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Focus on Cycle Management

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Rolf Tolle, Lloyd's Franchise Performance Director, speaking at Argenta's Pre-Auction meeting on 12 August, warned that without active cycle management many lines could become marginal or loss making in 2009. Initial assumptions for 2008 business plans have been revised in the face of an acceleration in both the frequency of claims

and in the rate of premium reductions. While 2008 is still anticipated to be profitable on both an annual accounting basis and the traditional three year basis, the projected loss ratios now look optimistic and performance is likely to be worse than originally expected.

Lloyd's will therefore be looking to see real reductions in both premium volumes and exposure, as well as concerted efforts to identify unprofitable business lines. While Rolf Tolle said that rate reductions on renewal business were on average 6%, when new business is taken into account, the overall rating reduction increases to between 8% and 9%.

Setting the scene for a tough round of business plan reviews, he stated that managing agents' assumptions would be challenged rigorously where they are inconsistent with market conditions. In particular, he would question business plans that do not give due credence to the weaker rates and to claims inflation in loss ratio assumptions. He anticipates some "very robust discussions" with managing agents. However he observed that during the five years he has been with the Franchise Performance Directorate (FPD) the Lloyd's market has changed, there is a greater level of understanding and trust between managing agents and the FPD and they are working together to face the challenges of a softening market. His message was that Lloyd's is well prepared and that "we can all make a difference this time".

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The above is a précis of the comments made by Rolf Tolle at Argenta Private Capital's pre-auction client meeting on 12th August 2008

Sector Reviews

Property

Both international and US markets are experiencing rate reductions of more than 10%, in particular for large commercial risks, where significant volumes of premium attract fierce competition. There are also signs of a relaxation of terms and conditions, with wider coverage in the form of increased limits.

Rates have been under the greatest pressure in the US catastrophe exposed regions, especially for the very large Fortune 500 accounts. These classes showed the strongest rate growth in the aftermath of the 2005 storms and in some cases rates have now fallen back to 2004 levels or below.

The International Organisation for Standardisation's (ISO) Property Claims Services reported US catastrophe claims in the second quarter of 2008 totalling more than \$6 billion arising out of 16 separate events. The most expensive, severe weather across seven states from Colorado to Minnesota, cost insurers \$850m. There is some evidence that recent loss activity has halted the trend of decreasing rates in specialist areas such as mining, although there is no guarantee that these will result in rate increases.

Whilst US surplus lines business remains under less pricing pressure, the flow of business to this market continues to be eroded as the US-admitted insurers relax the standards for the business they are prepared to write, thereby keeping business that would otherwise have gone to the surplus lines market.

Casualty

Rates continue to soften, except in classes most affected by the sub-prime crisis, such as professional indemnity (PI) and directors' & officers' (D&O) insurance for US financial institutions. Economic downturn is expected to have an impact on most casualty lines and attritional claims activity is increasing.

In the US, other PI rates, having reached a peak in 2005, continue to fall, although they are still at a multiple of the depths reached in 1999/2000. Coverage has not widened, but there are reports of multi-year deals. The medical malpractice market is coming under competitive pressure from the US domestic market, even though medical claims inflation is moving ahead of the Consumer Price Index.

UK and International PI rates have fallen faster than expected, by approximately 15% in the first quarter of 2008, with no sign of let-up. Likewise, at an estimated 8%, the fall in rates for employers' and general liability is ahead of expectations. At the same time claims inflation is running at approximately the same level, driven by higher care awards and legal costs, among other factors.

Increase in claims in the first half of 2008 is having little effect on the direction of property rates

Softening of rates continues and attritional claims activity is rising

Weakening of rates is less severe than in direct property and sector remains relatively well rated

Margins remain good but little room for further reductions

Marine hull renewals flat

Property Reinsurance

In general, reinsurance classes have held firmer than have direct lines. Results for 2006 and 2007 were excellent prompting new capital into the business and rates have reduced by a risk-adjusted 10% to 15%. Although there has been significant catastrophe activity, the losses have not impacted reinsurance layers to any meaningful extent, as there has been no single severe event.

Many companies have been able to reduce their reliance on reinsurance following a number of years of strong results and are retaining more risk before the attachment point of reinsurance. This reduces premium volumes to reinsurers and lowers the probability of attritional loss. Underwriters argue that it is the higher layers that are better rated in technical terms, so the end result should be a better-rated but more volatile book.

