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REINSURANCE MARKET UPDATE

Reinsurers Strong Amid Credit Crisis



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Reinsurers Strong Amid Credit Crisis

The 2007-2008 credit and liquidity crisis is having a significant impact through most sectors of the financial services industry. Estimates of the credit-related market value lost extend beyond \$1 trillion - a level not even considered in September 2007. The mortgage crisis has made other worldwide or regional market downturns in recent decades seem minor, or represent only temporary setbacks. Thus far, this crisis has occurred in a period with few significant insured or reinsured losses. Fortunately, reinsurers are in excellent financial shape and can sustain reasonably significant property catastrophe or other large sequences of non-catastrophe losses and continue to meet the needs of cedents around the world. Indeed, reinsurance capital is perhaps the largest source of capital in the world where the general trend in cost is declining. Insurers will find that reinsurance is now a substantially more accretive form of underwriting capital than it was at this time last year. Equity premiums and credit risk spreads for insurers have become significantly more expensive and the incremental benefit from reinsurance as an alternative source of underwriting capital has become even more pronounced.

The financial market reforms created as a result of the 2008 credit crisis will be significant and will most likely follow close examinations of consumer impact, business conduct, banking conflicts, transparency to investors and suitability and ratings of structured finance products. Local legal and regulatory responses will need to be closely coordinated to provide appropriate and positive reform to those economic regions affected by the malaise.

Balance sheet lending, loan underwriting and credit management will again be viewed as high value, not commoditized, banking skills. Investors will again value high quality credit underwriting and participate through more transparent investment products. Banks will need to relearn skills to underwrite and hold, attract and grow capital at a pace consistent with their growth aspirations as they practiced up to the mid-1980s - skills never sacrificed by the vast majority of insurers and reinsurers around the world.

Insurers performance during this critical period has not been flawless but it has been positively differentiating from their other financial services sector peers. Most insurers and reinsurers managed to have small or reasonably manageable earnings or capital impacts. This outcome reflects a very successful and high level of enterprise risk management by insurers and reinsurers. Indeed, even reasonably high levels of property or liability catastrophes could be sustained by insurers without material disruption of the global business.

Figure 1: Subprime Writedowns - Banks & Securities Firms

COMPANY	TICKER SYMBOL	SUBPRIME MARKDOWN	CHANGE IN MARKET CAP *	
			(\$B)	Percent
Citigroup	C	55.1	-178.8	-66.0%
Merril Lynch	MER	51.8	-57.1	-71.6%
UBS	UBS	44.2	-73.7	-69.4%
HSBC	HBC	27.4	-85.3	-8.3%
Wachovia	WB	22.5	-73.5	-71.3%
Bank of America	BAC	21.2	-88.8	-39.5%
Morgan Stanley	MS	14.4	-46.9	-51.9%
JP Morgan Chase	JPM	14.3	-46.8	-26.5%
Deutsche Bank	DB	10.8	-41.1	-41.5%
Credit Suisse	CS	10.5	-30.3	-38.2%
Barclays	BCS	9.1	-63.8	-43.3%
Lehman Brothers	LEH	8.2	-30.3	-78.0%
Goldman Sachs	GS	3.8	-26.9	-29.3%
Bear Stearns**	BSC	3.2	-16.1	-93.2%
Subtotal		296.5	-859.4	-33.7%
All Other Banks & Securities Firms		204.6		
Total		501.1		

* May 31, 2007 to August 15, 2008

**Writedown reflects figure announced prior to acquisition

Source of Writedown Info:
 Bloomberg.com: Aug 12, 2008
<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8sW0n1Cs1tY>

That said, we do believe the January 1, 2009 renewals will, for the first time since the credit crisis began, reflect a lesser rate decrease than would otherwise be available had the crisis not reached its current or projected level. Figures 2 and 3 set forth our expectations for rate on line, capacity and retention changes by region:

Figure 2: United States: January 1, 2009 Expectations

REGION	ROL CHANGES	CAPACITY CHANGES	RETENTION CHANGES
Personal lines national			
Heavy Year	+25 to +35%	Flat to -10%	20+%
Moderate Year	+5 to -5%	+5%	+10 to +15%
Light year	-5 to -15%	+15%	+5 to +10%
Personal lines regional			
Heavy Year	+15 to +20%	Flat to -5%	+5 to +15%
Moderate year	Flat to -5%	+10%	+5 to +10%
Light year	-10% to -20%	+20%	+5 to +10%
Standard commercial lines			
Heavy Year	+25 to +50%	Flat to -20%	25+%
Moderate year	+10 to 5%	+5%	+10 to +25%
Light year	-10 to -20%	+10%	Flat to +25%
Complex commercial lines			
Heavy Year	+25 to 50%	Flat to -30%	+15 to +33%
Moderate year	+15 to -5%	Flat	+10 to +25%
Light year	Flat to -20%	+10%	+5 to 20%
Assumes no changes in insured catastrophe exposures and no significant catastrophe model changes Rate of change measured from January 1, 2008 terms			

