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JLT Re

Reinsurance Renewal Report

2007: A Year of Plenty?

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KEY MESSAGES

- A benign hurricane season in 2006, combined with firm reinsurance rates, enabled reinsurers to achieve strong underwriting results and to start repairing the damage sustained over the previous year. In addition, improvements in investment income are widely reported, further strengthening reinsurers' balance sheets.
- At the January 2007 renewals, reinsurance rates on most classes remained flat or showed modest declines, often despite more significant decreases on underlying primary business.
- The only exception was US property catastrophe reinsurance where prices on some programmes have risen substantially, driven by a shortage of retrocessional capacity. This was hardly a surprise for the market - reinsurers had been widely expected to bring the January 2007 pricing in line with the levels achieved in July 2006. However, in many cases such increases were less severe than anticipated.
- The strong rating environment of 2006 brought about a surge in alternative reinsurance capacity through sidecars and catastrophe bond programmes. Increased use of Industry Loss Warranties (ILWs) was also reported. It is unclear however whether such programmes will be a significant influence on the US property catastrophe market.
- Although it appears that the market has achieved underwriting discipline in most classes, investors are questioning whether the industry is over-capitalised for the current level of demand, and if so what impact the excess capital may have on its future performance.

SECTOR HIGHLIGHTS

AVIATION

In the run-up to the January 2007 renewals, the expectation of clients was that reinsurance pricing on their major risk excess-of-loss programmes would reduce. The rationale for this includes dramatically falling rates/ premiums in the original insurance market, driven by a combination of excess capacity and a lack of major loss activity. The reality however was somewhat different as the aviation reinsurance market held firm, with only modest reductions of 5% to 10% being seen.

Outside the major risks market, a continuing run of losses from second and third tier airline operators, and particularly helicopter operators, has led to lower reductions in original rates/premiums than those seen in the major risks arena. As a consequence, reinsurance pricing was more stable with reductions, if any, of less than 5%.

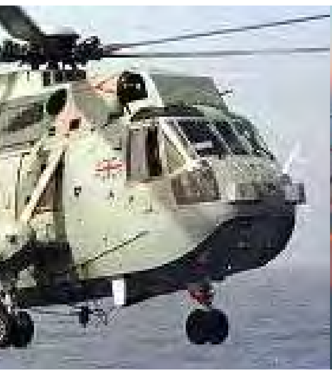
Rates remain stable in the aviation retrocessional market where capacity is more limited, especially in the primary levels of attachment.

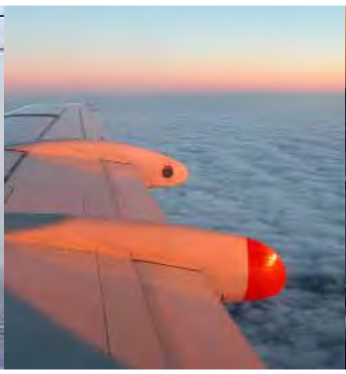
No significant changes in terms and conditions were reported. AVN52 limits continued to increase within original policies with USD150m or even USD250m becoming the norm. Despite this the main reinsurance market held firm with the limit of USD50m for major risks, with the excess, if required, being separately reinsured.

In the space market, reinsurers are under continued pressure from cedants to provide longer periods of cover, which have been resisted so far.

Generally, there has been no change in reinsurance capacity. Lloyd's aviation capacity has increased slightly but the increase was mainly due to existing capacity relocating to Lloyd's from outside. A combination of price drops on original business, less severe reductions in reinsurance premiums and continuing availability of capacity may lead to increased pressure on margins for primary insurers. Without further weakening in reinsurance rates, higher retentions throughout 2007 and in 2008 can be expected.

How far will both original and reinsurance rates fall? The aviation market already has an extremely low premium-to-exposure ratio. Some market observers believe that total airline premiums written in 2006 would barely add up to one full policy limit loss on a major IATA airline. Under these circumstances, it is hard to see how the market could provide further reductions without imposing coverage restrictions. Despite a period of benign losses, the aviation market remains on edge.





