

UIB GROUP TREATY REINSURANCE

REINSURANCE ROUND UP JANUARY 2011



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INTRODUCTION

It is interesting to compare what we are talking about at the beginning of 2011 with what we were saying twelve months ago.

What is striking is how little things have changed in the last twelve months and how this was evidenced in comments about the Monte Carlo and Baden Baden conferences where the generally accepted description was that they were “flat”, or that they were a “non event”.

This is due to the fact that despite a number of significant losses for example in Chile and New Zealand and despite an apparent lack of investment income, Reinsurers’ results for 2010 will be good and the market will still be awash with capacity.

The 1st January renewals saw rate reductions of 5%-10% and there is no reason to suppose that this will not continue for the 1st April renewal round.

At the time of writing the impact of the Queensland floods has not been evaluated with loss estimates ranging from USD3 billion to USD6 billion. At the moment it is expected that the floods will be treated as three separate losses from the point of view of Catastrophe covers. Whilst this will have an effect on the prices paid by Australian reinsurance buyers, it will not be large enough to have a major impact on the market.

For the market to harden, a loss of at least USD50 billion is needed, whilst a loss of USD150 billion is needed for the market to undergo a fundamental change.

Coupled with a soft market we are witnessing a trend for markets to retain more business as is described in more detail below, which is resulting in an exodus of business from the international market.

It can therefore only be presumed that this tightening on Reinsurers’ margins will lead to cost cutting exercises and increased “M and A” activity during the course of 2011.

In this short report we have concentrated on our experience of what is happening in some of the markets where we are active and which we hope that you will find of interest.

LONDON MARKET

International business

The London market reacted to the numerous international market losses principally from Chile, France and New Zealand by attempting to keep reductions to a minimum. That said, where renewals were loss free, reductions of between 5% and 10% were achievable. Although this was in some cases not enough to compete with some aggressive rating from European reinsurers who were keen to maintain their market positions. Where programmes had been affected by losses, rating was increased by factors in line with the perceived underlying inadequacy of the existing base.

The excess in capacity is still very much evident; despite this, significant rate reductions were being resisted so that adequate returns are protected for the risk transfer.

Non Marine Retrocession

The retrocession market has in general held up, with very limited discounts being offered for loss free renewals. A continuing trend to multi-territory protections was seen, as previously the market preferred territorial towers. The available capacity has increased with a number of new entrants to the market, although this has not adversely affected the level of rating. There still appears to be a continuing divergence between client expectations and reinsurers' pricing with catastrophe coverage on Direct and Facultative risk accounts being most difficult.

Lloyd's

The Lloyd's market capacity continues to increase and in the last year has increased by 6%. This additional capacity needs to be serviced against a background of reducing rates and less reinsurance being purchased. This means that capacity must be better utilised and a number of syndicates have adopted various strategies to maintain the premium volume and returns.

The trend for Lloyd's syndicates to open offices away from Lime Street continues thus enabling Lloyd's to participate in business which ordinarily would not have been provided to them by London brokers. These territories can also offer significant tax benefits which further improves the usage of capital for profit. Another strategy has been for syndicates to move capacity within a syndicate from business where margins are not viable to classes of business where the returns are greater. This has resulted in a number of teams of underwriters moving from one syndicate to another as focus changes.



In a softening market we have seen the top ten syndicates reduce their participation in the market which has enabled them to keep their available capacity in line with a reduced premium income in an effort to protect their profitability. Those syndicates who have perfected the art of cycle management are naturally those who are showing the best results

The Lloyd's market still is a very attractive proposition for potential investors where returns can be significantly greater than other investment opportunities. The Lloyd's Franchise Board has taken a measured approach to the expansion of the market and has only permitted new entrants where it can be seen that they will attract business which is currently not available to the market. A majority of these new entrants have business plans which do not include reinsurance and are vehicles to further enhance Lloyd's position within the insurance sector. This strategy has caused some concern with it being commented that there should be no new entrants as existing syndicates struggle with softening rates and continued over-capacity.

However, despite these concerns, the Lloyd's market goes from strength to strength.

