Financial Review
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Could 2013 Be the Apex of the Next Few Years?

Reinsurance rating outlook holds at stable for now.

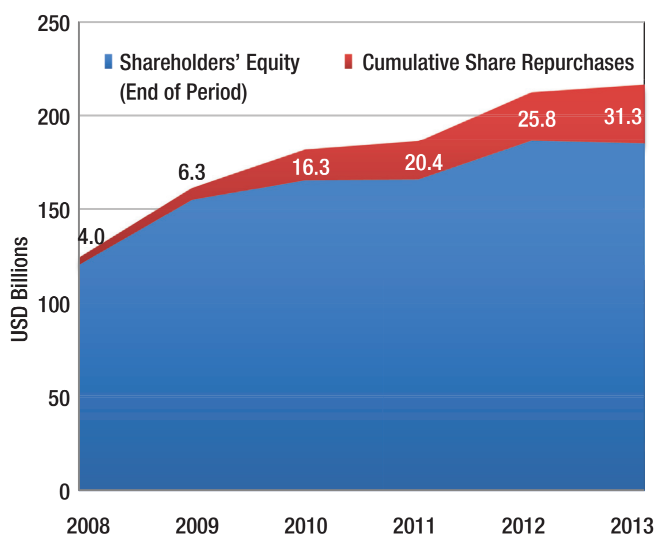
Given the major adversity overcome to produce a very respectable profit, 2013 was a miraculous year for reinsurers. The relatively benign level of catastrophes is of course the major driver, aided by what now seems an endless flow of favorable loss-reserve development from prior accident years. It would be foolish, though, to gaze into the rearview mirror and lose sight of the difficult road that lies ahead, which may be far more treacherous. A.M. Best's forward view heavily weighs the various prospects that would tip the reinsurance industry's rating outlook to negative from stable. A revised outlook would reflect A.M. Best's view that reinsurance companies may face enough downward market pressure to cause an uptick in the number of negative outlooks or downgrades. The remainder of this report will frame out the challenges.

The increasingly competitive landscape emerged at the January renewal, spurred by the continuous flow of alternative capacity; increased retention among primary insurers; the narrowing of players on existing reinsurance programs; and excess capacity among traditional reinsurers fighting to hold existing positions. While competition was most pronounced on U.S. property catastrophe programs, the overflow of capacity to other business classes and regions exerted pressure across the board.

Unfortunately, the investment side of the profit equation does not look much better. A low interest rate environment has been the mode of operation for longer than most market observers can recall. The outlook for any near-term improvement appears distant without stretching for yield and taking greater asset risk. The overwhelming market response has been to keep fixed-income duration short in an effort to insulate against interest rate risk and an inevitable decline in market values. However, adjustments to this strategy are evolving.

The best hope for now is that the deterioration in price, terms and conditions stays within a rational level. Enterprise risk management has served the segment well in allocating capacity to the most profitable opportunities while avoiding accumulation of unprofitable business. Capital management initiatives were well-executed and still may be the better alternative to chasing underpriced business, even as the cost of share repurchases increases. Should a soft market persist or broaden, it may well lead to increased merger and

Exhibit 1
Global Reinsurance – Shareholders' Equity Plus Cumulative Share Repurchases (2008-2013)



Note: Analysis excludes Lloyd's and Berkshire Hathaway.
Source: A.M. Best research

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acquisition activity as larger players look to deploy excess capacity and smaller players feel pressure to find a safe off ramp. Acquisitions, however, are by no means an easy solution, as potential legacies can prove to be very costly over time.

With underwriting coming under increasing competitive pressure, there is additional consideration to allocating a greater share of capacity to primary insurance platforms, where pricing is more stable. Alternative asset strategies also are coming into vogue. Both can serve as a pressure-release valve but must have sound risk parameters.