Energy

The rapid rise in asset values has led to increases in insured exposures and the limits of indemnity bought by operators. This has the effect of masking the softening of rates as premium volumes have remained at a high level.

The real value of deductibles has been eroded as they have failed to keep pace with asset inflation. There has also been pressure on sub-limits within policy limits, for example for Gulf of Mexico windstorm risks. Although most underwriters seem content with the prevailing rates, there is not much scope for further reductions while at the same time retaining an adequate margin for catastrophe losses.

Marine

Hull renewals continue to be broadly flat with vessels working hard, thereby raising fears of problems being stored up when they are eventually brought into dry dock. This is likely to coincide with reducing economic activity.

The erosion of the value of deductibles is also a concern, with a trend towards ever larger ships increasing average claims costs. The International Union of Marine Insurance (IUMI) estimates that annualised hull and machinery losses for the 2007 year will exceed \$1.5billion, compared with a cost in 2006 of just \$350m.

Despite this increasing trend, it seems that Lloyd's underwriters continue in the main to have missed much of the loss activity. Underwriting discipline is essential here as there is a large variance in the quality of crews available, with the lack of experienced crew likely to result in more accidents.

Underwriting Strategy for 2009

Also speaking at the Argenta's Pre-Auction meeting on 12 August was Andrew Colcomb, director of Argenta Insurance Research Limited, who gave an overview of expectations for the coming auctions and factors to be taken into account when planning underwriting for 2009. Extracts from his speech follow:

Reduced capacity and reduced premium income for 2009

Lack of supply likely to drive up auction prices

We now have received all Syndicates' preliminary business plans for 2009. Many, including core members' Syndicates 33 (Hiscox), 510 (Kiln), 609 (Atrium) and 623 (Beazley), show significant de-emptions for 2009. These, coupled with the cessation of the first Special Purpose Syndicates (SPSs) 6101/2 (Argenta/Catlin) and 6103 (MAP), mean that almost every Member's entitlement to capacity will be down for 2009. Our two large MAPAs, 7006 and 7049, both have reductions in capacity entitlement for 2009 of slightly more than 14%. Most syndicates that are not reducing their capacity are reducing their premium volumes, so, for example, we see MAP 2791 planning to write less than 50% of capacity.

Auction prices reached new highs last year, where the average price of capacity more than doubled from 2006 prices to 20p per £1. This was driven by low supply of capacity and high demand from individual Members.

We have not been notified of an intention to cease underwriting by many clients. Nor have many indicated to us that they propose to reduce their underwriting by more than the reduction that has been imposed on them by de-emption and cessation of SPS syndicates. Supply of capacity to the auction will necessarily be tight.

Supply of capacity in the auctions is likely to be limited

What is likely to happen in the September auctions and what should your strategy be? Our obligation to you is to deliver you in the best possible shape so that you can take the best advantage of the profit opportunity in a future hard market.

Lloyd's is in a much better market position than it was at the start of the last downturn in 1997. In addition your capacity is with the best underwriters in this well placed market. We suggest that you accept the reduction in underwriting limits for 2009, thereby not increasing your exposure to the soft market, but you can feel comfortable that you are ready to reap the rewards of any future hardening of the market.

Our advice to individual members is to have an in-depth discussion with your Client Director who knows you best, knows your risk appetite and knows your financial circumstances.

Sit tight and be prepared for the upturn

However, in general terms you can approach such discussions in the knowledge that our past advice has positioned you with this strong subset of Lloyd's syndicates. Some "fine tuning" may be appropriate but in general we are recommending a period of consolidation – "Sit tight". Your syndicates are ranked highly within the market and give you the best opportunity to take advantage of the hard market when it comes.

AM Best affirms Lloyd's Rating (July 2008)

Lloyd's has had its A (Excellent) financial strength rating affirmed by rating agency AM Best with a stable outlook.

