Reinsurance

XL CATLIN

Surety Survey 2016

Re...

Contents

Foreword

It is with great pleasure that I present to you our first Surety Survey. Based on 36 in-depth interviews with XL Catlin surety clients in all major markets, we believe it is a powerful tool that provides an overview of the current state and near-term prospects of the USD 13 billion global surety market.

Our survey shows that the global surety market is cautiously optimistic, despite prevailing overcapacity in the wider insurance industry. In mature markets, economic recovery should drive premium growth, while in developing markets the current downturn is not expected to substantially challenge long-term growth perspectives.

While rates, and terms and conditions remain under pressure, loss ratios are relatively stable. As a result, surety insurers have started to strengthen their underwriting discipline, maintain a close grip on costs and closely manage client relationships. The executives polled for this survey expect reinsurers to continue to play a key role in protecting their clients' balance sheets, enhancing capital efficiency, supporting them with know-how and expertise and providing risk capacity for further growth. However, the contraction of reinsurance panels and a reduction of cession rates predicted by some market pundits does not appear to be on the horizon.

XL Catlin's reinsurance operations are fully committed to the development and growth of the global surety market. With this, our first Surety Survey, we aim to provide greater transparency and information on the trends and developments that dominate current surety markets. Our study also underpins our aspiration to establish ourselves as a core reinsurer in this important line of business, which has a vital role to play in supporting the global economy.

We hope you will enjoy reading this report and benefit from its findings.

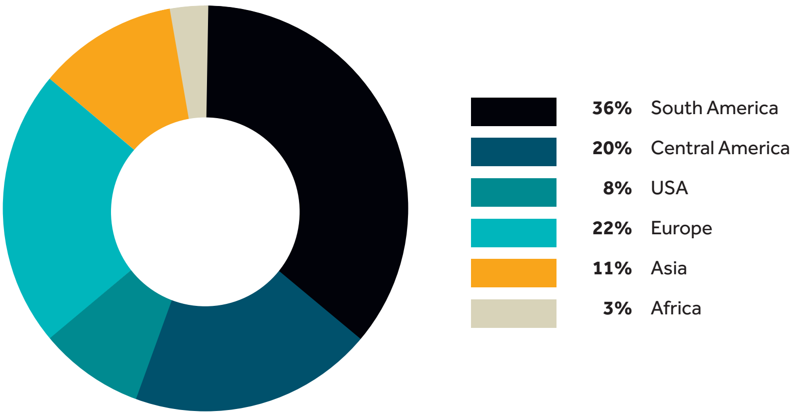
Please do share your feedback and thoughts on how we can collectively promote the awareness and understanding of the relevance of the surety market.

Peter Schmidt
Chief Executive
Global Credit & Surety Reinsurance
Reinsurance Property & Casualty Asia Pacific
and Latin America
XL Catlin

Methodology

The findings of this report are based on in-depth and structured telephone interviews with executives representing 36 regional and international insurance companies active in the field of surety. The interviews were conducted in December 2015 and January 2016 by Dr Schanz, Alms & Company AG, a Zurich-based research, strategy and communications consultancy, on behalf of XL Catlin.

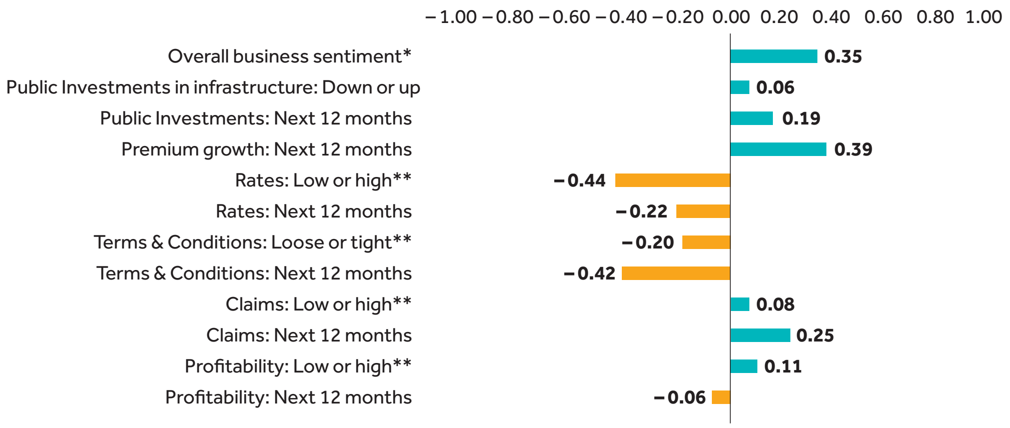
Country of origin of the surety executives participating in the Surety Survey



