GR Global market report

- The big picture: Painful year for the USA
- Timeline: Regulating to unify the industry
- Dodd-Franks: The good, bad and the ugly
- Market map: Making sense of the numbers
- Inside / out: A cocktail of challenges ahead

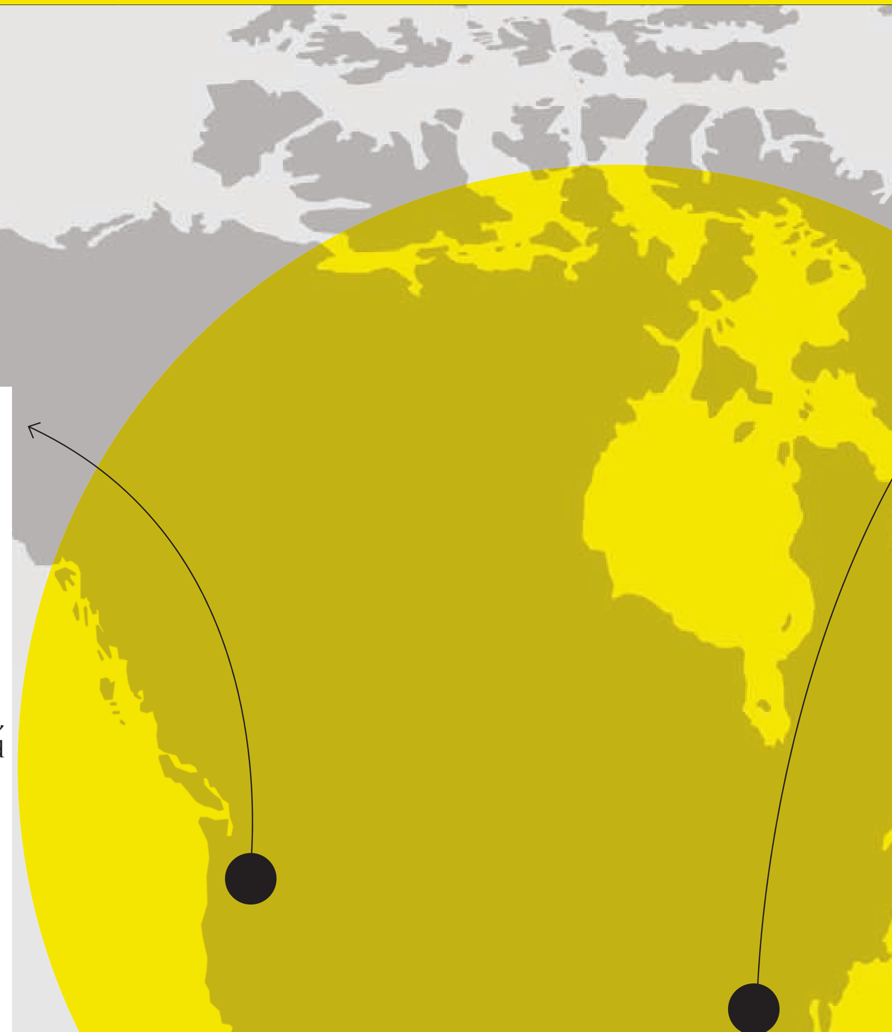
IN ASSOCIATION WITH

DEWEY & LEBOEUF

THE BIG PICTURE

America's reinsurance

Two issues worked against the US insurance market in 2011 and both leaving residual effects that have carried on into 2012. Forces of nature are always an expectation for insurers, but in combination with economic forces of man, the results have been painful



ACTS OF MAN

The debt difference

- US downgrade fallout not as bad as feared
- Exposure to eurozone debt has different effect

Last year, investors were forced to reconsider a stalwart assumption of modern finance after rating agency Standard & Poor's downgraded long-term US debt to AA+ on 6 August, the first time it had ever fallen below its coveted AAA status.

As Congress struggled to put in place a debt deal by the 2 August deadline, broking firm Towers Watson said US insurers had voiced concerns over their investment portfolios, short- and long-term interest rates and a decline in equity markets.

According to figures from the US Federal Reserve Board, the US national debt is more than $15 trillion, with insurance companies holding a $253.7bn stake in Treasury securities.

S&P said at the time of the 6 August downgrade that it "reflects our opinion that the fiscal consolidation plan that Congress and the administration recently agreed to falls short of what, in our view, would be necessary to stabilise the government's medium-term debt dynamics".

At the time of the downgrade, and amid widespread panic and confusion, an AM Best stress test of the capital position of all of the US-based property/casualty companies showed promising results.

AM Best group vice-president John Andre says: "There wasn't as big a downgrade you might expect. There was no one going from As to Bs. Just movements within the high A range."

But the nightmare of debt entanglement has continued into 2012, with S&P downgrading the ratings of nine eurozone countries in mid-January.

AM Best senior financial analyst Greg Reisner said US insurers' long-term portfolios will be affected differently by exposure to the two different debts.

"There are subtle differences as it regards US debt and European debt. Both European debt and US debt have their risks. The risk and merits can certainly be debated.

"However, with regards to the debt of European countries, given the current structure of the eurozone, individual countries on their own lack some flexibility as compared to the USA."

