perils, including hurricanes, earthquakes, wildfires and floods. By combining satellite imagery with streaming hazard data showing precipitation bands, wind speeds and other related details, clients are able to track the potential impact of an event on their portfolios' locations.

MAN-MADE CATASTROPHE MODELING

In addition to the modeling of natural perils, GC Analytics has acquired expertise in modeling man-made catastrophes. This is accomplished through both the use of commercial modeling platforms and the development of proprietary tools. The wide range of services offered covers the assessment of man-made events for conflagration, terrorism, casualty events, pandemic events that may hit a life portfolio and marine cargo accumulations.

METARISK® - CAPITAL MODEL IMPLEMENTATION (PARTIAL OR FULL)

MetaRisk is Guy Carpenter's proprietary stochastic reinsurance and capital modeling platform. It is a uniquely powerful, flexible and transparent solution that enables us to model clients' entire portfolios rapidly, accurately and reliably.

MetaRisk provides a realistic way of modeling reserve risk, which reflects (re)insurers' own reserving practices. By building a parallel version of a client's underwriting risk model (gross losses, ceded premium and ceded losses) in MetaRisk, we can undertake comprehensive validation and sensitivity testing. MetaRisk employs sophisticated algorithms that most closely replicate the treatment of secondary uncertainty by RMS so that the platform's estimation of extreme losses, for example, 1-in-200-year events, is nearly exactly the same as that produced by the actual vendor model.

MetaRisk's simulation speed empowers carriers to compare any desired metric for multiple alternative selections for loss frequency and severity. Consequently, they can sensitivity-test their original assumptions around loss ratio, premium growth, underwriting cycle and inflation.

MetaRisk is also able to simulate clients' underwriting risk (losses and reinsurance) with a sufficient number of simulations within a relatively short timeframe. This allows an assessment of the impact of potential simulation error within the main capital model on key extreme scenarios, such as the 1-in-200-year underwriting result.

PORTFOLIO MANAGEMENT

Guy Carpenter offers multiple tools for clients who are looking to implement portfolio management and enterprise risk management (ERM) strategies. Our tools focus on both natural and man-made catastrophes and we work with clients to tailor the right short-term and long-term solutions.

A key element of portfolio management is the alignment of a firm's capital management framework with catastrophe modeling output, so returns can be targeted down to the county, postal code or even location level. With this information, a firm can re-underwrite the "worst offenders" in the existing portfolio and target new areas for growth according to defined performance metrics. The portfolio management process is pursued through data management, portfolio assessment and portfolio optimization.

RANGE OF CUSTOMIZED ADVISORY SERVICES

Guy Carpenter offers deep advisory expertise in areas that many clients will find useful in evaluating their risk exposure. Our rating agency service offers expertise in areas that help clients in their interaction with A.M. Best. The guidance includes support for evaluating current risk tolerances, catastrophe risk appraisal and advice on the interaction between the company and the rating agency. These services are supported by further offerings including capital advisory, strategic advisory, reserve risk modeling, ERM and reinsurance counterparty risk exposure. Our business intelligence unit also publishes regular analyses of industry issues, as well as bespoke research at the request of individual clients.

ACTUARIAL EXPERTISE

GC Analytics' expertise and industry leading modeling proprietary software can help carriers parameterize their portfolios, supplement their existing data with more from the industry and enhance model performance through additional technical knowledge and capabilities.

GC Analytics teams can also propose a number of tailor-made solutions to assist (re)insurers with their implementation of regulatory legislation, such as Solvency II. These solutions are targeted and specific, ensuring they are achievable and deliver measurable value.

FOR MORE INFORMATION, PLEASE CONTACT:

David Flandro
Global Head of Business Intelligence
+44 207 357 3267
David.Flandro@guycarp.com

Lara Mowery
Managing Director
+1 952 832 2104
Lara.A.Mowery@guycarp.com

Imelda Powers
Managing Director
+1 917 937 3577
Imelda.Powers@guycarp.com

Sherry Thomas
Managing Director
+1 952 820 6425
Sherry.L.Thomas@guycarp.com

Cory Anger
Managing Director
+1 917 937 3281
Cory.I.Anger@guycarp.com

Julian Alovisi
Assistant Vice President
+44 207 357 2967
Julian.Alovisi@guycarp.com

About Guy Carpenter

Guy Carpenter & Company, LLC is the world's leading risk and reinsurance specialist and a member of the Marsh & McLennan Companies. With over 50 offices worldwide, Guy Carpenter creates and executes reinsurance solutions and delivers capital market solutions* for clients across the globe. The firm's full breadth of services includes line of business expertise in Agriculture; Aviation; Casualty Clash; Construction and Engineering; Excess and Umbrella; Life, Accident and Health; Marine and Energy; Medical Professional Liability; Political Risk and Trade Credit; Professional Liability; Property; Retrocessional Reinsurance; Surety; Terrorism and Workers Compensation. GC Fac® is Guy Carpenter's dedicated global facultative reinsurance unit that provides placement strategies, timely market access and centralized management of facultative reinsurance solutions. In addition, GC Analytics® utilizes industry-leading quantitative skills and modeling tools that optimize the reinsurance decision-making process and help make the firm's clients more successful. Guy Carpenter's website address is www.guycarp.com.

