



Market News

January 2011

(ISSUE: 2011/01)

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In this issue we report on the 1 January renewals. In common with many market observers, we consider what will cause the current decline in rates to ease and to change direction. The New Zealand earthquake and the still unfolding drama of the Queensland floods are likely to be the most significant loss events to affect the 2010 year of account and we provide an update to our preliminary forecast result for the year.

1 January Renewals

Three reinsurance brokers, Aon Benfield, Guy Carpenter and Willis Re, published reports on the January renewals and all three identified average rate reductions of between 5% and 10%.

Guy Carpenter included the following table, which shows that, with the exception of Global Marine & Energy and Global Credit, Bond and Political Risk, rates are either flat or going down.

Class	Rate Movement
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%
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	Flat to Down 5%
US Medical Professional Liability	Flat
US Surety	Flat to Down 10%
US Agriculture	Down 10% to 15%

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Rates are either flat or reducing in most sections....

...but 1 January renewals better than expected for some e.g. in US catastrophe exposed business.

Excess capital and no growth in demand still holding back an upturn.

Aon Benfield highlighted rate reductions of between 5% and 10% in US catastrophe programmes with hurricane exposure, but said that renewal terms, including ceding commissions and aggregate deductibles, changed to reflect a net price decrease of a further 5% to 10%.

Our discussions with Lloyd's underwriters confirm these movements and rates, although there are some variations. A senior catastrophe reinsurance underwriter told us he had budgeted on a 10% reduction in rates for US catastrophe risks at 1 January, but actual experience had been a 6% reduction. This he attributed to the possibility of increased demand for reinsurance cover following the launch of a new version of the RMS catastrophe model due in February. (Many insurers and reinsurers use catastrophe modelling companies such as RMS as part of their risk management procedures). The new version of the model is expected to show increased exposures in certain areas, which may create demand for additional insurance and reinsurance protection.

Other underwriters emphasise the importance of charging the right rate for the risk, regardless of rate movements; if the buyer is not prepared to pay, then the risk is not renewed and the syndicate's premium income reduces. Better a lower premium income than a risk written at an inadequate rate.

However, the trend is inescapably downward. There is excess capital supporting the Market. Aon Benfield reports that reinsurer capital increased by 17% in the first nine months of 2010 to \$470bn, surpassing the prior peak level reached in 2007. Despite continued share buybacks and increased dividend payments, reinsurer capital remains in excess of demand for capacity. Market observers comment on the low investment returns and declining back year releases as providing little cover for reducing underwriting returns and this leads to discussion over what will cause a change in the Market's direction.

Guy Carpenter provides the following analysis:

'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'.



Questionable theories about what will cause a market uplift.

We question this view. It is true that most insurers and reinsurers have one major catastrophe built into their business plan; they are prepared for one big loss, and this could act as a brake on any upward movement in rates following a major insured event. However, a US\$50bn insured loss is a very large loss – two and a half times Hurricane Ike in 2008 - which would result in capital impairment in certain quarters and, with the news coverage that would accompany such an event, would be more likely to cause a sustained uplift in rates.

The distinction between the effects of a US\$100bn and a US\$150bn event may also be misleading. Most reinsurers set out to avoid exposure to ‘smaller’ loss events, for example, the policies they issue are geared to provide cover for events that cost more than US\$10bn. Reinsurers’ exposure very often also reduces at the upper end. Because the possibility of a US\$100bn insured loss is seen as very remote, buyers may choose to retain the risk above a certain level. In consequence, many reinsurers’ exposure flattens out above US\$65bn and the impact on them of a US\$75bn loss may not be very different from a US\$100bn or a US\$150bn loss.

Frequency of loss probably has a greater impact than magnitude.

Although market observers may disagree about the magnitude of a loss that is going to lead to a turn in the Market, there is wider agreement that the occurrence of more than one event would have a more immediate and definite impact. Reinsurance policies commonly provide cover for one event, plus one ‘reinstatement’ or further event. As happened in 2004 and 2005, once the second US hurricane had struck, cover is needed for a possible third event (which occurred in both of those years) and the Market will charge the appropriate (higher) price. Frequency of loss causes more worry than magnitude.

2011 Atlantic Hurricane Season

Above average US hurricane activity forecast for 2011.

Both Colorado State University (CSU) and Tropical Storm Risk (TSR) predict another year of above average hurricane activity for 2011. TSR predicts activity at approximately 40% above the norm. Both entities will revise their predictions as the year progresses. The table below shows the December 2010 forecasts compared to TSR’s long term averages.

	Named Storms	Hurricanes	Intense Hurricanes
TSR Forecast 2011	15.6	8.4	4.0
CSU Forecast 2011	17.0	9.0	5.0
TSR Average 1950-2010	10.5	6.2	2.7

*“Too much of water hast
thou, poor Ophelia....”*

*New Zealand Earthquake
Commission doubles
estimate of cost of loss.*

*Floods affect a large area,
the size of France and
Germany combined.*

Hurricanes are named alphabetically in chronological order from six lists that rotate annually. The lists only change when there is a hurricane that is so devastating that the name is retired and another hurricane name replaces it.

Thus, the 2011 hurricane name list is the same as that for 2005, although four were retired after the devastating 2005 hurricane season, so on the 2011 list Dennis is replaced by Don, Katrina by Katia, Rita by Rina, Stan by Sean, and Wilma by Whitney. The full 2011 list comprises: Arlene, Bret, Cindy, Don, Emily, Franklin, Gert, Harvey, Irene, Jose, Katia, Lee, Maria, Nate, Ophelia, Philippe, Rina, Sean, Tammy, Vince and Whitney.