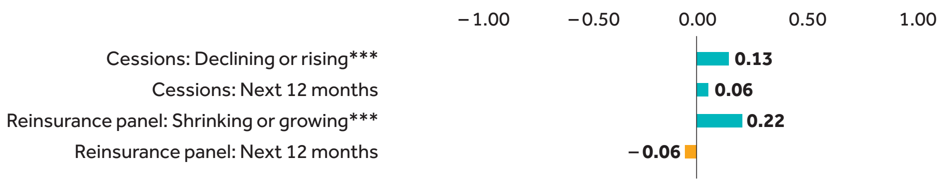
Key survey readings

The Survey measures current trends observed in the global surety insurance market, tracking them over time to monitor changes in attitudes.

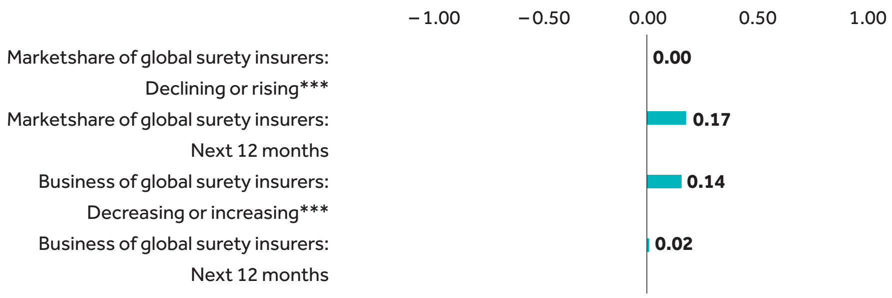
Key readings – surety market assessment



Reinsurance buying



Role of global insurers



*on a scale of -2 to +2 (all others on a scale of -1 to +1) ** as compared to the average of the past five years *** in the last 12 months

Key findings

In the view of polled executives, the surety industry is relatively robust, although not immune to the current oversupply of capacity which affects insurance markets worldwide. On a scale from +2 (very strong) to -2 (very weak), the average global surety market sentiment came in slightly bullish at 0.4. Interviewees are optimistic that the surety industry will benefit from economic recovery in the US and in European markets – as fragile as it still is – while hoping to buck the current economic downturn in developing economies as their fundamental, long-term growth parameters remain largely unscathed.

The surety sector's strengths are also its weaknesses: its continued strong reliance on public spending and, to a lesser degree, private investments in infrastructure and construction in particular. According to interviewees, investments remained stable over the course of the past 12 months and the outlook is mildly positive. In mature markets, existing infrastructure needs to be maintained and modernised, while in emerging markets it still has to be developed and expanded for markets to realise their full potential.

Surety insurers are striving to diversify their services beyond the construction sector. In Europe in particular, but also in some Latin American markets, surety insurers are cooperating with the banking sector to provide back-to-back cover for risks that go beyond the banks' capacity or business interest.

As a result, the polled executives expect premiums to rise for the next 12 months. However, as competition intensifies – for instance, from multi-line insurers pushing into new markets – already low rates may decline further. However, there remain market segments where specialist knowledge is required and insurers continue to write risks at attractive rates.
Similarly, the terms and conditions that prevail in the surety market are perceived as average to loose and may deteriorate further, although conditions may be upheld or even improve for complex contracts.

Low loss ratios have been a strength of the surety sector. Claims are currently perceived as slightly higher than the historical average and might rise further over the next 12 months as markets benefit from an economic recovery and are willing to take on more risk. Slightly higher losses are also expected in markets exposed to tighter public expenditure, especially in Latin America.