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Guy Carpenter Report: World Catastrophe Reinsurance Market

MARKETPLACE REALITIES

SOLID FOOTING AND A FOUNDATION FOR GROWTH

2012

Willis

MARKETPLACE REALITIES

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We also invite readers to visit the Publications **What We Think** page of **www.willis.com**, where you will find many other articles and studies of immediate and enduring value to risk managers, financial executives and corporate governance stewards of every stripe.

Marketplace Realities is updated semi-annually.

EDITORIAL STAFF

Eric Joost | Jonathan Fried | Paulette Callen | Arlene Calandria

MARKETPLACE REALITIES

INTRODUCTION

SOLID FOOTING AND A FOUNDATION FOR GROWTH

For years, many in the insurance industry have been saying, brace yourself – if we're hit by a string of major catastrophes, the market will turn. By many counts, 2011 is already the most expensive year on record for catastrophic losses. So far, no market turn. Yes, rates in CAT areas are up. And insurer profits are down from 2010. But overall, supply is still strong.

What's the take-away? Could it be that the old paradigm of regularly revolving hard and soft markets doesn't apply anymore? Perhaps. More certain is that the marketplace, after years of falling rates, has become an efficient place. Current struggles aside, profits are being earned with lower premiums. The industry appears to be not only resilient and prudent but elastic, nimble, even smart. These are good traits in a business environment subject to the vagaries of natural and human-generated catastrophes.

Whether or not you believe catastrophes are in fact on the rise, whether or not you see another big hit to the global financial infrastructure around the corner, it's hard to avoid the impression that the world is an increasingly risky place. Computers, the greatest boost to productivity in this generation, give us a whole new lexicon of exposures in Cyber risk. The world political landscape has shown us that things can shift significantly over the course of a few spring weeks. And every day we're reminded that in a global marketplace, when lightning strikes in one financial corner, the thunder is heard half way around the planet.

Yet none of this seems to threaten access to the contingent capital that is available through the payment of reasonable premiums. In uncertain times, it appears, you can count on insurance.

So where to from here? As in any successful industry, we go where the demand is. The obvious place is in the growth areas of the world, particularly Asia. But demand for insurance and risk-related services may come from places we haven't always looked for it in the past.

Some of the greatest risks facing businesses and private citizens in North America – flood, terrorism, disasters in general – are backstopped by the government. Think of federal flood insurance, TRIA (the Terrorism Risk Insurance Program) and FEMA. The combination of government debt and poor growth may, in the not so distant future, spell a decline in the ability of government to maintain this role. There is only one industry ready to fill the void.

Another source of demand, one we see rising right now, is in risk management support. Risk managers are being squeezed from at least two sides. On one side, risk managers have fewer resources with which to handle the analytic work of risk management. On another, the list of risks that must be addressed if an organization wants to sustain itself keeps growing beyond Property and Casualty. Cyber, Environmental, Trade Credit and Supply Chain risk are just a few areas of expanding exposure where help is needed. We can provide it.

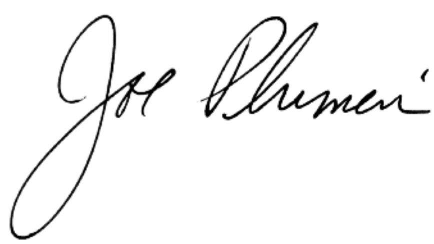
This trend is particularly clear in the area of employee benefits. Companies seek benefit partners who can take work off the desks of their HR people whose hands are full with day-to-day issues – never mind the enormity of health care reform.

The nature of business in the developed world is also evolving. The assets of 21st century companies are increasingly intangibles, such as brand, data and intellectual property. Traditional insurance focuses on tangibles, such as buildings and machines. The shift in organizational risk calls for a change in risk management approach – another factor that should increase the demand for sophisticated risk management expertise.

This doesn't mean we're out of the broking business. Hardly. We will always be focused on the nuts and bolts of policies and protection and what that costs – that's why we publish this guide. But we must at the same time respond to the larger trends at work that may be shaping our industry for years to come. Our roles as partners in the success of our clients and of society in general could be ready to surge forward.

We have built a foundation for the growth of our industry.

We are, more than ever, a foundation for the growth of enterprises everywhere.



Joe Plumeri
Chairman & CEO
Willis Group

MARKETPLACE REALITIES

PROPERTY

- 2011 may break all records for insured losses. Before hurricane season even got underway, **$70B** of property losses hit the market. **We are on track to pierce the $100B mark for the first time**.
- **The release of RMS 11.0 impacted the market as much as the catastrophic losses**. Many loss estimates in Tier 2 hurricane zones **increased by 50% to 100%**. Underwriters have been forced to either charge more for their CAT capacity, find another attachment point on programs or cut their line size.
- Reinsurance rates, up marginally in Q1 and Q2, moved up 5% to 15% on average. Increases were in the 10% to 20% range for accounts with losses.
- For January 2012 renewals, reinsurance rates are expected to climb further due to the 2011 insured losses and RMS 11.0.
- **Many insurers are running loss ratios in excess of 100%**.

