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CAPITAL AVAILABILITY, MODELING ADVANCES, AND SOFT MARKETS: A BROKER'S VIEW

REMARKS PREPARED FOR DELIVERY
PWC BREAKFAST
MONTE CARLO – SEPTEMBER 12, 2011

I want to talk to you today about a subject close to the heart of everyone in this room.

It's the start of the Monte Carlo conference... We're in the middle of the North Atlantic windstorm season... And we've suffered an unprecedented frequency of catastrophe losses over the last 18 months.

What else could my topic be but the market cycle and when will the market turn?

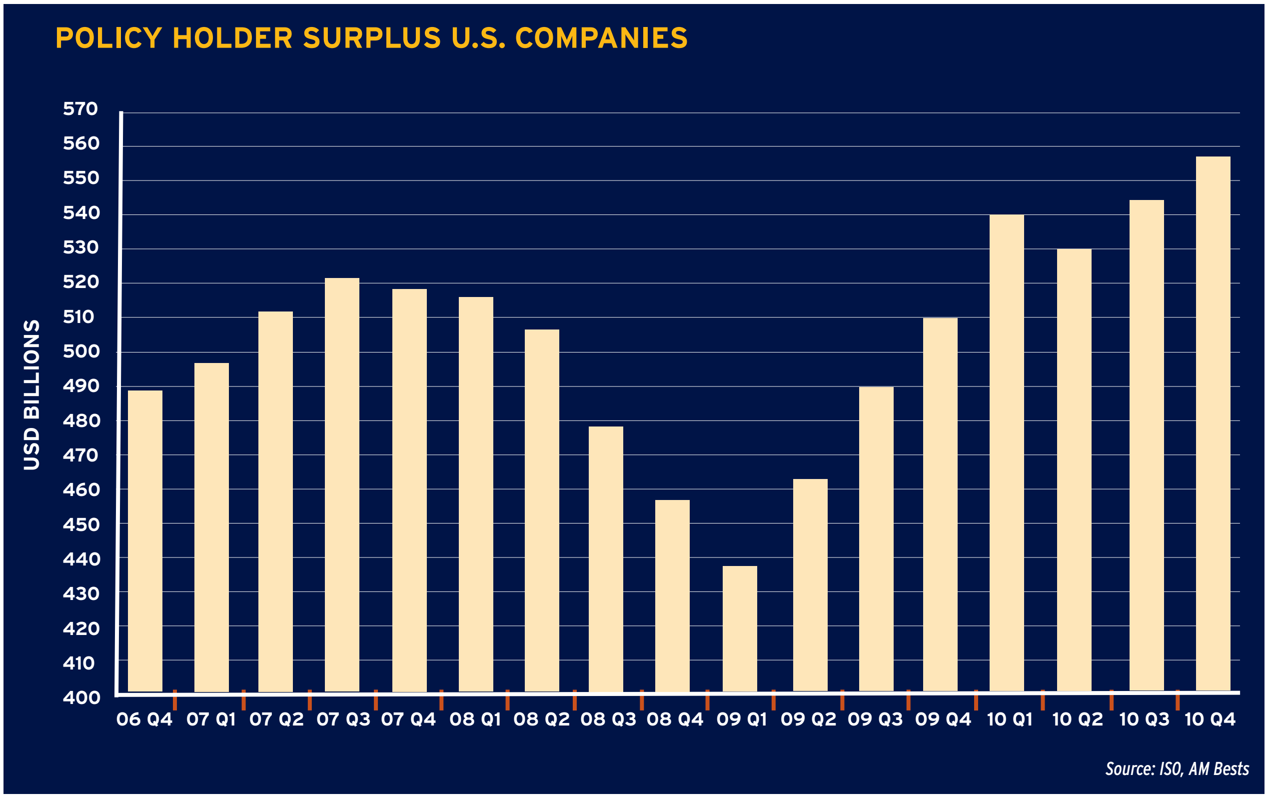
It's commonly agreed that the key factor underpinning the current soft market cycle has been the financial strength of the global reinsurance industry, which has led to over-capitalization. Today I want to explore the notion of market capitalization and whether the market really is as over-capitalized as some of us feel.

We all have a tendency when thinking about the market cycle to look at previous market cycles and presume that the same patterns will emerge again. I am not so convinced that the historic market cycle movements will be repeated again – in fact, I suspect that the "market cycle" has actually broken down into a number of sub-cycles.