MARINE & ENERGY

Following two rollercoaster years for catastrophe losses, the marine and energy market benefited from an unexpectedly benign hurricane season in 2006. Many marine underwriters, particularly those writing offshore energy business in the Gulf of Mexico, did not start their renewal discussions until relatively late in the year in order to develop a better understanding of the market. As a result, both brokers and reinsurers are likely to face greater pressure to meet the Contract Certainty at Inception (CCI) targets imposed by the Financial Services Authority (FSA).

After the dramatic price increases in January 2006, offshore energy underwriters with Gulf of Mexico exposures have seen modest declines in reinsurance premiums of around 5% on average, although reinsurance rates for this business are still at historically high levels. Many offshore energy underwriters have significantly scaled back their reinsurance requirements and increased their retentions on Gulf of Mexico business.

Outside the Gulf of Mexico, offshore energy reinsurance programmes have seen reductions of 10% on average. It appears that the market has found a temporary equilibrium on Gulf of Mexico and international business.

The onshore energy market has seen price falls of 10% on average, and there is now little difference in premium terms between accounts with US windstorm exposures and the rest of the market. In Asia, both original and reinsurance rates have softened even further driven by abundant capacity and increased competition both from indigenous companies and local branches of Lloyd's syndicates.
No significant changes in terms and conditions compared to 2006 have been reported.

In the marine hull market, rates have come down from their 2006 levels, with cedants experiencing average decreases of 5%. The marine cargo market is seeing similar trends although competition is perceived to be less intense in this segment.

Given relatively high levels of pricing especially in the offshore energy market, some market observers are concerned about underwriting discipline, as pricing in this sector has historically shown volatile tendencies. Other concerns include claims inflation, which means that original premiums are under pressure on a real basis. At the end of 2006, it is estimated that over a half of all 2005 hurricane claims have been paid, and the remainder is expected to be paid by the end of 2007.

SECTOR HIGHLIGHTS

PROPERTY

US Property

At the January 2007 renewals, the key influence on the US property catastrophe market was the shortage of retrocessional capacity, which helped to keep pricing on North American business robust despite the relatively mild hurricane season and several new entrants coming into this market. Some market observers comment that retro buyers have become dependent on a single market, with Berkshire Hathaway and a few smaller players (e.g. Lancashire) dominating the scene.

The lack of retro capacity means that property-catastrophe reinsurers with large portfolios of business that used retro to manage their exposures are now forced to reduce their gross exposures, thus limiting supply and driving prices even higher. Catastrophe capacity on an ultimate net loss (UNL) basis is as scarce and expensive as ever.

As the January 2007 renewals were approaching, tight capacity was expected to keep pricing for US property-catastrophe business in line with the levels achieved in July 2006. In reality, the January 2007 pricing fell somewhat short of such expectations, although prices were still higher compared with their January 2006 levels, and pricing increases were substantial on some accounts.

Many cedants have significantly scaled back their core reinsurance programmes, while maintaining higher retentions. The price difference between the lower and upper ends of programmes is now uncomfortably close and is a reflection of the high return periods expected by those markets, which are willing to offer capacity at higher levels, along with their ability to command high prices due to a lack of capacity.

Some market observers believe that the current levels of retro prices are unlikely to be sustainable in the long term. The January 2007 renewals have seen coverage restrictions designed to make the products more attractive to reinsurers, e.g. coverage was limited to specific territories rather than being offered on a worldwide basis. Late entry into the market by new retro writers may cause price softening during the year, however, the new entrants are not expected to offer substantially better products in the near future, e.g. they are likely to insist on a single territory, a single limit, and a high rate on line.

In the absence of traditional retro capacity, the market has seen an increase in alternative forms of capacity, such as catastrophe bonds, sidecars and Industry Loss Warranties (ILWs). Capital market players such as hedge funds appear to have developed an increased appetite for writing ILWs. The majority of new capacity created recently has been diverted to ILWs and other non-traditional forms of reinsurance. Although underwriters tend to use alternative reinsurance structures selectively, they are expected to continue buying ILWs throughout the year to reduce retentions and enhance more restrictive core programmes.

