

Global Reinsurance 2006 Outlook: Volatile Earnings And Near-Term Capital Strain Dog Sector

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As we approach the end of a tumultuous year that saw unprecedented catastrophic losses for the global reinsurance industry, Standard & Poor's Ratings Services' outlook on this sector remains negative.

This implies that downgrades are expected to exceed upgrades in the near term. Key concerns supporting the negative outlook include near-term strains on reinsurers' financial strength reflecting the largest catastrophe loss year in history in 2005; continued lower-than-expected operating performance and higher than expected volatility displayed by the sector; heightened concerns on the industry's ability to appropriately price risk exposures and manage risk aggregation; potential for adverse reserve development for recent catastrophe events; continued low differentiation among industry players; and low barriers to entry.

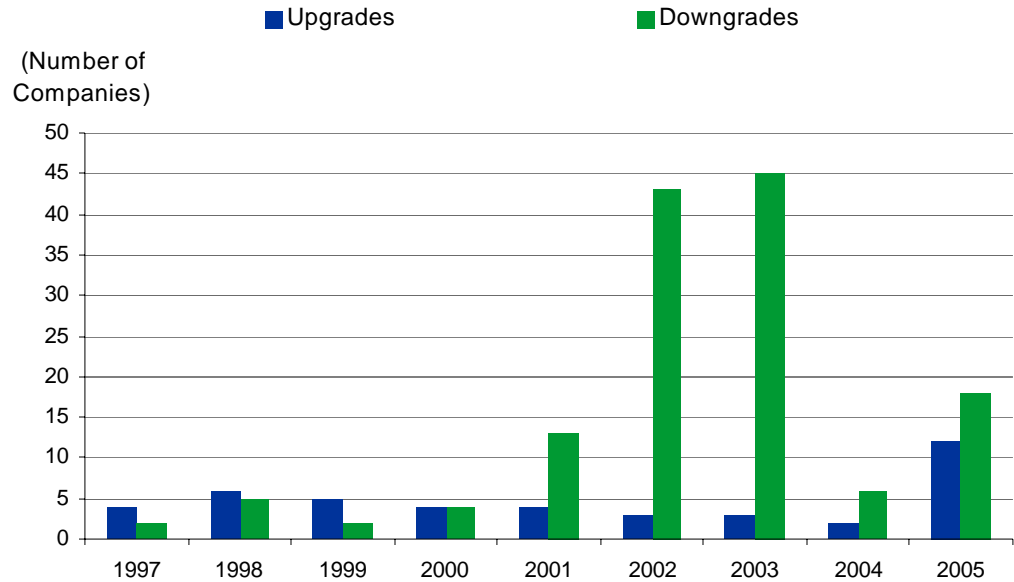
Partially offsetting these factors is the expectation of substantially improved pricing and terms and conditions in property and the likely stabilization of casualty rates in 2006; continued support of the industry by the capital markets; expected lower reserve additions related to U.S. business written in the late 1990s relative to previous years; and the expectation of substantial enhancements in modeling and risk management tools utilized by the industry over the coming year.

