

Current Downstream Market Conditions

The price rises that we have seen from January 1st renewals onwards, in general have not been as severe as originally anticipated. On average we have seen increases on the expiring rates of approximately 5% to 12.5%. Although prices are rising by these amounts at the moment, the extreme “knee jerk” reaction that was threatened by leading reinsurers and forecast by industry commentators has yet to materialise. We say “yet to materialise” because there many contributing factors that we highlight and discuss later in this document, that could still bring about significant changes.

It is not just rates that have been effected on the most recent renewals but also the conditions and underwriting merits of each individual account.

A factor of the economic crisis is that treaty reinsurance costs have increased across the board since 1st January 2009 as the companies providing such reinsurance seek to recoup falling investment income. With investment income severely reduced but still representing a major part of a reinsurers balance sheet they are faced with increasing prices on the traditional insurance coverage they provide to replace the lost income.

The implication of this is that those companies providing facultative reinsurance cannot afford to purchase as much treaty reinsurance as before, or it may not be as readily available, and therefore they must increase their focus on underwriting on a greater profit related basis. Without being able to rely as much as they did previously on a large treaty reinsurance protection, facultative reinsurers need to generate sufficient premium income to cover them for the handful of major losses they can expect in an underwriting year.



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Therefore facultative reinsurers will now have less of an appetite for the less attractive accounts and on the accounts they do write, will be looking for maximum premium income.

Although we are yet to see a wholesale approach to increasing deductibles and Insured's retentions it is an area that underwriters are analysing and checking as exposure to attritional losses has to be minimised and avoided.

Current Upstream Market Conditions

Upstream accounts at the moment are experiencing increases ranging from 7.5% to 20% depending upon the historic claims record of the particular Insured. Whilst there are always exceptions to the rule, the average increase is in the region of 10% to 12.5% on upstream business. Again the increases are not as severe as first predicted but as mentioned above there are numerous factors that could yet change this.

In order to minimise premium increases, certain Insureds are examining other aspects of their insurance programmes that can be sacrificed e.g. increasing deductibles. These options have always been available but the increases in rates in 2009 have made these more prominent in Insureds' thought process.

Upstream rates are also influenced by what happens in the Gulf of Mexico during the forthcoming windstorm season. At the moment those renewals on the east coast of the US and

around the Gulf are seeing increases of between 10% and 25% as well as capacity being tightened. Several programmes with renewal dates later in the year are bringing their negotiations forward to ensure there is no shortage of capacity. With state fund capacity such as Florida reducing from last year there could be more of a call for catastrophe cover from the private insurance market.

Underwriters have changed and are continuing to change the way they rate a stand alone OEE programme in that rates will reflect a greater emphasis on well Authorizations for Expenditure and other characteristics rather than focusing on the depth of the well. With re-drilling costs varying widely, rating by well depth is no longer an accurate reflection of the risk.

In the same way as downstream energy underwriters, those writing upstream risks are concentrating on maximising profit for the capacity they have and therefore the less attractive accounts whether it be less attractive because of premium generation or because of poor risks management etc will be the ones to suffer the most.



Anticipated Rates for the Remainder of the year

The big question is whether the current price hikes we are seeing from underwriters will be sufficient to compensate for the investment losses they have experienced so far or may experience in the near future. If the current rate increases are not sufficient to achieve this then further increases could be seen. Although this particular financial crisis is seen as a one off occurrence, unfortunately it is not an occurrence that is easily fixed or recovered from in a speedy manner. The time it takes for economies to recover and for the additional streams of income to filter back to an underwriters balance sheet will dictate the length of time underwriters look for rate increases.

2008 was a bad year for energy underwriters with the volume and severity of losses they paid, if a similar year occurs especially in respect of global natural catastrophes then rates in the latter part of the year will reflect this. A benign year for natural catastrophe losses will allow rates to stabilize.

Security Ratings

According to Standard & Poors, "at present it is unlikely to take widespread ratings actions, but if the disruption in the financial markets continues though 2009, that is going to put significant stress on reinsurers' balance sheets"

"If further price increases over the course of the year fail to materialise and there are additional hits to the balance sheet - this could raise doubts about the industry's ability to rebuild excess capital to the extent necessary to compensate for its recent loss of financial flexibility" In such a situation Standard and Poors may change its outlook to negative.

As the 2009 year pans out and further underwriters release their annual results, the extent of their exposure to the financial crisis will become clearer and may well result in individual underwriters experiencing a downgrade. The situation is something that all ratings agencies are constantly monitoring and reviewing.

It is not just the rating agencies doing this but brokers themselves such as UIB, are constantly monitoring the situation as we need to ensure that the markets we use when placing our business are as solid and solvent as they ought to be. If certain re/insurers do not meet our own internal criteria then we are not authorised to use such security without express instructions for the Re /Insured with whom we are working.

