Argenta

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Quarterly Review

Argenta Insurance Research Limited

The Rise of Alternative Capital

2013 will be recalled as the year that so-called alternative or non-traditional capital began to make real inroads into the reinsurance marketplace. Alternative capital, which may be defined as products not offered by the traditional insurance and reinsurance markets, takes many guises. These include industry loss warranties, catastrophe bonds and collateralised reinsurance, referred to collectively as Insurance Linked Securities, or 'ILS'.

A summary of each of the main types of ILS is given below.

A Catastrophe Bond ("cat bond") is a risk linked security which is designed to raise money for the issuer, usually an insurance or reinsurance company, in the event of a catastrophe such as a hurricane. It has a special condition that states that if a defined catastrophic event occurs, the issuer's obligation to pay interest and/or repay the principal is either deferred or completely forgiven. Examples of a defined event include an earthquake loss of a given magnitude in California or a hurricane of a given force striking one of a number of states in the US. Although catastrophe bonds are typically designed to give an issuer protection against catastrophe losses, there is no requirement for there to be an insurable interest, as is the case for insurance and reinsurance. Larger insurers can and have designed cat bonds that respond to their own loss experience, although this will make the product less transparent to bondholders.

An Insurance Loss Warranty ("ILW") is a contract through which one party will buy protection based on the cost to the insurance and reinsurance industry of a given event, for example an East coast windstorm with an industry loss exceeding $25 billion. The purchaser will receive a pre-agreed sum of money if the cost to the entire insurance industry exceeds a certain amount. Although there is normally a condition that the purchaser has an insurance exposure to the event, there remains a considerable amount of basis risk (in this example, the risk that the purchaser's actual loss experience is better or worse than the market average). Recent innovations include the use of a county weighting so that purchasers can more closely match their purchase of ILWs to their books of in-force insurance and reinsurance.

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Collateralised Reinsurance Investments ("CRI") are privately structured securities used to gain exposure to the traditional reinsurance market. Similar to cat bonds, a CRI will pay out upon the occurrence of a pre-defined catastrophe event. CRI however are more customisable and less liquid investments than catastrophe bonds and offer a broader range of risks and return profiles and have higher barriers to entry. CRIs offer non-insurance investors a route into the reinsurance market, whereby its capital can be allocated to a single buyer via an escrow account. The reinsurance buyer can draw down on the capital if the specified event takes place, but the capital and premium is paid to the investor if the policy term expires without loss.

Is alternative capital a threat?

Although non-traditional forms of capital have long been seen as a potential threat to the reinsurance market, they are also complementary. (Re)insurers are often both a buyer and seller of reinsurance protection and many of the alternative products meet a demand that the reinsurance market could not otherwise fill – for example, for protection against extremely low frequency events. Where both have participated on similar types of business, pricing levels have rarely been significantly different between the two products. However, in the words of one managing agent "the tectonic plates have shifted faster this year". Prices for ILS have begun to diverge from those of traditional products, some ILS products are seen as a better deal, although the reinsurance industry has responded with rate reductions.

Opinion is divided on the longevity of investors in ILS. Some believe that they will take flight when either returns fall below their expectations, or if losses are incurred. Others point to the longer term, slower to commit, more reluctant to divorce nature of pension funds (rather than the more fickle hedge funds) and believe that these new entrants will be a permanent feature of the market. What is certainly true is that pension funds investing in the ILS sector are only exposing a tiny fraction of their total capital into the space. Time will tell whether their appetite survives the first of the rough times to which the insurance sector is prone.

Catastrophe Losses

There were two modest catastrophe events in the first quarter of 2013. Cyclone Oswald, which brought high winds, mini-tornadoes and heavy rain to Queensland and New South Wales (Australia) in January, killed at least 6 people, and caused insured losses of around A$1.1 billion (US$1 billion, £650m). Intelsat 27, a communications satellite, was destroyed when the rocket carrying it into orbit exploded over the Pacific Ocean, some 56 seconds after launch. We understand that the payload was insured for around US$400m (£255m), the largest loss ever sustained by the space market.

Floods in Europe will be a significant event for (re)insurers.