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Chart 1

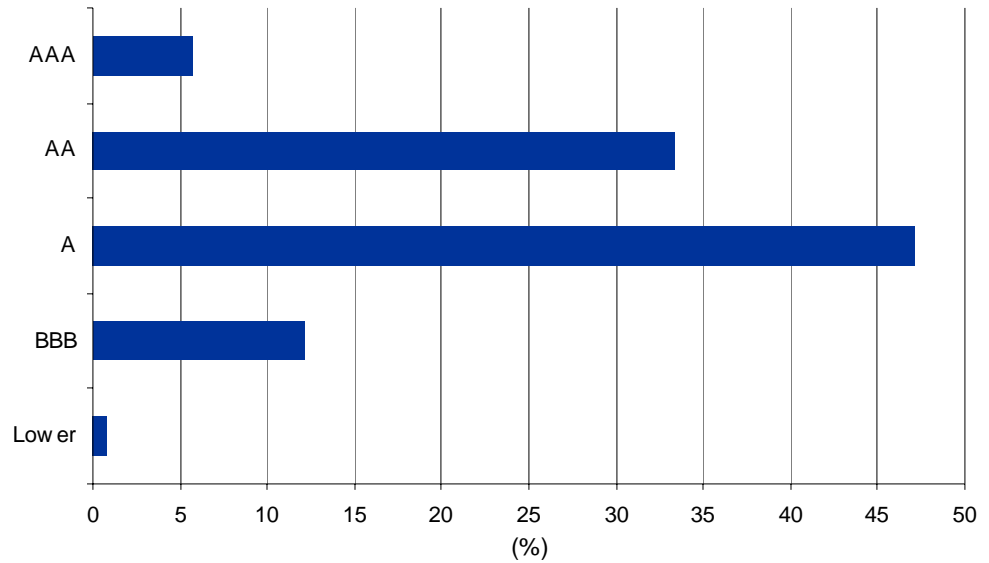
Ratings Trends: Global Reinsurance Sector



Following the placement of several reinsurers on CreditWatch with negative implications after the occurrence of Hurricanes Katrina, Rita, and Wilma, in recent weeks Standard & Poor’s has resolved the majority of these CreditWatches, although a few reinsurers are still on CreditWatch at this time. Through the process of resolution of these ratings, Standard & Poor’s has downgraded five reinsurance groups in the past two months: XL Capital Ltd. (XL), PXRE Group Ltd. (PXRE), RenaissanceRe Holdings Ltd. (RenRe), Transatlantic Holdings Inc. (Transatlantic), and the operating companies of IPC Holdings Ltd. (IPCRe). The ratings on Swiss Reinsurance Co., which are currently on CreditWatch with negative implications pending this group’s acquisition of GE Insurance Solutions Corp., are also expected to be lowered by one notch following the closing of the acquisition (assuming it is completed under current terms), although this action would not be as a consequence of hurricane activity. In addition, the ratings on Montpelier Re Holdings Ltd. (Montpelier) and Aspen Insurance Holdings Ltd. were affirmed and removed from CreditWatch but were assigned negative outlooks. Partially offsetting these actions is the continuation of positive outlooks on Arch Capital Group Ltd. and Endurance Specialty Holdings Ltd. (Endurance). In the case of a few of these companies, the magnitude of losses caused by the 2005 U.S. hurricanes along with related concerns of potential increased frequency of large natural catastrophe events and risk modeling/risk management weaknesses revealed following the recent catastrophes, were key drivers to the negative rating actions. For other groups, these losses only represented an addition to other areas of concern previously stated by Standard & Poor’s on these credits. Standard & Poor’s recent rating actions also reflect its view that the reinsurance sector as a whole continues to bear greater-than-expected earnings volatility, and operating returns posted by the market remain substantially below what would be expected given this volatility.