ACTS OF GOD

US catastrophe bill tops $44bn

- But harder market still some way off despite 2011's record losses
- US industry's combined operating ratio expected to fall 6.5 points

Market experts predict US property/casualty insurers face a 24-month wait for a traditional hard market to surface despite the industry's books suffering a severe underwriting blow in 2011 as a result of natural catastrophes.

Many had hoped for a hardening of the market as the US market picked up about $44.1bn of the $105bn total global natural catastrophe bill for 2011, says rating agency AM Best.

Most of 2011's record-breaking insured losses bill was for events that occurred beyond US shores, while the US market has shelled out more than twice the 2010 bill of $19.6bn.

On the home front, the industry faced a record-breaking tornado season, wind storms, winter storms, wild fires in the southwest and Hurricane Irene. Most domestic losses were as a result of tornadoes that hit the midwest and southwest in April and May.

According to data by AM Best, the industry's combined operating ratio is expected to deteriorate 6.5 points to 107.5% in 2011 from 101% in 2010.

This poor result is driven by unstable and weak macroeconomic conditions coupled with high catastrophe-related losses, elevated losses in certain non-catastrophe exposed lines and fewer reserve releases from prior years.

Combined operating ratio in 2011 (%)

US national debt clock

TIMELINE

Unifying the industry

Individual states' long-established rights to regulate the insurance industry could be about to change. Lauren Gow reports

Insurance in the USA has always been an amalgamation of rules and precedent that has remained just on the right side of effective. In principle, there is good reason for each state to govern its own insurance practices, with each state having a vested interest in what is best for its citizens.

But policyholders in catastrophe-ridden states such as Florida argue that they pay above the odds in comparison to neighbouring states because of this fragmented approach.

The National Association for Insurance Commissioners (NAIC), a voluntary association of state insurance commissioners, made headway in solving this issue in November with the adoption of revisions to the Credit for Reinsurance Model Law and Regulation.

"The real key for supervisors is to stay on top of change and understand how risks are emerging in the companies they supervise. The NAIC's view is: don't get a false sense of confidence because you've got some rules and therefore you have solved the problem. Rules only go so far. Systems have to be built and supervisors have to work together and really share information," NAIC chief executive Therese Vaughan says.

These changes, as well as those stemming from the impending Dodd-Frank Wall Street Reform and Consumer Protection Act, will unify all US state insurance commissioners and streamline the industry.

But the biggest unifier of the market came in the form of the single biggest terrorist attack on US soil, the September 11 attacks. The attacks singlehandedly changed the course of insurance in the USA and abroad.

What the industry has faced since the attacks has not only forced issues such as terrorism risk to the surface, but has also made an example of the issue of contract certainty in insurance.

THE STORY

Florida
Large-scale hurricanes change the market forever

● In 2004 and 2005, Hurricanes Charley, Frances, Ivan, Jeanne, Katrina, Rita and Wilma made a direct hit on US shores, resulting in more than $132bn total damages (indexed to 2010).

WHAT HAPPENED

2005-06
Property insurers raised statewide average rates, causing some policyholders' premiums to double or triple; outgoing governor Jeb Bush and governor-elect Charlie Crist held a special meeting to discuss rate hikes.

Terrorism
September 11 and contract certainty

● Four co-ordinated suicide attacks using hijacked planes targeted New York City and Washington, DC. Nearly 3,000 people died in the attacks, which were attributed to Middle East terrorist cell al-Qaeda headed by Osama Bin Laden.

2001
Property developer Larry Silverstein sought to claim $7.1bn, double the face value of World Trade Center buildings 1, 2, 4 and 5 by arguing separate plane strikes on two separate buildings constituted two occurrences within the policy definition.

Red tape
State versus federal control and the NAIC

● The US insurance market has traditionally been governed on a state level, which in reality means each insurer must obtain a permit to write cover in each state, slowing down regulation changes and causing unnecessary work.

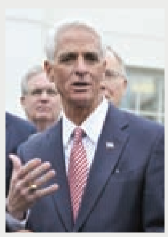
1752
The first American insurer created – Philadelphia Contributionship for the Insurance of Houses from Loss by Fire with the assistance of Benjamin Franklin. Franklin also established the first life insurer.

DATA: INSURANCE INFORMATION INSTITUTE, (1) ADJUSTED TO 2010 DOLLARS BY THE INSURANCE INFORMATION INSTITUTE USING THE US DEPARTMENT OF LABOR BLS CALCULATOR

2007
A law was passed to expand a state programme selling catastrophe back-up coverage to insurers, allowing them to pass savings to consumers.

2008
Florida's lawmakers froze Citizens Property Insurance Corporation's rates until 2010, while extending provisions allowing regulators to block insurance rate hikes.

2009
Governor Charlie Crist signed into law a bill allowing Citizens Property Insurance Corporation to raise premiums by up to 10%. The law also made it easier for insurers to hike rates as much as 10% to meet rising reinsurance costs. Crist also vetoed a bill that would deregulate property insurance rates.