Capacity

At the moment the capacity in the energy market both upstream and downstream is more than sufficient and there have been no significant changes than previously reported. There will be some restrictions mainly in areas such as natural catastrophe, but the difference now compared to say a few months ago is the way that underwriters use their capacity.

With underwriters needing to maximise profit on every line they write we have seen them walk away from renewals if the terms and conditions do not meet their specific criteria. The times where lines may have been written as a favour to brokers or to

maintain a relationship have gone. Although this practice was far from widespread, it is now increasingly difficult for brokers to complete placements.

In the past few years most accounts could be placed in the London and European market, but nowadays Brokers must rely on the network of international offices and resources they have at their disposal to complete placements at the most competitive terms. At UIB we now utilise A rated security from around the world via our network of offices that we may not have used in previous years.

New markets have emerged particularly in the Middle East as local reinsurers there expand their portfolios to include business worldwide and also more and more branch offices of major European and Bermudan reinsurers set up there. Some areas such as Caribbean windstorm might be excluded from the treaties of the new participants but for business elsewhere in the world the new markets are a welcomed alternative to the London and European markets. These new participants have probably helped in keeping the average increase in rates in single figures rather than the double figures that were predicted.

A big challenge for underwriters going forward is maintaining their current capacity. Rating agencies appreciate that raising additional capital is very difficult at the moment so they are not putting pressure on underwriters to do so at the moment but recommending underwriters keep themselves "financially flexible".

Standard and Poors believe that an insured loss of more than USD 35bn in the current economic climate could spark a desperate scramble for capital among reinsurers. Many companies would have to seek restorative capital but the problem would be where do they find such investors in the current climate.

Right issues would not be as effective as they were in the past, because of the lack of suitable investors, but may be the first option. With the reduced availability and increased cost of reinsurance, those that can raise capital will prosper but those that can't will have to scale back their portfolios.

If insurable losses are sustained during this coming year it is possible that because of the difficulty in finding replacing capacity, market capacity as a whole could reduce in the coming years.

A major factor now affecting capacity in certain areas of the world is currency exchange rates. As

an example the Japanese April renewals were affected by the strength of the Yen against the Dollar and especially the British Pound. The Pound has fallen 30 percent in value against the Yen since last year which has tightened capacity which subsequently contributed to average increases of 5% to 10% for those accounts with natural catastrophe cover. Therefore current exchange rates can have an additional effect on renewal rates on top of the contributing factors we have already discussed.



Underwriting Results

We have already seen some underwriters release their results for 2008 and await to see how results and exposure to the financial crisis develop in the coming weeks. An example of some of the recent results were Hannover Re who announced that investment income for 2008 was EUR 278.5m compared to EUR 1.12bn in the previous year. CEO Wilhelm Zeller commented "the fact that 2008 was a lost year for our company can be attributed entirely to the problems on the investment side"

Swiss Re saw their return on equity dive to -3.4% in 2008 against 13.5% in 2007, which resulted in a downgrade from AA- to A+ and saw Warren Buffett increase his stake to 20% for a GBP 1.8bn capital injection.

Not all underwriters experienced bad news with SCOR actually fairing relatively well. SCOR improved their liquidity mainly due to focusing their investments on government securities and short-term investments. It was not all good news as high catastrophe claims dented the net profit.

The challenge for underwriters now is that they have to contend with more complex investment issues than they did previously. The success of these investments will impact the rates we see in the energy market and the capacity available.

Apart from a few notable exceptions the insurance and reinsurance industry has survived the challenge so far but if further assets and investment losses are incurred more pressure will be applied to rate increases on the traditional insurance programmes. Average increases of 5% to 12.5% would soon increase.

Now is the time for Brokers to show their worth and ensure their clients receive the best terms and conditions available. Relationships will be tested but a strong partnership between the Insured and the correct broker will prove to be a valuable asset.

Summary

- Rates on average increasing but not as much as originally anticipated.
- Lines being written to maximise income.
- Underwriters are not afraid to lose business if their underwriting criteria is not met.
- Terms and Conditions looking to be tightened especially self insured retention / deductibles.
- Current rate increases are thought to be sufficient to help replace lost investment income.
- If the market can experience a benign natural catastrophe year with regards to insured losses rates should stabilise for the latter part of the year.
- Underwriters are confident of being able to maintain a healthy balance sheet, via more disciplined investment thus avoiding any security downgrading.
- The new appetite for worldwide business especially from the Middle East underwriters is helping to stabilise rates.
- Fluctuations in exchange rates have affected the capacity offered especially with regards to natural catastrophe cover in some parts of the world.
- We wait to see if the more disciplined investment and current rating will produce the necessary financial results for underwriters and avoid more aggressive price hikes.



United Insurance Brokers Ltd
69 Mansell Street
London
E1 8AN

Tel: +44 (0) 20 7488 0551
Fax: +44 (0) 20 7480 5182

www.uibgroup.com