Chart 2

Ratings Distribution: Global Reinsurers

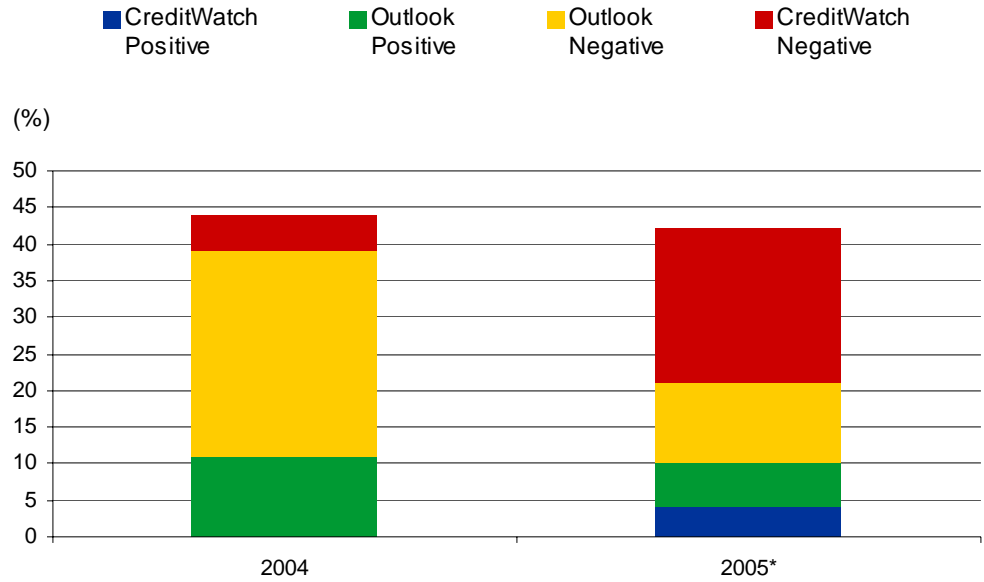


As of Nov. 28, 2005.

Despite the recent downgrades, the reinsurance sector as a whole continues to display strong financial strength, with 6% of global reinsurers rated 'AAA', 33% in the 'AA' range and 47% in the 'A' range. In addition, 65% of reinsurers now have a stable outlook. Financial strength, however, has continued to decline in recent years. Just five years ago, 36% of global reinsurers were rated 'AAA', 36% were in the 'AA' range, 22% in the 'A' range, and only 7% were in the 'BBB' range (12% in 2005). The resulting effect of this decline in financial strength is that ceding companies are expected to continue to make significant efforts to maintain a diverse base of reinsurers and increase the use of nontraditional reinsurance in their reinsurance programs as a means of reducing their exposure to reinsurers' counterparty credit risk.

Chart 3

Global Reinsurance Outlook/CreditWatch Distribution



*As of Nov. 28. Chart does not include companies with stable outlooks.

2005: A Year Not To Remember

The high number of large natural disasters in 2005 caused substantial losses to reinsurers and led companies to report large earnings and capital losses third-quarter 2005 and beginning of the fourth quarter. The three major North American hurricanes—Katrina, Rita, and Wilma—alone may cost the insurance and reinsurance industry as much as \$70 billion to \$90 billion. With global reinsurers expected to absorb a substantial part of this loss, the sector is expected to end the year at an operating loss. This follows stronger operating years in 2003 and 2004, when the top 40 global reinsurers posted about \$19 billion and \$16 billion in pretax operating gains, respectively. The industry’s operating performance was much weaker from 1999 through 2002, when substantial reserve additions for asbestos claims and poorly priced business in the late 1990s, as well as significant losses from the Sept. 11, 2001, terrorist attacks took a toll on the sector. Overall, medium and long-term returns produced by the global reinsurance sector have remained elusive as the industry only managed to produce a meager five-year ROR of 2% from 2000-2004, and an impressive 10-year ROR of 5% from 1995-2004.

Not surprisingly, operating losses are not expected to be even among reinsurance players in 2005. Specialized property/catastrophe players lost as much as 60% of their June 30, 2005, capital base and several years worth of earnings in the third quarter due to significant catastrophe activity, while more diversified multi-line reinsurers lost closer to 5%-25% of their capital base and are expected to post operating results closer to the break-even for full-year 2005. This highlights the benefits of line of business diversification and increased challenges specialized property/catastrophe reinsurers might face in the future if large catastrophe events do indeed become more frequent.

Why Premium Prices Will Go Up—Rethinking Risk

The magnitude of large natural catastrophe losses incurred in 2005 combined with the apparent increased frequency of large natural disasters is prompting reinsurers to re-evaluate their whole approach to catastrophe modeling and risk management. As part of this process, estimated probable maximum losses are expected to increase substantially in 2006, as vendor models and reinsurers' own proprietary models are enhanced to account for higher frequency. Underwriting judgment is also expected to be placed front and center in reinsurers' future risk management strategies, as many management teams recognize that over-reliance on catastrophe models contributed to several companies substantially underestimating the potential for aggregation of losses and the dangers of uncertainty factors such as political risk (as seen in current disputes over flood coverage).