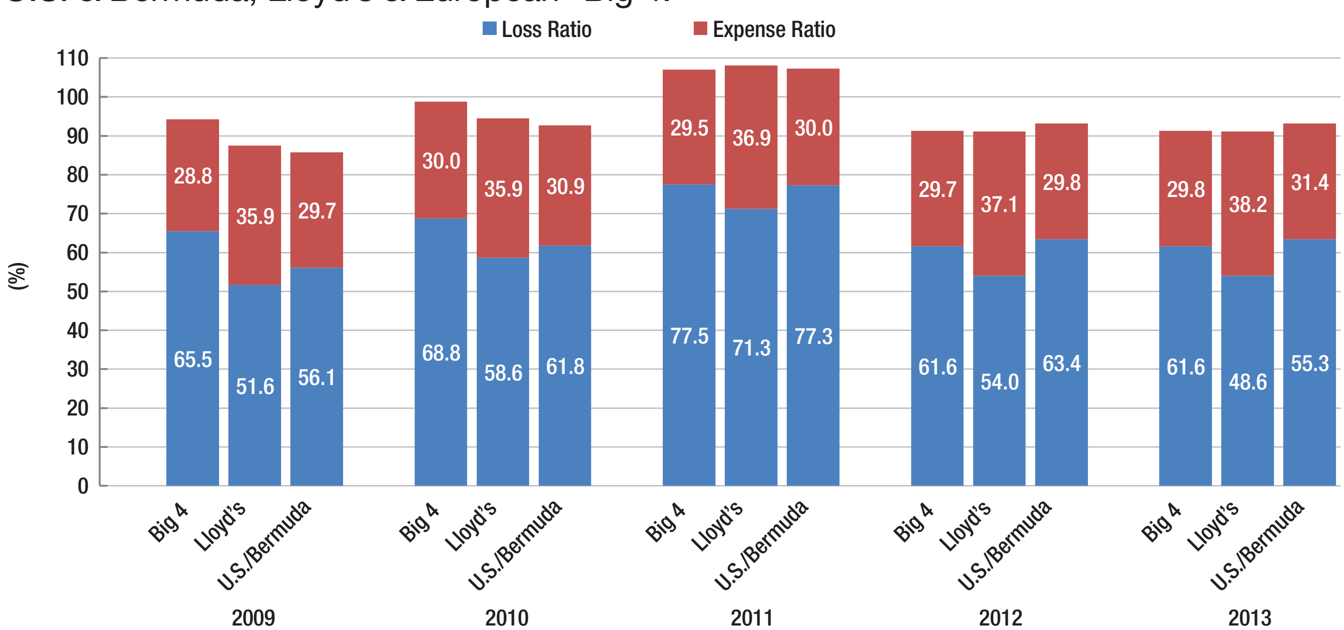
At this stage of the market cycle, the worst scenario would be to forego prudent enterprise risk management controls, relaxing underwriting criteria or taking an overly aggressive investment posture. It appears that the market is at an inflection point, and it is critical that rational heads prevail. The next chapter will begin to unfold at midyear renewals. Ideally, this trend would be toward more stable pricing, terms and conditions, but it now appears that the pressure on underwriting will continue. If that is the case, it will be interesting to see how the new capacity reacts. Additional inflows likely will only accelerate the deterioration. A large U.S. catastrophe *may* help stabilize the market – or will it?

It seems ironic that as underwriting opportunities have waned, the reinsurance sector has attracted additional capital to a market already saturated with it. Is this smart money or is it naive? It's no secret that investors and money managers are enticed by the non-correlating aspects of the property catastrophe business and the tax advantages gained by being an active offshore reinsurer. The insurance business also offers the potential for generating cost-free investment float, which appeals to money managers looking to increase assets under management and reap the lucrative fees that come with that. However, the key to cost-free float is the ability to generate an underwriting profit, which is not easily achieved and especially difficult in a soft market.

Exhibit 2

Global Reinsurance – Combined Ratios (2009-2013)

U.S. & Bermuda, Lloyd's & European "Big 4."



Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

Warren Buffett, chief executive officer of Berkshire Hathaway Inc., referred to this goal of generating investment returns on cost-free float in his recent letter to shareholders:

"Unfortunately, the wish of all insurers to achieve this happy result creates intense competition, so vigorous in most years that it causes the P/C industry as a whole to operate at a significant underwriting *loss*."