International Property

The rest of the property market has seen a different picture at the January 2007 renewals. Despite the recalibrated catastrophe models for Europe, higher modelled losses have not translated into price increases that some practitioners anticipated in the aftermath of the 2005 hurricanes. In general, pricing appears to be stable on European business.

In the UK, the commercial property market is experiencing price reductions fuelled by competition from composite insurers and EU companies passported into the UK market. Commercial property rates have fallen by around 10%.

The January 2007 renewal season in Asia, which did not include India, Japan or South Korea, saw the trend of price reductions continue.
Many accounts, which had sustained losses during the year, enjoyed renewal terms at expiring levels, and accounts with good loss records achieved double digit reductions. This was largely driven by the abundance of capacity and the relatively low limits bought compared with the demand throughout the rest of the world.

The Philippines, although hit by a typhoon giving rise to insured and reinsured losses in 2006, did not see significant increases in reinsurance pricing. Proportional treaties, which are still widely used in Asia, saw reductions in pricing as a result of improved commission terms, e.g. as sliding-scale commissions were replaced by flat commissions.
Two major January 2007 renewals in China saw changes in treaty leadership as cedants were able to strike very attractive deals with reinsurers. China continues to be characterised by severe competition as a number of reinsurers continue to build market share. Taiwan saw a successful renewal season from cedants' point of view, with substantial reductions on both per risk and catastrophe programmes.

Engineering

As far as the direct and facultative markets are concerned, they saw a number of changes and new entrants. Members of the engineering treaty and facultative team who had previously been at GE, left Swiss Re in September 2006 to join Chaucer Syndicates in time for the January 2007 renewals. At the end of 2006, WR Berkley, a large US commercial property-casualty insurer entered engineering business by recruiting a team of experienced underwriters to establish a London presence. 2006 also saw the Mayflower engineering team moving to Brit Insurance and setting up operations under the name of Contego Underwriting Agency.

A number of cedants have increased retentions on their quota share treaty and excess-of-loss programmes, which also brought a slight relaxation in the terms of coverage given.
Overall, there were no new restrictions imposed by reinsurers during this renewal season.

In general, excess-of-loss programme rates eased by 5% to 7.5% at the January 2007 renewals. Zurich is still pre-eminent as a centre for engineering reinsurance, and this can only expand as and when Converium regains an "A" rating from Standard & Poor's. Prospects in this market remain upbeat for the future.

SECTOR HIGHLIGHTS

CASUALTY

North America

Following the reserving inadequacies of business written between 1997 and 2001, claims trends in most casualty lines have since improved, with insurers and reinsurers returning to profitability. Although initially favourable loss trends did not translate into price reductions on many casualty lines, with underwriters preferring to wait for several years of loss development, growing competition has helped push rates down at the January 2007 renewals.

The US Directors & Officers (D&O) market appears relatively weak, with pricing falling by up to 20% on some accounts. Lower claims frequency due to a reduced number of class action lawsuits in 2005 and 2006 has affected pricing in this market. During 2006, the market saw a number of "options backdating" cases involving major US corporations, however, it is unclear whether they will result in substantial D&O claims.

In the US Errors & Omissions (E&O) market, rates have remained flat or experienced slight reductions of up to 10% on some accounts. The market is very fragmented and the price movements vary by account. In general, at the time of the January 2007 renewals pricing for larger accounts was weaker than for smaller business.

Underwriters of US medical malpractice business returned to profitability in 2004, and the segment is now experiencing increased competition for original business. Reinsurance rates have remained stable so far but are coming under pressure as claims experience has improved significantly, both in terms of claim frequency and severity. The improvement can be partially explained by the recent tort reform initiatives.

In the US commercial motor market, increased competition among reinsurers has resulted in softening rates, by up to 5%. This growing competition is fuelled by a combination of increased capacity from reinsurers seeking diversification away from property and higher retentions by cedants driven by improvements in profit margins on original business.

