GR Global market report

The big picture: Coping with catastrophes
Timeline: Bermuda keeping pace with change
Market map: Crunching the numbers
Horizon: What lies ahead for regulation
Inside / out: Contrasting views of Bermuda

THE BIG PICTURE

Bermuda's reinsurance

Bermudian reinsurers are inextricably linked to the biggest stories in the global reinsurance market in 2011. Whether buying or selling, claiming or being claimed upon, Bermuda's market held up surprisingly well in the face of unusual levels of catastrophe activity

USA: WINDSTORMS
$20BN

CATASTROPHE

Reasons to be cheerful

- Reinsurers have coped with record losses
- Firms benefited from a lack of big US hurricanes

Bermuda's reinsurance market sustained a huge income blow in 2011, with a record $105bn in catastrophe losses recorded.

According to Munich Re, the year's 820 events caused about $380bn in economic losses, nearly two-thirds higher than 2005's $220bn. Earthquakes in New Zealand in February and Japan in March accounted for nearly two-thirds of these losses, making the first quarter the costliest on record.

Despite the losses, Canopius Bermuda chief executive Susan Patschak says the Bermudian market has coped better than expected, with no signs of trouble in balance sheets to date.

"It seems to still only be an income statement event as opposed to a balance sheet event for companies on the island. It will be interesting to see what happens once fourth-quarter results come out."

Patschak also says that the nature of single big events and the lack of catastrophic Atlantic hurricanes meant reinsurers have been better able to cope with the large losses.

"Cumulative losses have been high but there has not been that one really severe event. Companies have taken one event at a time and been able to keep their balance sheets in order.

"With no really big hurricanes in the USA last year, I think people were able to catch up a bit of lost revenue from the many catastrophes that happened," Patschak says.

Significant overcapacity in the market has meant that the 1 January renewals season has not achieved the market hardening that many had hoped, according to Deloitte insurance partner Stephen Ross.

"It has only been in catastrophe-hit areas that the reinsurance rates have increased significantly. In the areas without significant losses, rate movements have been virtually non-existent or marginal."

But Patschak says it is more complicated than simply waiting for market cycles to occur naturally.

"I believe the levels of amplitudes of the hardening and softening of the market will not be to the extremes that we have seen. When people say 'When is it coming?', I do not see it ever coming back because there are too many other people waiting in the wings with different forms of capital.

"Looking back at KRW [Hurricanes Katrina, Rita and Wilma], I was convinced that not only would the property markets harden but the casualty too.

"However, when the hedge funds decided to take the plunge into the cat market, it did not happen. As a result, people were not capital constrained like they expected to be. They had their capital shelves waiting and were able to reload within days."

For Patschak, the issue of excess capital and how best to deploy it continues to plague the market. "No one wants to give back their capital for fear they might need it again soon," she says.

M&A

Consolidate and conquer

- Mergers are set to continue, but taking on the lessons of 2011
- Companies unable to compete outside Bermuda will face pressure

Consolidation looks set to continue in the Bermudian market in 2012 as reinsurers struggle to weigh excess capital issues against fierce competition.

Market leaders say lessons have been learnt from 2011's biggest merger sagas, including the battle to buy Transatlantic and failed bids for Omega.

Endurance chief executive David Cash says: "There will be more consolidation, although it does appear it will depend on the terms of the company that is being acquired."

Companies that lack book diversification and an ability to compete effectively outside Bermuda will face the biggest pressure as merger targets, according to Cash.

Canopius Bermuda chief executive Susan Patschak says: "We really have to wait and see what happens with the fourth-quarter results. There are certainly rumours out there about a couple of companies that are going to take it on the chin and it might be just the last blow for them."

With excess capital looming for another year, Bermudian reinsurers may be willing to make acquisitions of small to mid-sized companies

"I think companies will have this as one of their strategies for growth going forward. Mergers and acquisitions won't shrink, though it probably won't happen to the degree that people imagine unless we see real distress in Europe," Cash says.

US investment firm Alleghany confirmed its $3.4bn deal with Transatlantic in November 2011, after the collapse of the Allied World merger and unsuccessful bids by Warren Buffett's National Indemnity and Ed Noonan's Validus.

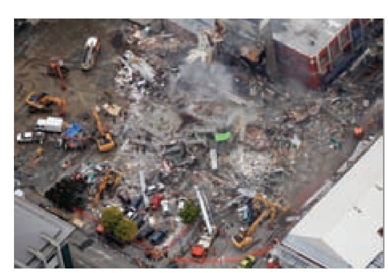
The Alleghany agreement will net shareholders $59.79 per share. Following the deal, Transatlantic will become an independent subsidiary of Alleghany.