Figure 3: Global: January 1, 2009 Expectations

REGION	ROL CHANGES	CAPACITY CHANGES	RETENTION CHANGES
Europe			
Northern (wind dominating)	Flat to -10%	+10%	Stable to +10%
Southern (quake dominating)	-5 to -15%	+10 to +15%	Stable to +10%
United Kingdom	-5 to -10%	Stable	Stable
Asia Pacific (x Japan)	Flat to -10%	+20%	Stable
Japan	Flat to -5%	Flat to -5%	Stable to +10%
Australia	+5 to -10%	+10%	Stable
Canada	-5 to -10%	+10%	Stable to +10%
South America	-5 to -10%	+10%	Stable
Mexico	-5 to -10%	+10%	Stable
Caribbean	-5 to -10%	+10%	Stable
Assumes no changes in insured catastrophe exposures and no significant catastrophe model changes Assumes no significant catastrophe losses occur before 1 January 2009 negotiations are completed Rate of change measured from January 1, 2008 terms			

Post-Catastrophe Dynamics

Should significant insured catastrophes occur prior to January 1, 2009, the fast pace of rebuilding capacity will be unprecedented since the reinsurance and insurance markets are now aligned with sufficient existing and contingent (sidecar and otherwise) capital providers.

Reinsurers will find plenty of capacity from hedge funds and alternative asset class investors but less from private equity firms than they have in the past. Private equity firms will focus more of their post-loss efforts on creating new insurers where franchise value is more clearly observable. This is a significant shift in the potential post-loss dynamics and the shift will bring new opportunities and challenges to on-shore markets. Post-Katrina was the first time that investors poured more capital into the industry than was lost. We expect this to recur following another major event or series of events given the availability of capital and the likely growth in demand for capacity.

Property Per Risk Reinsurance Market

Significant property risk losses have been sustained by insurers and reinsurers worldwide during 2008. Heavy industries such as mining, metals, pulp and paper and energy have contributed the majority (56 percent) of the insured losses in 2008. These risk losses have negatively influenced the downward trend in property per risk reinsurance rates. The result has been price and terms and conditions changes rather than capacity reductions. Aon Re Global does not anticipate capacity reductions on January 1, 2009 renewals, nor do we expect price increases on unaffected programs; indeed, such programs are likely to see further rate relief. Reinsurers, however, are not likely to match the level of rate cuts offered by insurers to their insureds.

Casualty Reinsurance Market

The casualty reinsurance market continues to suffer from reduced demand from cedents in 2008. The reduced insurer demand has less to do with disagreements over terms and conditions with reinsurers than it does insurers' desires to minimize ceded premiums in order to preserve top line growth in the face of a softening insurance market. While these insurer actions increase net risk at a time when cycle risk is increasing, we do not believe high-net retentions will be significantly reassessed until confidence in reserve redundancies is eroded by losses or actual reserve releases.

Casualty capacity layers may actually increase or reflect lower levels of decreases than would have otherwise been achieved had the leverage from the underlying layers not been lost by reinsurers. Casualty reinsurance premiums on consistently placed program structures will see decreases in net reinsurer economics of between 0 and 15 percent.

The influence of losses related to the credit market deterioration appears to be contained within the D&O and E&O professional liability lines and of the surety and credit businesses. The underwriting limitations and sub-sector limits on aggregation, especially for financial institutions, appears to have been the right formula to limiting the industry's exposure to the significant net consequences sustained by some insureds. Reinsurers in particular will have performed well in this loss avoidance measure.

Facultative Reinsurance Market

The facultative reinsurance market is balancing between two competing and substantial influences. The first is the same influence that is driving higher casualty net retentions - the desire of cedents to spend less on reinsurance to sustain net premium growth in a softening market. The offsetting influence is the increased use of facultative certificates by underwriters that fear the higher net treaty retentions.

We expect the property and casualty facultative markets to reflect rate, terms and conditions changes that are similar to the movements insurers offer their insureds. Property and casualty facultative reinsurance premium volumes will be down in 2008 and 2009 with the decreases in casualty volumes being higher than the decreases in property volumes.

Catastrophe model miss continues to be a driver of facultative purchases. Underwriters have begun to understand the shortcomings of the latest versions of the standard catastrophe models and have concluded that facultative reinsurance for excess layers and large limits can, at reasonable terms, meaningfully reduce tail risk.