PRICE PREDICTIONS

Type of Accounts	2012 Q1 Forecast
Non-CAT	-5% to Flat
CAT (or poor loss experience)	+7.5 to +12.5%

CONTACT

David Finnis
Executive Vice President
National Property Practice Leader
404 302 3848
david.finnis@willis.com

MARKETPLACE REALITIES

CASUALTY

- **Casualty/General Liability rates are stable, with most insureds receiving a slight increase or flat renewals**. Some buyers are still seeing moderate rate decreases.
- The driving force behind overall Casualty costs remains the extent of exposure rather than rates, as pricing tends to be flexible.
- **Carriers are competing for new business and regional carriers are often more aggressive for middle market risks**.
- Insureds should carefully monitor the emerging trend in which states are reinterpreting the definition of an occurrence under Liability policies. Clients whose work product can be subject to faulty workmanship or similar claims should pay particular attention to these developments.
- Due to the rising number of product recall events or other events that damage a company's brand, insureds should consider stand-alone Product Recall and Brand Protection cover.
- Investment in safety and technology yields rewards in the marketplace.
- Reinsurance pricing matches GL market pricing trends.
- The current market offers opportunities for buy-outs and other insurance products to close out legacy collateral and program agreements.

PRICE PREDICTIONS

Flat to +5%

CONTACT

Pam Ferrandino
National Placement Leader
Casualty Practice Leader, Placement NA
212 915 7928
pamela.ferrandino@willis.com

MARKETPLACE REALITIES

UMBRELLA AND EXCESS

- Umbrella and Excess rates are firming but not hardening.
- **Many incumbent carriers are seeking rate increases in the range of 5% to 10%**.
- Capacity remains abundant and carriers largely remain bullish for new business, but **some are walking away from renewals if they can't achieve minimum increases**.
- Carriers are continuing to better define their appetite by industry with their terms and conditions reflecting their target niche.
- Energy accounts are generating higher rate increases than other exposures and carriers are actively working to identify energy exposures that may have been misclassified within their accounts.
- Reinsurance pricing is in step with the market's pricing trends. **Facultative capacity for higher excess, however, is limited**.

PRICE PREDICTIONS

Flat to +5%

CONTACT

Pam Ferrandino
National Placement Leader
Casualty Practice Leader, Placement NA
212 915 7928
pamela.ferrandino@willis.com

MARKETPLACE REALITIES

WORKERS' COMPENSATION

- **Firming Workers' Compensation rates do not indicate the arrival of a hard market**.
- Carriers are actively seeking new business.
- Few carriers have an appetite for monoline Excess Workers' Compensation.
- Reinsurance capacity remains abundant.
- Several states (WI, MI, OH, KS and IL) are in various stages of modifying their Workers' Compensation programs.
- Many national carriers are willing to consider Sureties as part of the collateral for financially strong insureds.
- Carriers seeking premium growth are offering buy-outs or other insurance products to close out legacy collateral and program agreements.
- **While most insureds are seeing their renewal rates range from flat to +5%, buyers in the Southeast continue to see modest rate decreases**.

PRICE PREDICTIONS

Flat to +5%

CONTACT

Pam Ferrandino
National Placement Leader
Casualty Practice Leader, Placement NA
212 915 7928
pamela.ferrandino@willis.com

MARKETPLACE REALITIES

AUTO

- **Auto Liability rates are firming and carriers are eager for new business despite increases in the frequency and severity of losses**.
- We expect these trends to continue through 2012.
- Buyers that have invested in safety and technology should brag about it.
- Large fleet owners should make the time to meet their underwriters and, if possible, their facultative underwriters to promote their risk profile.
- **Now is the time, while carriers remain hungry for premium growth, to consider buy-outs or other insurance products to close out legacy collateral and program agreements**.
- Reinsurance pricing is following the market's pricing trends.

PRICE PREDICTIONS

Flat to +5%

CONTACT

Pam Ferrandino
National Placement Leader
Casualty Practice Leader, Placement NA
212 915 7928
pamela.ferrandino@willis.com

MARKETPLACE REALITIES

EMPLOYEE BENEFITS

- With one year of health care reform compliance under their belts, employers are now focusing on elements of the law that will become effective in the next few years. Government agencies have struggled to publish compliance details sufficiently in advance of effective dates.
- **Employers will continue to see the cost of insurance rise as insurers pass down the costs of complying with the health care reform law**.
- As the costs of health care continue to increase, employers are actively seeking more aggressive cost containment strategies. **More employers are considering self-insurance options. Costs are also shifting to employees**.
- Interest in wellness programs as a means of improving employee health and reducing costs continues to grow. Employers with existing programs are expanding them.
- Shrinking revenues continue to thwart employer efforts to offer competitive total reward programs.
- Employers are relying more heavily on their advisers and brokers to navigate regulations and to help them achieve greater cost savings. **Brokers will be under increasing scrutiny to demonstrate the value they bring beyond insurance placement**.
- Fewer employers are able to retain the grandfathered status provided by the health care reform law as cost-cutting plan design changes cause the loss of protected status.
- **Countering the expectations of many observers, health care reform does not appear to be causing employers to stop providing benefits to their employees**.
- Attempts by federal and state politicians to amend or repeal the health care reform law continue. Several legal challenges to the law have been brought in federal court and the U.S. Supreme Court is expected to hear these challenges in 2012.