The second quarter has seen more catastrophe loss activity. Floods in Germany and other parts of central Europe in May and June could cost insurers more than €5 billion. Although some Lloyd's business have established European offices in order to attract more business in these areas, the market continues to be dominated by the large European insurers and reinsurers, so Lloyd's will have a below average market share. Large individual risk losses include: a collapse at an open cast mine in Utah (USA), where tens of millions of cubic metres of spoil tumbled into the quarry, with the possible loss put at $1 billion; and an 8,000 ton

container vessel, the MOL Comfort, split in two on 17 June before sinking in the Indian Ocean on 10 July. Although the hull, valued at $83 million, is not believed to be insured at Lloyd's, it is likely that at least part of the cargo will be. Experts are assuming a total loss of the 4,400 containers valued at up to $100,000 each, so the total cost of the loss could exceed $400 million. 1,600 tons of fuel oil was aboard at the time of loss, giving potential for the cost of clean-up falling to Protection & Indemnity ("P&I") insurers.

Reserves for Superstorm Sandy reduced, but increased for Costa Concordia.

There has been limited movement in reserves for the catastrophes of 2011 and 2012. Reserves for Superstorm Sandy have been marked down by 2%, however the reserves for Costa Concordia have been increased by 8%. We anticipate that many syndicates will be increasing their reserves for this event further as the costs of stabilising and removing the wreck have escalated to more than $1 billion. This could bring into play participants on the third layer of the reinsurance of the International Group of P&I clubs, which attaches excess of a $1.06 billion total loss. Many of the underwriters we speak to regularly had anticipated a deterioration in the cost, with consensus for reserving being around $1 billion.

Tornadoes: A Rising Risk?

Earlier this year Lloyd's Emerging Risks produced a report which examines tornado risk and whether it is changing. After a brief explanation of the meteorological characteristics of tornadoes, the report goes on to focus on tornado records and trends. The report highlights that historical tornado data can be both unreliable and inconsistent, which makes identifying long term trends, and possible links to tornado patterns and climate change, almost impossible. To find the report on the Lloyd's website, type 'tornadoes' into the search box.

Underwriting Conditions

A narrower range of outcomes is predicted for 2014.

Although conditions may change as we move towards the active part of the North Atlantic hurricane season and we have only recently received preliminary business plans from managing agents, the predominant themes emerging are, on the one hand, downward pressure on some of the higher margin classes, such as property treaty reinsurance, terrorism and war, but with improved rating on some (but by no means all) of the lower margin business. Coupled with the increased ability of syndicates to mitigate the downside through purchase of reinsurance, we are anticipating a lower base case profitability for 2014, with a range of outcomes that is narrower than for some years. We will be describing the impact of this on our forecasts for 2014 in more detail, in both our next Quarterly Review and also in our forthcoming book of Syndicate Profiles.

Reinsurance

The reinsurance market has been dominated by the so-called 'de-coupling' of ILS prices from those desired by the traditional industry, referred to above, whereby investors are prepared to break away from pricing levels set by the traditional reinsurance market i.e. investors are prepared to take the risk for less premium. Although there was price stability at the beginning of the year, and increased premiums were paid for programmes impacted by Superstorm

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Downward pressure on reinsurance pricing evident in mid-year renewals…

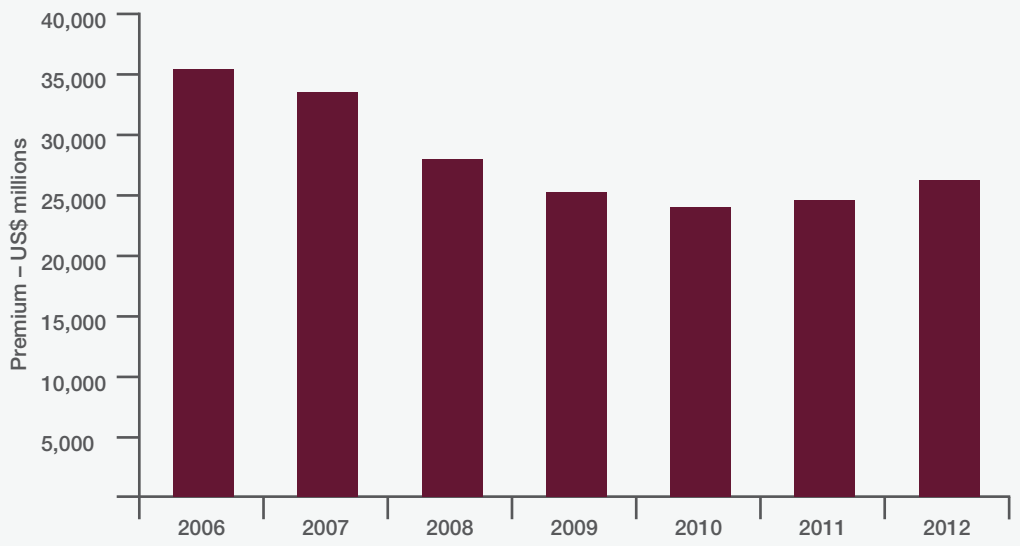
Sandy, there has been less discipline in the second quarter renewals. Rate reductions on some Florida business reached 25%, although Lloyd's syndicates were not at the head of the downward rush. Many underwriters tend to prefer to limit their Florida exposure to writings of the state-wide insurers, as protections of Florida-only insurers are feast or famine, with the added risk that the insured company may not survive a big loss, giving no hope of payback. Away from the Florida market, decreases were still evident, but in the 5% to 10% range, with increases for loss hit contracts.