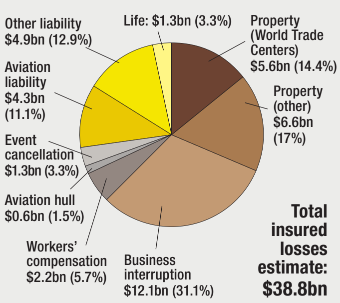


2011
Florida governor Rick Scott signed into law SB 408, which was deeply unpopular with policyholders but a small victory for the insurance industry. The bill allowed insurers to pass reinsurance costs onto policyholders and limited the window and scope for sinkhole claims.

WHAT'S NEXT

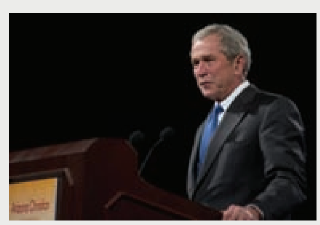
- **The tug-of-war** between Florida lawmakers, US-based insurers and reinsurers, foreign insurers and reinsurers and policyholders will continue.
- **Ironically, all parties** are actually looking for the same answer, which is a fair price for insurance that covers the cost of any claims. But the definition of 'fair' differs widely.

2002
Congress enacted the TRIA (Terrorism Risk Insurance Act) and the Insurance Information Institute released loss distribution information for September 11 attacks.



2004
A jury found in favour of 10 insurers that will be subject to a 'one occurrence' definition, meaning their liability was limited to the face value of the towers. A second case found nine insurers were subject to a 'two occurrence' definition and therefore liable for a maximum of double the face value or $2.2bn.

2007
President Bush extended TRIA requiring the Treasury to establish a process for the allocation of pro-rata payments if terrorism-related insured losses exceed the government's annual $100bn cap.



- **Despite the huge loss,** the September 11 attacks led to a positive change in the international insurance market in the form of contract certainty. The lack of contract certainty at the time of the acts, and in the decade since, has drawn together the UK and US markets to seek resolutions.
- **Further improvements** could be made with technical innovations, like e-trading, to speed up processes.

1871
NAIC formed after the US Supreme Court decision in *Paul v Virginia* [1868], which established state supremacy over the insurance industry. It ruled that insurance policy contracts were not in commercial contracts and that insurance was not subject to federal regulation. This established state-based regulation.

1995
NAIC officially declared itself a 'private trade organisation' – US district judge Peter Leisure stated that the NAIC was not a government body but "a private trade association composed of government regulators from different states".

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

- **The NAIC has taken the first real steps** towards unified state regulation but the Dodd-Frank Act will force insurance regulation into the federal scope.
- **Rapid changes will be difficult to swallow,** but hopefully a big picture focus will outweigh any localised politics.

HORIZON

Dodd-Frank: it's the new sheriff in town

Set to become law this spring, the Dodd-Frank Act is the US government's response to the 2008 financial meltdown. But as Lauren Gow reports, it contains much for insurers to be concerned about

The Dodd-Frank Wall Street Reform and Consumer Protection Act, a new fiscal responsibility regime, is expected to unsettle US financial institutions this year.

The Act is a direct result of the 2008 financial meltdown and will incorporate all US financial institutions including insurers and reinsurers. Many in the industry question the relevance of a regime that puts banks and insurers under the same risk banner, but Federal regulators are adamant that the regime will be fair for the insurance industry.

Part of the new regime is the formation of a committee of regulators, the Financial Stability Oversight Council (FSOC), on which insurers hold three seats. "Although there is no federal insurance regulator, insurance is represented because it is quite clear that insurance is within the definition of 'financial institution', so it can be studied by this council for potential systemic risk," Dewey & LeBoeuf partner Charles Landgraf says.

One non-voting seat will be held by a chosen representative of the National Association for Insurance Commissioners (NAIC), currently Missouri Insurance Department director John Huff. A second non-voting seat will be held by the Mike McRaith, director of the new Federal Insurance Office (FIO), which has been created within the Treasury by Dodd-Frank. A third voting seat is to be held by an insurance expert appointed by US president Obama and is currently held by Ray Woodall.

The FSOC's final rules are expected to be delivered in the spring.

FIVE STEPS TO DODD-FRANK'S IMPLEMENTATION

1 June 2009:
The new law on fiscal responsibility was initially proposed by the Obama administration, with the White House sending a series of proposed bills to Congress. Obama calls it a "sweeping overhaul of the US financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression".

2 July 2009:
A version of the legislation was introduced in the House in July 2009.

3 December 2009:
The Act received its name as revised versions were introduced in the House of Representatives by Barney Frank, and in the Senate Banking Committee by chairman Chris Dodd.