PRICE PREDICTIONS

+10-12%

CONTACT

Maureen E. Gammon
Employee Benefits Attorney, National Legal & Research Group
Willis Human Capital Practice
610 254 7476
maureen.gammon@willis.com

MARKETPLACE REALITIES

CYBER RISK

- The market for stand-alone Cyber policies remains competitive, with **rates flat to down 5% for renewals. With mounting losses, renewal rates have begun to flatten**.
- **First-time buyers should still find a competitive environment**, though the range between insurers may narrow if losses mount.
- New markets have entered the space.
- Several markets have revised their policies, bringing in more robust data breach incidence response services.
- Insurers are moving to **provide panels of breach response firms. Insureds agreeing to use the panels may be able to buy higher sublimits for breach notification cover**.
- More markets are putting up excess limits, building capacity for large placements, while the competition is driving down the price.
- Policy wording continues to expand both for privacy coverage (regulatory and PCI fines/penalties and breach cost sublimits) and more dramatically for Network Business Interruption coverage. One major carrier has introduced a Reputational Loss cover triggered by a covered incident.
- Insureds that buy Errors & Omissions (E&O) policies are often able to add Cyber risk by endorsement. Exceptions include financial institutions.
- Privacy laws continue to spread both in the U.S. and Europe.
- The European Union and the U.K. have enacted new laws mandating notification to residents following a breach of their personal identifiable data.
- 450 privacy breaches were reported publically in 2010, down from 612 in 2009. Stolen laptops were involved in 19% of the breaches and 61% were the result of external intrusion, according to the Open Security Foundation. **Despite the decline in the number of privacy breaches, the overall cost of cyber crimes is rising**.

PRICE PREDICTIONS

Renewals	Flat to -5%
First-Time Buyers	Competitive

CONTACT

Geoffrey K. Allen
National E&O and eRisk Practice Leader
212 915 7951
geoffrey.allen@willis.com

MARKETPLACE REALITIES

DIRECTORS & OFFICERS (D&O)

- **Primary rate decreases remain common but are easing into the single digits, and at least one major carrier is mandating flat renewals**.
- Capacity, meanwhile, remains constant, with no new entrants into the marketplace for commercial (non-financial) risks. **We expect abundant competition to continue to drive double-digit reductions in excess pricing where minimum premiums have not already been reached**.
- Capacity for financial services firms continues to increase as commercial carriers calculate that most suits related to the credit crisis are already in.
- Coverage enhancements for public companies that were first made available at a price in 2010 will be rolled into placements in 2012 at no additional premium.
- **The most significant product changes are in the area of investigations. Limited coverage is most often available for individual directors and officers rather than the companies**.
- Despite the fact that reinsurance does not play a large role in either the pricing or terms and conditions for D&O insurance, it is the most frequently cited reason for carriers refusing to write multi-year deals for for-profit companies.
- As derivative and opt-out D&O claims become more common, global claim settlements grow more complex and costly.
- More companies are looking at independent directors-only coverage or increasing the limits that they carry in this top-most segment of their D&O tower.
- Another major D&O trend is the expansion of global programs to incorporate local placements (where non-admitted coverage is not permitted).
- Buyers may be able to purchase additional limits without warranty statements or new pending and prior litigation exclusions.

PRICE PREDICTIONS

Overall	Flat to -10%
Large Public Company	Flat to -5% on primary, -5 to -15% on excess layers
Other Public companies	-5 to -10% on primary, -10 to -15% on excess
Private Companies	Flat to +/-10%
Nonprofit Entities	Flat to +/-10%

CONTACT

John Connolly
D&O Practice Leader
610 254 5686
john.a.connolly@willis.com

MARKETPLACE REALITIES

EMPLOYMENT PRACTICES LIABILITY (EPL)

- In the global marketplace for EPLI, Bermuda and London are most likely to offer competitive terms on larger risks.
- **Soft market conditions largely follow those seen in D&O – with rates of decrease flattening**.
- Capacity overall remains abundant, but at least two major carriers have announced their intention to restrict their maximum capacity on primary layers. This may, in part, be a reaction to the U.S. Supreme Court's decision in *Dukes v. Wal-Mart*, which denied federal class action status to the nationwide class of plaintiffs – potentially leading to many more (and hence costly) state-based class actions.
- **As the global credit crisis drags on, significant EPL claims are being brought outside the U.S.; this is expected to continue into 2012, potentially impacting the risk profile of multinational firms**.
- **A trend to look for is policy wording addressing new media exposures**.
- Carriers have little appetite for wage-and-hour claim coverage, with limited coverage available only to smaller organizations.
- Strategic buyers will look for opportunities to leverage their D&O purchase with potential EPL markets, while private and nonprofit firms usually combine the purchase.

PRICE PREDICTIONS

Overall	Flat to -5%
Large Global Companies	Flat to -10% on primary, -5 to -15% on excess layers
Mid-Size to Large Domestic Firms	-5 to +10%
Private and Nonprofit Entities	Flat to +/-10%
Smaller Employers (fewer than 200 employees)	Flat to -10%