The reinsurance segment has performed well over the long term relative to the total industry. However, this was through a hard-market dynamic. The key phrase here is long term. Near-term results can be very lumpy. The greatest opportunities usually follow significant catastrophes when capacity is in relatively short supply. Now, it's questionable whether capacity will ever be in short supply. After the $100 billion industry losses in 2011, there were some pockets of short-lived opportunity, but the magnitude of those losses did not move the market as might have been expected; it merely slowed the softening, and capital poured in.

As the common disclaimer states, historical performance is not a guarantee of future results. In the reinsurance business, many years of profit can be lost in the blink of an eye if accumulation controls are not prudent and underwriting and pricing parameters not sufficiently comprehensive. Investors beware! It is not as easy as it may look. Buffett wisely points out the old adage, "the other guy is doing it, so we must as well." This psychology may be the real force behind the rush of alternative capacity.

Exhibit 3

Global Reinsurance – Operating Cash Flow as a Percentage of Shareholders' Equity (2009-2013)

U.S. & Bermuda, Lloyd's & European "Big 4."

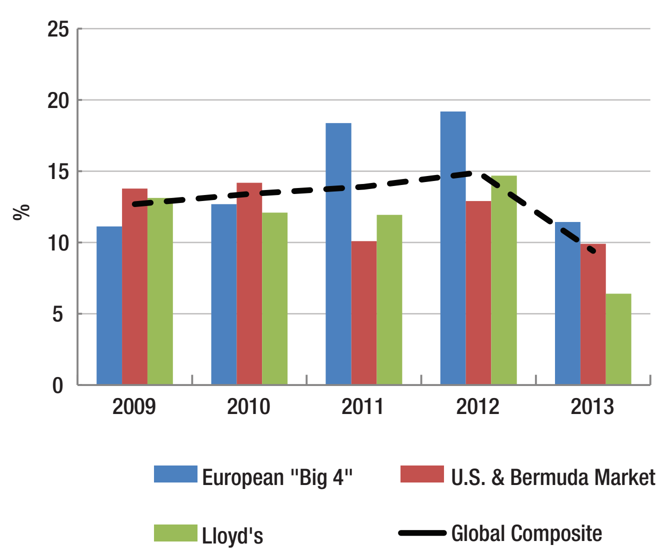
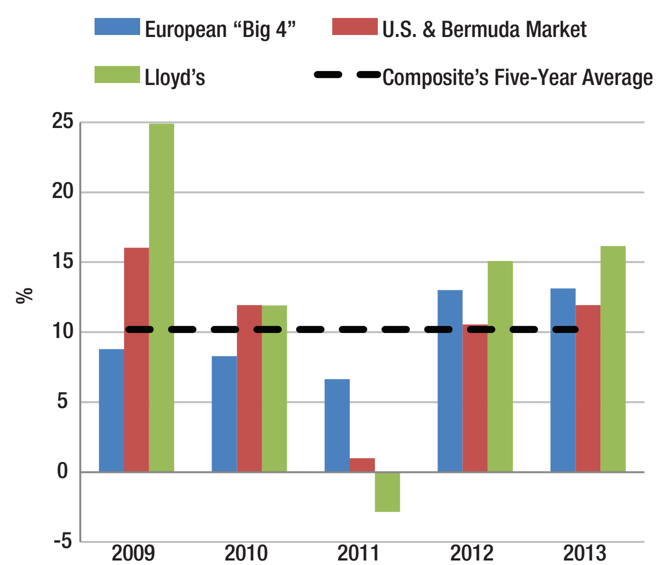


Exhibit 4

Global Reinsurance – Return on Equity (2009-2013)

U.S. & Bermuda, Lloyd's & European "Big 4."



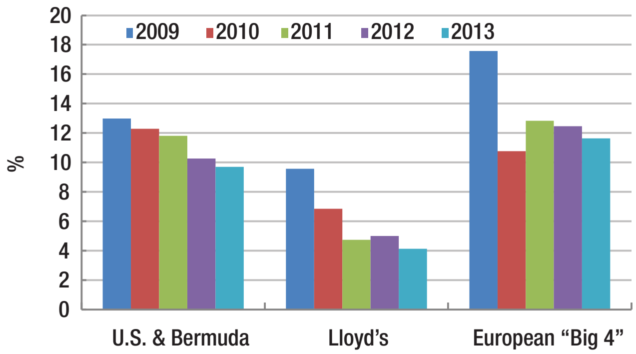
Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

Does Financial Performance Deserve a Pat on the Back?