4 July 2010:
President Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act.

5 Spring 2012:
Proposed implementation date for Dodd-Frank Act.

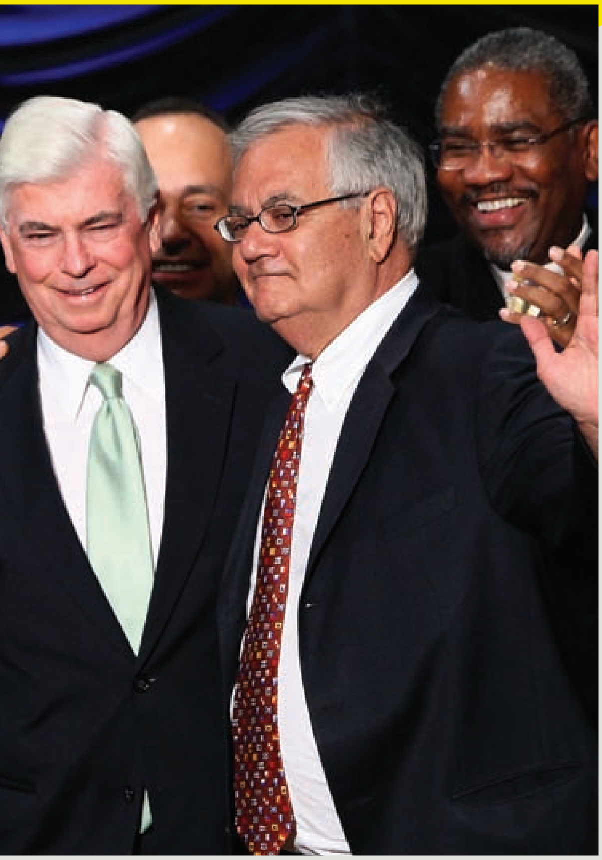
WILD WEST OF REGULATION

THE GOOD: FIO remedies the lack of expertise

The Federal Insurance Office (FIO) has been created to remedy the lack of insurance expertise at federal level. The scope of the FIO's oversight extends to all lines of insurance except health insurance, long-term care insurance and federal crop insurance.

Under the present interpretation of the legislation, the FIO has a largely free scope in determining the subject matter of its prepared annual reports to Congress. But there are two compulsory reports whose results should prove to be a useful, reflective insight of the US market.

The first is due within 18 months of the enactment of the legislation and deals with the modernisation of US insurance regulation, while the second



is a comprehensive look at the US and global reinsurance market.

The FIO may require insurers to submit data, with the director empowered to issue subpoenas to gain such information. But the legislation requires the FIO to obtain data from federal and state regulatory agencies or publicly available sources, if possible, before requiring insurers to submit such data. There is also an exemption for small insurers.

The FIO's first report, which was due at the end of January, is to review the uniformity (or lack of) in insurance regulation in the USA.

WE SAY: The need for insurance expertise and representation at a federal level is long overdue. The formation of the FIO is a positive step.

THE BAD: Life insurers to be branded a risk

FSOC is ultimately responsible for deciding which financial institutions need heightened supervision by the Federal Reserve Board, as a result of potentially posing a systemic risk to the US economy.

Insurers will fall under the 'non-bank financial company' heading, under which they will be subject to a size test of whether they hold more than $50bn or more in assets in the USA, as well as being assessed on debt levels and how interconnected they are to other financial institutions.

These rules have yet to be finalised but give a clear indication that US insurers, particular life insurers, could be designated a systemic risk.

Dewey & LeBoeuf's Landgraf says: "It is possible that a non-life insurer could be designated but just looking at the way the rule-making is developing, it is more likely to be life insurers. However, very few will be designated and it will be the first time that many of them had anything to do with the Federal Reserve Board. This means the board will be their macro prudential overseer and require information above and beyond what their prudential supervisor does."

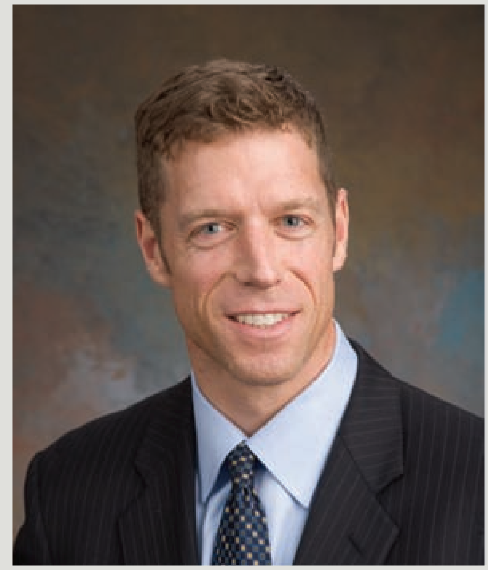
Once an insurer has been declared a systemic risk by FSOC, it is referred to macro supervision by the board, which may impose new, additional capital requirements and conditions on top of its existing prudential supervisor's requirements.

There is also a second wave of concern at holding company level for those insurers facing designation as a systemic risk in the form of a creation of the 'Resolution Plan' for the Federal Deposit Insurance Corporation in case of insolvency.

"The uncomfortable fact is that one of the big headline stories during the financial crisis was American International Group [AIG]. It was very deeply involved in the crisis through credit default swaps, which aren't a traditional insurance product written by a traditional insurance company," Landgraf says.

"Because of this disaster, it has been very difficult, if not impossible, to argue politically that there is a reason for the insurance sector to be excluded from this new systemic risk supervision mechanism that was being set up."

WE SAY: The Resolution Plan, or 'living will' as it was dubbed during the legislative debate, will be an enormous burden on insurers. Though the idea for a plan dealing with insolvency is undoubtedly useful, the resolution will need to be updated each time there is a change in the structure or condition of the insurer.