There are several reasons why over-capitalization has been seen as the culprit for soft markets. For one, recent years' Nat Cat losses have by and large not had an appreciable effect on reinsurers' capital. To illustrate, if we look at the selected group of 20 major reinsurers their shareholders' funds at the end of the first quarter 2011 were 20% larger than they were at the end of 2008, but 12% lower than they were at the end of December 2010.

In the face of the recent run of natural catastrophe losses, reinsurers have changed their capital management strategies and some previously announced share buyback plans have been suspended. Reserve releases, which have flattered results over the last few years, are continuing, though at a reduced rate. Increasing M&A activity is resulting in fewer, larger, better-capitalized reinsurers.

In light of all this, it's widely believed that the broad market needs a further considerable loss of capital – whether from underwriting losses or investment losses – in order to harden.



The movement in U.S. policyholders' surpluses gives a clear view of how quickly U.S. insurers recovered from the financial crisis of 2008.

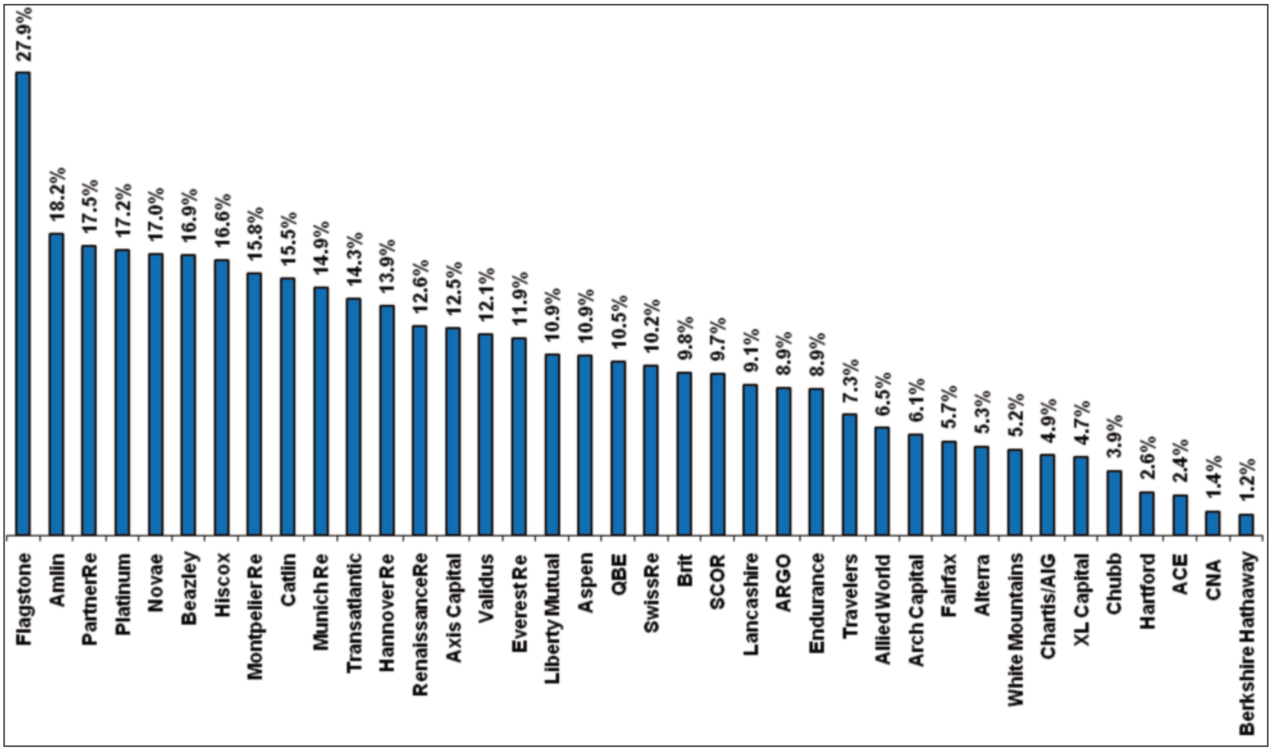
MAJOR NAT CAT EVENTS OVER LAST 18 MONTHS

DATE	EVENT	INSURED LOSS	REINSURED LOSS
Feb-10	Chile EQ	9,000	8,000
Mar-10	Windstorm Xynthia	4,000	3,000
Sep-10	1st NZ EQ	5,000	4,000
Dec-10	Australia Floods	2,000	1,250
Jan-11	Cyclone Yasi	5,000	4,000
Feb-11	2nd NZ EQ	12,000	11,000
Mar-11	Tohoku EQ	35,000	13,000
Apr-11	U.S. Tornados	8,500	1,500
May-11	Joplin Tornado	4,900	1,500
Jun-11	3rd NZ EQ	4,000	2,000
Aug-11	Irene	5,000	-
	TOTAL	**94,400**	**49,250**

The next slide shows how the industry as a whole has suffered somewhere in the region of $100 billion of insured natural catastrophe losses in the last 18 months, of which in excess of $50 billion have fallen on the global reinsurance industry…

…which means that $50 billion of cash will leave the industry over the next two years as claims are paid.