Property

…but improving opportunities in US E&S market.

The poor underwriting performance of the US property and casualty industry, with an average combined ratio of 107% over the past two years, is resulting in the admitted market withdrawing from some sectors and business occupancies. Although Lloyd's underwrites as an admitted insurer in the states of Kentucky and Illinois, the vast majority of Lloyd's direct writings in the US are as an Excess and Surplus ("E&S") lines insurer. The admitted market is highly regulated; rates and policy wordings must be filed with the state insurance commissioners. The insurance commissioners must approve changes to the policy form or the ratings manual. E&S insurers have far more freedom over rates and policy language. The size of the E&S market is therefore largely dictated by the risk appetite of the admitted market, contracting when the admitted market is risk seeking, expanding when it is risk averse. Although some business is never likely to be placed in the admitted market (and this forms the nucleus of business written into many Lloyd's binding authorities), new business coming into the E&S market tends to be of higher quality than the business that is already there. Many underwriters are reporting increased premium volumes to their binding authority books in consequence of this effect, a process that can be seen in the chart below.

US Excess & Surplus Lines Insurance



Source: Lloyd's

We regularly refer in our publications to MarketScout, an insurance exchange based in Texas which monitors US property and casualty rates and publishes a barometer of rate movements.

For the month of June, MarketScout reported that US commercial property & casualty price rises continued apace, with the average composite rate up five percent for the fourth month in a row.

MarketScout reports US commercial property & casualty prices up for fourth month in a row.

There is however a cloud on the horizon in the shape of Warren Buffett's Berkshire Hathaway. It has recruited a large number of key executives from AIG's E&S insurer Lexington, and some from AIG itself, and formed Berkshire Hathaway Specialty Insurance. Buffett commented *"It's official: we are moving into commercial insurance in a substantial way, and we are here to stay."* While the initial target will obviously be the books of business previously written at AIG and Lexington by the new Berkshire team, it is apparent that such a large scale new entrant may place a brake on rate rises achieved in the sector.

Away from the E&S arena, market conditions remain competitive, albeit at levels where underwriters still feel there is a respectable profit margin. Demand for terrorism insurance (styled as political violence cover to avoid disputes as to whether the perpetrator is a terrorist) continues to increase. Supply is increasing at a greater rate, with rate reductions available on most renewal business.

Casualty

All areas of the casualty market can be described as challenging. In the UK, the market for general liability, employers and public liability is extremely competitive with composite companies like Chartis (AIG), Zurich, Allianz, RSA and XL all aggressively seeking new business. There is some respite in professional indemnity, as although rate increases are scarce, many client companies are reporting higher fee income, on which premiums are adjusted. As insurers' investment portfolios make ever lower returns, especially as longer dated bonds begin to mature and need to be reinvested at lower interest rates, it is expected that insurers must begin to look for higher original premiums. There is scant evidence yet that this is happening, and results are increasingly reliant on reserve releases.

Casualty market remains challenging…

The US is little different, although some underwriters are reporting improvements in specialist market segments such as directors and officers and employment practices liability. There is also more scope for growth as the US economy appears to be recovering more rapidly than does Europe's.