FIO director MIke McRaith will hold one of three insurance seats on the Financial Stability Oversight Council

THE UGLY: Federal powers to override state

Under Title V of the Dodd-Frank Act, the Treasury and the US Trade Representative have a new advance authority to negotiate international agreements on insurance prudential matters. That agreement effectively becomes law, without a need to go back to Congress for approval or be ratified like a normal treaty.

Also, the director of FIO will have the power to review any state supervisory measure thought to be inconsistent with any commitment made within such an agreement. The director is then allowed to issue an order pre-empting the state order if certain conditions are met.

One of those conditions is that the state regulation must not treat a non-US insurer or reinsurer less favourably than a US insurer or reinsurer.

This move is popular with foreign insurers and reinsurers who have objected strongly to the collateral obligations forced upon them by state regulators, rules that did not apply to US insurers and reinsurers.

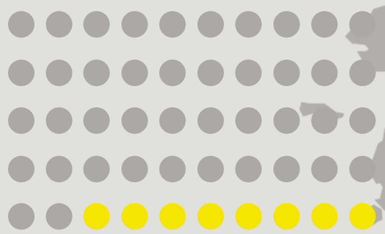
WE SAY: Congress may have put restrictions on the advance authority within Title V, but insurers are right to be extremely concerned. State regulators will have the opportunity to participate in a 'consultation' and provide input, but not have any veto powers. State regulators also face the real possibility of having their own regulations trumped by the FIO in order to keep international agreements on track.

MARKET MAP

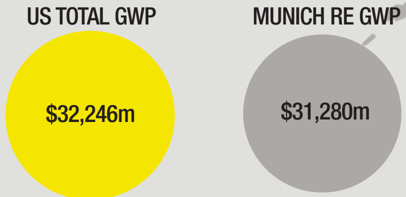
KEY STATS

TOP 50 GLOBAL REINSURERS

The top 50 global reinsurers, listed annually by rating agency AM Best. As the statistics show, US reinsurers take nine top places but their total GWP only just surpasses the market's biggest player, Munich Re.



= US reinsurers



LIFE INSURANCE

EMERGING MARKETS GREW ANNUALLY BY **12.6%**

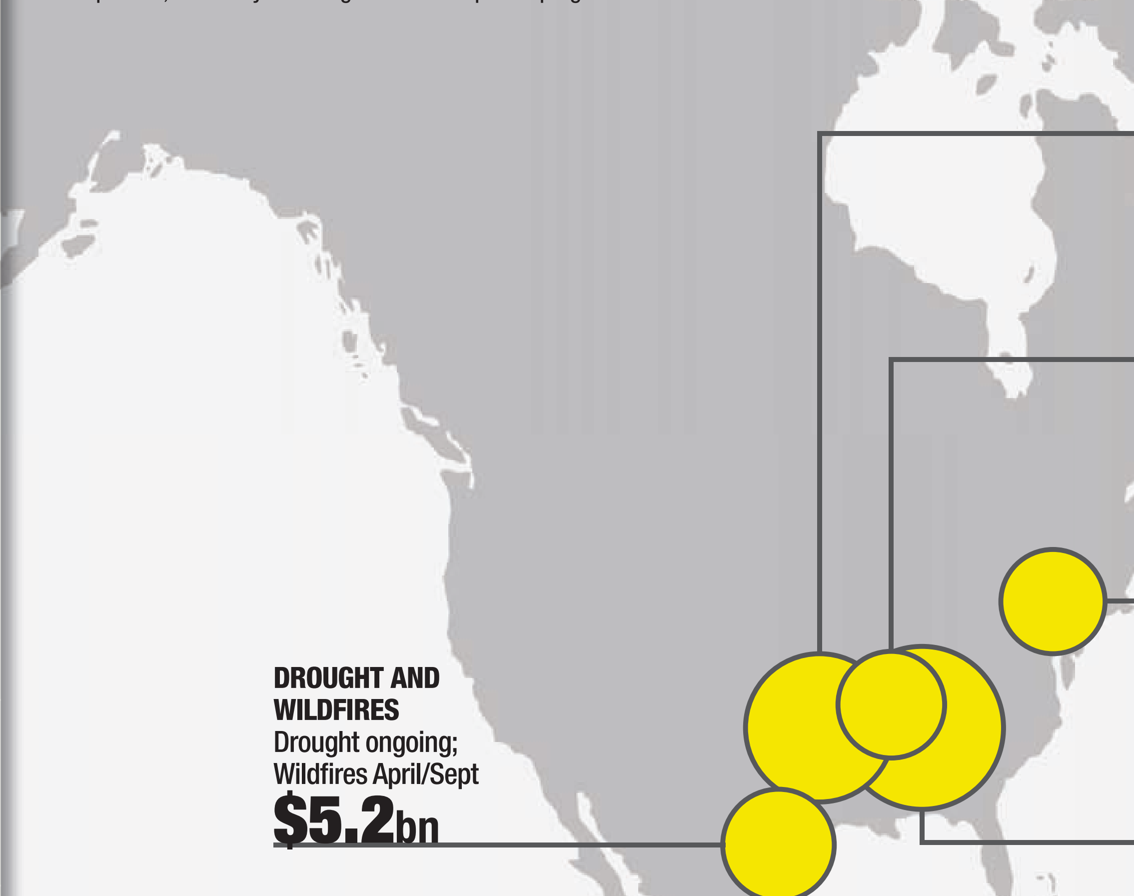
INDUSTRIALISED COUNTRIES ONLY GREW **0.6%**