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INTERNATIONAL MARINE AND ENERGY TREATY



There is no doubt that Energy was the main protagonist at the 1st January 2011 with Hull, Cargo and other Marine sub-classes playing less dramatic roles.

Hull and Cargo capacity for both excess loss and pro rata treaties continued to be plentiful and the possibility of a capacity squeeze arising out of a shortage of capital, predicted by some towards the end of 2009, is a distant memory. Indeed, many small to medium sized excess of loss and pro rata programmes could have been placed several times over.

Hull and Cargo excess of loss treaties were generally renewed at between expiring prices and less 5% to 7.5%,

depending on results. That said, those programmes with chronic claims problems or major shifts in portfolios were given somewhat tougher treatment. This was in contrast to the reductions of 10% to 25% at the 1st January 2010. However, as in 2010, in certain circumstances reinsurers were prepared to award substantial reductions in order to retain leadership of favoured business.

Market discipline surrounding priority levels appears to have toughened somewhat and discipline on minimum rates on line for top layers and conditions appears to have been maintained.

Hull and Cargo pro rata treaties were generally renewed with commissions and retentions unchanged. As usual those placed as a part of bouquets, where substantially greater limits are placed for the non-marine classes, were generally not subject to close scrutiny by reinsurers and capacity was plentiful.

Treaties with Energy exposure, on the other hand, were subject to hardening in rates. The Deepwater Horizon loss, whilst largely retained by BP's captive, will still give the market an insured / reinsured loss counted in the billions of dollars. The market was sensitive to what could have been an insured loss of many more billions, the shock of such a substantial single risk loss in the Gulf of Mexico (after several years guarding against natural catastrophe exposure) and realisation of the potential for very complex liability losses in the future. The Enbridge pipeline losses in July and September only served to pile on the pressure. Resolve amongst reinsurers led to average rises in the region of 25% on excess of loss treaties and hardening original rates have given rise to increased incomes under pro rata treaties. Capacity for both is somewhat restricted.

Last year's increasing trend of markets providing benchmark quotations has now become almost universal. Most reinsurers, whether they are existing following market on a programme or prospective market, are willing to give their ideas of pricing. In many cases, these terms are given either with the implication that the reinsurer does not wish to become the leader or as strictly non-binding indications. This represents an effort on the part of non-leading reinsurers to give added value in addition to providing regular capacity which is currently quite plentiful for non-Energy business.

The reinsurance programmes of London Market insurers / reinsurers were put into the market extremely late this year with some not fully placed at inception. This led to a bottleneck in London

towards the end of December and slower than usual response times from reinsurers there. The wisdom of entering the market early to seek terms has been frequently questioned in the past. It has been felt by some that the early entrants into the renewal market each year have a more difficult task securing competitive terms as reinsurers' resolve tends to be stronger in the early stages of the season in a soft market. During this renewal season though, buyers pursuing a "holding back" strategy risked suffering the consequences of a slow responding market. However, it was notable that the European markets seemed able to maintain high levels of service in spite of these circumstances.

In 2011, non-Energy marine treaties continue to represent good value to buyers both in terms of price and conditions, with plentiful capacity available. Energy excess loss treaty terms, whilst tougher than in 2010, do not appear to be out of proportion with (on average) hardening original rates and are a natural reaction to a difficult year.

INTERNATIONAL AVIATION TREATY RENEWAL – 1ST JANUARY, 2011

For the direct aviation market the second half of 2010 represents the triumph of experience over hope.

In May 2010 the aviation market loss figure, including minor losses, was USD733 million, compared to USD1.59 billion at the same point in 2009. This meant that cumulative losses for 2010 were running 10 percent below the 1996-2009 average.