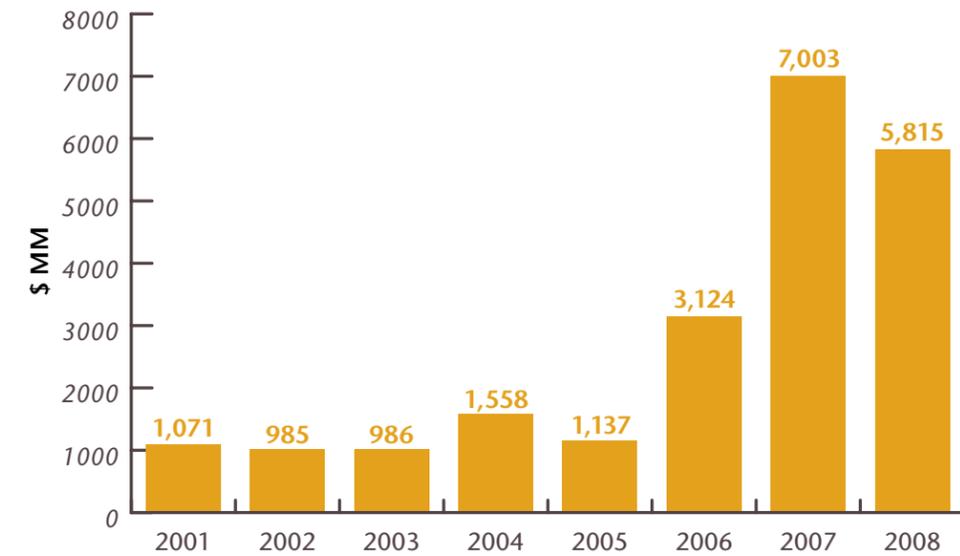
Significant emphasis is being placed upon the technology, data capture and needs assessment elements of managing facultative reinsurance more effectively at the cedent level. Aon Re Global Fac's Consultative FacSM engagements provide results that are better than the standard market reductions for cedents.

Capital Markets

While the pace of bond form transactions in 2008 may not reach the record levels attained though the end of 2007, the market continues to develop at a significant pace. Significant new sponsors have entered or plan to sponsor transactions during the year. Nearly every significant property and casualty insurer and reinsurer in peak catastrophe regions such as the United States, Europe and Japan have integrated capital markets capacity into their risk transfer or risk financing structures. We expect this complementary capacity to continue to provide between 10 and 30 percent of the capacity required by insurers that purchase more than \$500 million of capacity.

A remarkably consistent group of investors in the sector have now gained more than ten years of experience. For many of these fund managers, this positive experience has led them to begin to build additional facilities that provide collateralized reinsurance contracts. Many investors now independently run catastrophe models to assist in their evaluation of the returns expected from investing in catastrophe bonds or writing collateralized reinsurance. The performance of the alternative asset class of insurance-linked securities (including catastrophe bonds) has substantially outperformed almost any other class of structured finance securities throughout the current credit crisis. This positive differentiation will continue to attract new investors and additional funds from existing investors to the sector.

Figure 4: Catastrophe Bond Issuance By Year (Years Ending June 30, 2008)



Source: Aon Capital Markets

Sidecar capacity has reduced as the returns on catastrophe exposed business have decreased and the capital of reinsurers has grown. Many reinsurers now count on significant retrocession capacity from the capital markets. We expect this trend to continue to build momentum and supply further capacity supporting reinsurer authorizations at January 1, 2009.

June and July 2008 Renewals

Aon Re Global is pleased to confirm that our guidance for June and July 2008 renewals, released in April, was predictive. Reductions indicated for U.S. programs tended toward the higher end of the range. Australian programs tended to reflect some of the layer experience sustained in flooding and wind events.

Our predictions for the June and July market were as follows:

Figure 5: June and July 1, 2008 Expectations

REGION	ROL CHANGES	CAPACITY CHANGES	RETENTION CHANGES
Americas			
U.S. national personal lines	-10 to -15%	+10 to +15%	+5 to +10%
U.S. regional personal lines	-15 to -25%	+15 to +20%	+5%
U.S. standard commercial lines	-10 to -15%	+10 to +15%	Stable
U.S. complex commercial lines	-10 to -15%	+10 to +15%	Stable to -10%
Canada	-7.5 to -12.5%	+10 to +15%	Stable
Caribbean	-5 to -10%	+10 to +15%	Stable
Mexico	-5 to -10%	+10 to +15%	Stable
South America	-5 to -10%	+10 to +15%	Stable
Europe			
Northern Europe (wind dominating)	Flat to -10%	+10 to +15%	Stable
Southern Europe (quake dominating)	-5 to -15%	+10 to +15%	Stable
UK	Flat to -10%	+10 to +15%	Stable
Asia			
Asia Pacific (excluding Japan)	Flat to -10%	+20 to +25%	Stable
Japan	Flat to -10%	-5 to -10%	Stable
Australia	Flat	+10 to +15%	Stable
Assumes no changes in insured catastrophe exposures Rate of change measured from June 1 and July 1, 2007 terms			

Aon Re Global: Unique Forward Looking Insights for Clients

Aon Re Global believes it delivers more value to insurers by identifying changes to the reinsurance markets in advance of key industry renewal dates rather than merely reporting on the varied results of actual renewals following key renewal dates. We work with each of our clients to help them understand how these global market factors will affect their property catastrophe reinsurance renewal. Factors such as insurer underwriting methods, data quality, capacity required, experience and current modeled margin levels can combine to create a better or worse outcome than shown.