An A.M. Best analysis of the global reinsurer composite showed strong underwriting profitability in 2013 and improvement in overall earnings as the sector benefited from a year of record-low catastrophe losses. The composite produced a calendar-year combined ratio of 88.6, compared with 92.0 in 2012 (see **Exhibit 7**). Superstorm Sandy was the largest single catastrophe event in 2012, producing an estimated industry loss of $25 billion. In contrast, 2013 results reflected not one single large event. According to Munich Re, insured catastrophe losses for the entire year totaled only $31 billion. The largest insured event was German hailstorms, which totaled $3 billion, followed by Central European floods and multiple tornadoes in the United States. Because these insured losses were smaller, the reinsurance segment did not absorb a significant share. Quota-share participations, which are more predominant in Europe, did result in greater participation by European reinsurers on the first two events when compared with the broader market.

Exhibit 5

Net Investment Income as a Percentage of Total Revenue (2009-2013)

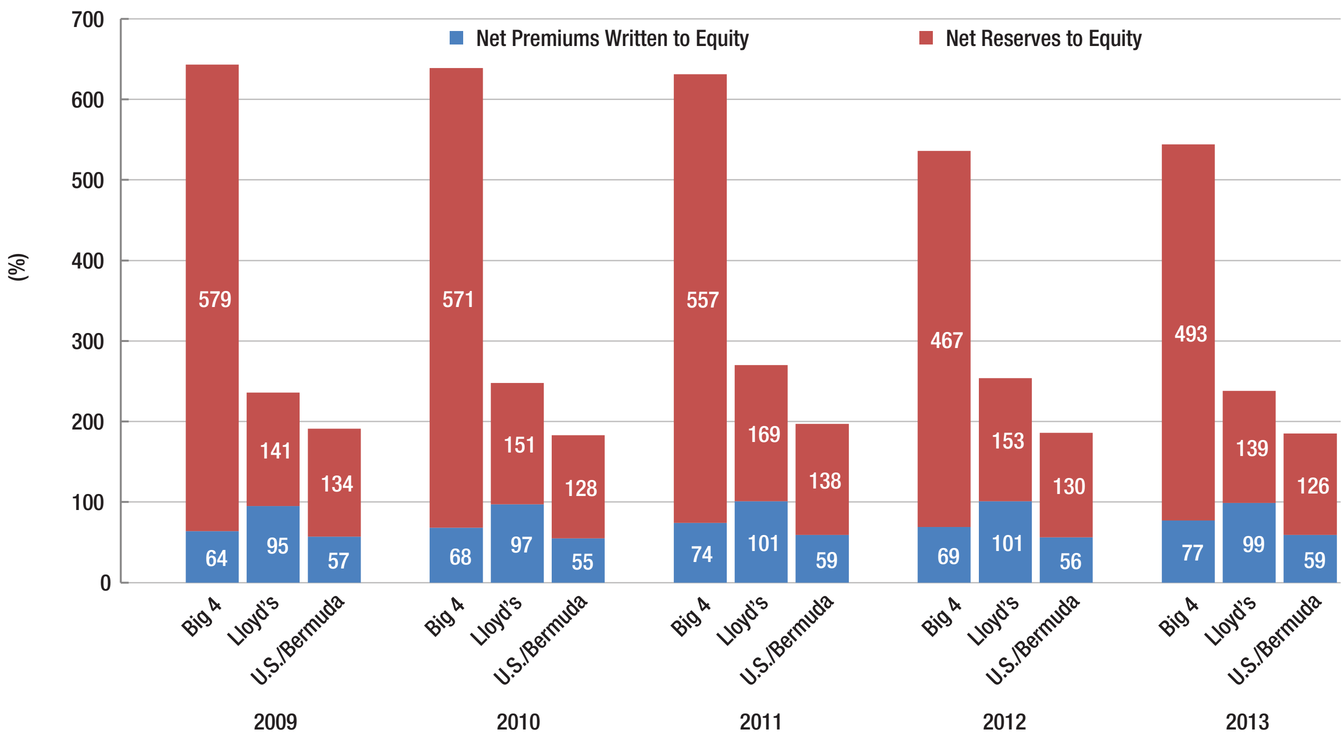


Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

Exhibit 6

Global Reinsurance – Underwriting Leverage (2009-2013)