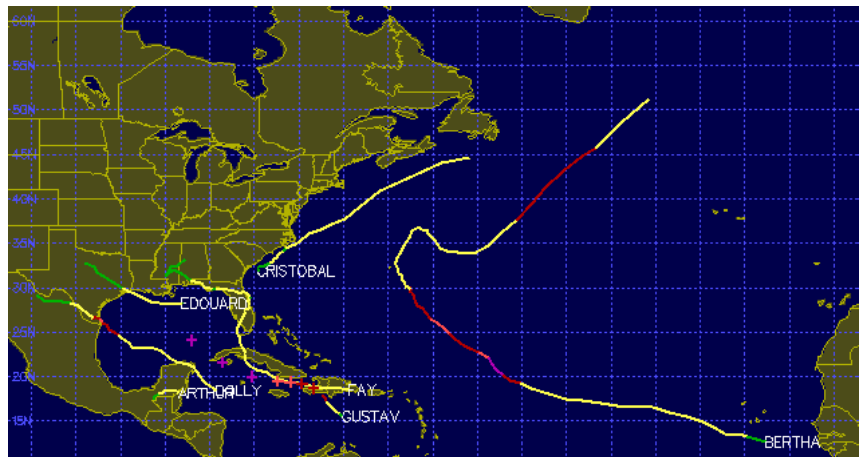
Lloyd's financial strength rating affirmed

The agency also affirmed the Issuer Credit Ratings (ICR) of Lloyds and Chinese operation Lloyd's Reinsurance Company (China) Ltd at "a+", as well as affirming the Society of Lloyd's ICR as "a".

Looking ahead, AM Best predicted that underwriting discipline at Lloyd's is likely to be maintained through 2008 and into 2009 and did not expect sub-prime related losses to have a material impact on Lloyd's performance, although uncertainty as to underwriting losses from this source "will continue for some time".

AM Best also cited strong underwriting discipline and an "excellent business profile" which has enabled it to attract and retain business, despite the development of alternative insurance centres in lower tax jurisdictions. The agency highlighted international platforms in China and Singapore and reductions in the cost of placing business that would further enhance its profile.

Hurricane Watch



The chart shows the track of the seven named Atlantic season storms so far in 2008. Only three of these have made landfall in the USA – Dolly and Edouard in Texas and Fay in Florida. Neither Edouard nor Fay reached hurricane strength, for which sustained windspeeds must exceed 74mph, so remained classified as tropical storms rather than category 1 or above hurricanes. Whilst insured losses from Dolly are estimated at \$300m those from Edouard are thought to be negligible. At the time of writing the impact, of Fay, which is the first storm to make three Florida landfalls since 1960, is being assessed. Heavy rain has caused widespread flooding but there has been no major wind damage. Meanwhile tropical storm Gustav looks like the

first storm of the season to get a clear run through the Gulf of Mexico and is predicted to reach Category 3. It could therefore become the first major hurricane to threaten the US Gulf coast since 2005.

Environmental conditions this year are reported to be such that hurricanes are more likely to develop, due to low wind shear and above average sea temperatures, particularly around the Caribbean.

For those who like to follow the path of hurricanes as they develop, we recommend the Tropical Storm Risk website at

<http://www.tropicalstormrisk.com>

Loss Activity

Q2, 2008 Losses



Record losses between April to June 2008 make the second quarter the worst for 20 years. The ISO's Property Claims Services unit now expects second quarter catastrophe losses to cost (re)insurers \$6.025bn, resulting from 16 US events of \$25 million or more in 27 states, being nearly double the number in the first quarter. Taking into account natural catastrophes in Q1, 2008, insured losses for the first half of the year are estimated at \$17 billion.

Arizona, Oklahoma and Texas were hit by hail storms and flooding in April, with insured losses of \$370 million, \$100 million and \$330 million respectively. This was followed in May by hail, tornadoes and windstorms originating from the Rocky Mountains and moving across central US states causing insured damage of \$800 million.



In June a fire at Universal Studios in Hollywood destroyed exhibits, film sets and an archive containing 40,000 videos and reels. The cost of the fire is estimated to be \$400 million and insured by General Electric.

Also in June, a pipeline explosion at Apache's Varanus Island gas production plant wiped out a third of gas supplies to the mining region of Western Australia. Energy mutual OIL hold the primary layer with the majority of subsequent layers written in the Lloyd's open market. The resulting business interruption claims from service companies mean a possible \$1 billion loss.



Floods in the mid west states of Iowa, Illinois and Missouri are said to be the worst for 15 years, with crop losses in Iowa alone initially estimated at \$3 billion. However, the subsequent growing season has been favourable, which is likely to reduce claims significantly.