Despite pressure on rates and conditions, the global surety market is profitable. The majority of executives participating in the survey see current levels of profitability roughly in line with the average of the past five years. Although claims are slightly up, the surety sector still benefits from comparatively low loss ratios, allowing for a decent return. However, the outlook for the sector's profitability is slightly muted. For 56% of respondents, profitability will remain unchanged over the next 12 months, while 25% expect a decline.

The strategic responses of the sector to the current challenges are limited, as in many markets external factors, such as public sector investments, foreign exchange rates or commodity prices, affect performance. Innovation and alternative sources of income are rare, but occur mainly in relation to banking-style products or insurers' increasing capability to capture business historically written by banks. Consequentially, interviewees frequently state that they are strengthening underwriting discipline, focusing on technical excellence and closely managing their client relationships. In addition, players are increasing or refocusing their distribution by expanding into neighbouring countries or specific client segments like SMEs, possibly adjusting the design or mix of their product offerings accordingly. This also includes cooperation agreements with banks, which are expected to become an even more common feature in the surety industry.

When asked about the key reasons for buying reinsurance protection, surety insurers predominately state that they aim to protect their balance sheets against large loss events and to access capacity for large risks. Since the surety sector continues to be dominated by national markets and local players, cedants appreciate reinsurers' global expertise and ability to support them in product development and in enhancing portfolio efficiency. Relationships are seen as stable and determined by soft factors, like expertise, know-how and responsiveness, in addition to capacity and the quality of the security, while pricing is mentioned as less of a decisive purchasing factor. Cessions have mainly grown in volume, but not in proportion, while changes to the composition of reinsurance panels remained rare.

To date, globalisation of the insurance sector has only had a limited impact on the surety sector. 67% of the executives polled have seen no increase in global players writing surety in their market over the past 12 months.

Introduction

Premium volume for the global surety industry amounts to approximately USD 13 billion, according to a Swiss Re sigma study from 2014. In the 10-year period from 2003 to 2013 premiums increased in aggregate by 75%, however, as a percentage of GDP, the market penetration rate remained unchanged at 0.022%. The largest markets are the US with roughly 40% of global premiums or USD 5.3 billion, followed by South Korea with a share of close to 11% or USD 1.4 billion. Italy, Germany and Mexico follow, each with between USD 600 million and USD 650 million in premiums.

Growth in surety markets has been driven largely by the 10-year economic boom in emerging markets up until 2013. In particular, Latin America registered the most substantial expansion in surety, driven by significantly increased activities in construction. Brazil grew on average by 28% per annum between 2003 and 2013, Chile by 20% and Colombia by 17%. Since 2003, the region's premiums increased four-fold, while the rate of surety insurance as a percentage of GDP (penetration) doubled to 0.044%, or 30% above the rate of North America at 0.033%.

North America is still the surety industry's largest region. However, its relative importance has declined over the past 10 years as growth in premium – at about 40% since 2003 – has trailed global growth. Consequently, North America's share of the global surety market declined by more than 10 percentage points to about 45% in 2013.

Europe's market share over this period remained largely stable at roughly 23%. The most dynamic market was Germany, almost tripling its premiums in the past ten years, while Italy, historically Europe's largest surety market, grew by just 20% in the same period.

Similarly, Asia's share stayed roughly unchanged at 13% with a penetration rate of 0.024%. While the role of Emerging Asia is still insignificant in surety insurance, South Korea continued to dominate the mature markets of Asia.