PRICE CONTACT

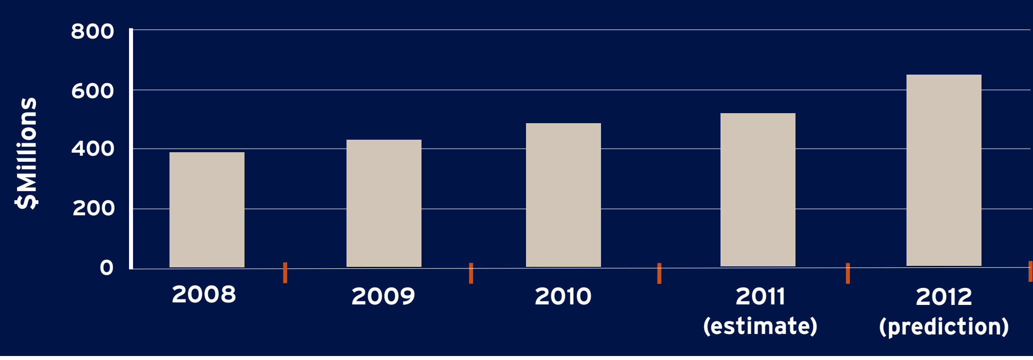
Ann Longmore
Product Leader
212 915 7994
ann.longmore@willis.com

MARKETPLACE REALITIES

ERRORS & OMISSIONS (E&O)

- For a range of E&O market segments, reductions are expected in Q1 2012. While reductions will depend on exposure and industry type, **for many, rates will fall by up to 5%**.
- The market is starting to divide. Insurers with the larger market shares are increasing their effort to keep rates flat and in some instances are walking away from heated competition.
- **However, a large section of the market is still aggressively competing for market share and is offering reductions**.
- **Competition will remain generally strong in the middle market through 2012**.
- Abundant capacity continues to drive the market. New entrants keep arriving.
- Authorized global E&O limits are approximately $700M. Typical insureds should be able to buy from $350M to $400M.
- While wording enhancements will be a key part of competition, **most insurers are standing firm on deductibles**.
- Policy forms for mature market segments will not expand meaningfully in terms of core coverage, although insurers will continue to **add or enhance options for Network Security and/or Privacy Liability coverage**.
- For several market segments – real estate, for example – large claims will make rate reductions and even flat renewals difficult to attain.

E&O CAPACITY



PRICE PREDICTIONS

Good Loss Experience	Flat to -10% in Q1 and Q2, flat to +5% by end of 2012
Poor Loss Experience	+5-10% in Q1 and Q2, +15-20% by end of 2012

CONTACT

Geoffrey K. Allen
National E&O and eRisk Product Leader
212 915 7951
geoffrey.allen@willis.com

MARKETPLACE REALITIES

FIDELITY

- **Rates will mostly remain flat, moving up or down a few points depending on the size and nature of the risk**.
- On paper, capacity has never been higher, but carrier appetite for primary layers on larger and complex risk has dropped off significantly. Far more companies are prepared to lead mid-sized or Fortune 1000 commercial risks than take a primary position on Fortune 500 or mid-sized to large financial institutions.
- Interest in the excess market for both commercial and financial institution accounts, however, remains exceedingly high. Expect this trend to continue into 2012.
- **The most notable trend in the Fidelity market is the willingness of most Commercial Crime underwriters to offer a discovery policy form vs. the traditional loss sustained contract used for decades**. Mid-sized to Fortune 1000 clients should press for the discovery form, which affords material advantages.
- Most underwriters have improved general terms and conditions on crime and FI Bonds over the past several years and we do not anticipate any retraction in 2012.
- Poor financial results continue for many of the leading markets. Unfortunately for many of these companies, loss ratios have been marginal to poor for several years.
- For stock brokers, FINRA Rule 4360 (effective 1/1/12) will require that their FI Bonds cover each and every loss limit (i.e., no aggregate) and that coverage for court costs will fall outside the limit of liability. Carrier responses to the new requirement has been mixed, but most agree they will be hard pressed to afford these terms for larger firms. FINRA will require those firms that are not able to meet the new requirement to produce a letter of declination from two carriers stating they are not eligible for this new coverage.

PRICE PREDICTIONS

Overall	Flat to +/-5%
Comprehensive Crime: ■ **Middle market and Fortune 1000** ■ **Fortune 500**	Flat to -5% Flat to +5%
Financial Institution Bonds: ■ **Middle market and Fortune 1000** ■ **Fortune 500**	Flat to -5% Flat to +5%

CONTACT

Stephen Leggett
National Fidelity Product Leader
212 915 7901
stephen.leggett@willis.com

MARKETPLACE REALITIES

FIDUCIARY

- **Rate decreases are beginning to flatten out on both primary and excess layers, as minimumpricing levels are approached on some of the largest placements**.
- Capacity remains constant, with no new entrants into the marketplace.
- Expensive ERISA tagalong litigation will continue and suits involving cash balance plans are still making their way through the courts.
- The ongoing financial crisis continues to afflict pensions. Hardship withdrawals are compounding the impact of depressed asset values at some funds.
- Uncertainty about the national health care agenda and potential changes in the definition of "fiduciary" in the health care context are not yet reflected in the marketplace.
- **The migration of recent D&O coverage enhancements into Fiduciary policies is expected to continue throughout 2012**. This can include affirmation wording relating to (presumptive) indemnification and advancement of defense costs as well as expanded coverage for investigations.

