

Willis Re 1st View

July 1, 2017

The Capital Conundrum



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1st View

This thrice yearly publication delivers the very first view on current market conditions at the key reinsurance renewal seasons: January 1, April 1 and July 1. In addition to real-time eVENT Responses, our clients receive our daily news brief, *The Willis ReView*, periodic newsletters, white papers and other reports.

Willis Re

Willis Re combines global expertise with on-the-ground presence and local understanding. Our integrated teams reveal hidden value in the critical intersections between risk, assets and ideas.

As the reinsurance advisory business of Willis Towers Watson, Willis Re can access and negotiate with worldwide markets and boost your business performance by facilitating better reinsurance decisions. Together, we unlock value.

Foreword: The Capital Conundrum

Mid-year renewals have continued with the same downward pricing trends seen at the 1 January and 1 April renewals, despite first quarter deterioration in many reinsurers' results. For the most part, excess capacity chasing modest demand has allowed buyers to achieve both further reinsurance cost savings, albeit at a reduced level to last year, and enhanced coverage.

The continued softening has been driven by the realization that, for the global reinsurance industry, the June and July renewal seasons are the last realistic chance for underwriters to meet their 2017 premium targets. This was clearly seen in the Florida renewals where, in the face of flat demand, a larger than anticipated influx of capacity, particularly from Insurance Linked Securities (ILS) markets, led to not only a further drop in pricing from the 2016 renewals but at a greater pace, albeit slight, than the reductions seen on U.S. property catastrophe programs earlier this year.

For international markets, rate reductions across most lines followed the ameliorating trend seen in January and April renewals with a strong demand from ILS investors where ILS markets' pricing is now matching or, in a few selected cases, more competitive than traditional reinsurers.

Underlying loss and expense ratios for many reinsurers are showing worrying trends, with combined ratios for many classes now looking unattractive.

In the face of stubbornly soft pricing, cost control measures are being applied widely and more aggressively across the entire global reinsurance chain, as managers of reinsurance companies seek to mitigate the effect through cost reduction. Market initiatives to contain and reduce costs such as the London market Placing Platform Limited (PPL) initiative are seeing increased impetus and support as the critical importance of the promise of greater efficiency is recognized.

Deterioration in first quarter 2017 results, along with continued high share price valuations, have deterred some reinsurers from instigating share buy backs, though dividends remain strong. Some market commentators are speculating that, taken together with the current rating environment, this reduction in share repurchases is a prelude to an increased level of merger and acquisition

(M&A) to support growth that is so challenging to achieve on an organic basis. While it is undoubtedly correct that scale gives organizations both the ability to be relevant to clients and the scope to more actively reduce cost, the challenge of execution remains. With only a limited number of opportunities and significant operating and performance issues emerging in some of the oft touted M&A candidates, undertaking new M&A is arguably more challenging than it has been for many years.

The recent WannaCry cyber attack has shone a bright light on the future potential for the cyber reinsurance market...



The recent WannaCry cyber-attack has shone a bright light on the future potential for the cyber reinsurance market but the longstanding puzzle of understanding and managing systemic cyber risk accumulation remains unsolved, despite the substantial ongoing efforts by many market participants. The goal of developing the cyber reinsurance market to sufficient scale so that it can help absorb the excess capital currently supporting the reinsurance industry remains some way off but, with an appropriate understanding of risk, it is ultimately achievable.

As noted in the 1 January 2017 and 1 April 2017 renewal seasons, the underlying weakening in the global reinsurance industry's performance has not yet reached an unacceptable level where reinsurers across the board feel compelled to take a stronger stance over conceding further modest rate reductions and walking away from clients. Much now will depend on the loss activity in the traditionally more active third and fourth quarters and on any instability in investment returns. More localized issues such as the Ogden tables in the U.K., poor results in some specific lines of business and uncertainty over Brexit, are unlikely to generate sufficient impact on a global basis to arrest the current global softening trend.

A handwritten signature in black ink, appearing to read 'John Cavanagh'.