Projected life premium rankings

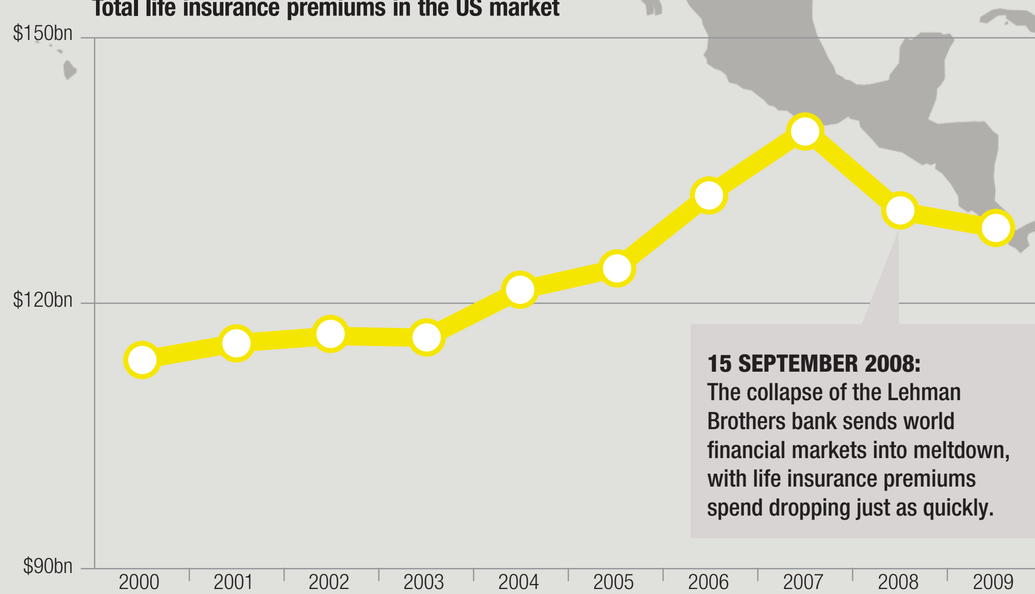
Country	2011	2021 est	
USA	1	1	➤
China	5	2	▲
Japan	2	3	▼
France	3	4	▼
United Kingdom	4	5	▼
India	8	6	▲
Italy	6	7	▼
Germany	7	8	▼
Taiwan	10	9	▲
South Korea	9	10	▼
Canada	11	11	➤
Brazil	17	12	▲
Australia	13	13	➤
South Africa	12	14	▼
Luxembourg	14	15	▼
Belgium	19	16	▲
Sweden	15	17	▼
Spain	16	18	▼
Switzerland	18	19	▼
Hong Kong	21	20	▲

PROPERTY/CASUALTY

2011 was a catastrophe-fraught year for US property/casualty insurers, with 37% of the total $105bn natural catastrophe bill accounted for on US shores. According to data from the National Association of Insurance Commissioners, the top 10 US property/casualty insurers suffered various levels of economic blows according to their diversity to catastrophe-exposed lines. Nine of the top 10 are likely to have suffered pronounced exposure, with only the Progressive Group escaping unscathed.