The result of this recalibration of risk is a building consensus that reinsurers need to hold more capital and charge substantially higher premiums for property, marine, energy, and related short-tail lines. As a result, substantial price increases and changes in terms and conditions are expected for the Jan. 1 renewals, ranging from significant increases in deductibles, lower limits, and 20%-30% premium rate increases in property contracts which are not heavily exposed to catastrophes, to as much as 30%-100% premium rate hikes for treaties with substantial catastrophe exposure. Marine and energy covers are expected to be completely reunderwritten, with contract terms potentially changing to exclude natural catastrophes (coverage would have to be purchased separately) and effective rate increases of as much as 200%-400%. Although it is still not clear whether casualty rates will also rise, it is safe to say that under the current underwriting environment rates in this area are likely to at least flatten for 2006, reversing the downward trend observed since the second half of 2004.

The Capital Crunch Eases

There has been a flurry of capital raising activity in the marketplace since September, with many reinsurers (and in particular those located in Bermuda) tapping the marketplace to replace lost capital and position their companies to participate in the hard market in 2006. Companies such as XL, Endurance, Montpelier, IPCRe, PXRE, Transatlantic, AXIS Capital Holdings Ltd., Everest Re Group Ltd., and PartnerRe Ltd., among others have all issued a combination of common, preferred, or debt instruments to bolster their balance sheets (although common and preferred issuances have been more common). Companies have also looked at other ways to bolster the strength of their balance sheet, as seen in PXRE's issuance of a catastrophe bond in order to protect the company against tail risk (extreme catastrophe scenarios).

It is interesting to note, however, that despite the expectation of impressive rate increases in 2006 and existing reinsurers' proven ability to tap the capital markets in recent months, the overwhelming majority of these companies have expressed little appetite to increase their risk exposures in 2006. In fact, most are planning to keep exposures flat or lower in the coming year. Standard & Poor's believes this reflects reduced appetite by market players to increase the potential volatility in their balance sheets, given the view that the industry may be poised for a higher frequency of large natural catastrophe events at least over the short to medium-term. In addition, reinsurers are building additional cushion in their internal models in determining how much capital they need to underwrite each unit of catastrophe risk, resulting in the expectation that companies will write less exposure for the same amount of capital from 2006 onwards. Consequently, existing reinsurers are expected to grow by 10%-30% in 2006, with most of the growth expected to reflect improved pricing conditions, not increased exposure.

Favorable Market Attracts New Entrants

With prices expected to rise and existing reinsurers likely to limit exposures, the stage is set for a number of new entrants to make their debut. In recent months there have been at least 12 new startups that have been announced, which are expected to be backed by about \$8 billion-12 billion in mostly private equity capital. This demonstrates surprisingly strong and continued interest by capital market participants in global reinsurance despite this sector's lackluster historical operating performance, and comes on top of at least another \$8-10 billion raised or in the process of being raised by existing reinsurance players. Of interesting note is the particularly relevant role taken by hedge funds in funding many of these start ups, as well as the presence of a few Lloyd's underwriters such as Hiscox and Amlin. As observed by the previous wave of start-ups at the end of 2001/beginning of 2002, Bermuda remains as the uncontested preferred ground for the licensing of these companies, with all the Class of 2005 start-ups with the exception of one expected to be based in Bermuda.

With an expectation of increased demand for reinsurance and the void to be left by existing players' limited appetite for increased risk, most of the announced start-ups are expected to fill this void by concentrating their writings on property catastrophe, marine, energy, and retrocession lines. Although the Class of 2005 start-ups are expected to provide some welcome additional capacity for primary insurers over the medium term, Standard & Poor's believes it is likely that the market will question the long-term commitment of some of the new entrants to the market, as well as their ability to maintain sustainable writings or expand into other lines of business when pricing and terms and conditions begin to soften in property and retrocessional lines. Standard & Poor's also believes some of these companies might have difficulty in filling their senior management and staff ranks with breadth and depth of management talent, as expertise in the market may be spread thin given the number of start ups in 2001/2002 and 2005. It is likely that many of these operations will be sold through initial public offerings in the next year or two, as it is not clear whether private equity investors and hedge funds' investment appetite will go beyond that timeframe.