**John Cavanagh, Global CEO Willis Re
July 1, 2017**

Property

Commentary by territory

Australia

- Market softening continues on mid-upper layers and bottom-end loss free layers, with rate of reductions dependent on perceived program price adequacy and level of first event retentions
- Reinsurer appetite remains limited for low level catastrophe layer and aggregate covers; as a result, pricing remains challenging in this component of the market
- Reinsurer pricing pressure on loss-affected layers
- Some reinsurers starting to reduce capacity where rates are perceived to be inadequate, although the majority of reinsurers willing to accept rate reductions on programs in order to preserve client relationships
- Other reinsurers looking to increase capacity and the overall effect is that capacity remains plentiful

Caribbean

- Downward pressure on original property rates continues
- This pressure is resulting in a squeeze on reinsurance margin for proportional business
- Reinsurers threatening to pull back in the more heavily competitive territories, such as Jamaica
- Improvements still available for excess of loss pricing

China

- Loss affected programs impacted by price increases though quantum varied depending on loss history which showed wide differences by buyer
- Reinsurers in general becoming more concerned over their own results and seeking to avoid lower layers with higher frequency of loss
- Large rate increases were anticipated by reinsurers on some severely loss hit programs and in some cases, rate increases were deemed insufficient, leading to some reinsurers choosing to walk away
- Placement in general more difficult than previous renewals even on loss free layers, particularly if there has been an increase in underlying exposure

Latin America

- The significant overcapacity for Latin American business is fuelling the continued soft trend
- Capacity for pro rata has also increased since last year, helped by the existence of event limits in most cases
- Very difficult for new entrants to the region to get on board certain programs — often easier to support local or regional retrocedants
- Buyers showing a growing preference for cross-class support from reinsurers
- Main catastrophe event in the last 12 months has been the 'Niño Costero' in Perú, generating greater than expected insured losses (including the agro sector)

Middle East

- Pricing appears to be at the bottom of the cycle; there is significant pushback from reinsurers
- Greater focus on the underlying rate adequacy of the portfolio than ever before
- This is being benchmarked against the market by an increased number of reinsurers
- Reinsurers are pushing retentions higher and commissions to new lows to protect against adverse results
- The Abu Dhabi National Oil Company loss has been a driver for an increase in pricing within the regional retro renewals
- With reinsurers willing to walk away from distressed business, discipline among the larger players is holding

South Africa

- Property proportional and net risk programs have been affected by large fire losses in the corporate area which led to a tightening of terms
- Catastrophe programs were renewed with more rate reductions on a risk-adjusted basis; however, when wildfires broke out in the Knysna area, they affected a large area of the Garden Route and this led to leaders insisting on requoteing catastrophe programs renewing at 1 July that have been impacted

United Kingdom

- Lack of any significant catastrophe loss activity coupled with continued excess supply of capacity has driven further rate reductions
- Structures remain largely unchanged from previous renewals; some buyers, however, are looking to reinvest premium savings in lower level purchases
- Increased demand for multi-year cover
- Significant amounts of capacity remain available with ILS displaying increasing appetite

United States

- Lack of major catastrophe loss activity and abundant capital continues to drive the soft market
- While there were signs of a deceleration in softening at 1 April, the Florida renewals at 1 June were noticeably competitive and saw some larger rate decreases
- Largely driven by a number of catastrophe bonds maturing but not being renewed, the ILS and collateralized markets are competing strongly for business, offering increased capacity at terms that are discounted over last year
- Upcoming catastrophe model changes are likely to decrease expected modeled losses and put further downward pressure on prices

United States — Florida

- Year-on-year risk adjusted price change for loss free programs ranged from -5% to \geq -10%
 - Catastrophe loss activity (Hurricane Matthew, tornado and hail) impacted pricing on some lower layers
 - Larger year-over-year risk adjusted decreases were achieved on higher layers with lower rate on lines
- Private market limits purchased were flat with reinsurer appetite increasing
- Expanded terms and conditions achieved with little to no impact on price
 - Loss occurrence definition changed to cover the life of a named storm
 - Multi-year capacity offered at the same terms as single year
- Reinsurers looking to quantify Assignment of Benefits (AOB) exposure and surcharged portfolios based on underlying geographic exposure
- Significant demand for single shot capacity driven by collateralized reinsurers looking to grow their portfolio
- Quota shares experienced pressure on terms and conditions with prior year loss ratio deterioration
 - Reinsurers pushing to add sliding scales, loss corridors and deficit carry forwards into contracts
- Strong demand continued for per risk and casualty treaties

