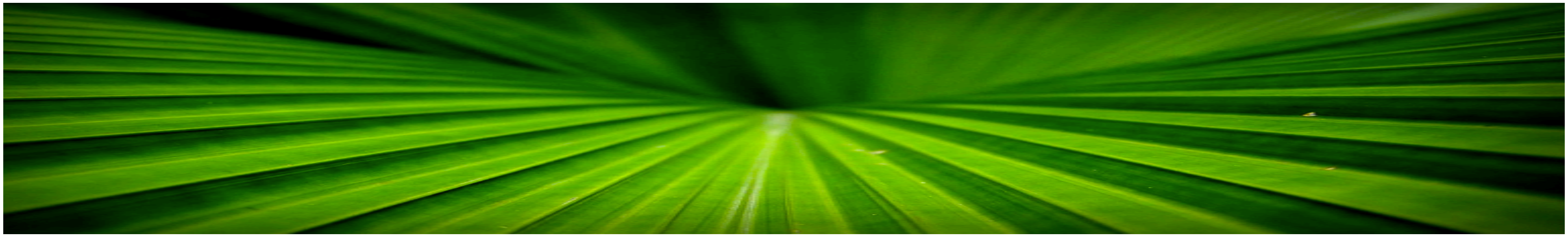

Reinsurance Pricing for Florida Property Risks

Presented by Michael Lyons
Weston Insurance Holdings Corporation

About the Author

- Michael Lyons is the founder & CEO of Weston Insurance Holdings Corporation (WIHC), Weston Insurance Company's parent company.
- Weston Insurance Company is an admitted wind-only insurance specialist, providing commercial & personal property coverage for windstorm and hail.
- Previously worked for Renaissance Reinsurance Ltd, as Assistant Vice President - US Underwriting, and later joined RenaissanceRe's Ventures team.
- Previously worked for Hannover Re's US specialty insurance operations; serving as Assistant Vice President, Underwriting Coordinator, Marketing Director & Program Manager for Praetorian Financial Group (now QBE) and Clarendon Insurance Group (now Enstar).
- Began insurance / reinsurance career 24 years ago, with Sorema North America Reinsurance in their finance department.
- Earned a Masters Degree in Applied Mathematics from SUNY Stony Brook, and the Associate of Reinsurance designation from the AICPCU.

Reinsurance Pricing Perspective

- Weston purchased $986 million of aggregate property catastrophe reinsurance limit effective June 1, 2013 – May 31, 2014.
  - 100% of the limit is for property risks located in Florida.
  - Met with 50+ reinsurers (many several times) over the past 2 years
- During tenure at RenaissanceRe Ventures, structured and managed reinsurance joint ventures and sidecars providing additional reinsurance capacity to Florida property insurers.
  - During this period RenaissanceRe was consistently at the top of the leader board in terms of providing reinsurance support to Florida domestic property insurance companies.
- During tenure at Clarendon Insurance Group, was Underwriting Coordinator for $2.4 billion in annual premiums.
  - During this period Clarendon was the 4th largest writer of property insurance in Florida.
  - During this period Clarendon had one of the largest and most complex reinsurance programs of any insurance company in the United States.
- Began career in reinsurance prior to Hurricane Andrew, and witnessed first hand the evolution of reinsurance pricing and the rapid adoption of catastrophe modeling software into assumed risk management.

Challenges for Florida

- Significant property development concentrated along the coast.
- Very high historical loss activity (many large hurricanes making landfall)
- Trillions of dollars of property to insure (more than Chile or the Netherlands)
- Construction not on par with other nations with similar hurricane exposure
- Lax construction code enforcement between 1973 – 1989.
- Florida is “peak” risk zone and hurricane is “peak” peril for most global reinsurance companies:
  - Writing Florida property risks is expensive from a rating agency capital perspective
  - Recent model changes suggest risk has been understated for certain property types
    - RMS v.10 to v.11 change suggests inland and commercial risks are more vulnerable than previously thought
  - Lloyds’ RDS framework for risk capital allocation is now more granular for Florida:
    - Previously just 2 scenarios; Labor Day 1935 and Hurricane Andrew
    - More scenarios = no more “free money” risks

Current Market Conditions

- Significant new reinsurance capital available to Florida property insurance companies.
- Reinsurance prices decreased an average of 15%, on a risk-adjusted basis, from last year’s June 1 renewal. *
- Retrocessional prices decreased significantly as well, helping reinsurers maintain margins despite downward pressure on rates for assumed risks.
- Investor demand for Insurance-Linked Securities (ILS) is currently higher than supply.

