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TREATY REINSURANCE

REINSURANCE ROUND UP
FEBRUARY 2012

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INTRODUCTION

In October 2011 despite over USD80 billion of Cat losses since January the market was only slowly showing slight signs of hardening.

However severe rain around Bangkok in October 2011 produced flood losses amounting to USD20billion which were totally unforeseen and, not being taken care of in modelling assumptions caused severe problems for a number of Reinsurance writers.

It was only after this loss that the market, particularly the Retro market showed signs of changing and prices started to harden.

At the same time the events in Thailand highlighted the need to assess more carefully CBI exposures which only come to light after a loss of this type.

Whilst pricing and questions of capacity are always paramount in the minds of reinsurance practitioners 2011 was unique in that so much time was spent trying to quantify SRCC exposure following the Arab Spring.

All reinsurers tried to quantify their exposure by the application of a mixture of original policy sub limits and "per event/annual aggregate" limits under Reinsurance contracts.

The above are a few of the points which have exercised the Reinsurance market over the past twelve months and which are discussed more fully in this short paper.

The aim of the articles is to draw on what we have experienced in those markets where we operate and we hope that you will find them both informative and enjoyable.

RENEWAL REPORT LONDON MARKET AND RETROCESSION

London Market

The London market have reacted to the recent numerous catastrophe events by hardening their approach to the level of rating. A number of renewals were presented to the market early in the season with reductions and these were generally resisted and in some cases required re rating to ensure complete placement. A number of companies/ syndicates who did not secure the level of rating they required refused to support accounts that in some cases had been long term relationships. As a result many syndicates reduced their accounts and consequently dramatically reduced their exposures. The renewal was generally accepted as being 'flat', with increases only being carried on accounts that had suffered losses within the last year.

The market have also paid close attention to certain terms and conditions namely SRCC and a more detailed approach to the Sanction clause. The Reinsurers have requested tighter wordings, sub limits and original policy deductibles.

The capacity available to the London market remains buoyant. A number of the blue chip syndicates within Lloyd's have announced increases in their capacity for 2012 of between 10% and 13% with overall Lloyd's market capacity rising to £23.7 billion an increase of 3% over 2011. This increase in capacity has been put in place to service the expected rate increases in certain classes of business in particular catastrophe reinsurance which has produced losses to the market.

There have been a number of new entrants to the market outside of Lloyd's. This new capacity has been used responsibly with pricing levels in line with market expectations. The Lloyd's franchise board remain resistant to new reinsurance capacity unless they can see that a business plan will attract business which is currently not available to the market.

Retrocession

The retrocession market during the renewal season has at times been very difficult, where we have seen the level of demand not being met by the available capacity. This has been driven by the price expectations of the providers which have not been acceptable to the buyers. Although there have been some new entrants and some existing capacity has been made available at more competitive pricing levels capacity remains tight.

There has been a noted departure from providing coverage on a risk and cat combined basis in the London market for so called multi territory soft retrocession accounts. However coverage on this basis can still be secured in international markets.

The retrocession providers have been reallocating their exposures to favour specific territorial towers of exposures whether UK/Europe US or Japan. The movement is largely due to the recent catastrophe loss activity in areas which were perceived to be less exposed to losses of this type.

As a result of this movement placements with a broad territorial scope have attracted higher than expected prices or have been extremely difficult to complete as many markets will only consider business where the Territorial scope is limited to the specific territories where the exposures are present. The same approach has been taken when considering the coverage of perils and it is now more common to name or limit the perils that are covered.

AVIATION RENEWAL REPORT

For the aviation market as a whole, 2011 represented the first time in six years that the market's loss activity was relatively benign, with total losses as at December 2011 being approximately 50% of the market's five year average of US$ 1.8bn. However, an ostensibly quiet claims year brought its own challenges for (re)insurers, with a number of significant direct aviation insurers openly questioning whether the current conditions in the aerospace market as a whole are sustainable.

As with (re)insurers in all other sectors of the (re)insurance market, aviation (re)insurers can now also point to a lack of investment income caused by turmoil in the global financial markets and poor interest rates as yet another difficulty that has to be overcome before they can return a profit.