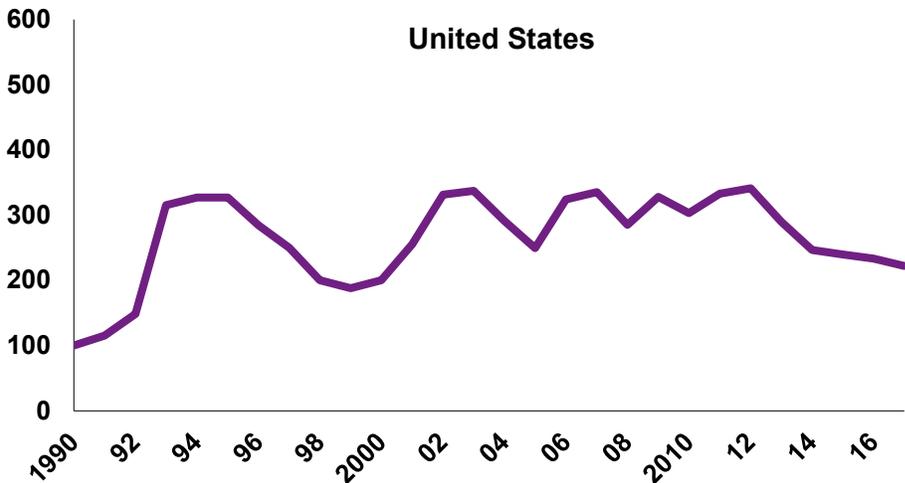
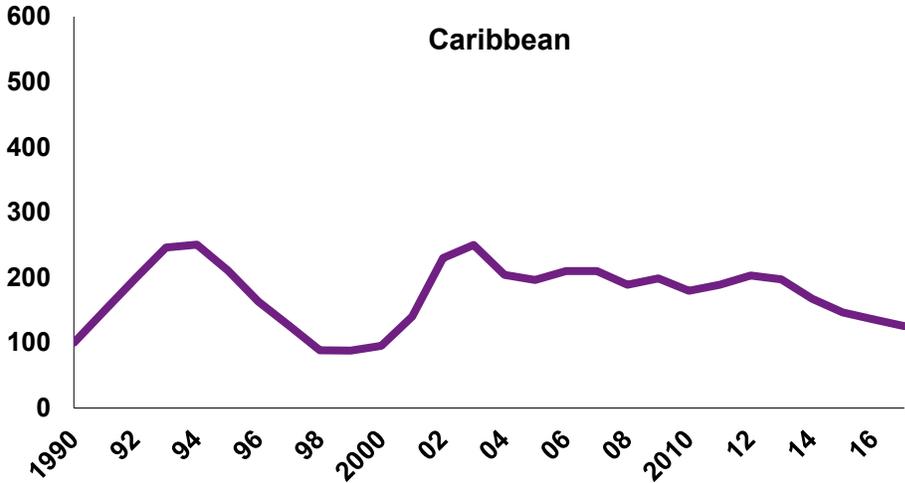
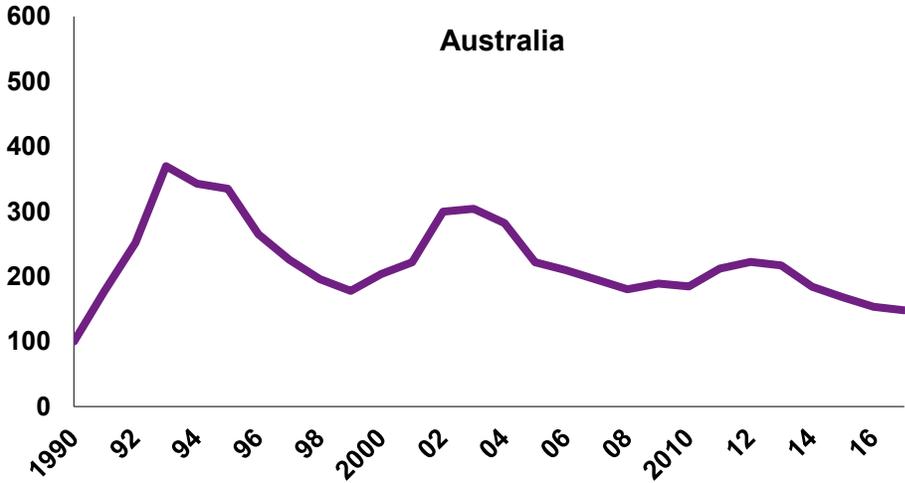
Property rate movements