U.S. & Bermuda, Lloyd's & European "Big 4."



Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

Perhaps the bigger headline is the absence of a significant U.S. hurricane. Although 13 cyclones formed in the North Atlantic, only two achieved hurricane strength. The number of hurricanes formed was well below the long-term average of six. The reason for the limited activity was atmospheric conditions and ocean temperatures at the time, which curbed the formation of hurricanes. Such conditions are unpredictable, according to Munich Re, and likely have no bearing on future trends.

The reported calendar-year combined ratio for 2013 also reflects the continuation of favorable loss-reserve development that amounted to 5.6% and 6.1% in 2013 and 2012, respectively. Since 2007, the global reinsurance sector has harvested $48.3 billion in favorable reserve development, a trend that surprisingly continues. At some point, this benefit has to slack off, but when? The good news for now is that reinsurers seem to have remained disciplined in their reserving philosophies, and incurred but not reported (IBNR) loss levels continue to appear quite adequate. The only yet-to-be seen threat is the risk of inflation, a bridge that reinsurers will inevitably have to cross, according to some market observers.

Underwriting profits – together with net investment income and realized capital gains – produced a sound overall profit for the year. The sector generated a return on equity (ROE) of 13.0% – a phenomenal result considering the significant challenges that continue. The general expectation going forward is for a ROE in the high single digits, given a normal level of catastrophe losses. With the current pressures on underwriting, this is only achievable if favorable reserve development out of prior accident years continues at the same pace, which seems unrealistic.

Investment income remains a critical component of sector earnings and serves as a ballast during periods of volatile underwriting. The flow of investment earnings has remained relatively healthy thus far, but the level has eroded slowly as fixed-income portfolios roll over into lower-yielding securities. Most companies also have been somewhat defensive in managing interest rate risk by remaining short on portfolio duration and building larger cash positions, which also has impeded investment returns. Combined with pressure on underwriting margins, this translates into the expectation for a lower ROE.

To combat this foreseeable trend, made certain by increasing competition from alternative capacity, reinsurers have shown more interest in engaging alternative asset strategies to bolster investment income. They appear to be approaching this aspect of risk with caution, allocating a small share of excess capital to such strategies.

The much-anticipated launch of Watford Re, a casualty reinsurance model backed by the hedge fund High Bridge Capital with Arch Capital as the underwriting manager, appears to be a forerunner in this evolution as it relates to longer tail casualty business. In theory, this vehicle should have greater flexibility to write long-tail classes because of its higher return from investment activities. Higher asset returns usually mean greater risk. It is not yet clear how well received this model will be among clients who want absolute certainty that the relationship will still exist five to 10 years down the line. Having an affiliation with a well-regarded and disciplined underwriter such as Arch is certainly a positive in this regard, but how many Arch Capitals are out there?

Stacking Up the Competition

Comparing the performance of European reinsurers, Lloyd's and the U.S. and Bermuda market shows distinct parallels and differences (see **Exhibits 2-6**). Each segment achieved outstanding underwriting and overall profits, but with slightly different underlying operating metrics. The overall winner appears to be the Lloyd's market, which produced a combined ratio of 86.8, marginally above U.S. and Bermuda's 86.7 result. The European "Big 4" produced a very acceptable 91.4, reflecting their greater orientation to casualty classes as well as quota-share participation on European insurers affected by storm and flood losses in 2013. Lloyd's demonstrated the clear advantage as measured by ROE, due largely to its extremely efficient capital structure. Each segment's performance benefited from continued favorable reserve development. Lloyd's and the U.S. and Bermuda market have averaged approximately six points of favorable development over the previous five years, compared with four points for the European "Big 4."