Marine

Although results generally have been acceptable, the overall classification blurs a wide range of performance, for example the continuing under-performance in the hull account has attracted the attention of Lloyd's Performance Management Division ("PMD"). War business has traditionally subsidised the hull account, although competition is eroding margins here.

…as does marine.

War is a market where insurers can cancel cover at very short notice and impose high premiums for ships in perceived hotspots, so can respond very rapidly to changing conditions. After 2012, one of the worst years in recent history, the loss of the MOL Comfort at around $500m, and the continuing deterioration of the Costa Concordia loss means marine insurers are looking at another difficult year.

The market for marine reinsurance did firm markedly in the wake of Superstorm Sandy, especially for contracts that had specie and cargo exposure, although this recovery was exceptionally short-lived.

Energy

Energy market facing competitive pressures after two very good years.

Recent performance has been good and loss ratios for this class are the lowest of any of the high level Lloyd's classes for the past two years. The renewal season for much of the class runs from April to July, with 90% of the book having been written by 1 July. The market softened as the renewal season progressed. Some clients elected to buy less cover for Gulf of Mexico windstorm risks and this, coupled with a fear of signing down on the part of underwriters, led to reductions of at least 10% being generally available. Onshore, the record for power generation risks has not been as good, with underwriters reacting by seeking to increase rates. The level of rate increases has nonetheless slowed between the beginning and the middle of the year, with the more recent round of renewals at single digit increases.

Aviation

Benign claims experience and good results continue in aviation.

Despite underwriters being unanimous in their condemnation of rating levels, results have been exceptional in the aviation sector. This is largely in consequence of a benign claims' experience coupled with increases in rating factors such as fleet values and passenger numbers. A recent Willis report pointed to average rate reductions of 5.1% on airline business, although much of the renewal activity is concentrated into the final few months of the year.

UK Motor

LASPO should benefit motor insurers.

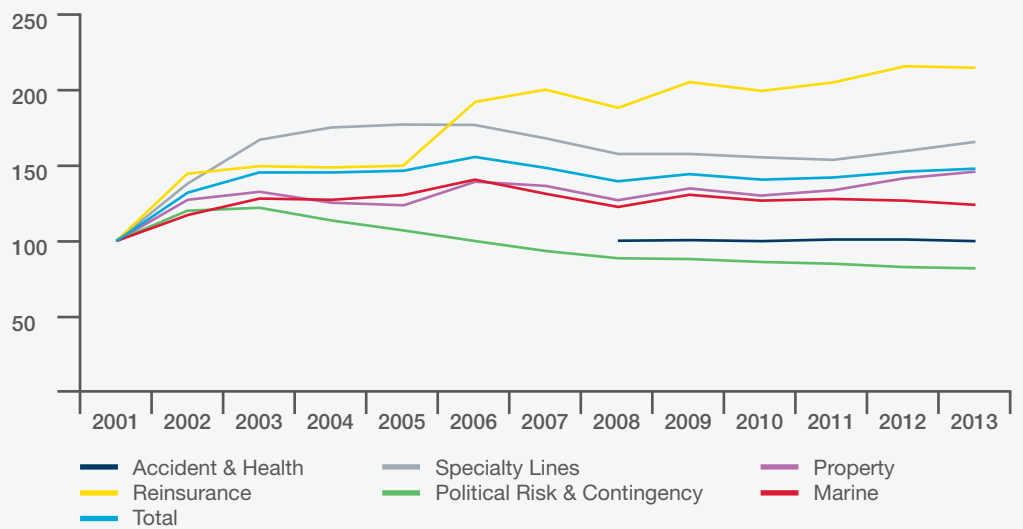
The name Legal Aid, Sentencing and Punishment of Offenders ("LASPO") Act 2012 gives little clue to the nature of the reforms brought into law on 1 April 2013 that should benefit motor insurers. Measures include: the outlawing of referral fees (paid by law firms to parties such insurers, brokers, vehicle recovery firms, repairers, police and hospital authorities for the contact details of accident victims); a cap on legal costs for smaller claims; a process for speeding up payment of claims to be followed by motor insurers; and a recommended 10% increase in the level of general damages. The actuarial firm Deloittes suggested that the reforms could be worth savings of as much as 8% of gross premiums to motor insurers.