The direct market remains a soft one with market overcapacity (some of it latent) and a general contentment amongst the significant players to accept 'as before' pricing for good quality airline programmes. This appears to have been the case for clean programmes even if there has been a substantial increase in exposures and limits, as insurers strived to maintain their market share.

Having said that, the December airline renewals (which produce over fifty percent of the annual direct market premium income) seem to indicate that it has become more difficult for brokers to place programmes at lead terms, with many insurers choosing to verticalise premiums or amend the terms accordingly. As the global direct aviation premium figure has now dipped below the US$ 1bn mark, it is safe to assume that the trend for increased verticalisation will continue in 2012.

For Aviation Treaty reinsurers, the writing of proportional treaties remains particularly challenging as the rating of the original business has, in most cases, followed the global trend and softened considerably. For this reason, reinsurers have been extremely reluctant to allow any increase in treaty commissions and the vast majority of requests of this type for business renewing at 1st January 2012 have been successfully resisted by reinsurers.

The Aviation Excess of Loss market's significant 1st January renewals saw those programmes with clean loss records and unchanged exposure receive small reductions in the region of 3%-5%. Those programmes with increased exposure or claims activity saw their programme price increase by at least 5%, and in one or two cases a double figure percentage price rise was recorded. This is indicative of the smaller excess of loss market's overall intention to hold their rates and their underwriting discipline in the face of the soft direct market conditions.

The P51 Mustang Crash at the Reno National Championship Air Races on 16th September, which killed 11 (and 2010's Dulles Hangar Collapse), has focussed the market's attention on the potential, and previously unassessed exposure from U.S. General Aviation risks. The Reno loss itself and the uncertainty behind the final loss figure, led to a clear trend by reinsurers to revise the treaty structures and the terms and conditions of U.S. General Aviation business, and for reinsurance buyers to seek to increase their retentions on their U.S. GA exposed programmes.

INTERNATIONAL MARINE AND ENERGY TREATY RENEWAL

Reinsurers entered this renewal season against a backdrop of catastrophe losses of unprecedented frequency from both catastrophe and non-catastrophe prone areas. Despite these losses generally causing cash impairment rather than capital impairment, and impacting the non-marine market considerably more than the marine market, marine reinsurers were clearly under pressure to try to implement some hardening in rates – or, at least, to halt the softening of recent years.

Unlike the 1st January 2011 renewal season which was dramatically late, the 2012 season started in good time and was well ordered. This meant that there was no tangible log jam in the renewal process and reinsureds who submitted their information in good time were generally spared the anxiety of shortfall in placement after the 31st December.

During the course of the renewal season, it became apparent that the Thai Floods loss of mid-October is set to become a very serious claim to the marine market, particularly via Japanese reinsurance programmes. However, with no accurate loss data from this event available to reinsurers in time for the renewal season, its effects have yet to be factored into rates.

In spite of the catastrophe loss record there was once again this year no shortage of worldwide capacity for marine hull and cargo treaty business. However capacity for energy excess loss treaties and marine excess loss treaties with energy exposure has been somewhat limited. In general, market discipline surrounding contract wordings has been maintained. The days of concerted efforts to amend or remove significant clauses from programmes in order significantly to divert from standardised cover appear to be over. Market discipline on minimum rates on line for top layers and priority levels was also strong; that said, reinsureds in general favoured maintaining or increasing excess points.

Even with the plentiful marine hull and cargo capacity, there has been an observable hardening in rates. During the last three 1st January renewal seasons, for renewals with good claims records, we have seen:

2010 - Reductions of between 10% and 25% commonplace

2011 - Reductions of between 0% and 5% / 7.5%

2012 – Renewals varying from 5% reduction to 5% increase

Energy excess loss prices showed a more profound hardening following an extended period of unfavourable results. Increases ranged from 5% to 15% depending upon the loss record and this was coupled with some increases in priority. There was also a tendency towards splitting energy portfolios at lower levels (for instance territorially between Americas / non-Americas) and placing separate mirrored layers to cover these. This had the effect of generating increased income to the reinsurance market whilst keeping rates on line at a viable level. For upstream portfolios, combined physical damage and liability cover was still available.