New Zealand Earthquake

In our December *Market News* we reported on the severe earthquake that struck the south Island of New Zealand on 4 September 2010. Much of the insurance is provided by the New Zealand government’s Earthquake Commission (EQC) which buys a reinsurance programme in the commercial market, including many Lloyd’s syndicates. EQC’s initial estimate of its loss was a range of NZ\$1bn to NZ\$2bn. The EQC set a deadline of 4 December by when potential claims had to be notified. The EQC subsequently increased its estimated range to between NZ\$2.75bn and NZ\$3.5bn. In consequence, many reinsurers have revised upwards their initial estimates of the cost of the earthquake. For example, Amlin plc increased its estimate from US\$75m to US\$160m. Estimates for the total insured cost of the event vary considerably. Aon Benfield specifies US\$3.05bn, but Catlin Group based its revised estimate on 22 December on an insured loss of US\$5.5bn to US\$6.0bn.

Queensland Floods

The catastrophic flooding that has been going on in Queensland since tropical cyclone Tasha made landfall on Christmas Day is going to raise many complex issues for insurers and reinsurers.

An area of more than 900,000 sq km was inundated in the following two weeks, with the town of Rockhampton worst affected. Attention has now shifted to Brisbane (Australia's third largest city) where, on 13 January, the flood waters were thought to have passed their peak. The mayor reported that 11,900 homes and 2,500 businesses in metropolitan Brisbane had been completely flooded, with 14,700 houses and 2,500 businesses partially under water.



Business interruption losses expected following infrastructure damage.

Queensland is also the home of Australia's mining industry, the Bowen Basin, containing the largest coal reserves. The mining industry was hit by floods in 2008, following which defensive measures were taken, including the construction of levees. Initial reports suggest that the defences were effective in some instances and that, since the waters rose at a lower speed than on previous occasions, there was time to move plant and machinery to higher ground. Due to infrastructure damage affecting roads, bridges and railways, business interruption losses are expected. However, BHP Billiton, which produced the largest mining losses following the 2008 floods, decided to self insure after that event and did not buy cover in the commercial market.

Local insurers buy catastrophe cover in the international markets.

The three main primary insurers in Queensland are Suncorp, which has the largest market share, IAG and QBE. They buy catastrophe reinsurance protection in the international markets, including Lloyd's, London, Bermuda and Europe. Since the floods have continued over a number of weeks, the question has arisen as to whether they are to be treated for insurance purposes as one event or more. Both Suncorp and IAG have stated that the Christmas rains throughout Queensland are distinct from the heavy rains that have hit South Eastern Queensland since the beginning of the year. From the Lloyd's perspective this could have a bearing on whether the loss falls on the 2010 or 2011 year of account, but it will depend on the anniversary date of any reinsurance purchased. For example, we understand that Suncorp's reinsurance renews on 1 July, whereas both IAG and QBE renew on 1 January.

Attention has also centred on whether flood cover is included in homeowner's insurance. For Suncorp, flood is part of the standard cover offered, whereas IAG offers only 'flash flood' as standard. This gives scope for coverage disputes, although it has been suggested that the Australian Ombudsman invariably rules in favour of the insured in coverage disputes.

Initial estimates of insured damage A\$3bn to A\$6bn.

There have been attempts to quantify the losses, but these are acknowledged as pure guesswork at present. Prior to the Brisbane events, the State Premier Anna Bligh put the total cost of rebuilding the damage as "well into sort of above A\$5bn (US\$5bn) territory.". At the same time JP Morgan estimated that insured losses could exceed US\$1bn, but accepted that any estimate at the moment would be crude in the extreme. The additional flooding in recent days will increase those estimates. An estimated range for the insured loss of A\$3bn to A\$6bn has appeared in the insurance press, but again this can only be speculative at this stage.

Preliminary forecasts due in May.

New Zealand earthquake and the Australian floods will impact the 2010 account result.

The 2010 Account

In our December *Market News*, we gave a very preliminary forecast for the 2010 year of account of a profit in the range 5% to 10%. Since most catastrophe reinsurance policies for Japanese business renew on 1 April and for Australian business on 1 July, a catastrophic event in either of these regions would impact primarily the 2010 year of account. The initial forecasts for the 2010 account, based on the figures at 31 March, will be released in May of this year, although some preliminary estimates may be given in March, based on the 31 December figures.

It is now apparent that the Queensland floods will produce as yet unquantifiable losses to insurers and reinsurers, including Lloyd's syndicates. There are uncertainties as to coverage, number of events and which year of account the losses will fall into, which may cause the estimates to fluctuate as they emerge over the coming months.

Whilst losses from the Chile earthquake in February 2010 will, for the most part, fall back on the 2009 year of account, we expect the New Zealand earthquake and most of the Queensland floods to impact 2010. Further, that the international (everywhere except the US) section of underwriters' property reinsurance accounts will be in overall loss. That said, as there were no significant US hurricane losses, the US property reinsurance accounts will be showing a good profit. The overall result for the combined US and international property reinsurance account will therefore depend upon the balance between the two books of business. Most property reinsurers write a predominantly US account, so we would expect the profits from this sector to outweigh any losses from the international business.

To forecast with any high degree of accuracy the result of the 2010 year of account at this stage is speculative, due to the many variables before closure at 31 December 2012. Whilst we would still currently believe that a profit is attainable, the recent revisions to the New Zealand earthquake and the Queensland flood loss estimates are presently causing us to think that the mid-point of the range will be closer to 5%. With the publication of Syndicates' 2010 Report & Accounts, due to be dispatched to members by 31 March, we shall get a clearer picture.

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