Lloyd's insurer Omega remains a target after the lapse of Haverford's 74p per share proposal. Haverford had offered an initial 83p per share deal but chief executive Mark Byrne says the offer lapsed once new financial information came to light.

Omega also received offers from fellow Lloyd's insurers Barbican, Novae and Canopius, though they were rejected by Omega's board.

JAPAN: EARTHQUAKE AND TSUNAMI
$35BN

AUSTRALIA: FLOODS
$2.2BN



NEW ZEALAND: EARTHQUAKE
$14BN

DATA: GUY CARPENTER

TIMELINE

A struggle for survival

Bermuda is battling to stem the flow of (re)insurance business from its shores. But as Lauren Gow reports, the rate of change from within government needs to be faster

Adapt or die. There is little doubt that Bermuda is choosing the former, but the rate of adaptation is its key to survival. With mounting pressure from within Bermuda and beyond its shores, Bermuda's government is working hard to stave off a flow of business away from the island.

Bermudian insurance insiders list the problems in Bermuda as numerous and wide-ranging. They include violence, corruption, high unemployment rates and an education system lacking high standards.

Short work permits mean expatriates do not feel settled on the island and leave some feeling isolated from the local community, unwilling to contribute. Insiders also reveal that, in 2011, about 30 senior managers left the island and returned home to the UK and USA, some taking their families with them and instead commuting to the island from the USA each week.

In addition, changes to US legislation on collateral held by foreign reinsurers is the first step to creating new barriers for Bermudian reinsurers to increase business opportunities in the USA. Up until late 2011, only a handful of states had adopted a reduced collateral policy.

However, at the close of the year, policy revisions by the National Association of Insurance Commissioners (NAIC) mean that Bermuda is making a slow but positive step forward.

After a cabinet shake-up in November and improving crime figures, premier Paula Cox is pushing changes through government, though some are proving less than popular within government and in the local community.

But with the Cayman Islands relaxing its visa legislation and major European jurisdictions lowering corporation taxes, Cox will have to fight hard to remain relevant and business-friendly to the (re)insurance market.

THE STORY

US regulation
Collateral reductions for foreign firms

- Under current National Association of Insurance Commissioners (NAIC)'s Credit for Reinsurance Model Law and Regulation, in order for US ceding companies to receive reinsurance credit, the reinsurance must either be ceded to US-licensed reinsurers or secured by collateral representing 100% of the US liabilities for which the credit is recorded.

Competition
Other jurisdictions vie with Bermuda to attract more reinsurers

- Competition is bearing down on Bermuda as other low-tax jurisdictions offer business-friendly incentives to attract reinsurers to redomicile their operations.

Expat exodus
Intellectual capital drains from island over safety fears

- Safety and security is "the single biggest threat to doing business in Bermuda" says one Bermuda chief executive.

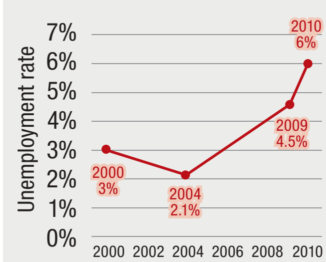
- In 2011, 32 top-tier managers left Bermuda due to what island insiders describe as "executive convenience".

WHAT HAPPENED

October 2008
Florida statute comes into effect for property and casualty lines, authorising the insurance commissioner to lower reinsurance collateral requirements for foreign reinsurers that have a surplus of $100m.

January 2003
Republic of Ireland introduces 12.5% corporation tax for trading income, down from 32% in 1998. A higher tax rate of 25% was introduced for passive income, income from foreign trade and certain development and mining activities.

December 2010
Bermuda's census shows unemployment figures have hit 6%, double that of 2000 figures.



DATA: BERMUDA DEPARTMENT OF STATISTICS

March 2011
New Jersey passes a law allowing the commissioner to reduce the amount of collateral required of reinsurers with surpluses in excess of $250m, within the commissioner's discretion.

April 2011
Indiana introduces reduced collateral status for property, casualty and life business for reinsurers holding at least $250m in surplus (or the equivalent).

November 2011
NAIC unanimously adopts revisions to the Credit For Reinsurance Model Law and Regulation. All 50 states, the District of Columbia and five US territories are now able to certify non-US reinsurers to post only a percentage of collateral based on a rating given for this reason.

WHAT'S NEXT

- **Reductions in collateral** mean barriers for Bermudian reinsurers doing business in the USA are now significantly lower.