Territory	Pro rata commission	Risk loss free % change	Risk loss hit % change	Catastrophe loss free % change	Catastrophe loss hit % change
Australia	Varies	-5% to -12.5%	Varies	-2.5% to -5%	-2.5% to +5%
Caribbean	0% to +1%	-5% to -10%	0% to +20%	-5% to -10%	0% to +20%
China	N/A	N/A	+15% to +35%	0% to +5%	+10% to +25%
Latin America	0% to +1.5%	0% to -15%	0% to +15%	-2.5% to -7.5%	0% to +15%
Middle East	0%	-7.5%	+17.5%	-7.5%	+5%
South Africa	-3% to -5%	N/A	+5% to +10%	0%	+10% to +12%
United Kingdom	0% to +2%	N/A	N/A	-2.5% to -7.5%	N/A
United States	0% to -2%	-2.5% to -7.5%	0% to +5%	-2.5% to -7.5%	+5% to +20%
United States — Florida	0% to -5%	-5% to -15%	0% to +5%	-5% to \geq -10%	-3% to +3.5%

Note: Movements are risk adjusted

Property catastrophe pricing trends

The charts on these pages display estimated year over year property catastrophe rate movement, using 100 in 1990 as a baseline.



Casualty

Commentary by territory

Australia

- Despite resistance to rate reductions from a select few reinsurers, abundant additional capacity has led to a continued softening across most lines of casualty business
- Some loss affected treaties renewed with no real sign of genuine rate increases
- Treaty breadth of cover remains an important consideration for buyers, along with relaxation of administrative burdens
- Buyers and reinsurers are increasingly prepared to sever long-term relationships if perceived mutually beneficial terms cannot be realized
- Reinsurers' appetite for systemic and accumulation risks has continued to strengthen and buyers seek solutions on both retrospective and prospective basis
- Appetite for cyber liability increasing cautiously across all segments and distribution channels

International — General Third Party Liability

- Reinsurers continue to see U.K. and European casualty business as a target class, bringing valuable diversification benefit and similarly for U.K. regional business
- Excess of loss capacity for regional U.K. and European casualty business remains abundant, albeit that concerns about Ogden rate change are having an impact on negotiations where U.K. exposures are dominant
- Despite pricing flexibility, rate changes comparatively less elastic than in short tail classes due to smaller reinsurer panel choice and buyer preference for reinsurer panel composition continuity; incumbent reinsurers have responded appropriately to client requests, thereby avoiding too much strain in their trading relationships
- Perceived claims handling and underwriting referral expertise continues to favor larger established reinsurers, and changes to the leadership of programs remain rare
- Balanced profitable casualty portfolios continue to find plentiful reinsurance partners for quota share if required

International — Cyber

- Increased demand for reinsurance as cyber market continues to expand
- Outside of London, most capacity remains quota share or stop loss with ceding commissions on former largely flat
- Pending regulation in European Union (EU) and Australia is stimulating demand internationally
- Reinsurers focused on aggregate accumulation as underlying coverage expands with first party exposures
- Risk quantification remains the holy grail with growing subscription to third party models, although these remain untested

United Kingdom — Motor Liability

- Excess of loss reinsurance market continues to be in a fluid state following change in the Ogden discount rate in Q1 and a lack of clarity about the political impetus to resolve the current situation
- Consequently, the market has seen some significant excess of loss rate increases, driven by reinsurers' concern about the uncertainty of the environment and the anticipated extra settlement quantum of large bodily injury claims
- The divergence of pricing view amongst reinsurers remains noteworthy, though there has been some coalescence of opinion moving into the mid-year renewals
- Excess of loss price increases are varying with (1) program attachment point and (2) portfolio characteristics
- Excess of loss price increases can be restrained by (1) detailed exposition of the degree of original rate increases in response to Ogden change; (2) demonstration of the realities of claims settlement quantum levels in the post-Ogden world
- Many reinsurers are understandably seeing the market dislocation caused by Ogden as an opportunity for expansion in U.K. motor given rising rates, especially those who managed to avoid any prior year deficit and start with a clean slate