At this point the market generally believed it was finally heading into a return to profit after three years of turbulence. However, it was noted at the time that a single loss could change this optimistic position

From May onwards the market suffered a number of significant losses including:

Month	Description	Estimated Market Loss
Jun-10	Jeddah Airport Spares Loss*	USD 360,000,000
May-10	Afriqiah Airlines	USD 240,000,000
Sep-10	UPS	USD 143,000,000
May-10	Air India Express	USD 105,000,000
Jul-10	Air Blue	USD 100,000,000
Nov-10	Qantas A380 Engine Failure	USD 69,000,000
Aug-10	Henan Airlines (CAAC)	USD 64,000,000

**This loss represents 2010's largest market loss.*

These claims, as well as smaller attritional losses, have meant that Hull and Liability losses totalled USD 2.15 billion in 2010.

Although this overall figure is down from 2009's total of USD 2.5 billion it does mean, over a four year period, claims exceed premium earned by more than USD 1 billion overall.

Digging deeper into the results 2010 represents the worst year ever for hull losses, with the total exceeding USD 1 billion for the first time. This is measured against a decade average of approximately USD 650 million.

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For liabilities, the position was reversed with a yearly total of USD 890 million which compares favourably with a decade average of USD 1.25 billion.

Additionally the human cost of air accidents rose from 732 deaths in 2009 to 828 in 2010 – a rise of 13 percent. Despite this, the statistics show that the fatal accident rate of 1 death for every 1.5 million flights has improved significantly since the 1990's average rate of 1 death per 700,000 flights. These clear safety improvements are likely to be of little comfort to (re)insurers in the face of the market's continued poor results.

In spite of the market conditions, the rate rises that you would have expected in the face of another poorly performing year have not materialised. This is due to a combination of market overcapacity and the poor returns available from other traditional avenues for the capital providers' investments. This rating situation is unlikely to change unless financial conditions improve (for example by interest rates rising significantly), or a number of very large catastrophic losses depleted enough of the market's capital to deter the further involvement of one or more major market players.

As it is, the market still contains a large amount of latent capacity which many of the larger (re)insurers have not chosen to use at this time and so we are some way from conditions being favourable for the rates to improve.

Estimates of the overall rate movements for the all-important 1st December renewals range from +10% to -5%, but this does not tell the whole story.

On larger accounts, such as Lufthansa, the market has seen a situation where the variation between the verticalised terms can vary by as much as 70%, which has been combined with the more disciplined underwriters digging their heels in and holding out for the best or better terms before committing their capacity.

As well as this, as you would expect, clients who have had large losses (such as UPS) saw their premium increase by approximately 100% at their 2010 renewal date.

The high concentration of the Airline market's December renewals and the volume of risks involved means it remains difficult for brokers to effectively market each airline and convince (re)insurers that one particular airline is any better than another in December's crowded marketplace.

Generally speaking, the direct underwriters who have performed better in 2010 are those who have underwritten technically and conservatively, rather than those who underwrite based on volume. Nevertheless the direct market remains unpredictable with underwriters searching constantly for the geographical area, company or class of business which would allow them to steal a march on their competitors and obtain an acceptable level of premium for their capital investment.

Regarding Excess of Loss (XL) business, the smaller market and lower premiums in comparison with the direct market means that generally the XL market is more predictable with less verticalisation occurring. This meant XL clients with clean, unchanged programmes received a modest rise of 5%-10% at their 1st January renewals. While those who have been unlucky enough to have significant losses over the past year(s) received cash rises of 25% and beyond.

Capacity for XL business remains reasonable with the significant market players remaining largely unchanged since 2009 and the only notable new entrant being Atrium 609 Consortium who have struggled to gain a significant market share since their entry.

For Proportional business, capacity remains limited especially from within the London market, with many brokers relying on significant lines at verticalised terms from the larger European reinsurers to achieve full placements even on treaties which have performed well historically.

With no new proportional market entrants expected, the trend of proportional placements struggling to find capacity is expected to continue in 2011 and beyond. As the London market feels that the worldwide hull rates are almost universally too low and the proportional records often poor, one has to now wonder whether the days of the London market offering clients their capacity for automatic proportional treaties are coming to an end.

In view of this there is a trend for many brokers to advise that those clients with enough income to do so switch from proportional to excess of loss arrangements, in order to increase the number of interested reinsurers and therefore increase the chances of a successful, fully A-rated placement.