*** Please note**: Florida property insurers did not benefit equally.

Benefits to FL Property Insurers

- Lower reinsurance prices at the June 1 reinsurance renewal meant property insurers could improve the overall security of their program by:
  - Purchasing additional vertical limits
  - Purchasing reinstatements for second and third events (sideways protection)
  - Adding drop down features to layers to prevent gaps in coverage
  - Replacing lower rated reinsurers with higher rated reinsurers
  - Eliminating basis risk by replacing parametric triggered coverage with indemnity based coverage
  - Reducing per occurrence and aggregate company retentions

Causes of Excess Reins Capital

More Supply of Reinsurance Capital

- No hurricane land falls in Florida since 2005 (streak of good fortune):
  - In years with no large loss events, reinsurers make and retain healthy profits
    - Only one Lloyds syndicate (Hiscox) dividended their 2012 earnings.
  - Retaining profits means more $$ chasing the same returns and the same risks
- $10 billion increase in alternative market reinsurance capital in past year and ½

Less Demand for Reinsurance Capital

- Large national insurers have also retained healthy profits, and have chosen to reduce their reinsurance buying as a result.
- More risk is being transferred via ILS and ILWs, eroding demand for traditional reinsurance.

More Supply + Less Demand = Lower Prices

Why are Florida risks interesting?

Pros:

- Low beta with relatively high yield.

"There is great demand in the market for cat bonds and industry loss warranties mostly originating from hedge funds, pension funds and private equity. The premise is that ILS are not highly correlated to other asset classes and offer appealing returns as compared to other fixed income investments. Currently, demand for these investments far exceeds supply. This has brought the pricing down for natural catastrophe risks, especially in the U.S. … It should be noted that capital market interest in reinsurance is currently limited to cat risk." - **Stefan Holzberger,** Managing Director of Analytics for A.M. Best Europe

Cons:

- Attritional losses are high and seem to be manufactured to some degree
- High level of insurance fraud relative to other states
- Suspect data quality
- Political uncertainty
    - The state (CPIC) is the largest property insurer (CPIC) and reinsurer (FHCF / SBA)
    - This inherently politicizes property insurance in Florida

Low Beta / High Yield?

- **Low Beta**: in finance, Beta describes the correlated volatility of an asset compared to a benchmark portfolio.
  - Hurricane risk has a near 0 Beta relative to a portfolio of equities and fixed income assets, and therefore can add uncorrelated returns to a portfolio.
  - Hurricanes occur independently of market cycles and financial crises.
  - Simply, mother nature doesn't care whether the stock market is up or down.
- **Relatively high yield**:
  - On-the-run 10 year "BBB" U.S. corporate bonds in the finance sector currently issue at 200 basis points above 10 year Treasuries: total yield of **4.60**%.*
  - On-the-run 5 year "BB" U.S. corporate bonds in the finance sector currently issue at 224 basis points above 5 year Treasuries: total yield of **3.73**%.*
  - Property catastrophe reinsurance comes with significantly more short-term volatility, but offers better absolute returns and in many instances better risk-adjusted returns.

* **Source**: Bloomberg FMCS & US Department of the Treasury as of 06.26.13 .

Sustainability of Current Market

- **Alternative Market Reinsurance Capital will continue to grow**:
  - GC Securities estimates $11 billion of additional investments by 2016.
  - Nephila Capital closed its doors to new investors after growing from $2 billion to $9 billion AUM in 4 years, but …
  - Aeolus Capital Management, Leadenhall Capital Partners and Elementum Advisors have grown to $1.7, $1.4 and $1.0 billion AUM in less than 3 years.
  - New capital sourced primarily from long-term institutional investors, including global pension funds: "Institutional investor acceptance of insurance risk as an uncorrelated source of returns is leading to an influx of stable, longer-term capital that needs less internal diversification." **John DeCaro**, Elementum Advisors
- **ILS demand and ILW supply continue to increase, increasing downward pressure on traditional reinsurance pricing**:
  - Everglades Re 2013 (cedant Citizens Property Insurance): $250 million
  - Armor Re 2013 (cedant American Coastal Insurance Co): $183 million
  - Oak Leaf Re 2013 (cedant Southern Oak Insurance): $30.5 million
  - Sunshine Re 2013 (cedant Florida Mutual Insurance Trust): $20.0 million

What if?

- **Global macroeconomic factors are currently moving in a direction favorable to Florida property insurance policyholders, but what if** …

  - A 1-in-100 year return period hurricane makes landfall in Florida?

    OR
  - A 1-in-500 year return period earthquake occurs in California?

    - Destruction of reinsurance capital, where is the tipping point?
    - Quality of data: actual losses versus modeled losses.

THANK YOU

- Thank you for your time.
- For more information about Weston, please visit:
  www.weston-ins.com