Initial reports regarding the cause of the Spanair Flight JK5022 crash in Madrid on 20 August suggest engine failure shortly after take off. The Spanair fleet was insured via the London Market and placed by Aon with a

number of insurers including ACE as lead. Although the extent of the loss to insurers is still unknown, the hull of the plane is reported to have been valued at \$9 million.

In reporting their results for the first half of 2008, the listed Lloyd's vehicles have commented on the catastrophe losses and the increase in the number of individual large risk losses. However, there are few details as yet on how these losses might impact the full year result, except from Amlin who describe their exposure as 'modest'. Since catastrophe activity is usually concentrated in the third quarter and as this could have a significant impact on the full year result, the lack of comment at the half year is not surprising. Some of the first half losses may attach to the 2007 year of account and estimates of the cost of such losses should now be reflected in the recently issued updated forecast results. (See pages 8 and 9 of the August 2008 issue of *Lloyd's Market Disclosures* for full details)

Corporate Affairs

Fairfax bids for Advent

Canadian financial conglomerate, Fairfax Financial Holdings (Fairfax) has made an approach to acquire AIM-listed Lloyd's insurer Advent Capital (Advent). Advent trades at Lloyd's through Syndicate 780. The remaining non-aligned capacity was during 2006. It also operates in the Bermudian market as Advent Re. Fairfax, with 45%, is the largest shareholder in Advent and claims the support of two further shareholders accounting for another 20% of Advent's equity. Fairfax has offered 165p per share, saying this provides shareholders "an opportunity to exit their investment in Advent that might not otherwise have been available by way of regular trading."

Advent dismissed the offer as materially undervaluing the company, pointing to a net asset value of 240p per share and an expectation that any takeover price would be at a premium rather than a discount to net asset value. By 14 August, Advent shares had risen to 207.5p.

Max Capital acquires Imagine

Max Capital has agreed to acquire the Lloyd's operation of Imagine Group. Imagine Syndicate Management Ltd manages Syndicates 1400, 2525 and 2526. The total consideration is approximately £11million. Syndicate 1400 has capacity of £125m all of which is provided by Imagine. Syndicates 2525 and 2526 are both non-dollar liability specialists, respectively trading in the employers' liability/public liability and professional indemnity markets. Non-aligned members represent a majority on both these syndicates, with Imagine's share of capacity ownership being 2% for Syndicates 2525 and 36% for Syndicate 2526. Imagine acquired the rights to manage Syndicates

Advent dismisses Fairfax offer

Imagine becomes Max Lloyd's

2525 and 2526 in 2006 from Abacus. Max Capital is a Bermudian reinsurer, with offices in Ireland and the USA and assets of over US\$5 billion.

Aon expands its reinsurance operations

Aon buys Benfield

On 22 August Aon Corporation Inc. announced plans to acquire London based reinsurance broker Benfield Group Ltd (Benfield). The acquisition was approved unanimously by the boards of both companies. Benfield is to become part of Aon Re Global and be known as Aon Benfield Re. AM Best ranks Aon as the top insurance broker in the world with brokerage revenue of \$6.1bn in 2007. Aon Re Global is also ranked top reinsurance broker worldwide with brokerage revenue of \$658m in 2007. Benfield is ranked third with \$656.7m. The acquisition will require both Benfield shareholder and regulatory approval and is expected to be completed by the end of the year. Aon said the acquisition would create “a premier reinsurance franchise with a global reach”.

Spotlight on.....Contingency

Contingency insurance at Lloyd’s covers some of the most diverse risks in the market, from multi-million dollar concerts to sponsorship of sports professionals. Unavoidable interruptions to a business or event can result in costly financial deficits for the manufacturers or organisers; contingency insurance aims to alleviate these potential losses.

Syndicates open to third party capital that write a contingency book include Hiscox 33, Cathedral 2010, Kiln 510 and Beazley 623. Of these Hiscox writes the largest book in premium volume at just under £10m projected for 2009, but this represents less than 2% of planned gross premium for the syndicate. The contingency book likewise represents a very small part of total premium income for the other syndicates, with none exceeding 3.5%.

Contingency insurance is divided into seven main areas according to risk codes set by Lloyd’s:

Product Recall

Retailers and manufacturers will often purchase product recall insurance as protection against defective products or malicious tampering which cause damage or injury to the receiving parties. The policy can cover the cost of recalling the product, manufacturing and distributing a replacement product and in some cases the resulting loss of profits.