- **The new Model Law and Regulation** still has to be approved by individual states, because insurance is regulated at state level in the USA, rather than at federal level.

March 2007
UK budget announces tax rate cut from 30% to 28%, effective from April 2008.

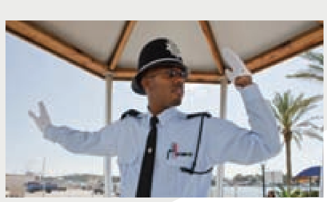
March 2011
UK lowers corporate tax rate by 2%, with the rate to fall by 1% per year until 23% is reached. UK chancellor of the exchequer George Osborne said when making the announcement: "Let it be heard … that Britain is open for business."

November 2011
Cayman Islands premier William McKeeva Bush outlines plans to offer 10-year work permits for senior executives and reduce work permit fees.

- **Bermudian premier Paula Cox** needs to consider any additional business incentives, such as further easing of work permit restrictions, improving quality of life and lowering tax that may assist Bermuda in fighting off competition from other low-tax jurisdictions.

April 2011
Bermudian economy, trade and industry minister Kim Wilson announces 10-year work permits will be available for expatriates if international businesses are able to prove they are "providing opportunities for Bermudians at all levels".

October 2011
Q3 crime figures show a crime rate decrease of 5.6% compared with the second quarter of 2011. It is the fifth-lowest quarterly figure since 2000.



November 2011
Premier Paula Cox announces that government revenues are expected to be between $10m and $20m less than the $940m projected in February's budget.

- **The Bermudian government** is trying to balance decreasing local unemployment against remaining an attractive centre for international business.

- **Working to lower crime rates** is difficult in an economically unstable environment but is necessary to avoid an expatriate exodus.

HORIZON

Bermuda set for Solvency II equivalency

Europe may be pushing for a more robust insurance framework with Solvency II, but Bermuda is not about to be left behind in the regulation stakes. Lauren Gow reports

For the past two years, Bermuda has been working against the Solvency II clock. In an effort to gain regulatory equivalency under the EU Solvency II directive, the Bermuda Monetary Authority (BMA) – Bermuda's financial services watchdog – has implemented a number of significant insurance regulations for the market.

Bermuda already has a robust regulatory system, but the recent changes to the Companies Amendment Act and the introduction of the formalised guidelines within the Insurance Code of Conduct mean the industry is spending more time and money on compliance than it ever has.

In addition, there is the looming threat of the Neal Bill, a piece of US legislation aimed at stemming the flow of premium dollars to tax havens.

But rather than being weighed down by the volume and complexity of changes, the Bermudian (re)insurance market is embracing the changes.

While (re)insurers there dismiss the likelihood of the Neal Bill passing, amendments to the Companies Act mean that doing business on the island could be easier, and more profitable, than ever before.

FIVE MAJOR MILESTONES OF SOLVENCY II

1 November 2009: The Solvency II directive was approved by the Committee of European Insurance and Occupational Pensions Supervisors (Ceiops), and will be adopted by all 27 EU member states plus three in the European Economic Area. Other countries can apply for equivalency. The new regime applies to insurance firms with GWP exceeding €5m ($6.6m) or gross technical provisions in excess of €25m.

2 October 2011: The European Insurance and Occupational Pensions Authority (Eiopa) published a report on its preliminary Solvency II equivalence assessment of Bermuda. The results showed that Bermuda's regime for commercial insurers meets the criteria for Solvency II equivalence, with certain caveats that the authority anticipated.

3 April 2012: Postponed until April 2012, the European parliament had originally earmarked January 2012. The vote is crucial to finalising Level 1 framework of Solvency II and Omnibus II.

4 March 2013: The directive should be integrated into countries' law and regulations by 31 March 2013.

'Nobody wants a loss of momentum, as insurers have been working towards Solvency II for many years'

Jim Bichard
PricewaterhouseCoopers

5 January 2014: The date for full implementation of the directive by all companies is now one full year later than the previous deadline that was proposed by the European Commission in January 2011.

BERMUDA'S ACTIONS

LEGAL: Neal Bill opposition grows

President Barack Obama's 2012 budget includes a provision based on bills HR 3424 and S 1693, which were introduced in Congress by US representative Richard Neal and senator Robert Menendez in October. The legislation aims to close what Neal calls an "unintended tax loophole" that gives foreign-owned insurers commercial advantage over their US competitors serving the domestic market.