Proportional treaty capacity remained intact although ceding commissions were under scrutiny where results were unfavourable. As in previous years, marine hull and cargo treaties placed as part of bouquets including larger property portfolios tended carry more favourable terms.

LATIN AMERICA

The global reinsurance sector encountered major challenges during 2011, which affected the industry in varying degrees, the main “impactors” being as follows:

1. Historic catastrophe losses
2. Model version changes
3. Unfavourable macroeconomic environment
4. Capital

We shall look at how the above factors affected the Latin American reinsurance market more specifically, in addition to local factors such as regulatory changes.

Catastrophe Losses

The historic amount of losses occurring in 2011 had little direct impact on rates in the Latin American region, not even in Chile where some catastrophe programmes saw slight reductions of up to 5% post the 2010 earthquake.

However, worldwide there has been an increase in the number of natural events, not only in catastrophe prone areas, but also in what has traditionally been considered as “non-peak” catastrophe regions, including Brazil.

The number of natural disasters has increased by more than 450% over the past 30 years. In this same period, Brazil has experienced 158 such events, ranking it 11th in the world in terms of frequency of occurrences.

In 2011, of the 253 natural events recorded during the year, 11.5% occurred in Latin America.

Although losses arising from these events were largely un-insured, there is a perception that with the significant GDP growth that Brazil is currently experiencing and increased insurance penetration, insured loss amounts will also grow in severity over time.

In January 2011, Brazil experienced its worst natural disaster since 1967 with the floods in the Serrana region of Rio de Janeiro, incurring an economic loss of approximately USD 1.2bn. Although the economic loss was greater than the insured loss, at least one catastrophe programme was affected by this event. Nevertheless, as a result of market conditions, any increase in the pricing of this particular programme was due more to increased exposures rather than to payback margins for the loss suffered.

With regards to other Latin American countries, Colombia also suffered severe flooding, resulting in economic losses of approximately USD 5.85bn. In terms of structural damage and filed claims, the Colombian floods were the only event in Latin America to rank in the top ten for 2011. Nevertheless, only programmes that suffered losses from this event experienced increases in pricing.

However, although the pricing of regional catastrophe programmes was not directly affected by the above mentioned events, the consequences of the Thai floods did prompt cedants to look more closely at the type of coverage they had, particularly with regards to contingent business interruption and loss of profits.

Model Version Changes

In addition to the severe losses suffered during the year, the reinsurance sector was confronted with significant catastrophe model version changes, particularly with RMSv11. Reinsurers had to interpret the implications of the new model outputs and in the process undertook comprehensive review not only of their modeling technologies and methodologies but also of their pricing and underwriting strategies. This led to significant fragmentation in market prices and assessment of risk, and also to changes in reinsurer line sizes.

These changes had more relevance to the US, European and Asian windstorm exposures. Consequently, the impact on Latin American catastrophe renewals was somewhat subdued.

Macroeconomic Environment

Unlike Europe and North America some emerging economies were still experiencing strong growth during 2011, Brazil being a case in point. With high interest rates, large scale projects for world events (i.e. World Cup 2014 and Olympic Games 2016) and energy production (Petrobras pre-salt basin), and huge government infrastructure investment (PAC - Growth Acceleration Program), Brazil is currently experiencing a boom and is one of the fastest growing economies. Brazil has recently surpassed the UK to become the 6th largest economy in the world.

Insurance penetration is increasing by 10% a year in Brazil across most lines of business.

In terms of reinsurance, cedants in the Brazilian market have purchased more and more reinsurance capacity in response to their growing exposures. Retentions have generally remained the same as retention levels are rigorously regulated by the supervisory authority.

Healthy Capital Environment

Despite the heavy catastrophe losses experienced during 2011, Reinsurers´capital funds were not as significantly affected as compared to the impact from catastrophe events in 2005.

Due to the 2008 financial crisis, Reinsurers applied a more conservative approach by retaining more of their excess capital to safeguard against the possibility of not being able to re-capitalise after a major event. This has resulted in a healthy level of capital within the reinsurance sector during the course of 2011, which helped to keep rates down in areas not affected by losses.

Looking specifically at Latin America, there has been an increase in the influx of capital – particularly of foreign capital – into the reinsurance sector, which has been driven predominantly by a positive economic outlook and changes in regulations, but which has been made possible by the existence of this excess capital in the global market.