Event Cancellation and Abandonment

Music concerts and major industry conferences can cost up to \$300m and the financial consequences of a damaged venue or disrupted infrastructure can be costly. Sponsors, organisers and exhibitors have great financial interest in such events and are able to arrange cover to protect them.

Non Appearance

Large events are often dependent on the appearance of a key speaker, musician or celebrity without whom the event would be meaningless. A multitude of factors can affect the appearance of such key attendees ranging from death, injury or illness to cancelled flights. For example the death of rock band WHO's guitarist John Enwistle had the potential to be a major loss in the market but a claim was avoided as the remaining members of the band continued their tour.

Film Completion Bonds

Many large budget films are financed by third party entities with a financial interest in the completion and cost of the production. They are given a guarantee by film makers that the film will be completed by an agreed date and to a pre-determined budget which in some cases it is not possible to accomplish. In such a situation film completion bonds will cover the excess cost of producing the film or, if the production is abandoned, a reimbursement of the funding provided so far.

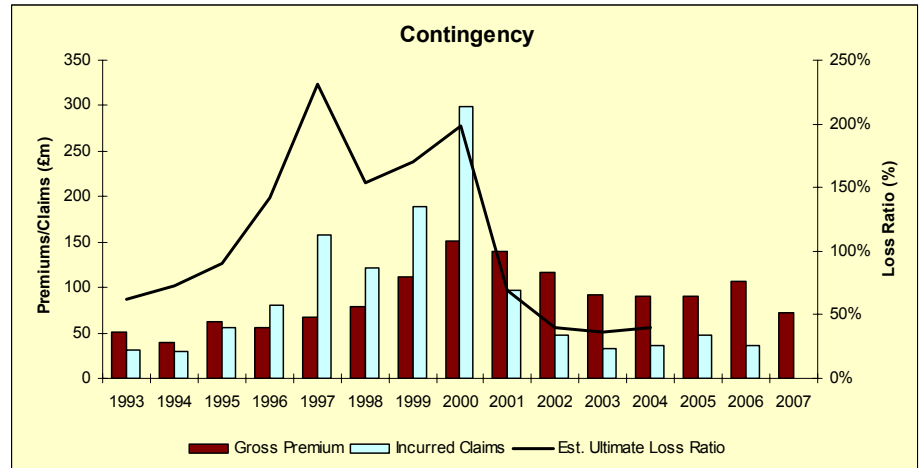
Prize Indemnity

Event organisers or sponsors often offer prize payouts if a team or individual wins a competition or game; anything from rolling a dice to a football team playing in the English Premier League. With prize indemnity or contractual bonus cover in place the winning players prize is funded by insurer(s).

Sponsors wishing to provide an incentive to a racing driver might promise a yacht if a podium finish is achieved, in which case they would pay a premium to cover the cost of the prize.

Alongside the above categories set by Lloyd's, there is a miscellaneous category which encompasses the remaining 'unclassifiable' business. The FPD has shown some concern in the past as regards what might find its way into this category and it continues to be monitored, but no specific limitations have been imposed.

Terrorism cover on contingency policies is generally written separately by specialist markets. A high profile risk such as the Olympic Games would most likely be underwritten as part of the terrorism book, rather than by the contingency underwriter. Monitoring aggregate exposures to a potential terrorist attacks is difficult, as a single event thousands of miles away from the actual written risk could affect the transportation of key individuals or goods. In addition, there are complex issues such as whether the *threat* of a terrorist attack, but no actual attack, which results in delay or cancellation constitutes grounds for a claim to be made.



The current Lloyd's contingency market is competitive. The above graph shows that the class has been profitable for a number of years. Policies with limits of \$300m are written in the market but these are few and far between and are quickly snapped up by the big players. The non-Lloyd's market also provides competition on smaller business and a single insurer can often swallow a \$5m risk by itself. Contingency's short tail characteristics have led to syndicates dipping in and out of the market, usually when there is competition in other classes, with only a few long term participants. The scarcity of profitable business has encouraged underwriters to seek to build strong relationships with their clients and to constantly to develop new products that they hope will sell. Their individual strategies are often a closely guarded secret and individual underwriters operate in isolation within the contingency market.

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