CAT LOSSES IN H1 2011 AS A PERCENTAGE OF OPENING SHAREHOLDERS FUNDS



As you would expect, the impact of these losses has varied by individual company – this next slide shows the publicly announced natural catastrophe losses of a group of reinsurers at first half year 2011 as a percentage of their shareholders' funds at the end of December 2010.

While there are outliers at either end, on average the 2011 natural catastrophe losses have cost reinsurers in the region of 10% of their shareholders' funds.

The overcapitalization argument may indeed not be adequate for an increasingly complex and subtle world. First, the rapid recovery from the financial storms of 2008 by the global reinsurance industry was buttressed by strong investment recovery and a particularly benign 2009 underwriting year. This rapid recovery resulted in an almost record level of share buybacks in 2010, though as noted earlier these have dramatically fallen away for 2011.

Today, with markets roiled by concerns about government debt in many countries – not to mention a potential double-dip recession – it's hard to believe that investment returns in 2011 will be anywhere near those of 2009 and 2010. The recent Quantitative Impact Survey 5 under Solvency II indicated a Europe-wide capital margin of €395 billion in excess of the regulatory requirement.

This looks a very comfortable margin but there is considerable uncertainty around the calculation of some key risks under Solvency II – and in particular, natural catastrophe. Add to this the uncertainty around the exact implementation – there are signs that it could take longer than January 1, 2013, with proposals such as Omnibus II, which would amend the Solvency II Directive, still being discussed. All of this is adding uncertainty about appropriate levels of regulatory capital, which will lead prudent executives to err on the side of caution until they have complete clarity around the new operating environment.

In the last 30 years we've seen three major hard markets. The mid-1980s, the early- to mid-1990s, and the early 2000s. In each case, the defining characteristic has been a reduction of industry capitalization and short-term difficulty in rebuilding and accessing new capital. This led to short-term capital starvation, which in turn made underwriters more risk-averse.

Prior to the 1990s, the insurance industry's ability to transparently manage risks through robust modelling techniques and clearly defined investment proposals was limited. With reinsurers unable to present a convincing investment picture, their ability to quickly attract new capital was compromised.

Today this has changed substantially. Advances in actuarial modelling techniques have greatly improved the risk/reward transparency of capital markets investors. At the same time, a number of those who did invest in insurance risks from the mid-1990s earned good returns, which increased the capital markets' confidence about investing in the reinsurance industry at appropriate points of the cycle.

The formation of Ace and XL as a response to the casualty crisis in the mid-1980s provided a template for start-up companies in Bermuda. The classes of 1992, 2002, and 2005 all followed the example, and the capital markets' appetite to invest in insurance and reinsurance risks has grown exponentially – witness Leadenhall Capital, Nephila Capital, and a host of others. An interesting article in the Financial Times a few months ago described how even conservative pension funds were investing one or two percent of their overall assets in natural catastrophe insurance risk that was uncorrelated to the rest of their portfolio.

The growing sophistication of Nat Cat modelling techniques – which only really developed after hurricane Andrew in 1992 – has reached such a stage that changes in modelling results are able to affect pricing even if there are no original losses. The recent change in the RMS version 11 model of U.S. Windstorm is a clear example of this.

All of these factors may be reducing the likelihood that the historic hard market cycles we've seen in the past will be replicated. I say "likelihood" because nothing under the sun is guaranteed, as we know, and "time and chance happeneth to them all." If a series of natural and economic catastrophes of significant strength converge in a given year, all bets are off. But – barring that kind of financial Armageddon – then instead of markets hardening across the board, we may see continued fragmentation along geographic lines, as well as lines of business.

What would this possible change in historic market cycle patterns mean for the various stakeholders in the industry?

For regulators, there should be concern that the convergence of modelling techniques could lead to systemic risk.

Regulators would also need to enhance their understanding of the impact regulation may have on market cycles, to ensure there are no unintended consequences. Examples would include closer monitoring of changes in reserving patterns as historic market cycles break down, as well as reducing the regulatory and taxation arbitrage available to some companies as they aggressively seek the most efficient operating models.

