Global Insurance Market Quarterly Briefing

BOARD DISCUSSION

Spotlight on Cyber

Cyber insurance in the US one of the few areas to show rate increases.

Rate levels have generally been increasing, even for companies without meaningful cyber losses to date.

Large buyers are being hit the hardest.

GLOBAL MARKET CONTINUES TO SOFTEN IN FIRST QUARTER

COMMERCIAL INSURANCE PRICING DECLINES SEEN IN MOST REGIONS AND LINES OF BUSINESS

The first quarter of 2015 saw global commercial insurance rates decrease, on average, compared to the same period a year ago. This eighth consecutive quarter of declines was driven in large part by an oversupply of capital, a dynamic supported whether looking at the growth in insurer surplus levels or the increased capacity deployed in new geographies and products. Coupled with strong underwriting performance, this overcapitalized position is behind the softening market. In both the insurance and reinsurance markets, consolidation accelerated over the last several quarters. The trend, which is expected to continue, is a clear sign that the industry is experiencing excess capital levels.

These macro market forces led to decreases across regions and in most major lines of business, with cyber insurance a notable exception (see page 2). Asia-Pacific experienced

FIGURE 1 Renewal Rate Change Ranges by Region and Line of Business Q1 2015
Source: Marsh Global Analytics

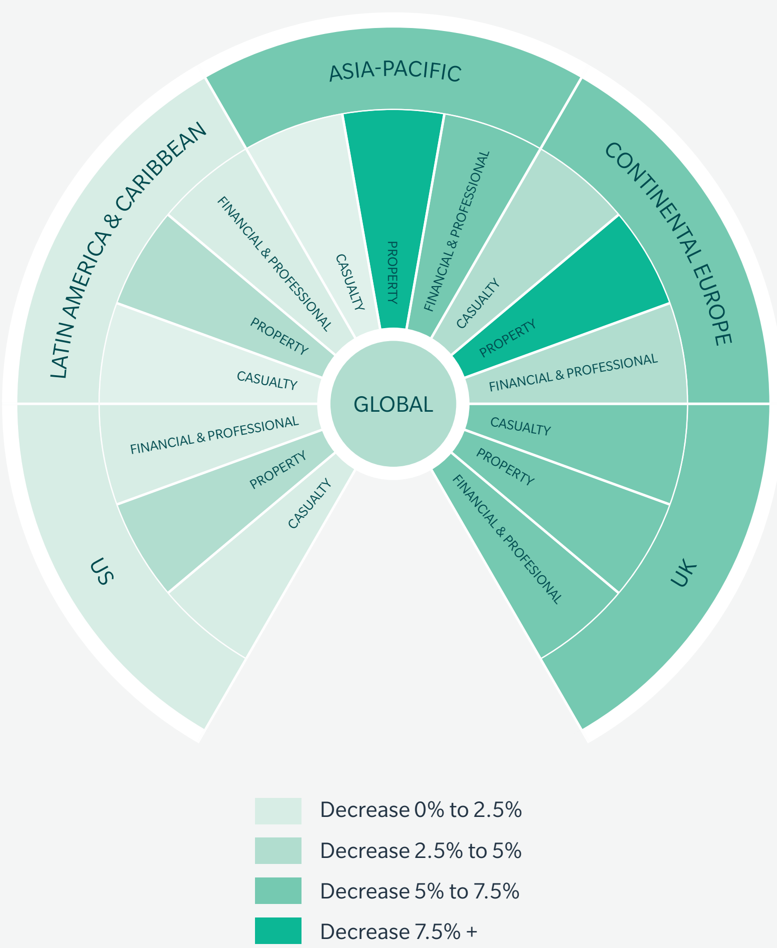


FIGURE 2 Composite Renewal Rate Change Ranges By Region
Source: Marsh Global Analytics