Rating levels remain under pressure, with both the AA Insurance and the confused.com rate indices indicating reductions of around 10% over the past twelve months. It would therefore seem that insurers have been prepared to reflect the expected savings from LASPO in advance of the Act becoming law. This is despite the industry recording a 104% combined ratio in 2012. Lloyd's motor insurers have largely turned their back on volume private car business (which is highly competitive, subject to government scrutiny, claims inflation and fraud and is now largely transacted via price comparison websites), and prefer niche areas such as commercial fleet, specialist vehicles, taxis and motorcycles.

Beazley Rating Indices

We have included, at the graph below, an updated version (to include the first half of 2013) of the rate index published by Beazley in previous publications. It does not cover all of the lines of business written at Lloyd's, but in our view gives a fair indication of comparative rating levels over the past decade. It can be seen that the reinsurance line at the top reflects the rate reductions at the mid-year renewals, but rates remain at historically high levels. Property continues to move up and, interestingly, in spite of the challenging environment we comment on above, casualty is improving. In its recent interim results statement (23 July) Beazley reports that 'Beazley Breach Response', which is a proprietary policy designed to address the multiple challenges confronting businesses that have suffered a data breach (including as a result of so-called cyber terrorism), continues to show strong growth.

Beazley plc Rating Indices



Source: Beazley plc, interim results to 30.06.13

Beazley's rating indices show that reinsurance rates remain at historically high levels.

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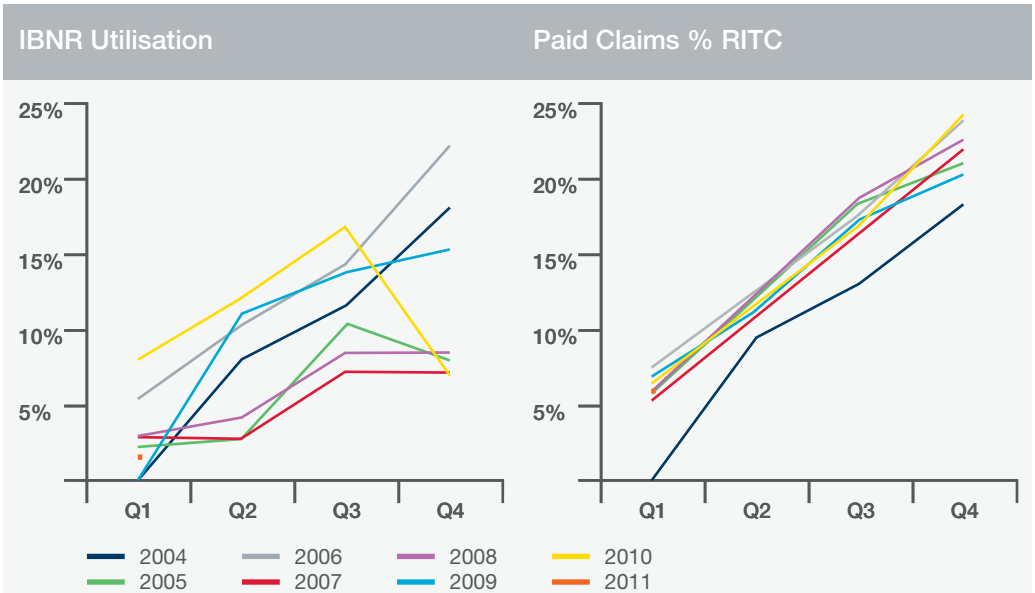
Reserves

Our analysis continues to indicate that there is a surplus in reserves held for old years. Over the past eight closed years, prior year releases have contributed an average of 4.5% of capacity to the overall result (less managing agents' profit commission). This is one of the principal reasons our forecasts tend to be better than those produced by the managing agents, which do not include prior year movements until the final quarters before closure. One of the key indicators of reserving strength is the ratio of provisions for losses incurred but not reported ("IBNR") to the total outstanding claims reserve. This ratio did reduce at the close of 2010 account, although in part this can be explained by an increase in claims reserves for catastrophe losses, such as the New Zealand and Japanese earthquakes. The fact that this indicator is still at its historically second highest level gives us some comfort that reserve releases will continue.

Releases from prior year reserves are expected to continue.

Because this is a bold assertion, we look at a number of other indicators to assess old year movements. These include the rate at which IBNR provisions are used up by increases in paid and outstanding claims (IBNR utilisation) and we look at paid claims as a proportion of the total reinsurance to close ("RITC") each year. Both give us cause for comfort, with the latter being astonishingly stable in its development.