PRICE PREDICTIONS

Overall	Flat to -10%
Companies with Large Concentrations of their Stock in their Employee Benefits plans	Flat to -10% on primary, -5 to -15% on excess layers
Companies without company stock in their plans	Flat to -5/+10% on primary, with -10 to -15% on excess
ESOP-Owned Firms	Flat to +/-15%
Private and Nonprofit Entities	Flat to +/-15%

CONTACT

Ann Longmore
Product Leader
212 915 7994
ann.longmore@willis.com

MARKETPLACE REALITIES

HEALTH CARE PROFESSIONAL

- **The Health Care Professional Liability (HPL) market will remain soft through the first half of 2012**.
- Pricing will depend on jurisdiction, loss experience and layer of coverage, but **rate reductions for now will average in the low single digits**.
- **Loss frequency remains at historically low levels while severity has moderated and is actuarially predictable**.
- Health Care Reform (PPACA) will continue to shape malpractice risk and underwriter response as we get ready for the 2012 Accountable Care Organization (ACO) implementation. Many primary policies will need to adjust terms and conditions to include response for cyber-related diagnosis and transmission failure, inter-related provider contracting and a new world of pay-for-performance.
- HPL is the most profitable P&C insurance line with a combined ratio well below 100 for an unprecedented five consecutive years and hence is also one of the most competitive, with excess capacity chasing a shrinking pool of insureds, as health care industry consolidation accelerates and the larger health care organizations assume more risk, particularly physician risk.
- Consolidation of insurers in the HPL industry will also continue, particularly among the physician insurers.
- Some insurers worry that "integrated occurrences" (i.e., related acts or batch coverage) have expanded to the point where almost any group of incidents can be aggregated and presented as a single loss (and therefore subject to only one retention or deductible). This issue can be divisive for insured and insurer as well as among insurers.
- Despite a few recent court decisions, there is no clear trend towards overturning the malpractice reform legislation enacted in many states in the last decade.
- Observers continue to express concern that a rising volume of patients seeking primary care services will overburden the health care delivery system and compromise care.
- The rapid adoption of the electronic medical record may present significant liability exposure while potentially reducing claims through better communication.

PRICE PREDICTIONS

Flat to -5%

CONTACT

Marcia Richardson
Knowledge Manager
Willis North America Health Care Practice
615 872 3319
marcia.richardson@willis.com

MARKETPLACE REALITIES

AEROSPACE

- **Rates are falling but with airline exposure growth, premiums are largely holding at current levels**.
- **Market appetite for airline risks varies significantly, resulting in dramatically different renewal results**.
- Economies of scale will improve results for the largest programs.
- The Aerospace sector continues to see softening market conditions.
- Corporate Aviation continues to see competition driving down premium volumes and bringing improvements in coverage.
- Excess capacity is available across all sectors. New entrants are adding small lines to this already competitive sector.
- **Industry and program consolidation in all sectors continues to erode premium levels**.
- With airline losses at a five-year low, 2011 should be a profitable year for underwriters.
- No losses involving large numbers of fatalities have occurred for over two years.

PRICE PREDICTIONS

Airline ■ **Premium** ■ **Rates** ■ **Exposures**	+/- 10% Flat to -20% +5%- +15%
Aerospace	Flat to -5%
Corporate Aviation	-10%+

CONTACT

Steve Doyle
Business Development and Sales Director, Willis Aerospace
+44 203 124 7208
steve.doyle@willis.com

CONSTRUCTION

- **While marketplace competition combined with a slow economy continue to produce a buyer's market, markets are increasingly focused on rate increases, and we expect to see this trend continue in 2012**.
- **New business is still attracting interest from virtually all carriers**.
- Claim disputes continue to rise, inciting vigorous debate on coverage interpretation, particularly in General Liability and Builders Risk.
- Markets continue to demonstrate more flexibility on underwriting job-specific wrap-ups for General Liability. This is a key concern for many contractors, given the recent changes in anti-indemnity statutes in some states
- Overall, construction remains slow with the exception of a few niches, such as health care, higher education, heavy civil work and public-private initiatives.
- We are seeing some increase in certain parts of the U.S. on private building and residential construction.
- The recent federal stimulus proposal includes direct construction spending of nearly $100B, but it appears unlikely to pass.
- **International and domestic catastrophes in 2011 have not had the impact on the market that many feared, but latest carrier results indicate that impact was notable and could push rates upward**.

PRICE PREDICTIONS

General Liability	Flat to +10%
Excess Liability	Flat to +10%
Workers' Compensation	Flat to +10%, State by state increases could be higher
Builders Risk	Flat to +10%, higher in high catastrophe areas
Project Insurance (Wrap-Ups)	Primary and excess rates remain flat with significant variation depending on job size, type of work and location.

CONTACT

Tim McGinnis
SVP, National Construction Practice
972 715 5263
tim.mcginnis@willis.com

MARKETPLACE REALITIES

ENERGY

DOWNSTREAM

- **The market remains in limbo, as increased capacity is offset by the impact of recent losses**.
- Three basic scenarios may develop:
  - If no further losses occur and no capacity withdraws, insurers will be forced to compete once more to maintain or enhance market share.
  - If significant losses materialize, yielding further increases in reinsurance rates, management could conclude that this class is unsustainable. Major capacity withdrawals could trigger the onset of a truly hard market.
  - If losses are modest, existing markets may continue to participate but reduce overall lines and capacities to allow for increased reinsurance costs. The result would be decreased capacity for 2012, but the effect of a price upswing would limited.