For buyers, enhanced modelling techniques are already helping to flatten the peaks and troughs of market cycles, putting greater emphasis on managing year-on-year earnings volatility. Transparency is reducing the ability of primary insurance companies to arbitrage the reinsurance markets, increasing the need to maintain primary pricing discipline. The increased use of transparent modelling would allow profitable niches to be exposed to more immediate competition, suppressing individual companies' underwriting profitability. This could only be offset by improved operational performance and tighter control of fixed costs.

A less volatile market cycle would also make it difficult for managers to build up reserves at high points in the market cycle in order to offset the strains of reserving during the down points of the cycle. Ultimately, the key sustainable differentiators will be risk selection and portfolio management.

For reinsurers a change in market cycle – and particularly a fragmentation in the market cycle – is leading to increased competition. In the 1980's the Bermuda market scarcely existed, and there were no emerging hubs in the Middle East and the Far East or Latin America as we see today. Regional reinsurers, such as China Re and Asia Capital Re – most of whom are affected mainly by their own highly localized market cycles – are proliferating, and with increased wealth in the emerging markets, these companies are well-capitalised and able to maximize their local relationships. From a global reinsurer's point of view the ability to move in and out of markets at various points in the cycle is being constrained by this increased competition.

Adding to that challenge is the trend of large multinational groups to use their balance sheet strength to retain expected losses and only cede more volatile low frequency/high severity risks to the reinsurance market. This creates a challenge for global reinsurers to build and maintain acceptably balanced portfolios. Some reinsurers acknowledging the difficulties in creating a balanced portfolio have continued the trend of diversifying into insurance business. The alternative risk market, for example, is replete with numerous global reinsurers who over the past decade developed the necessary insurance and operational expertise to write profitable insurance portfolios.

In addition to exploring new markets, a number of reinsurers have taken more active steps to manage their capital in the last 10 to 15 years to produce acceptable returns over the market cycle. In fact, a clear demarcation is emerging between those companies that are able and willing to take a longer view of capital management and those that are actively managing on a short-term basis. The short-term capital management technique has gained in popularity in the last five to seven years, though whether it can survive a harder market with potentially restricted access to new capital remains to be seen. Successful reinsurers are seeking to build more flexible approaches using enhanced economic capital management tools to help them steer their portfolios.

The factors I've outlined could make soft markets the norm going forward, unless there is another financial crisis reducing investment flow from capital markets.

We should not underestimate the potential for such a crisis. Globalization and technology have linked markets and economies throughout the world. The insurance and reinsurance markets do not stand in splendid isolation – they are interconnected and heavily affected by the global financial markets. The growing sophistication of modelling techniques and capital markets products may have kept the spigots open in some markets while closing them in others. But the combination of abundant natural catastrophes with, for example, a significant debt crisis and inflation would still have the power to dramatically shrink capacity, resulting in an insurance crisis.

What might happen to the insurance and reinsurance industry if Portugal, Italy, Greece or Spain defaults on their debt? A recent article notes that, in December 2010, the European Central Bank estimated that European insurers' exposure to the sovereign debt of these four countries was 17% of their total assets. The article goes on to estimate that this sovereign debt exposure could equate to 40% of European insurers' equity.

This default exposure and its potential balance sheet implications alone would be bad enough. But insurers, like the rest of us, are operating in a very fragile economic environment. Interest rates are close to zero, unemployment is high, and inflation is a growing concern. Inflation could be the monster under the bed. Inflation can be more deadly to an insurer's economic health than defaults, earthquakes, winter storms, or tsunamis. In March the EU's Economic and Monetary Affairs Commission indicated that euro zone inflation would be 2.2% this year, which is a 22% increase over 2010. In a zero interest rate environment reinsurers face two options - they either accept a continuously weakening balance sheet or they raise their rates. If reinsurers face inflation and sovereign debt default together, all bets are off, as these events could still trigger a global hard market that will affect life, health, workers' compensation, property and casualty insurance and reinsurance.

But barring this type of financial Armageddon, the current levels of overcapitalisation may be reduced by losses or poor investment returns, but that should not return us to the bouts of capital starvation that drove market behaviour in some of the earlier hard markets.

If this is true, then all market players and stakeholders will have to adjust to a new reality in which outsized underwriting returns will only be available on a localized basis, and even then possibly only for short durations. As a former underwriter – although some in this room would argue with that! – I will always maintain that underwriting excellence remains key to the success of any reinsurer – but more sustainable competitive advantages need to be developed through operational excellence and reduction in costs, particularly the cost for reinsurers to access the risks they would like to write.

I appreciate your listening to these thoughts about possible changes in the very nature of the market cycle, and I look forward to hearing your own thoughts and responding to your questions. Thank you.