Another interesting development in this new formation phase in 2005 is the phenomena of the sidecars, in which third-party private investors (such as hedge funds) are banding together to form special purpose entities to provide additional underwriting capacity to existing players for property and other short-tail lines of business. The agreement between these sidecar investors and the reinsurer typically provides for a two to three-year direct quota-share (to the sidecar) of the reinsurer's book of business for these short-tail risks. How many of these vehicles will ultimately be formed in coming months and whether their existence will continue beyond the two-three year timeframe expressed in their models is uncertain. However, these vehicles may prove to be a viable alternative for the market in times of capacity crunches. In addition, due to their short-term business plan, they are likely to provide less long-term competition to the market when prices soften, compared with full-blown newly established reinsurers. All together, the number of formations in 2005 has exceeded Standard & Poor's initial expectations. Their presence is certain to at least cap some of the price increases expected in 2006, and could eventually contribute to the softening of rates over the medium to longer term.

Time To Bulk Up?

In recent years, the uncertainty present in the balance sheet of legacy reinsurance players due to continued reserve additions for prior years have substantially cut the appetite for mergers and acquisitions in the sector. In the past two years, the global reinsurance industry has chosen to grow either organically or through purchased books of business. In this case rather than acquire an entire company, a reinsurer would purchase the renewal rights to a particular business, thus relieving itself of the burden of paying for past claims.

Against this backdrop the industry was perhaps taken by surprise with the recent announcement by Swiss Re of its intention to acquire GE Insurance Solutions. This acquisition is expected to make Swiss Re the largest reinsurer in the world. Although the anticipated strengthening of GE Insurance Solutions' reserves by \$3.4 billion prior to the completion of the acquisition should diminish the risk of future adverse reserve development on GE Insurance Solutions, Standard & Poor's believes the central question related to this acquisition is whether Swiss Re will successfully leverage its larger size to perform substantially above the industry in coming years, or whether due to its sheer size its future operating results will simply mirror the industry.

Although GE Insurance Solutions' book of business appears to provide a good fit to Swiss Re's existing writings, the analysis of past acquisitions in the reinsurance sector has shown that past acquisitions have proven problematic for the industry. The ultimate degree of success of this acquisition will likely be seen over the next soft cycle, when Swiss Re should be expected to leverage its substantial market position and outperform the market.

Conclusion

Although some of the negative ratings pressure has been eliminated via rating actions since September 2005, Standard & Poor's outlook on the global reinsurance industry remains negative, reflecting higher than expected volatility in earnings and near term capital strains on the industry following substantial catastrophe losses in 2005. Standard & Poor's also believes the magnitude and complex nature of the 2005 hurricane losses could lead reinsurers to post moderate reserve development related to these losses over the next 6-12 months. These concerns are offset by the expectation of a substantially improved underwriting environment for property and other short-tail lines of business in 2006 and continued support of the industry by the capital markets.

Assuming the industry experiences a normal level of catastrophe losses in 2006, global reinsurers are poised to post substantially improved operating results in the coming year. The longer-term ability of the industry to post consistently strong operating results, however, is still in question and will be largely dependent on industry players' ability to correctly price and manage their risks; appropriately determine capital needs for volatile lines; and management teams' commitment to maintaining underwriting and pricing discipline at all times in an industry traditionally defined by underwriting cycles.

Standard & Poor's expects to revisit its outlook on the industry once the impact of the Jan. 1 renewal season becomes clearer and Standard & Poor's completes its review of reinsurers that remain on CreditWatch.

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