Source: Argenta Insurance Research Limited

Forecast Results

The Managing Agents' forecast results in the tables below are based on the total data for each of the syndicates available to third party capital, with an aggregate capacity of just under £7 billion in 2013 (or around 30% of Lloyd's total capacity). The aggregate forecast for these syndicates' open years are as follows:

Year	Cap £m	EGPI £m	ENPI £m	Pure Year £m	Prior Year £m	Inv Income £m	Admin Exp £m	Mid point £m	Est % Cap	NULR %	Cat Loss
2011	6,564	4,883	3,690	503	61	139	–475	228	3.5	84	10
2012	6,730	5,130	3,855	670	13	127	–509	291	4.3	82	10
2013	6,917	5,542	4,205								

Change on Q4

Year	Cap £m	EGPI £m	ENPI £m	Pure Year £m	Prior Year £m	Inv Income £m	Admin Exp £m	Mid point £m	Est % Cap	NULR %	Cat Loss
2011		117	80	–8	42	9	17	59	0.9	–1	0
2012		134	119								0
2013		22	–46								

EGPI – Estimated Gross Premium Income.

ENPI – Estimated Net Premium Income.

NULR – Net Ultimate Loss Ratio, being ultimate claims costs expressed as a percentage of forecast ultimate premiums (after deduction of reinsurance and acquisition costs).

NB: these figures include all syndicates with a third party participation through any of the three members' agents in any year 2011 to 2013. They are not intended to be representative of individual member's overall results.

Small deterioration in 2011 pure year forecast result more than offset by increase in prior year release.

The 2011 account has deteriorated very slightly, with a one percentage point increase in the net ultimate loss ratio, although this is balanced by improvements in the forecast prior year result. Our analysis on reserves above suggests that there will be further releases from old years, albeit at slightly reduced levels over 2010.

Investment Income

The investment income is currently forecast at 70% of last year's return. 2012's average return was 3% on assets and, whilst this suggests a projected return of around 2%, the actual position for the three year underwriting account is more complicated. The underwriting year is credited with a portion of the total returns on the syndicate's investment according to the average funds available for investment on each year of account. This means that the bulk of the investment return in 2013 will be applied to the 2011 underwriting year, which has the greatest share of the total funds following receipt of the RITC premium from the 2010 account.

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However, the 2011 account has made a small investment return already, being that amount earned on the underwriting balance during 2011 and 2012.

Fall in bond markets in second quarter likely to be reflected in investment returns.

Our analysis leads us to understand that most syndicates with third party capital have bond portfolios with average duration of less than two years, when compared to the Lloyd's average of between two and three years. Following indications from the US Federal Reserve that it would begin tapering its quantitative easing stimulus by the third quarter this year, and could, in some inflation and unemployment conditions, begin to increase interest rates, there were falls in bond markets in June this year. Although interest rate increases are to the benefit of insurers in the longer term (in that they increase the investment return), in the short term the requirement to value assets at their market value ("mark to market") means that there is a risk of capital losses as interest rates rise.

The managing agents that we have spoken to have indicated that there were indeed investment losses in the second quarter, but these have generally not outweighed the gains made in the first quarter. Even so, the indicated 2% return may now be difficult to achieve. Investments markets continue to be an area where the hazards of getting it wrong far outweigh any benefits of getting it right.

Argenta's 2011 Year of Account Forecasts

Argenta continues to forecast a better result for 2011 than Managing Agents' current mid point estimates.

We continue to believe that the final 2011 result will be substantially better than forecast, with many of the established syndicates such as Hiscox 33, QBE 386, Kiln 510 and 557, Beazley 623, Meacock 727, Cathedral 2010, Argenta 2121 and MAP 2791 likely to make further releases from reserves. We predict that these syndicates will achieve a very small, but positive return. The fall in the value of Sterling against the US Dollar in the first half year increases the premium volumes (which translates into a better pure year result), although these gains could of course be reversed in the second half year. Other than small rounding differences, we are generally more optimistic than the managing agents as to the final result, normally in consequence of the projected prior year movement; the two main exceptions being Jubilee 779 (where the 2010 year of account remains open) and Sportscover 3334, which has a poor history of reserve shortfalls and is again showing a prior year deficit at this early stage.