United States — General Third Party Liability

- Abundant reinsurance capacity remains available for general liability, umbrella and excess casualty
- Severity and frequency trends remain stable and benign, other than some isolated low-level auto severity in the lead umbrella segment
- Clients are achieving improved renewal terms, or multi-year commitments from the reinsurance market on existing terms

United States — Healthcare

- Healthcare liability reinsurance pricing remains stable overall, with only modest movements depending upon individual program experience
- Margin requirements have been unchanged from 1 January renewals
- Claim frequency trends remain at very low levels relative to historical periods on the original business
- Reinsurance capacity remains strong and panels are well diversified
- Reinsurance limit capacity has grown over recent years and remained consistent at 1 July renewals

United States — Motor Liability

- For commercial auto as a whole, claim severity/frequency continues to rise faster than premium growth, but the gap is shrinking
- Significant downward pressure on quota share ceding commissions and excess of loss layers +/- 10% depending on loss experience
- Reinsurers interest remains tepid at best placing heavy emphasis on expertise and the track record of the buyer
- In personal auto, carriers continue to push rate to offset increased claims frequency trends and higher repair costs
- Flat to downward pressure on quota share ceding commissions where reinsurers have not earned full margins

- Reinsurers increasingly attracted to niche programs based on preferred distribution, regional expertise or use of technology

United States — Professional Liability

- Professional Lines reinsurance market has leveled off after three years of improved terms for cedants
- Growing pressure on margins with continued rate deterioration in Management Liability and, to a lesser extent, Errors & Omissions (E&O) coupled with dramatic increase in frequency of Securities Class Actions and pockets of loss development for E&O
- Nearly all quota share treaties renewing flat, with exceptions being circumstances of outstanding experience (good or bad) or demonstrable changes in underlying portfolio
- There continues to be more flexibility for buyers of excess of loss based on the additional levers available to reflect experience and/or exposure change.
- In order to maximize terms, composition of reinsurer panels continues to change with long-term partners reducing shares and orders being completed with new participants

United States — Workers' Compensation

- Workers' Compensation composed of two distinct markets: Working layer, which includes single claimant coverage, and catastrophe coverage, intended to provide coverage for multi claimant events
- Historically, working layer capacity has been within the first \$10 million of limit; in recent years this has expanded and today most programs include single claimant capacity up to \$15 million or \$20 million
- Working layer pricing has held firm through 1 July renewals with increases in programs experiencing higher nominal loss cost or even increased trended and developed losses into the layer(s)
- Catastrophe capacity continues to soften modestly

Casualty rate movements

Territory	Pro rata commission	XL — No loss emergence % change	XL — With loss emergence % change
Australia	0%	-5% to -7.5%	0% to -5%
China	N/A	-5%	N/A
Europe — General Third Party Liability	N/A	0% to -10%	Varies
United Kingdom — Motor Liability	N/A	Varies	Varies
United States — General Third Party Liability	+2%	-5% to -10%	-5% to +5%
United States — Healthcare	0% to +5%	0% to -5%	0% to +2.5%
United States — Motor Liability	0% to -2%	0% to +5%	+10%
United States — Professional Liability	-.5% to +.5%	0% to -10%	0% to +10%
United States — Workers' Compensation	0% to -2%	Working layer: 0% Catastrophe layers: -2% to -5%	Working layers: +5% to +10% Catastrophe layers: N/A

Note: Movements are risk adjusted

Specialty

Commentary by line of business

Marine

- Little has changed since our 1 April review
- The trend towards portfolio underwriting, where each client is underwritten as a whole rather than based on the individual terms of the contract presented, continues to take hold as market pressures refuse to subside
- Leaders are still having to navigate the balance between retaining business and resisting the erosion of terms; this makes for lengthy negotiations in some cases
- However, as has been the case for some time now, once lead terms are set, capacity remains abundant
- Talk continues of the market floor being in sight, but, as yet, this has not materialized

Non-Marine Retrocession

- This is not a major renewal period for catastrophe retrocession business and therefore the reductions above should be seen in context of lower activity (i.e., <10% of annual retrocession limit purchased at 1 July)
- A marginal increase in ultimate net loss (UNL) limit was purchased compared to this time last year, as buyers looked to take advantage of ILS funds deploying remaining aggregate prior to the wind season
- The growth was predominantly driven by existing buyers purchasing up to higher return periods and a small number of new buyers entering the market
- Multi-class retrocession limit continues to grow with new purchases in this quarter
- Traded volume for industry loss warranties (ILWs) is down as the large traditional carriers have replaced their ILW protections with catastrophe bond and/or UNL capacity