The new Bill will effectively eliminate that competitive advantage and defer the tax deduction for any reinsurance premiums paid to a foreign affiliate (if the premium is not subject to US tax).

In addition, to ensure foreign-based insurers are not disadvantaged relative to domestic insurers, the legislation

allows foreign-based groups to avoid the deduction deferral rule and be taxed similarly to a US company on the income from affiliate reinsurance transactions. A foreign tax credit is provided for any foreign taxes paid on such income.

While the Bill is not aimed specifically at Bermudian (re)insurers, the effect of its passing is undeniable. Bermuda-based law firm Conyers Dill & Pearman's director, David Doyle, says: "This Bill is certainly a threat to Bermuda. While the Bill applies to all foreign reinsurers, it is clear that it is aimed directly at us and, if it is passed, it would end up hurting Bermuda – no question."

As opposition mounts, (re)insurers in Bermuda are adamant that the Neal Bill will be unsuccessful. Insurance advocacy group The Coalition for Competitive Insurance Rates says that more than 100 insurers, independent experts, state government officials, business owners and associations have publicly filed opposition letters against this tax proposal.

We say: With so much opposition to the Bill, both from inside and outside the USA, questions need to be asked about whether the positive effects of ensuring US capital remains on US shores are worth it, considering the negative effect for the global insurance market.

REFORM: Regulation overkill?

The Bermuda Monetary Authority (BMA) issued an Insurance Code of Conduct in February 2010. Originally, full compliance was required by 31 December 2010, but this was later pushed back to 1 July 2011.

Conyers Dill & Pearman's Doyle points out that the code is broadly consistent with the BMA's previously published guidance notes, and is within the principles of the International Association of Insurance Supervisors, of which it is a member.

"It formalises a lot of the previous guidelines introduced by the BMA, now captured in one document," Doyle says.

Non-compliance consequences

Since the July 2011 compliance date, the BMA has enforced the code through its regular prudential supervision and reviews of insurance companies. The code applies to all insurers in the Bermuda market, and failure to comply with it is an offence.

In addition, from 2012 every insurer is required to submit, as part of its annual statutory return, a statutory declaration confirming that it complies with the requirements of the code.

Failure to comply will be taken into account by the BMA in determining whether an insurer is conducting its business in a "sound and prudent manner", says Doyle. Compliance failures could result in suspension of business licences.

We say: The Code of Conduct is regulation overkill in such a small market. Although Bermuda is known for admirably strong financial services regulation, at a time when (re)insurers are struggling with global economic uncertainty and the rush to achieve Solvency II equivalency, the cost and effort of further regulation could do more harm than good.

(Above, left) The US Capitol building in Washington, DC
(Above, right) Bermudian premier Paula Cox

REGULATION: Business-friendly measures

On 14 December 2011, Bermuda's government enacted changes to the Companies Amendment Act, aimed at resolving practical issues that have arisen in recent years. While the changes are not written specifically for insurers, the Bermudian insurance industry welcomes them.

"This is one of the most important amendments to the Act in the past 10 years," Conyers Dill & Pearman's Doyle says.

He adds: "It is important to note that the government is committed to working with the private sector to ensure Bermuda retains its competitive edge in the offshore world."

Long-awaited changes

The changes to the Act introduce new concepts and procedures into the legislation, including a new process for mergers as an alternative to existing amalgamations, while sole directorships and corporate directorships of Bermuda companies will be permitted.

(Re)insurers in Bermuda say the market has pushed for these changes for years. Companies will also have the option of waiving their annual general meeting.

The changes are also aimed at removing the bans on providing financial assistance, which (re)insurers say is "encouraging". In addition, paperless share transfers will be possible for listed companies.

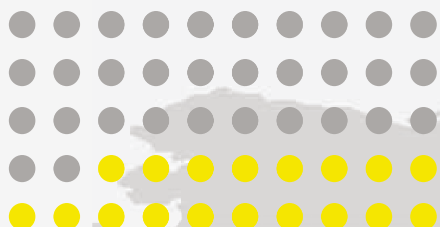
We say: These are good, sound developments aimed at the weakest points in Bermuda's business law. With competition fierce in other low-tax jurisdictions, any changes like this will not only encourage domiciled companies to stay but hopefully encourage further economic development on the island.

MARKET MAP

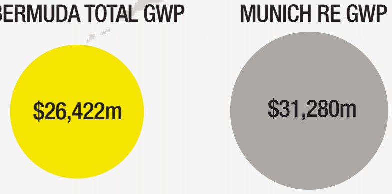
KEY STATS

TOP 50 GLOBAL REINSURERS

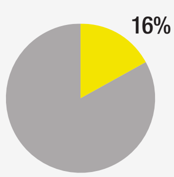
The top 50 global reinsurers list, compiled by rating agency AM Best, is the who's who of the market. Bermuda's reinsurers take 18 of the top spots, highlighting its importance in the global market.