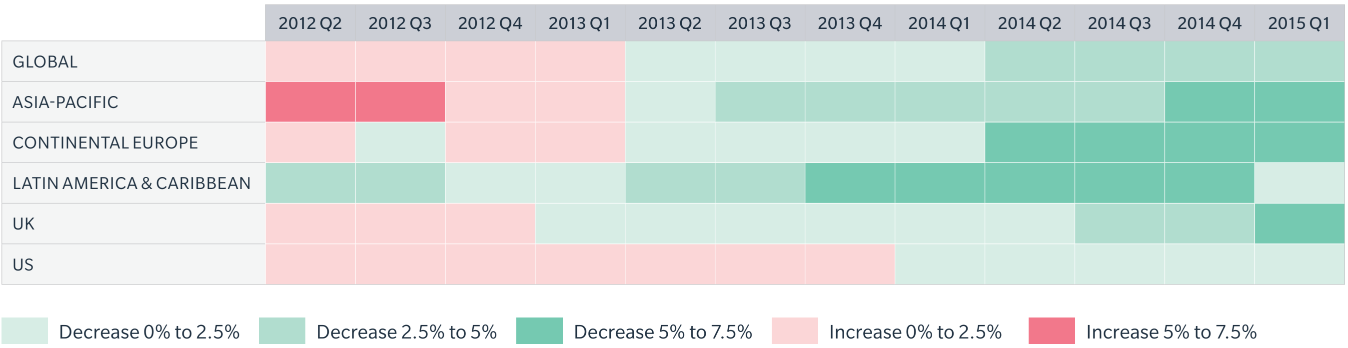
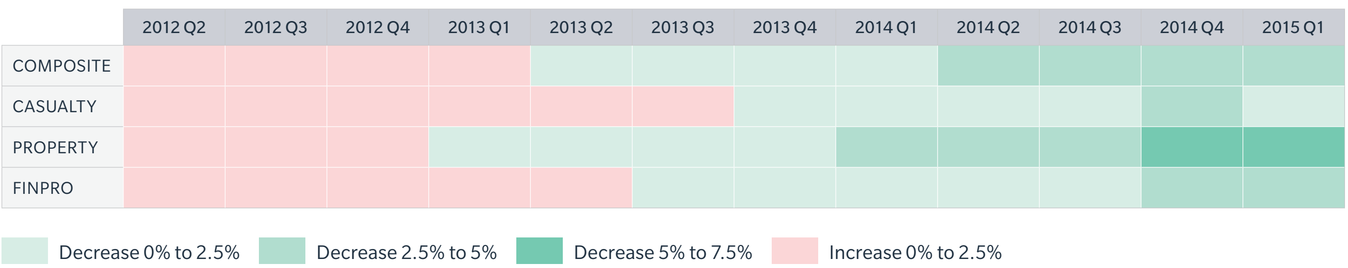


FIGURE 3 Renewal Rate Change Ranges By Insurance Line
Source: Marsh Global Analytics



the largest composite rate decrease, followed by Continental Europe, the UK, Latin America, and the US (see Figures 1, 2, and 3).

In insurance lines, property showed the largest rate declines, on average, across all regions in the first quarter, led by Continental Europe and Asia-Pacific. “It has been another benign year for major catastrophe losses, and the abundance of capital, in the primary markets and in reinsurance capacity, including new alternative capital, is driving increased competition, forcing rates lower,” said David Batchelor, president of Marsh’s International Division.

Casualty insurance rates, on average, decreased across regions, but did so more modestly than property rates.