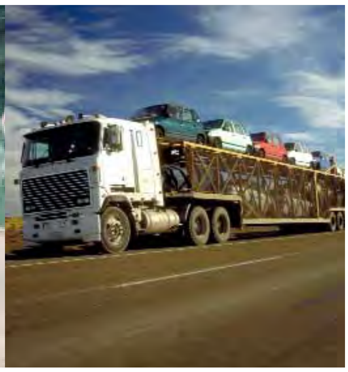
Despite pressure from new entrants, the US workers' compensation market has remained stable, however, some cedants bought less reinsurance following improved underwriting results.

United Kingdom

In the non-motor market, the January 2007 renewals were characterised most strongly by the impact of Contract Certainty, with the majority of programmes being completed prior to the year-end. In order to facilitate this, more reinsurers than usual were involved in the quoting process, to allow placing brokers to complete placements rapidly.

Reinsurers have continued to react to softening primary pricing. Underlying rates have continued to fall, by as much as 5% to 10% compared to the 2006 levels. This has led to rate increases on some excess-of-loss programmes and a limited re-alignment of reinsurance capital, as reinsurers sought to maintain their dollar incomes.





However, overall rates remain similar to the 2006 levels, with any increases offset by reductions. Treaty conditions are largely unchanged from those in 2006.

The motor sector remains competitive in Europe, leading to reductions on loss-free layers of up to 10%, despite the pressure of bodily injury claims inflation. The exceptions are France, where some programmes have experienced rate increases of over 10%, and the UK, where rates have hardened less, by up to 5%.

The casualty market is concerned about legal costs associated with recent extradition proceedings in the UK, as well as the development of a class action litigation culture in several European countries.

Asia Pacific

The three markets, which operate a common law system, i.e. Hong Kong, Malaysia and Singapore, have experienced fairly stable renewals with no significant changes in terms and conditions, despite substantial premium reductions achieved on original insurance business.
While original rates may have dropped by 20% or more in Hong Kong, the majority of excess-of-loss programmes for motor and employee compensation business saw rate reductions of 5% to 10%, although certain accounts were faced with rate increases compared to the 2006 levels.

Malaysia is a tariff market for motor, and employee compensation limits there are minimal. At the January 2007 renewals, reinsurance excess-of-loss rates were flat or slightly reduced from the 2006 levels, possibly safeguarded by the requirement for locally placed reinsurance. In Singapore, excessive competition has forced insurance rates on motor and employee compensation down by up to 40%. Despite this, reinsurance rates were down only by up to 10% on the majority of excess-of-loss programmes.

There is an increase in many Asian countries in other forms of liability coverage, particularly in the financial services sector. However, the limits generally required in most countries mean that existing reinsurance opportunities are still somewhat limited.

CAPITAL ISSUES

Is the industry over-capitalised for the current level of demand?

The devastating hurricane losses have concentrated insurers and reinsurers' minds on the importance of achieving and maintaining underwriting discipline. With robust 2006 underwriting results, capital management has become a key focus for shareholders, and the question of returning capital to investors is ever present.

Whether this is a realistic option for many insurers and reinsurers is another matter. It is estimated that less than half of capital supports business written in the current year, therefore a decline in the top line does not automatically translate into substantial amounts of 'free' capital that can be returned to shareholders.

There is a debate whether the industry is over-capitalised for the current level of demand. Throughout 2006, the market has seen an influx of new capacity. Most recently, Lloyd's announced an 8% increase, bringing its underwriting capacity to GBP16bn.

One of the consequences of excess capital is continued M&A activity. In a capital-rich environment, growth is harder to come by. Some companies, especially mono-line reinsurers, may start looking for diversification through acquisition. On the other hand, the shortage of affordable retro coverage has already put pressure on smaller insurers and will continue to do so. The ability to reduce outward reinsurance costs through M&A may prove attractive to a number of players.