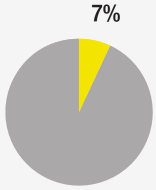
Bermuda = double the reinsurers of any other region



TOP 50 REINSURERS' TOTAL GWP



TOP 10 REINSURERS' GWP

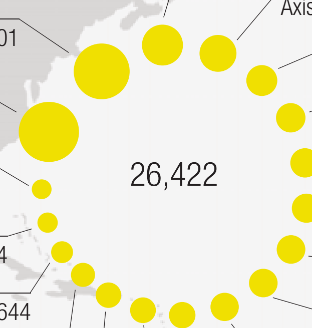


MARKET REALITIES

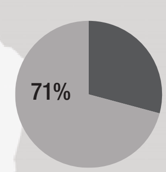
The amount of industry attention and column inches devoted to Bermuda gives the impression that it is the centre of the reinsurance universe. This perception is heightened by the fact that, as a catastrophe reinsurance hub, Bermuda plays a major role in handling the industry's largest and most headline-grabbing losses and is a focus for start-ups. A glance at the premium numbers, however, shows that while Bermuda certainly punches above its weight, it is by no means the leader.

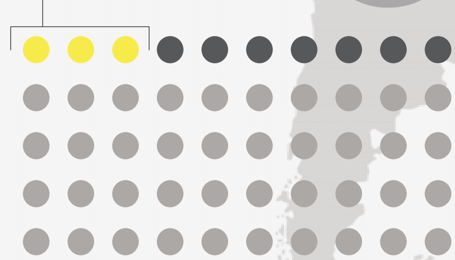
BERMUDA

GWP 2010 ($m)