2012 Year of Account Forecasts

2012 forecasts also expected to improve.

We anticipate that many managing agents will be able to release part of the remaining reserve set aside in the original business plan for catastrophes (the 'catastrophe loading') as the policies which incept mid-year begin to run off. This should result in an increase in the managing agents' forecast at the second quarter, published at the end of August. Our forecasts have this built in, together with our expectation of further prior year surpluses. We have trended down our expectation of prior year surpluses for Syndicate 386 on both the 2012 and 2013 years of account.

2013 Year of Account

We have reduced the projected profitability of some of the catastrophe lines in the light of the weaker rates achieved on some of the mid-year renewals. This has led to a small reduction in the overall profitability, from 8% to 7%, although at this stage, early in the Atlantic hurricane season, such movements are little more than noise.

					2011			2012		2013
		Managing Agent			AIRL	Man Ag		AIRL		AIRL
		Q412	Q113	Q412	Q113	Q113	Q412	Q113	Q412	Q113
33	Hiscox	0%	3%	7%	7%	3%	8%	9%	8%	8%
218	Equity	–7%	–7%	–6%	–6%	0%	2%	2%	2%	2%
260	Canopius	–6%	–6%	–6%	–6%	–7%	–7%	–7%	–1%	–1%
308	Kiln	5%	4%	7%	6%	8%	7%	8%	9%	9%
318	Beaufort	6%	7%	8%	9%	2%	4%	3%	5%	5%
386	QBE	19%	23%	23%	23%	14%	18%	15%	15%	12%
510	Kiln	5%	6%	7%	8%	3%	7%	7%	8%	8%
557	Kiln	7%	8%	8%	9%	2%	3%	3%	16%	16%
570	Atrium	–5%	–5%	3%	3%					
609	Atrium	8%	8%	10%	10%	5%	8%	8%	9%	9%
623	Beazley	3%	5%	7%	7%	3%	8%	7%	8%	8%
727	Meacock	6%	6%	12%	12%	6%	13%	12%	13%	11%
779	Jubilee	–1%	–1%	–4%	–5%	–4%	–3%	–4%	–2%	0%
807	Kiln	–4%	–2%	–4%	–2%					
958	Canopius	–12%	–12%	–12%	–12%	–9%	–5%	–7%	6%	2%
1176	Chaucer	–8%	–8%	–6%	–3%	30%	32%	30%	36%	34%
1200	Argo	0%	1%	1%	5%	4%	2%	3%	4%	5%
1969	ANV	0%	0%	0%	0%	5%	3%	5%	3%	5%
2010	Cathedral	1%	1%	4%	4%	8%	7%	9%	9%	9%
2121	Argenta	1%	1%	3%	3%	9%	6%	10%	6%	6%
2525	Asta	–5%	0%	7%	8%	–5%	6%	7%	11%	10%
2526	Asta	0%	–3%	0%	–3%	0%	–1%	0%	2%	2%
2791	MAP	10%	12%	11%	13%	5%	9%	9%	8%	7%
3334	Sportscover	–3%	–3%	–3%	–7%	4%	1%	–1%	0%	0%
4020	Ark	8%	8%	6%	7%	6%	5%	6%	7%	7%
4242	ICAT	10%	10%	10%	10%	8%	4%	5%	10%	10%
5820	Jubilee		–25%		–25%	0%	–5%	–2%	2%	2%
6103	MAP	18%	20%	18%	20%	15%	10%	15%	24%	18%
6104	Hiscox	13%	15%	13%	18%	13%	15%	15%	18%	16%
6105	Ark	8%	8%	6%	7%	6%	6%	6%	9%	9%
6106	Amlin	16%	16%	16%	19%	43%	17%	43%	28%	25%
6107	Beazley	5%	10%	5%	11%	20%	8%	21%	22%	19%
6110	Pembroke					–3%	5%	–3%	7%	4%
6111	Catlin					6%	8%	8%	7%	7%
6113	Barbican								16%	16%
Market		3%	4%	5%	6%	4%	7%	7%	8%	7%

Our next Quarterly Review will be issued prior to the capacity auctions, the first of which takes place on 24/25 September. In addition to comment on market conditions, it will contain updated forecasts based on the second quarter figures.

Profits forecast for 2013.

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