Regulatory Changes

In 2011, there were a number of regulatory changes that specifically targeted the reinsurance sectors of both Argentina and Brazil.

Argentina

In February 2011, the Argentinean insurance superintendency, the SSN (Superintendencia de Seguros de la Nacion), announced the introduction of a new reinsurance sector regulatory framework to be implemented from 1st September 2011.

The new framework only allows "local" and "admitted" reinsurance companies to transact reinsurance business in Argentina.

Local Reinsurer:

1. Argentinean companies or branches of foreign reinsurance companies with a minimum capital of either (Argentinean Pesos) ARS 20 million or 16% of earned premiums, whichever the greater;
2. it is compulsory to reinsure the first USD 50 million of each risk with local reinsurers;
3. can only retain risks totaling 10% of their capital;
4. must retain at least 15% of total premiums, on an annual basis;
5. can enter into retrocession agreements, but only with other local or admitted reinsurers;
6. cannot cede more than 40% of their premiums to any related companies or companies in the same financial group.

Admitted Reinsurer

1. foreign reinsurers registered and admitted to operate in the Argentinean market;
2. can reinsurer the portion of each risk in excess of the first USD 50 million;
3. can reinsure "exceptional risks" that cannot be underwritten by local reinsurers, with the SSN´s prior approval on a case-by-case basis;
4. can write retrocession business;

The new regulatory framework has attracted a significant influx of foreign capital – there are currently over 101 registered foreign reinsurance companies in the country.

Another factor in this trend is that as a Mercosur member country and as a more established reinsurance market, some reinsurers in Brazil have moved their entire back office operations to Argentina where labour and operational costs are much lower.

Due to uncertainties prior to 01/09/11 about how the regulation was going to apply and its full impact on the market, all treaties and a great number of facultative covers were cancelled and rewritten before the effective date. Terms and conditions were generally maintained with adjustments only applicable in the event of adverse results. Consequently, the full effect of these regulatory changes on reinsurance premium rates and coverage purchasing shall only be seen during 2012.

Brazil

Two new CSNP resolutions 225/2010 and 232/2011 came into effect on 31st March 2011.

CSNP Resolution 225/2010 makes it obligatory that at least 40% of each reinsurance cover (facultative and/or treaty) is placed with local reinsurers;
CSNP Resolution 232/2011 limits intra-group (i.e. related companies or companies belonging to the same financial conglomerate) reinsurance cessions to only 20% of each coverage contracted; lifts all restrictions on bond, export credit, rural credit, domestic credit and nuclear risks.

The above regulatory changes in Brazil has seen an increase in the number of companies (mostly foreign reinsurers) registering to be “local” reinsurers. In 2010, there were 7 local reinsurers, increasing to 9 during 2011, with Alterra and Zurich announcing their local reinsurer status in January 2012. In addition, there are 2 to 3 other applications currently being processed.

These changes have led to a general "levelling out" of reinsurance premium rates in the market, as local reinsurers have been able to exercise more power and to impose terms and conditions that are more acceptable to their underwriting criteria rather than follow or go along with the ever-more competitive terms that had been available prior to the regulatory changes.

In addition, brokers have become less able to "price" the market and drive placements on this basis; although placements could be completed at more competitive terms with admitted/eventual markets, the need to comply with the minimum 40% local placement has meant that renewal negotiations have revolved mostly around scope of coverage, conditions and exclusions, etc.

Renewal Outcomes

Colombia / Peru

Catastrophe exposed treaty accounts saw maximum increases of up to 5%. All other renewals generally experienced flat pricing.
Facultative renewals saw flat to slight rate increases.

Chile

Property catastrophe treaty renewals were generally flat with some slight reductions in non-loss affected accounts.
Property risk programs renewed flat to down 5 percent.
Facultative risks renewed at varying levels: small risks experienced flat pricing, medium risks achieving 5 percent reductions and large risks achieved 10 percent reductions.
Proportional treaty terms and commissions remained the same predominantly.
Non-property treaty business capacity is stable and pricing/terms are flat to softening.
Reinsurance capacity increased with some new entrants in the market.