Will the recalibrated models increase demand for reinsurance?

Following the unforeseen hurricane losses, RMS has moved away from the long-term historical average approach to estimating catastrophe losses and adopted a five-year forward-looking view of risk. This is seen as an acknowledgement that a period of higher frequency and severity of natural disasters was likely in the short term, driven by higher sea surface temperatures in the North Atlantic. The RMS models are reported to increase projected losses by 25% to 40% for the coastal regions. Other modelling companies have also acknowledged that weather cycles influence the short-term frequency of hurricanes by providing a short-term frequency perspective in addition to their long-term risk models.

Earlier in 2006, there was an expectation that the recalibrated models would encourage companies to buy more reinsurance. This did not materialise at the time of the January 2007 renewals. In some cases, the opposite has happened as cedants reduced the amount of reinsurance bought. However, several large insurers have recently announced catastrophe bond programmes, which may suggest that the expected increase in demand had benefited non-traditional markets.

The recalibrated models have had some impact on capital requirements as rating agencies have stepped up their criteria for measuring catastrophic risk and the amount of capital a primary insurer must hold to reflect its windstorm exposure.

Has the balance between traditional and non-traditional solutions changed significantly?

In the aftermath of the 2005 hurricanes, many insurers and reinsurer had the opportunity to take their first serious look at alternative reinsurance arrangements, e.g. catastrophe bonds.

Issuance of catastrophe bonds has been on a steady increase in recent years. By the end of 2006, total issuance is reported to have reached USD4bn. In addition, a similar amount of capital was raised in 2006 through sidecar arrangements. Sidecars, traditionally a vehicle of choice for reinsurers, are gaining popularity among original insurers as well. Lexington Insurance Company, a member of the AIG group, set an example by establishing its own sidecar, and others are expected to follow.

Capital market vehicles remain a small portion of the overall market for risk transfer, estimated to be less than 5%. However, there is evidence that capital market players have become more active market participants. Hedge funds have started to assume insurance and reinsurance risk directly, e.g. via fronting arrangements or wholly owned reinsurance subsidiaries.

Companies that established sidecar arrangements in 2005 and 2006 include:

Harbor Point Re	Lancashire
Lexington	Renaissance Re
XL Re	Brit
Arch Re	Hiscox
Validus Re	MAP
Montpelier Re	Paris Re

Is Singapore poised to become the new Bermuda?

Finally, 2006 saw increased strengthening in regional reinsurance markets, notably Singapore. Already an established reinsurance centre for Asia, Singapore has attracted a number of new entrants, e.g. branches of Lloyd's syndicates and international insurers, focused on Asian cedants. Another development is the establishment of local reinsurers such as Asia Capital Re, supported by international capital and with ambitious growth plans.

With the influx of capital into Singapore, the question often asked is: “What are they going to write?” While the new local ventures would have access to business that otherwise is unlikely to be offered to their parent companies in London, it is unclear to what degree they would also be competing for business that is traditionally placed in London, e.g. facultative marine and energy, power and major property risks. Whatever the answer, the new entrants are widely expected to change the market dynamics in the region.

Whether Singapore will become another Bermuda remains unclear at this stage, however, the likelihood is that the rating behaviour in Singapore will be the antithesis of the Bermudian model. Capital is headed for Singapore in anticipation of regional growth and a capacity crunch that is hard to see, even on a very distant horizon, while the capital established in Bermuda was the response to a very immediate opportunity. This can only be good news for certain reinsurance buyers in the short and medium term as they are offered good security at prices that are likely to be aggressive.

ABOUT JLTRE

JLT Re is a dedicated reinsurance broking and consulting organisation that was established on 1 January 2006. Headquartered in London, it is a wholly owned subsidiary of the Jardine Lloyd Thompson Group. JLT Re is authorised and regulated by the Financial Services Authority and accredited by Lloyd's.

We provide risk management services to many of the world's largest insurers and reinsurers. Our clients benefit from our international network of reinsurance offices and from the global network of our parent company, JLT Group.

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