PRICE PREDICTIONS

Generally flat

UPSTREAM

- **The underlying softening of recent years has been undermined by:**
  - Natural catastrophe losses
  - The "Gryphon A" incident – a significant loss caused by a simple moorings break
  - The potential for more expensive reinsurance in 2012
  - Increased management pressure
- A post-Macondo market within a market remains for stand-alone Operators Extra Expense (OEE) and Marine cover.
- Markets are tightening on Floating Production and Storage Offshore units (FPSOs) – particularly for Business Interruption (BI).
- Competition could resume later in the year, as no significant energy windstorm losses have occurred so far in 2011.

PRICE PREDICTIONS

Generally flat

CONTACT

Robin Somerville
Global Communications Director
+44 20 3124 6546/somerviller@willis.com

MARKETPLACE REALITIES

ENVIRONMENTAL

- The market appears to have peaked for the moment, with 30+ carriers focused on environmental underwriting. Some have either dropped certain coverage lines or pulled out of the market altogether.
- **Competitive terms and pricing continue with respect to the base coverage forms of Contractors Pollution Liability and site-specific Pollution Legal Liability insurance**. However, prices are up for select risks.
- Frequent changes in personnel among and between the various markets raise questions of depth of expertise and bench strength, which can create issues with respect to responsiveness and service.
- **Breadth of product offerings, capacity and underwriting appetite differ dramatically from market to market**. In some cases, new forms are being developed or coverages are being added to existing pollution policies; in others, coverage terms are being limited.
- Certain product lines continue to move toward commoditization (e.g., Contractors Pollution Liability), while others are being "re-underwritten" by some carriers (e.g., Underground Storage Tanks). Some products have become extremely difficult to procure (e.g., Cleanup Cost Cap).
- **Given the plentiful capacity in the market, many insureds are implementing layered program structures**.
- Long-term policies are less available. One- to three-year terms are preferred for operational coverage. Ten-year terms are still available for project-specific applications and for historical protection – most often relevant to transactional placements. In some cases, Contractors Pollution Liability project terms plus completed operations coverage may be available for as many 15 to 17 years.
- Increased writings and the development of longer term policies placed in prior years continue to drive an increase in claim activity among the various product lines.

PRICE PREDICTIONS

Contractors Pollution Liability	-15% to +5%
Pollution Legal Liability (including combined GL/PLL)	-10% to +5%
Environmental Professional Liability (including CPL)	-5% to +5%
Financial Assurance Instruments (USTs, Closure, Performance Bonds)	Flat to +5%
Cleanup Cost Cap	+10% to +20% (if available)

CONTACT

Rich Sheldon
National Placement Leader
North American Environmental Practice
610 254 5625
richard.sheldon@willis.com

SPECIAL CONTINGENCY RISKS

- **The U.S. Special Risks (Kidnap & Ransom) market is firmer with respect to rates than in recent years, the result of losses in Mexico, Venezuela, Nigeria, Pakistan and North Africa**.
- With respect to Mexico, some carriers are placing sub-limits on basic coverage.
- **Due to the political turmoil in North Africa and the Middle East, carriers are reducing limits for Emergency Political Repatriation and Relocation coverage**. In some cases, country exclusions are appearing for Libya, Syria, Egypt, Bahrain and Yemen.
- Buyers with exposures in the U.S. and low-risk overseas locations can expect flat renewals.

PRICE PREDICTIONS

Flat to +10%

CONTACT

Todd Cranche
SVP, Special Contingency Risks – North America
212 915 8217
todd.cranche@scr-ltd.co.uk

MARKETPLACE REALITIES

POLITICAL RISK

- **Market stability remains** after a period of active claims in 2009-2010 and early 2011 when Political Risk products were vigorously tested and delivered their intended value.
- In theMiddle East we have seen an increase in claim activity.
- Premium rates rose in 2011, **but the market has flattened somewhat and rates even decreased in certain countries** (e.g., Brazil, Turkey, Russia, Argentina).
- The premium base for the rest of 2011 and 2012 is expected to be around $1.4 billion, with losses at less than 100%of that amount.
- New underwriters continue to enter the market after one significant carrier stopped writing new business in June 2010 despite extremely low claim experience.
- **Resource nationalism in Venezuela and Bolivia, etc. and the Arab Spring have focused attention on Expropriation cover**.
- Sub-sovereign risks have proved to be problematic as the sovereigns sitting behind these risks have not supported these companies when they have run into financial problems. Underwriters are looking for more sovereign business and less subsovereign risk (municipalities, states, or quasi-government companies).
- Losses remain concentrated in **Ukraine, Kazakhstan, Brazil, Bahrain, Indonesia and Libya**.
- Reinsurance capacity seems to be buoyant for the 2011-12 renewal season.
- Reinsurers continue to impose certain restrictions and, as a result, some underwriters are more conservative in their underwriting.
- In the year ahead, we anticipate several trends:
  - Moderation of upward pressure on premiumrates
  - Increased underwriter due diligence and increased focus on structure and security
  - Policies above $30M needing to be syndicated
  - More risk sharing between underwriters and insureds (carriers' preferred indemnity levels will be 60-75%)

PRICE PREDICTIONS

Flat to +10%

PRICE CONTACT

John Lavelle
North America Political Risk Practice Leader
212 915 8256
john.lavelle@willis.com