Personal Accident/Life Catastrophe

- Direct and facultative rating remains flat
- Treaty rating flat to -5%

Political Risk

- The number of new claims and monitored situations being reported has continued in 2017, albeit frequency is down
- Capacity continues to outstrip demand both in direct and reinsurance terms
- Additional covers have been successfully purchased
- Excess of loss pricing remains flat
- Terms and conditions for proportional covers were unchanged

United States — Medical Excess

- Continued increases in severity and frequency of large medical claims in the medical excess reinsurance industry
- High cost pharmaceuticals increasing at 18% annually and are outpacing inpatient hospital claims
- United States medical insurance industry facing more changes due to the new administration, e.g., major changes and cutbacks in Medicaid system
- Significant capacity and competition in the medical reinsurance market, with over 20 U.S. medical reinsurers
- More interest in capital motivated reinsurance to assist with market expansion and acquisitions
- Health carriers now required to file Own Risk and Solvency Assessment (ORSA) and are seeking assistance from third party consultants

Specialty rate movements

Territory	Pro rata commission	Risk loss free % change	Risk loss hit % change	Catastrophe loss free % change	Catastrophe loss hit % change
Non-Marine Retrocession	N/A	-5% to -10%	0% to +10%	-5% to -10%	0% to +10%
Personal Accident/Life Catastrophe	0%	0%	0%	0% to -5%	0%
Political Risk	0%	0%	+5%	0%	+5%
United States — Medical Excess	0%	0% to +10%	+5% to +40%	N/A	N/A

Note: Movements are risk adjusted

Capital Markets

ILS and M&A commentary

- Insurance Linked Securities (ILS) spreads continue to decline for liquid investments such as catastrophe bonds
- ILS funds are raising new money to put to work in catastrophe and elsewhere
- Terms and conditions on ILS-backed reinsurance have largely converged with reinsurance backed by traditional promise-to-pay reinsurers
- Deal activity in sidecars, catastrophe bonds and elsewhere heavy through 1 July with a significant pipeline for remainder of the year
- Merger and acquisition (M&A) activity in the global insurance sector remains robust, despite slightly lower levels of transaction announcements and deal volumes as seen in previous years, most notably the activity seen in 2015
- In the U.S., there continues to be cautious optimism about the potential for deregulation and tax reform under the new administration; however, acquirers and sellers may be waiting on the sidelines until there appears to be more clarity on the ultimate direction of the Trump agenda
- In Europe, a consistent M&A theme relates to the overall challenging economic environment (e.g., low economic growth, interest rate environment and political uncertainty) combined with the challenges a number of incumbents face with the implementation of Solvency II capital requirements. New disclosure requirements and stress-testing will likely cause transaction activity to pick up, especially for non-core life divisions that are less capital efficient under the new Solvency II framework
- In Asia, there continues to be strong demand for investors looking to export capital from domestic markets to companies or assets in Europe and North America. Recently, some Asian governments, particularly China, have begun to monitor outbound activity in order to more closely regulate capital outflows, which may act to curb the ability for some buyers to execute transactions if they do not already have funds available outside of the domestic markets.
- Globally, investor interest and news coverage related to InsurTech has risen considerably. While most participants in this space are at early stages of capital formation (e.g., seed capital or Series A), we would expect to see M&A activity pick up as select companies emerge as clear leaders in their specific areas of expertise (e.g., distribution, claims outsourcing, data analytics, IoT, cyber). Notable transactions in this space include Travelers' acquisition of Simply Business and Allstate's acquisition of SquareTrade
- There have been several noteworthy deals in recent months — Intact's acquisition of OneBeacon, CF Corp's acquisition of Fidelity & Guaranty Life, KKR's acquisition of USI, Vitruvian's acquisition of CFC (London), Sirius' acquisition of IMG, Great-West's acquisition of Financial Horizons (Canada) as well as a high profile process underway for Wells Fargo's brokerage business

Note: Capital markets commentary provided by Willis Towers Watson Securities www.willis.com/securities

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