BRAZIL

Bonds

Due to a significant increase in demand for bond capacity in the market in 2010, insurance companies sought to increase treaty limits, often by doubling or tripling the size of their proportional and non-proportional treaties, and in some particular cases, increasing the limit five-fold.

Meanwhile, net retentions remained low due to SUSEP regulations.

Companies that experienced positive results also benefited from increased commissions and improved terms.

Despite this surge in capacity demand, the market was able to accommodate it quite comfortably, due mainly to the number of new entrants into the market and to the fact that companies set up new reinsurance underwriting teams targeting this line of business in Brazil. There are still a number of licenses currently being processed that are due to be issued early in 2011.

Some examples include ONDD, Novae Re Zurich, AWAC, Ariel Re and Catlin Zurich.

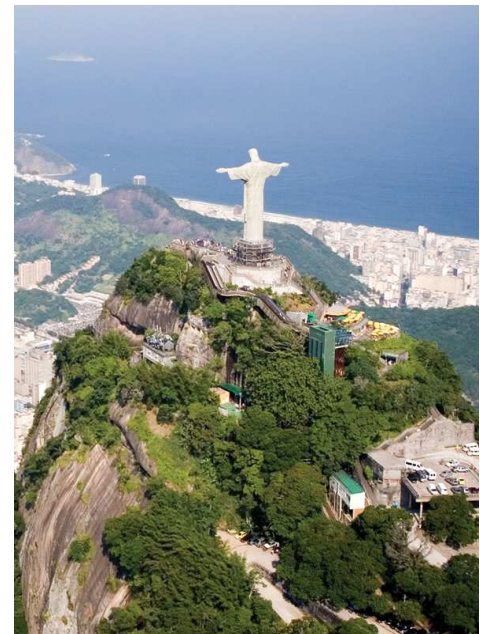
In addition, there were some notable mergers in the Bonds market during the course of 2010, namely Travellers' acquisition of majority shareholding of local bond reinsurer J Malucelli and Swiss Re's acquisition of the majority control shareholding of UBF Seguros - a leading player in the surety and agricultural insurance business.

In view of the number of infrastructure, construction and engineering projects that will be developed in Brazil over the next 5 to 10 years (involving both new and renovation works) as a result of the Brazilian government's PAC plan (Growth Acceleration Programme), the 2014 World Cup, the 2016 Olympic Games and the pre-salt and oil and gas deposits, this line of business is set to grow substantially during this period of time.

As an indication, it is expected that total investments in the infrastructure sector will reach an estimated amount of USD 1 trillion over the next decade.

Due to the scale and number of projects that will be undertaken during this timeframe, the Brazilian government founded in 2010 a state-owned insurance company – Empresa Brasileira de Seguros (EBS) – in order to provide capacity over and above the capacity provided by the private sector.

The fundamental idea is that EBS should work in conjunction with the private sector rather than as a



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monopoly and to offer insurance support for projects that hold little appeal to the private insurance companies, such as social/low income housing (“minha casa, minha vida”) and other such social welfare programmes.

EBS will also be fundamentally involved in providing surety capacity for government projects wherever there is a shortfall in the private sector.

Professional Lines

In 2010, Directors and Officers (D&O) insurance experienced substantial growth in Brazil, rising by 41% to 45% in the first quarter of 2010 compared to the same period in 2009.

Although this type of cover is still relatively new in Brazil and the grounds upon which directors and officers could be held liable are limited, there has been a widening of cover recently which has led to an increase in the number of actions being taken against executives over the last few years. This has led companies to purchase more D&O insurance.

The recent growth trend has also been driven by new regulations introduced by the Comissão de Valores Mobiliários (CVM) - the Brazilian securities regulator (equivalent to the SEC), which came into force in 2010. The new rules were drafted to increase transparency, forcing companies to disclose the fact that they have D&O insurance and the amount of cover taken out. This new transparency has led to an increase in the number of companies taking out this type of cover.

In addition, the opening up of the Brazilian market has led to a trend of incorporating certain types of international D&O covers into local policies, in a bid for differentiation by insurance companies competing to gain more market ground.