The longer term trend illustrates that both the U.S. and Bermuda market and Lloyd's produced better underwriting returns, driven by lucrative property catastrophe opportunities after hurricanes Katrina, Rita and Wilma and favorable reserve run-off (see **Exhibits 8-10**). On a five-year basis, the U.S. and Bermuda market produced a lower average combined ratio of 93.2, compared with 93.4 for Lloyd's and 96.2 for European reinsurers. The Lloyd's market demonstrates a clear advantage on a ROE basis, with the five-year average coming in at 12.3% compared with 9.8% for both U.S. and Bermuda and Europe's Big 4. U.S. and Bermuda and Lloyd's return metrics are more volatile year to year, as the Europeans seem to benefit from the stability of their life operations as well as greater diversification in the non-life businesses.

One overriding trend that negatively affects all segments is the steady decline in net investment income over the five-year period (see **Exhibit 5**). The global composite illustrates this dilemma best where annual net investment income has declined from USD 31.0 billion in 2009 to USD 25.3 billion in 2013. The trend is concerning for all and necessitates raising the bar on underwriting performance, which is becoming increasingly difficult in a capacity-saturated market.

In terms of capital, the overall trend has been flat. Considering the current market environment, this is probably a good thing! Contributions to rated capacity from earnings totaling USD 28.5 billion have been muted by a roughly USD 12.5 billion decline in other comprehensive income, dividends of USD 7.4 billion and USD 5.5 billion in share repurchases. Interest rate exposure for rated balance sheets is mitigated by improved investment earnings and cash flows, which have contended with the ensuing pressure on net investment income in recent years.

Reinsurance Rating Outlook: Hold at Stable For Now

The rating outlook for the global reinsurance segment remains stable. However, due to the rapidly changing market environment and increased competition across a broadening array of business classes and regions, A.M. Best expects to re-evaluate this outlook after the midyear renewal season.

The current stable outlook reflects strong levels of risk-adjusted capital, discerning enterprise risk management, and historically favorable underwriting and overall performance. There also has been a slow improvement in the global economic environment underpinned by the United States, which represents the world's largest insurance market.

Reinsurers had exhibited strong discipline on both the underwriting and investment sides of operations. Yet there are early indications that underwriting restraint may be waning as competition from alternative capital intensifies. The supply/demand equation of too much capital chasing the same opportunities has not only put pressure on reinsurance pricing, but also placed focus on reinsurance terms and conditions. The recently concluded April renewals revealed a worse than expected outcome for reinsurers as the abundance of worldwide capacity weighed on negotiations.

Despite these competitive market conditions, new capital continues to enter the reinsurance market, creating additional pressure as available capacity is reallocated to a broader spectrum of business classes and regions of the world. This situation is exacerbated by primary insurers continuing to increase retentions, thus decreasing the pool of available opportunities.

While the risk-sharing struggle between primary and reinsurance companies is significant, it is much different from the inflow of capital entering through insurance-linked securities (ILS) and into collateralized structures and even rated balance sheets. This external threat (with vast amounts of money) is of concern and could be the game-changer. These players' ability to operate at a lower cost of capital is placing pressure on the traditional reinsurance model to become more capital efficient or increase investment returns by taking more asset risk.

Given these dynamics, A.M. Best believes that many non-rated vehicles likely will suffer steeper losses as a percentage of capital under a significant event. Keep in mind that A.M. Best's rating outlook focuses on the companies that carry Best's Credit Ratings. However, when A.M. Best weighs the various market forces affecting the reinsurance sector, we must also consider non-rated sources of capital and their perceived commitment, their reinsurance acumen and appetite for reinsurance risks. Convergence capital still appears to be in its early stages. As pondered earlier, a large catastrophe in the United States *may* help stabilize the market, or will it? Reinsurers that have global reach; diversified business platforms, including primary insurance distribution capabilities; and the capability to manage third-party capital are better positioned to withstand these competitive pressures over the near term.