Total life insurance premiums in the US market

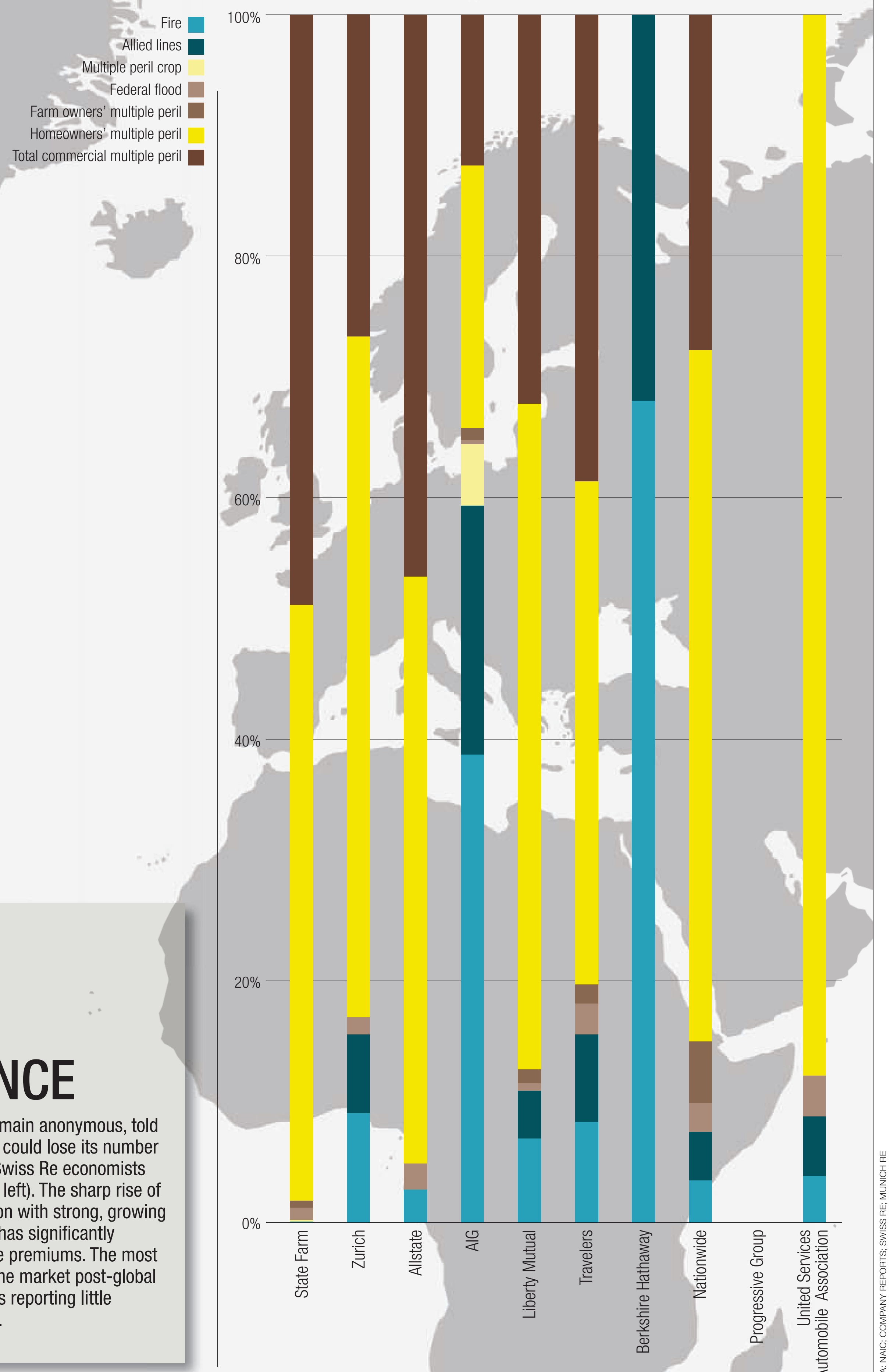


SEVERE STORMS, TORNADOES
20-27 May
$6.7bn

FLOODS
April-May
$5bn

HURRICANE IRENE
22 Aug-2 Sept
$4.9bn

SEVERE STORMS, TORNADOES
22-28 April
$7.3bn



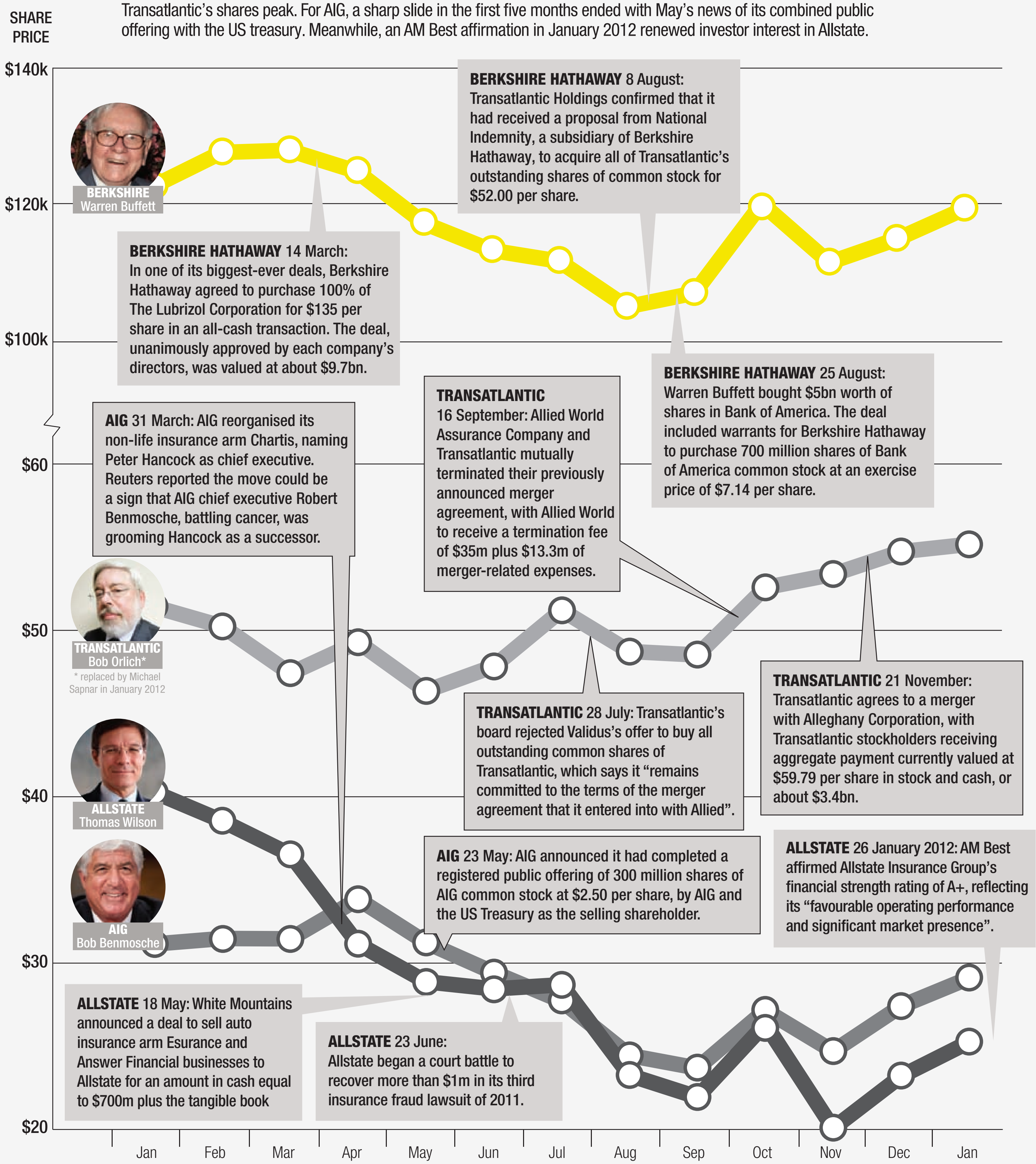
LIFE INSURANCE

US market insiders, who wished to remain anonymous, told *Global Reinsurance* they fear the USA could lose its number one spot in the next decade, though Swiss Re economists have argued differently (see table, far left). The sharp rise of life insurance premiums, in conjunction with strong, growing economies in the emerging markets, has significantly dwarfed the sluggish growth in US life premiums. The most notable fall in premiums was felt by the market post-global financial crisis, with many life insurers reporting little improvement in the intervening years.

MARKET MAP

BIG MOVERS

Four of the USA's biggest listed insurers battled fluctuating share prices in 2011. The Transatlantic saga saw Berkshire Hathaway's price hit a year low after its failed $52 per share offer in August, while the merger deal with Alleghany saw Transatlantic's shares peak. For AIG, a sharp slide in the first five months ended with May's news of its combined public offering with the US treasury. Meanwhile, an AM Best affirmation in January 2012 renewed investor interest in Allstate.



INSIDE / OUT

A potent cocktail of challenges

Lauren Gow talks to industry leaders to get their views on the latest market developments

INSIDE VIEW

Seraina Maag
XL chief executive, North America property and casualty

OUTSIDE VIEW

Sean McGovern
Lloyd's general counsel and North America director

ECONOMIC INSTABILITY

Inside view: The impact of the global economy and the political environment (they are so intertwined these days) on the industry in general is pretty significant. You just have to look at the impact that fiscal policies are having on the interest rate environment, which in turn has a significant impact on our business.

Then we have the impact of the European sovereign debt crisis and the slowdown in Asia, both of which have an impact on the US economy and US insurers. At XL, we are more optimistic about our growth prospects because of what we've done over the past 12-18 months. We've made significant investment in our business, including adding new lines of business like surety.

Outside view: The current economic instability has meant that insurers and reinsurers, wherever they are in the world, are worrying as much about the asset side of the balance sheet as they are about the liability exposure side.