The Brazilian market has also seen a substantial growth in "termos de compromisso" type of cover.

"Termos de compromisso" is the term given to settlement agreements whereby a CVM investigation is settled on the basis that the company under investigation agrees to certain conditions, as well as paying a settlement sum (which could be to the CVM or to third parties that have suffered a loss).

An increasing number of companies have taken out additional cover protecting them against the payments made under "termos de compromisso", and any costs incurred negotiating these settlements with the CVM.

There is currently a debate within the market as to whether these settlements are ‘agreements’ or in fact ‘fines’, which would not normally be covered under a regular D&O policy.

Consequently, after the significant softening of the Reinsurance market in 2009/2010, there were signs of hardening in some Reinsurers’ attitudes by the end of 2010, due largely to the growth in cover for “termos de compromisso”.

Those companies with losses affecting their Reinsurance companies will see a hardening of terms to their programme renewals during 2011.

Property & Engineering

The property and engineering books of business remained very competitive during 2010, with Engineering rates experiencing substantial reductions.

However, in view of the colossal investments in the infrastructure and engineering sector in Brazil, insurance companies sought substantial increases in their reinsurance programme capacities during 2010, in some cases doubling the size of their covers.

Reinsurance terms also remained competitive with very few losses affecting programmes.

In a move to improve the marketing and commercialization of their products, some insurance companies are offering Engineering and Bond cover as packages.

Changes to Legal Environment

During 2010, the legal requirement to offer 60% of all Reinsurance cessions to local registered markets was reduced to 40%, with the remainder allowed to be placed with Admitted and Eventual reinsurers, (Eventual reinsurers are still restricted to a maximum of 10%, except for Bond business).

However, on 6th December 2010, **Resolution 224** amended the CNSP 168 regulation to include the following 4th paragraph under Article 14:

“The liabilities assumed in insurance, reinsurance and retrocession in the Country cannot be transferred to companies related or belonging to the same financial conglomerate based in other countries”.

This resolution becomes effective from **31st January 2011**.

The above resolution will have significant implications to those Reinsurers who have in the past retroceded a great proportion of their liabilities to their head offices, particularly Munich Re and Mapfre Re.

For Mapfre Re, their alliance with the IRB and Banco do Brasil in May 2010 will assist in alleviating their need to find suitable retrocession partners, but for other markets this will be a point of considerable difficulty during 2011.

This will also have considerable implications on those insurance companies that obtained reinsurance cover through group global programmes. This will create a need for more reinsurance cover in the Brazilian open market.

In addition, **Resolution 225** amended CNSP 168 regulation Articles 15 and 39 as follows:-

Art. 15 – “The insurance company will contract with local reinsurers at least forty percent of each cession of reinsurance in automatic or facultative treaties.”(NR)

Art. 39 – “The reinsurance treaties, either automatic or facultative, may foresee clauses for claims control in favour of the local reinsurer, when this retains a larger quote of proportional participation in the risk.”

This Resolution becomes effective from **31st March 2011**.

The significance of this resolution is that insurance companies no longer have to offer at least 40% of their cessions to local reinsurers, but rather actually place a minimum of 40% with local markets.



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Consequently, the implication is that at least 40% of all placements will have to be placed at terms either acceptable to or quoted by local reinsurers.

This effectively protects local reinsurers to a certain degree and in some ways renders the market less open and free.

The foreseeable result of this resolution is that either there will be an increase in locally registered reinsurers operating in the Brazilian market in 2011, or insurance companies will elect to effect placements with differential terms between local markets and the admitted/eventual markets.

MENA REGION



In line with expectations during the last quarter of 2010, the 'soft' reinsurance market continued across the MENA region for the 1st January 2011 treaty renewals with proportional treaties, on average, being renewed on more or less expiring terms while reductions between 5% and up to 15% were observed on XL contracts.

Despite the poor results reported in the 1st quarter of 2010 and while the underwriting results in 2010 are far from the almost record levels reported in 2009, nevertheless the overall underwriting margins achieved by reinsurers in 2010 are quite positive and have directly influenced the reductions seen in the renewals.