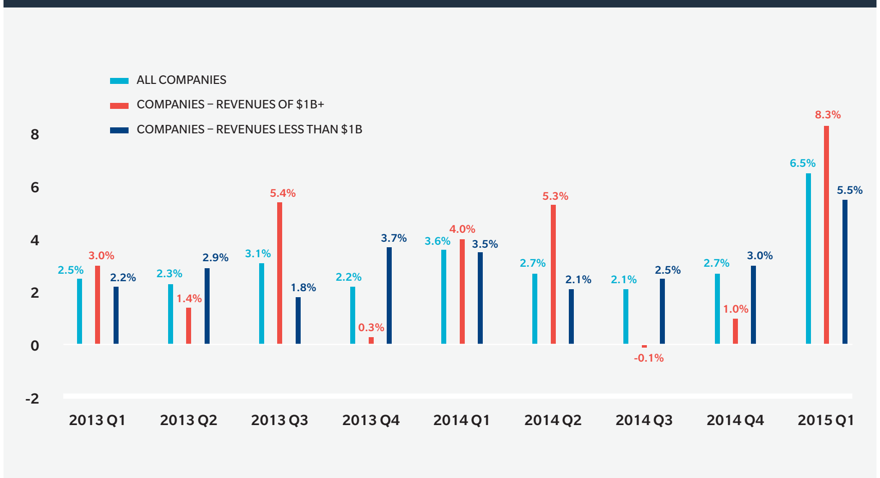
SPOTLIGHT ON CYBER

Cyber insurance in the US was one of the few areas where average rates increased. As in the prior quarter, the firming of rates in the US occurred at an accelerated pace (see Figure 4). The capacity for cyber remains strong, and is expanding. Carriers continue to innovate on policy language and to examine the different coverage types that companies may require, including network security, privacy, business interruption, extortion, and crime.

Cyber pricing is challenging for insurers due to the risk’s dynamic nature. The cyber market involves competing forces: On one side is the growth in both client demand and carriers’ desire to enter a fast-growing space; on the other is the rapid growth in loss activity, particularly for large clients and those with significant amounts of data at risk. The result is significant overall rate volatility, making market response to individual accounts challenging to predict. At the same time, there appears to be relatively little differentiation in pricing from one insured to the next. Carriers are asking detailed questions to better understand the nature of each insureds’ exposure, controls, and loss propensity, although those distinctions do not necessarily make their way into the pricing of accounts. Insurers appear to be underwriting and managing loss potential not by individual account selection and pricing disparity, but by controlling aggregate loss potential through limits constraints according to industry, geography, and total amount of cyber coverage offered.

"Many companies are interested in more coverage and higher limits," said Tom Reagan, Marsh's Cyber Practice leader. "At the same time, the market is looking for better segmentation models to price the exposure appropriately. Given the nature of the uncertainty about future loss experience currently existing for cyber, rate levels have generally been increasing, even for companies without meaningful cyber losses to date."

FIGURE 4 US Historical Rate (Total Price Per Million) Changes—Cyber Liability
Source: Marsh Global Analytics



COMPONENTS OF THE PRICING ENVIRONMENT

The Marsh Global Insurance Index stood at 0.967 in the first quarter of 2015, down from 0.977 in the previous quarter (see Figure 5). Our index methodology captures a rolling four-quarter view of rate movements. Each quarterly change shows the rate change for the current quarter over the prior year for the same period. By rolling the last four quarters together, we are able to capture the effective rate level for a full year and provide a quarter-to-quarter view of changes in the marketplace.

As was the case last quarter, contributors to market conditions in the first quarter of 2015 included several underlying economic and market factors, which can be organized broadly within a supply-and-demand framework. We describe this market framework through:

- Capital committed to the market.
- Insurer profitability.
- Insurer pricing methodologies. (Insurers are becoming more sophisticated with some of their underwriting tools and techniques, such as predictive modeling, and have been able to refine prices based on a better understanding of true exposure and loss potential.)

"[Cyber insurance] rate levels have generally been increasing, even for companies without meaningful cyber losses to date."

CAPITAL INFLOWS AND OUTFLOWS

The insurance market continues to see overall surplus levels increase. AM Best's recent "U.S. Property/Casualty — Review & Preview" report (published in mid- February 2015) estimates that 2014 year-end surplus levels grew more than 6.2% to US$711 billion. This follows two years of additional surplus growth at 10.7% (2013) and 6.3% (2012). The trend of increasing surplus is likely to continue this year.