Argentina

Treaty renewals were stable, with prices, terms and conditions as expiry overall due largely to the regulatory changes, as discussed above.
Facultative renewals were also stable with flat to slight increases in pricing.

Brazil

There are no specific renewal periods in Brazil, however, during 2011 cedants generally pushed for increased capacity and improved commission terms under proportional treaties. Non-proportional terms continued to be very competitive, but "levelled out" due to the introduction of regulatory changes.

Original rates continued to fall between 15% to 25% across all lines of business, and co-insurance continued to play a strong role in the market.

Due to the strong economy and future potential, Brazil continues to be an attractive prospect for reinsurers and more and more capacity is entering the market.
Despite the historic losses suffered during 2011, the changes to catastrophe model versions and an unfavourable economic environment, the global reinsurance market is not moving towards what is recognised as a traditional and sustained hard market. This is largely due to the excess levels of capacity currently available.

The1st January 2012 renewals saw a fragmented approach to pricing, with rate increases generally applying to catastrophe loss affected treaties only.

In Latin America, the factors impacting other markets had little direct effect on reinsurance pricing. Prices were generally stable with slight reductions or increases in particular cases, determined predominantly by levels of exposure.

However, the onset of the Thai floods did prompt insurers to consider the type of coverage they carried, particularly with regards to contingent business interruption.

Cedants continued to exert pressure to improve terms, however, the significant rate reductions achieved in prior years (i.e. in non-loss affected areas) was brought into check with the implementation of new regulations giving “local” registered reinsurers more leverage to impose less competitive terms.

There continues to be an influx of foreign capital into the regional market, due to the positive economic outlook in the region and also to regulatory changes coming into effect.

MENA REGION

The Arab Spring

While the world insurance and reinsurance markets were most struck by one of the worst natural catastrophic years, it was the ‘Arab Spring’ that had the most impact on the market dynamics and renewal terms of the MENA. The unrest started in Tunisia and swept across the region but progressed most in Libya, Egypt, Yemen, Syria and Bahrain.

The key issue was how to define the events. There was not much of a debate when it came to Libya which was viewed as a civil war therefore beyond the scope of coverage nor in Yemen and Bahrain given the insignificant magnitude of reported losses. The issue was most challenging in Egypt and Tunisia. While the insurance companies, backed by their federation or ministry, defined the events as Strikes, Riots or Civil Commotion (SRCC), the main lead reinsurers took the view that these are political events and excluded from the scope of the treaties as per the standard political violence clauses.

The debate highlighted the lack of clarity of the wording and definitions and the thin line between SRCC and Political Violence. This ambiguity along with the fact that all treaties are subject to local jurisdiction, the potential legal costs and the ‘follow the fortunes’ principle influenced the leading reinsurers to agree to pay the claims to most clients on a commercial basis but without admission of liability. The non-admission was of utmost importance to protect reinsurers from setting a precedent against themselves in case such events are repeated in the same countries or other parts of the world.

Key changes introduced to varying extents in 2012:

- Excluding SRCC in some countries
- New Political Violence exclusion clause. There are discrepancies between the wordings of different lead underwriters and some leaders are applying different wordings to different territories.
- SRCC Event Limit or Annual Aggregate Limit.
- SRCC Minimum (guideline) rates
- SRCC sub-limits of original sums insured of 25% to 50% & minimum deductibles 5% to 10% of each and every loss.

The sanctions on Syria have limited the international market support and many leading and regional reinsurers pulled out of the market in 2012 paving the road to other reinsurers to step in and take the lead.

Other Issues

1. While there weren’t any major NATCAT events in the region; however, the worldwide losses led to a hardening of the few CAT specific programs and an introduction of cession or event limits on most proportional treaties.
2. Risk programs witnessed slight hardening averaging 5% increases on XL and reductions of 5% on commissions of proportional treaties. The hardening was more felt by the regional reinsurers with increases in the retrocession costs particularly for multi-territory treaties including CAT. It is becoming more difficult to place combined risk and event programs.
3. Increase in the number of ‘A’ rated regional reinsurers (mainly by A.M. Best); however, this may be under threat given the sovereign downgrades of a number of MENA countries during 2011.
4. The application of a leader’s fee is becoming more common.

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