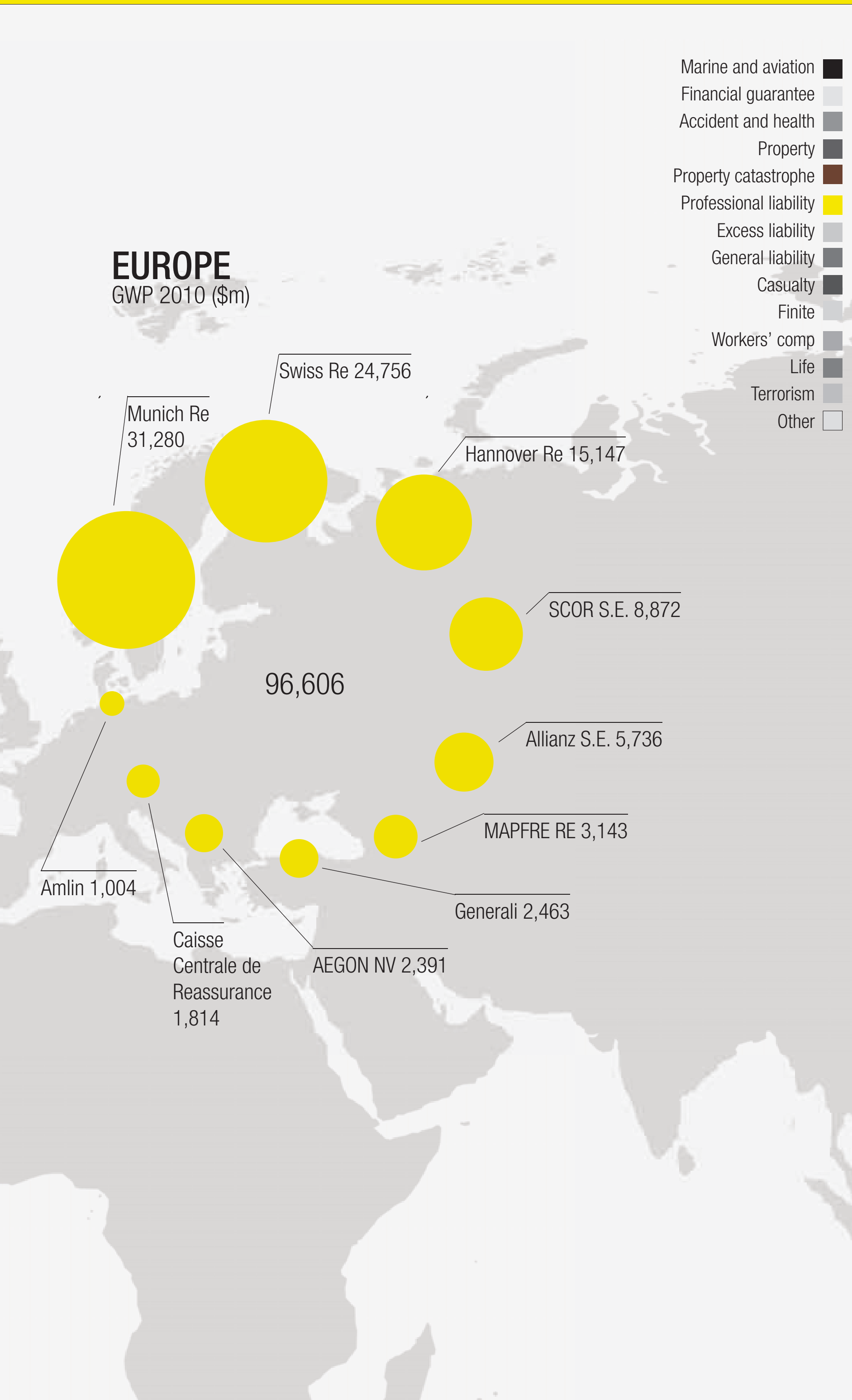


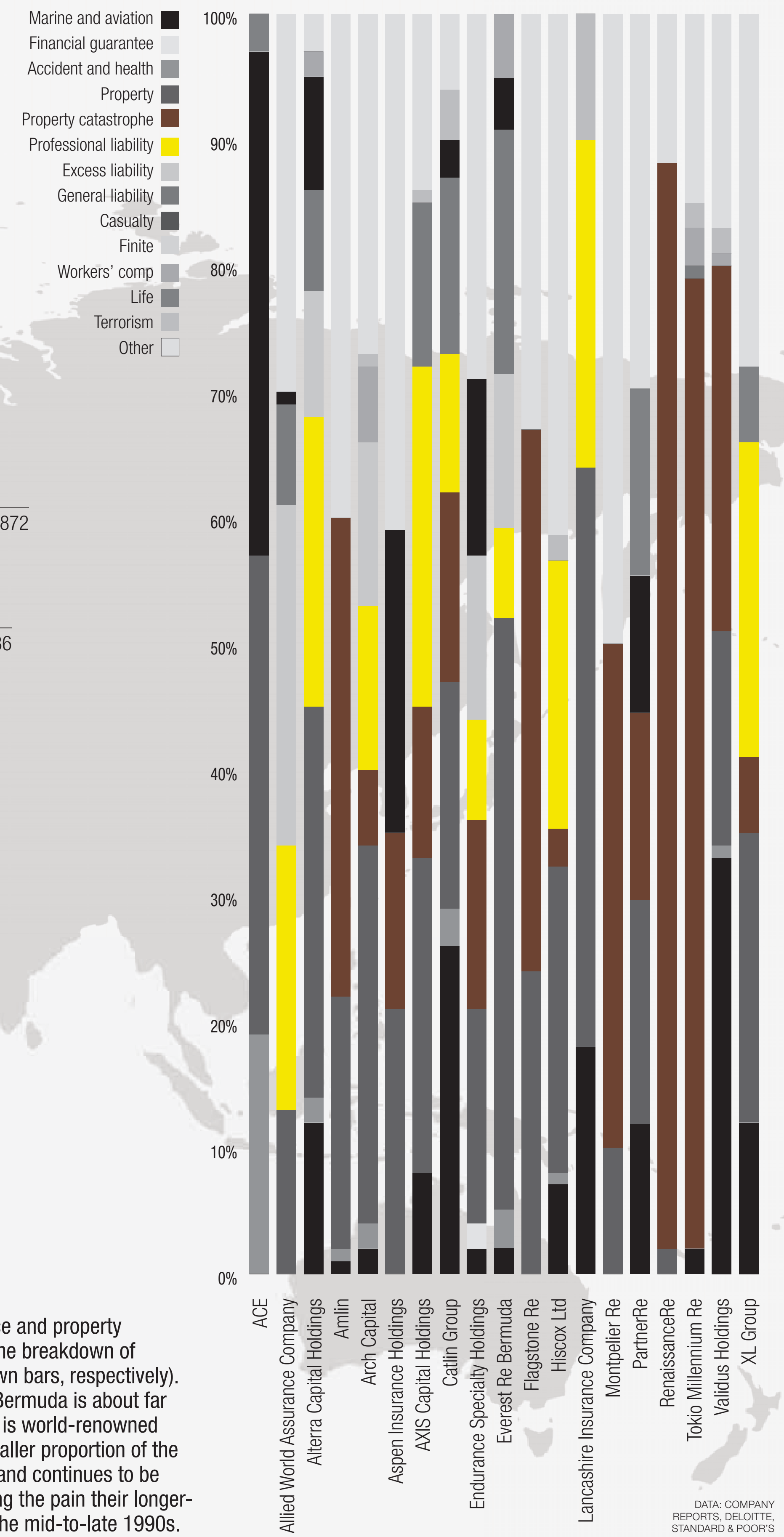
TOP 50 GLOBAL REINSURERS





DATA: AM BEST, COMPANY REPORTS





LINES OF BUSINESS

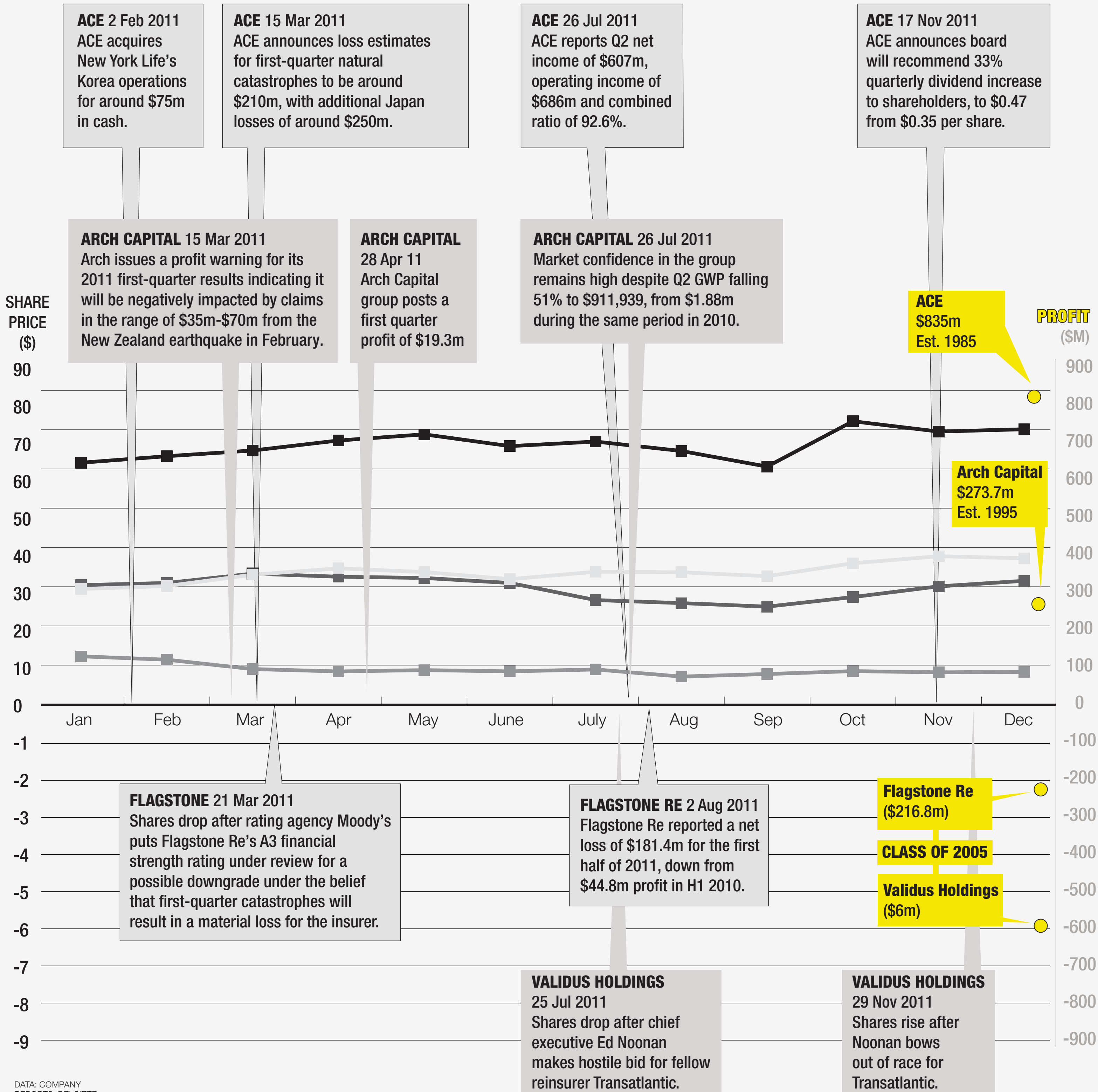
Bermuda's roots in professional liability insurance and property catastrophe reinsurance can clearly be seen in the breakdown of what companies are writing (the yellow and brown bars, respectively). However, it is also clear that, despite its image, Bermuda is about far more than these business lines. While the island is world-renowned for catastrophe reinsurance, this makes up a smaller proportion of the total than one might expect. Interestingly, the island continues to be underweight in general liability, possibly reflecting the pain their longer-established counterparts endured in this line in the mid-to-late 1990s.