MARKETPLACE REALITIES

SURETY

- The Surety and Fidelity Association of America (SFAA) continues to report exceptional loss ratios. The most recent reports are helping to fuel the continuation of aggressive growth strategies.
- Insurance companies' desire for sureties to increase revenues in the face of a sluggish economy has further increased competition among sureties.
- We are seeing expansion of capacity and a willingness to provide larger bonds to qualified contractors.
- At the same time, there is growing evidence of surety loss development, and reinsurers have reported an increase in payment bond loss activity across the country. No doubt this activity will drive tougher underwriting in areas such as contractors' liquidity, composition of working capital and leverage.
- As public private partnerships, long common outside of the U.S., finally take root here, plans for projects in excess of $1B are no longer uncommon. In the recent past, single bonds rarely exceeded $250M; now, some sureties are advertising the ability to provide single bonds in excess of $1B. The overall amount of work available, however, still seems to be diminishing. Increased single bonds limits and increased aggregate limits will still be possible for better risks but less available for contractors with weakening financials.
- Until the published loss ratios deteriorate further, we anticipate the surety market will remain competitive for good accounts and tougher underwriting tactics will be directed at financially stressed buyers, with concentration in the subcontractor market.

PRICE PREDICTIONS

Moderate Fluctuation

CONTACT

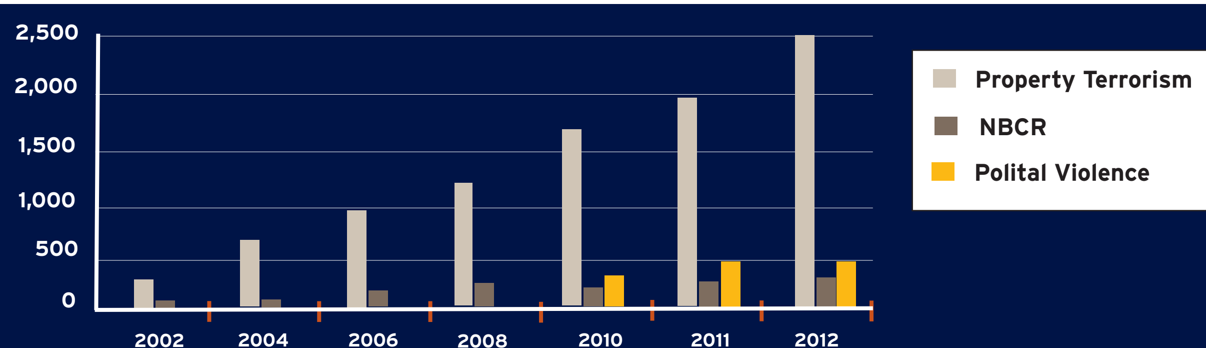
John Phinney
National Surety Practice
973 829 2947
john.phinney@willis.com

MARKETPLACE REALITIES

TERRORISM

- Rates for stand-alone terrorism continue to be flat and may be declining slightly for risks outside of major metropolitan areas. The market may harden, however, as reinsurers reevaluate loss positions following political upheaval in 2011.
- Terrorism capacity is now estimated at a maximum of $2.5B per risk; this can be significantly reduced in highly aggregated areas, such as major cities.
- Insureds continue to form captives to cover otherwise uninsurable terrorism exposures. Existing captives are adding capital and expanding scope.
- Doubt over the extension of the Terrorism Risk Insurance Protection Reauthorization Act in 2014 could impact the market as early as 2012. The complacency created by the absence of successful terrorism attacks on U.S. targets may be replaced by worry if Congress does not authorize a further extension of the federal backstop for terrorism loss.
- The outbreak of politically motivated violence has pushed multinational companies to reevaluate their terrorism and political violence protection.
- The rapid deterioration of operational environments in previously secure global markets has compelled multinational companies to broaden conventional terrorism policies to include acts of political violence, including civil and cross-border war.
- Despite some market availability, buyers show little interest in coverage for nuclear, biological, chemical and radiological terrorism (except in the case of captive insurers).

TERRORISM CAPACITY ($MILLION)



PRICE PRICE PREDICTIONS

-5% to +5%

CONTACT

Wendy A. Peters
Terrorism Practice Leader
610 254 7288/wendy.peters@willis.com

MARKETPLACE REALITIES

TRADE CREDIT

- Despite unstable economic and political conditions worldwide, Trade Credit insurance rates and capacity remain aggressive, **offering significant opportunities for corporations wishing to transfer the risk of non-payment of receivables**.
- **Rates are down 20-30% from historic 2008 highs**.
- If the economy slips back into recession, however, a swift and sharp increase in premium rates and contraction in available capacity should be expected.
- Reinsurance capacity remains plentiful for Trade Credit markets.
- The record volume of claims paid during the financial crunch validated the product as a means of mitigating the risk of losses due to bad debt. In 2010, and through the first three quarters of 2011, carriers saw a reduction in the frequency and average size of claims from the highs experienced in 2008 and 2009. At the same time, claim activity remains above prerecession levels in terms of frequency.

PRICE PREDICTIONS

Flat to -10%

CONTACTS

Scott Ettien
East Coast
212 915 7960
scott.ettien@wllis.com

Brian Brown
East Coast
212 915 8254
brian.w.brown@willis.com

Damion Walker
West Coast
949 930 1776
damion.walker@willis.com

Vanessa De La Cruz
West Coast
213 607 6282
vanessa.delacruz@willis.com

Scott Pales
Midwest
312 288 7735
scott.pales@willis.com