Capital and cycle management remain the keys to long-term success. Reinsurers have been lowering their cost of capital through refinancing of debt and right-sizing their capital bases, mostly through share repurchases. A.M. Best continues to expect significant share repurchases for the global reinsurance segment, depending on the level of future catastrophe activity and market opportunities. Both operating and total ROE will be squeezed as underwriting margins are pressured by increased competition, a dwindling level of favorable reserve development and low investment yields. A.M. Best expects ROE to range in the high single digits, which includes some benefit of favorable reserve releases from older accident years. Despite these lackluster returns, however, risk-adjusted capital should remain strong as companies also reduce their retained exposure to less attractively priced, volatile business classes.

A possible change in the rating outlook to negative will reflect A.M. Best's view of future earnings capability and risk-adjusted returns on capital. If the reinsurance market enters the destruction of capital phase and financial flexibility is seen to be constrained because of weak operating fundamentals, more negative rating actions likely will follow.

Contributor
Scott Mangan

Exhibit 7
Global Reinsurance – Trend Summary (2009-2013)
(USD Billions)

	2009	2010	2011	2012	2013	5-Year Avg
Net Premiums Written (Non-Life Only)	$120.9	$128.0	$137.0	$146.6	$158.0	$138.1
Net Premiums Earned (Non-Life Only)	127.8	126.7	133.4	143.7	151.5	136.6
Net Investment Income	31.0	24.3	26.0	27.3	25.3	26.8
Realized Investment Gains/(Losses)	(4.2)	10.6	2.4	7.6	1.3	3.5
Total Revenue	**206.0**	**227.9**	**226.4**	**250.4**	**250.3**	**232.2**
Net Income	**24.1**	**20.3**	**4.9**	**24.9**	**28.5**	**20.5**
Shareholders' Equity (End of Period)	184.3	193.9	194.3	218.4	219.0	202.0
Loss Ratio	58.9%	63.8%	76.1%	60.7%	56.5%	63.0%
Expense Ratio	30.6	31.6	31.3	31.3	32.2	31.4
Combined Ratio	89.5	95.4	107.4	92.0	88.6	94.4
Favorable Loss-Reserve Development	-3.9	-4.9	-6.3	-6.1	-5.6	-5.4
Return on Equity	14.6	10.6	2.5	12.1	13.0	10.2
Return on Revenue	11.7	8.9	2.2	10.4	11.4	8.8
NPW (Non-Life Only) to Equity (End of Period)	65.6	66.0	70.5	67.1	72.2	68.4
Net Reserves to Equity (End of Period)	296.7	292.8	298.4	264.2	268.5	283.1
Gross Reserves to Equity (End of Period)	332.2	326.6	326.6	293.5	296.0	313.8

Exhibit 8
U.S. & Bermuda Market – Trend Summary (2009-2013)
(USD Billions)

	2009	2010	2011	2012	2013	5-Year Avg
Net Premiums Written (Non-Life Only)	$50.3	$52.6	$55.0	$56.7	$59.8	$54.9
Net Premiums Earned (Non-Life Only)	51.1	52.4	54.4	55.5	56.6	54.0
Net Investment Income	8.2	8.1	7.6	7.1	6.8	7.5
Realized Investment Gains/(Losses)	0.8	2.2	(0.1)	2.2	(0.0)	1.0
Total Revenue	**63.1**	**65.7**	**64.6**	**68.6**	**69.6**	**66.3**
Net Income	**12.4**	**11.2**	**0.9**	**10.1**	**12.1**	**9.4**
Shareholders' Equity (End of Period)	88.4	95.1	93.7	101.7	101.4	96.1
Loss Ratio	56.1%	61.8%	77.3%	63.4%	55.3%	62.8%
Expense Ratio	29.7	30.9	30.0	29.8	31.4	30.4
Combined Ratio	85.8	92.7	107.3	93.1	86.7	93.2
Favorable Loss-Reserve Development	-6.1	-6.2	-6.0	-5.8	-6.4	-6.1
Return on Equity	16.0	11.9	1.0	10.6	11.9	9.8
Return on Revenue	19.7	17.1	1.5	14.8	17.4	14.1
NPW (Non-Life Only) to Equity (End of Period)	57.0	55.3	58.7	55.7	59.0	57.1
Net Reserves to Equity (End of Period)	133.6	127.9	137.5	130.3	125.7	130.9
Gross Reserves to Equity (End of Period)	166.9	158.0	168.9	157.7	150.4	160.1

Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

Exhibit 9
Lloyd's Market – Trend Summary (2009-2013)
(USD Billions)

	2009	2010	2011	2012	2013	5-Year Avg
NPW (Non-Life Only)	$27.4	$27.3	$28.6	$31.4	$33.4	$29.6
Net Earned Premiums (Non-Life Only)	26.6	26.5	28.0	30.2	32.5	28.8
Net Investment Income	2.8	1.9	1.4	1.6	1.4	1.8
Realized Investment Gains/(Losses)	(2.0)	(3.0)	(4.0)	0.1	(0.1)	(1.8)
Total Revenue	**29.5**	**28.4**	**29.5**	**32.3**	**33.5**	**$30.6**
Net Income	**6.2**	**3.4**	**(0.8)**	**4.5**	**5.3**	**3.7**
Shareholders' Equity (End of Period)	28.9	28.1	28.2	31.2	33.6	30.0
Loss Ratio	51.6%	58.6%	71.3%	54.0%	48.6%	56.5%
Expense Ratio	35.9	35.9	36.9	37.1	38.2	36.9
Combined Ratio	87.4	94.5	108.1	91.1	86.8	93.4
Favorable Loss-Reserve Development	-5.6	-5.9	-6.5	-7.2	-8.0	-6.7
Return on Equity	23.9	12.1	-2.8	15.1	16.2	12.3
Return on Revenue	20.9	11.9	-2.7	13.9	15.8	12.0
NPW (Non-Life Only) to Equity (End of Period)	94.8	97.1	101.4	100.7	99.2	98.7
Net Reserves to Equity (End of Period)	141.1	151.3	168.6	153.0	139.4	150.3
Gross Reserves to Equity (End of Period)	187.8	199.6	226.8	208.3	186.3	261.1

Exhibit 10
European "Big 4" Reinsurers – Trend Summary (2009-2013)
(USD Billions)

	2009	2010	2011	2012	2013	5-Year Avg
NPW (Non-Life Only)	$43.1	$48.1	$53.4	$58.5	$64.8	$53.6
Net Earned Premiums (Non-Life Only)	50.2	47.8	51.0	58.1	62.4	53.9
Net Investment Income	19.9	14.3	17.0	18.6	17.1	17.4
Realized Investment Gains/(Losses)	(5.0)	8.3	2.4	5.2	0.4	2.3
Total Revenue	**113.5**	**132.7**	**132.3**	**149.4**	**147.2**	**135.0**
Net Income	**5.5**	**5.7**	**4.7**	**10.2**	**11.1**	**7.5**
Shareholders' Equity (End of Period)	67.0	70.7	72.4	85.0	83.9	75.8
Loss Ratio	65.5%	68.8%	77.5%	61.6%	61.6%	66.6%
Expense Ratio	28.8	30.0	29.5	29.7	29.8	29.6
Combined Ratio	94.3	98.8	107.0	91.3	91.4	96.2
Favorable Loss-Reserve Development	-0.8	-3.1	-6.5	-5.8	-3.7	-4.0
Return on Equity	8.8	8.3	6.6	13.0	13.1	9.8
Return on Revenue	4.8	4.3	3.6	6.8	7.5	5.5
NPW (Non-Life Only) to Equity (End of Period)	64.3	68.1	73.8	68.8	77.3	70.7
Net Reserves to Equity (End of Period)	578.9	571.0	557.1	467.0	492.7	529.1
Gross Reserves to Equity (End of Period)	612.3	604.0	569.5	489.1	515.9	553.6

Note: The Global Reinsurance composite includes the U.S. & Bermuda Market (excluding Berkshire Hathaway), Lloyd's and the European "Big 4" (Munich Re, Swiss Re, Hannover Re and SCOR). This composite's makeup is fluid and changes over time.
Source: A.M. Best research

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