DATA: COMPANY REPORTS, DELOITTE, STANDARD & POOR'S

MARKET MAP

BIG MOVERS

What happens when you take four Bermudian companies' share prices over the course of the worst year on record for natural catastrophes? Interesting pictures come to light, including two of the most profitable companies at third-quarter 2011 results, Arch Capital and ACE, are also two of the oldest companies on the island. Two members of the Class of 2005, Validus and Flagstone Re, may have had a bumpier ride, but they can learn lessons from their older rivals.



DATA: COMPANY REPORTS, DELOITTE

INSIDE / OUT

Surfing a wave of change

Lauren Gow talks to industry leaders to get their views on what the future holds for Bermuda

INSIDE VIEW

David Cash
Endurance chief executive

OUTSIDE VIEW

Stephen Ross
Deloitte insurance partner

SOLVENCY II

Inside view: Solvency II has been a long-running saga and moving target. What has impressed me over the past 12 months has been first, the level of engagement between Bermudian regulators and companies, and European regulators. There appears to be a strong dialogue and mutual respect. Secondly, if you look at the work Bermuda has done putting in place the regulatory framework, I think we are most of the way there. There are gaps to be filled but it appears to me that European regulators are prepared to work with us to see that done.

Outside view: You can't have a discussion about this market without discussing Solvency II equivalency. I think Bermuda has done a good job of being well positioned to be in the first wave of equivalence, along with Switzerland and Japan. That is particularly the case for Class 3 and 4 (the major reinsurers). When I speak to Bermuda reinsurers, it is very clear that they see equivalence as absolutely critical for Bermuda, hence the focus by the Bermuda Monetary Authority.

DOMICILES

Inside view: When I think about insurance and reinsurance in Bermuda, I don't see domiciles changing. It is hard for some of these domiciles to match Bermuda in terms of critical mass of professionals and companies. What we have clearly seen in Bermuda is that the government is prepared to make adjustments to the work permit regime to make the island more competitive. Longer term, the things that would change Bermuda's competitiveness is where (re) insurance is purchased. That is less about the market and more about where the buyers come from. If the Asia-Pacific area becomes a larger buyer, perhaps we'll see Bermudian companies put more resources into a market like Singapore to access those markets.

Outside view: Trends are developing around how businesses will be structured going forward. If you looked at Bermuda five or six years ago, it was the location of choice for your holding company and principal reinsurance carrier. But what we are seeing now is that it is much more fluid. Bermuda will remain a critical reinsurance centre; it will now depend on where individual businesses seek to base themselves. I think businesses are now looking at this on a much more regular basis than they have historically, because things are moving from a tax perspective and a regulatory perspective. Bermuda will remain a hub but it may not be a location dominated by holding companies like it has been.

M&A

Inside view: There will be more consolidation, although it does appear it will depend on the terms of the company that is being acquired. That is one of the lessons that has come out of the Transatlantic saga. I think there will be pressure on companies that are not diversified and don't have the ability to compete outside Bermuda through their own infrastructure; I think there will be pressure on companies like that to be consolidated. Additionally, you will start to see some of the Bermuda companies that have been around for a while, like Endurance, looking for small to mid-size acquisitions. I think companies will have this as one of their strategies for growth going forward. Mergers and acquisitions won't shrink, though it probably will not happen to the degree that people imagine unless we see real distress in Europe.

Outside view: If you look at both the Bermuda and the Lloyd's market, you can see that there is a clear correlation between size and valuation and it is very clear that bigger businesses generally are being valued higher than their smaller peers. With a few exceptions I think that size really does matter when it comes to scale of reinsurance businesses. It used to be the case that if you had $1bn in shareholders' funds, you were in the game. But now, we are seeing that number increasing up to $3bn. That is going to be an important driver and that is why I think there is going to be a lot of consolidation in the market, particularly around those smaller players.