In addition, the international reinsurance market is overcapitalized and that is more so the case in the MENA region where there is significant competition between the international reinsurers, who are paying increased attention to the MENA, as well as existing and new regional capacities, conventional and Retakaful, that are hungry for growth. This excess capacity, both on the reinsurance side as well as the direct side (given the increase in number of local insurers), is having a negative effect on original rates as well as the combined ratios of

proportional treaties. It is evident that many direct insurance companies are struggling to grow due to the fierce competition in their local markets and many companies are now actively seeking growth in neighbouring countries either through establishing subsidiaries, accepting foreign inward facultative business or through acquiring shares in or taking over competing companies.

Moving forward, it will be interesting to observe whether the direct insurance market goes through a wave of mergers and acquisitions which is becoming an appealing option to shareholders as a venue of growth and as a way to save on the reinsurance cost through economies of scale when buying a joint cover for a number of subsidiaries.

2010 Highlights

While markets are slowly recovering from the impact of the financial crisis and most lines of business are steadily growing, Engineering and Cargo business are not recovering at the same pace in some territories given the drop in international trade as well as a slow-down in construction projects.

The increase in CCR's (Algeria's national reinsurer) legal cession to 50% has had a significant impact on the market dynamic. International reinsurers and brokers have seen their lead and/or following lines/orders on Algerian direct insurers' treaties reduced to cater for CCR's share. In addition, CCR now controls a significant share of the market which was reflected in the 2011 renewal structure and which will become more evident during the year and in the 2012 renewal.

Following the cancellation in 2009 of the compulsory cession on Marine business to the Societe Centrale de Reassurance (SCR), the national reinsurer of Morocco, the compulsory cession on fire, engineering and decennial liability business has also been cancelled effective January 1st, 2011.

The floods in Egypt, Morocco and Saudi Arabia did not have any real impact on the reinsurance renewal terms; however, it has raised the question of separately rating the catastrophe exposure which is currently covered in many markets at no additional premium.

Following the rise in catastrophe events over the past few years, reinsurers no longer view the MENA as a catastrophe-free region and lead underwriters are pressuring their clients to cater for this exposure. This has been evident by the inclusion of event limits across most proportional treaties and many companies are starting to purchase separate catastrophe XL covers to protect their retained lines.

The latest wave of UN sanctions against Iran has made it virtually impossible for underwriters and brokers to operate in that market. The Iranian market, given its huge risks and relatively healthy original rates, was a major source of revenue for many companies focusing on the MENA region.

The expected secession of the 'oil-rich' Southern Sudan in 2011 is expected to bring many challenges and opportunities to the market. Sudan is currently considered by most companies as part of the MENA region; however, it is probable that moving forward, South Sudan's business will be handled by the 'Sub-Saharan' departments of reinsurance companies.

There has been a rise in demand for Motor quota share covers to replace many of the existing gross account XL protections used by most companies for this line of business. This has been met by more international and regional reinsurers willing to support this line of business subject to minimum agreed original rates.

2011 Opportunities

While the MENA regions' contribution to world premium income continues to be negligible, it continues to enjoy healthy growth rates and huge potential for development. One of the key features of the region is its demographics; in most countries more than half of the population is under the age of twenty, meaning the labour force is set to grow at an annual rate of 4-6% until 2020. While this poses a major challenge to governments, it is also an opportunity for personal lines (re)insurers to increase market penetration through new and innovative products. Linked with the shifting demographics are the oil-dependent countries' continued attempts to diversify their economies by investing in non-energy industries and services which will create demand for new types of cover.

The influence of regulatory authorities across the region is increasing which is evident from the new legislation in some countries as well as the introduction of new compulsory covers. This has proven to be the most effective way to increase premium income (as has been seen with healthcare in Saudi Arabia and the UAE). This trend is expected to continue, particularly in medical and liability business.

The number of construction projects across the region is expected to grow, with many government tenders already announced, some of which are on a Public-Private Partnerships (PPP) basis. There will be more of a focus on infrastructure and power-generation projects as opposed to the more luxurious projects that have identified the region for many years.



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