We have had a period of significantly low interest rates for four years and continued financial market volatility, particularly in the eurozone. That's creating an environment where insurers need to be focused on preserving their capital position. It's certainly creating some headwinds in terms of being able to preserve that capital.

CATASTROPHES

Inside view: Catastrophes had a big impact in 2011. It was the fifth-largest year on record. Personal lines was hit much more than commercial lines, but what we have started seeing is that it is beginning to help the market in terms of rates.

We are clearly in a transition. From what we have observed and what you hear consistently throughout the market, even from our competitors, is that property-related rates have gone up, in particular where you are insuring properties in a catastrophe-prone location or that have had prior losses. It has definitely helped the market transition into a more rate-hardening environment.

Outside view: Clearly the economic environment has had a depressing effect on the side of demand and put an inflationary effect on claims. When you combine that with the catastrophe losses of 2011, you have a pretty potent cocktail of challenges for the global industry and I'd include the USA in that.

Last year is expected to be a record cat year for the industry, with losses of over \$100bn, including major events in the USA costing \$20bn, and yet there is talk only of improving rates, not hardening rates. The industry is well capitalised but that, in a sense, is the problem – there is too much capital.

LLOYD'S-STYLE MARKET IN NEW YORK

Inside view: My personal view is that a Lloyd's-style market would be really hard to do, as we have a really well-entrenched marketplace. They have been trying to do it for years, so I think that if people really want that, they would have been able to do it by now.

Also, with the excess and surplus lines market and the way it operates over here, we have an avenue for placing these tough risks through the wholesale market. I don't really see a need for it and there doesn't seem to be a desire in the marketplace for change.

Outside view: While it has been talked about a lot, we don't see much in the way of [Lloyd's-style marketplace] activity, and my sense is there isn't really any demand for it from the industry. If there was, it would have happened by now – it would have happened a long time ago.

There was a lot of talk about it being a competitor to Lloyd's, and it clearly would be if it was established, but our position is that Lloyd's isn't afraid of competition. We've been watching for developments, we haven't seen any and I am not expecting any in the near future.