"While there are always some insurers exiting certain lines of business, overall market activity and capacity to write insurance increased during the quarter," said Dean Klisura, Marsh Global Industry Specialties and Placement leader. "Aiding the market's overall capacity has been the willingness of companies to consider placement opportunities outside their local geography. This strengthens the global nature of the marketplace."

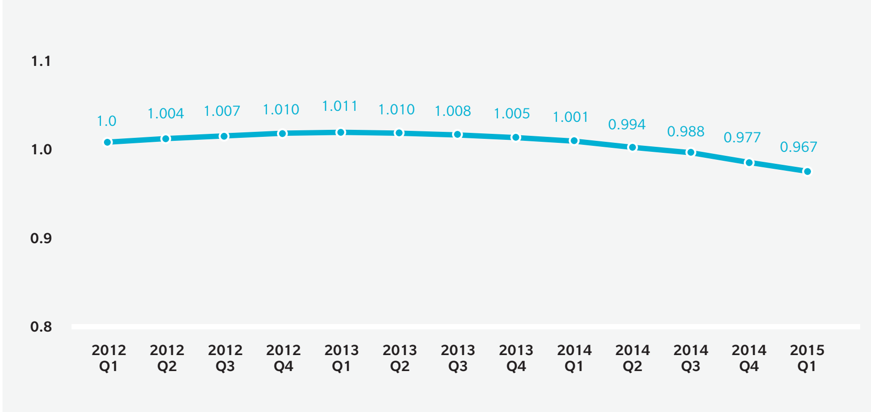
INSURER PROFITABILITY

Insurers over the last several years have achieved profitable underwriting performance. Despite the weakened interest rate environment, which lowers investment returns, strong underwriting performance has generated attractive combined ratios for the industry. The US property and casualty market had a combined ratio of 96.4 for 2013 and an estimated 97.2 for 2014, according to AM Best, indicating two consecutive years of profitable underwriting results.

The result of profitable underwriting performance is that excess profit is either distributed as dividends to shareholders, used to repurchase stock, or put toward surplus levels. Importantly, insurers need to write against that increased capital position to generate adequate returns. The pressure to write more premium grows each year. The supply-and-demand model dictates that as capital grows, market capacity and appetite grow, and market prices generally decline.

"We continue to see price competition between markets and across almost all lines of business. This has become a consistent trend in Latin America over the last two years, including in the first quarter of 2015," noted Ricardo Brockmann, CEO of Marsh Latin America and Caribbean.

FIGURE 5 Marsh Global Insurance Index
Source: Marsh Global Analytics



INSURER PRICING METHODOLOGIES

Generally, the ability of insurers to segment risk is increasing as they create more sophisticated pricing models using additional data. While true in many lines with well-understood exposures and consistent coverage forms, lines of business with more recent underlying risk issues and where less data exists provide a challenge to appropriately define potential exposure to loss. Add to that a situation where the underlying risk is dynamic, and you see an exception to the rate declines for the rest of the market, namely cyber insurance.

Cost for cyber coverage is particularly volatile for large buyers with substantial volumes of protected health information (PHI) and credit card data due to the catastrophic risk these information types present. While primary rates are increasing, most of the marketing challenge is in the excess layers. The result is that large buyers are being hit the hardest — not only are they the subject of the most rate action due to their exposure base, but they buy the largest towers, where they are seeing the rate increase effect maximized due to the focus on excess pricing action (see Figure 4).

Uncertain situations usually present both challenges and opportunities. Cyber is an interesting example of this dynamic. The demand for coverage has never been greater and insurers are generally interested in writing more business. As the ability to model cyber risk increases, uncertainty is generally decreased, and more accurate segmentation is likely to occur. Recent high-profile cyber events help make the case for sophisticated pricing methodologies.