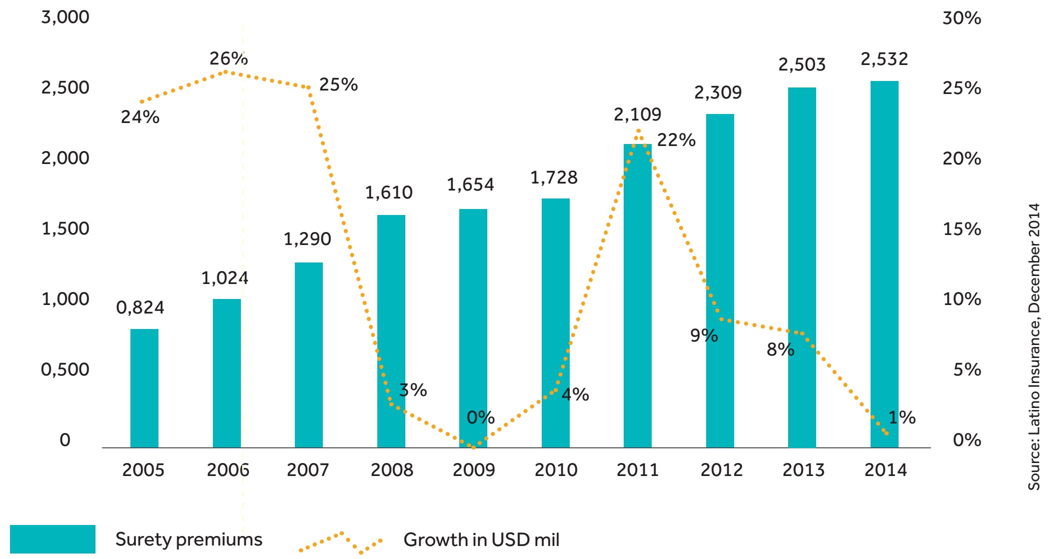
Cessions vary largely according to region. Based on data from XL Catlin's reinsurance operation, cessions in the US are close to 10% while in Latin America, by contrast, rates are closer to 50% of premiums. The comparatively small cession rate in the US is explained by the prevalence of excess-of-loss reinsurance contracts rather than pro-rata risk sharing.

Gross Written Premiums of USD 13 billion by region, in USD mil and in %, 2013

USD mil		
5,850	45%	North America
2,210	17%	Latin America
2,936	23%	Advanced EMEA
285	2%	Emerging EMEA
1,726	13%	Advanced Asia
44	0%	Emerging Asia

Source: Swiss Re Sigma 2014

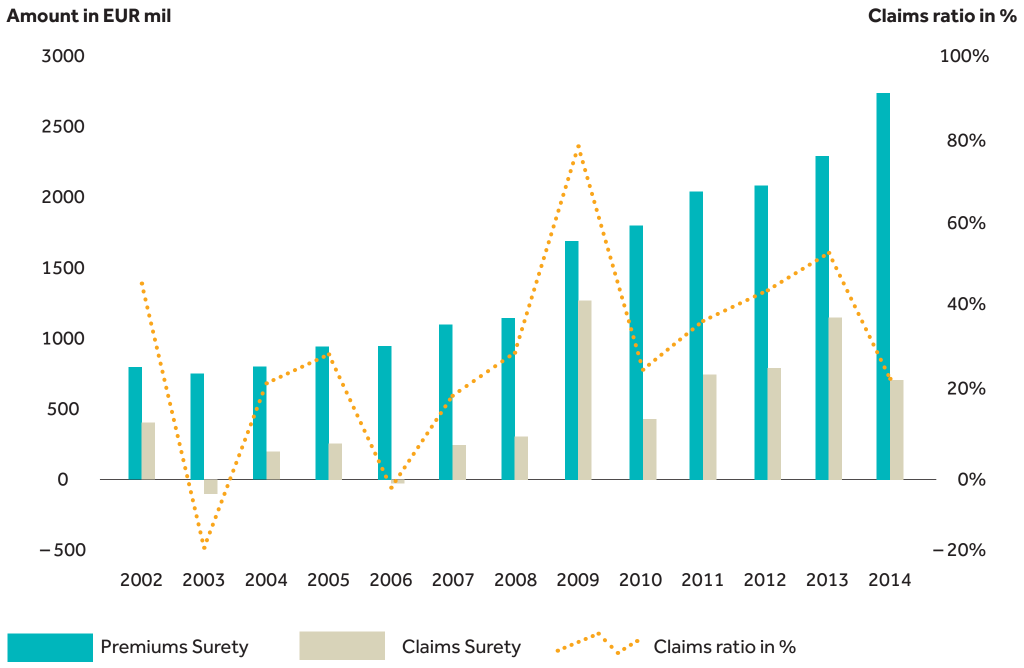
Latin America – Surety: Premiums & Growth



In the past, surety markets demonstrated a strong resilience to adverse developments mainly triggered by economic recession. With an unchanged penetration rate of 0.022% of surety premiums vs. GDP, the surety sector managed to maintain its relevance for the overall economy over the past 10 years. Although the sector remains largely reliant on demand from infrastructure projects, wide-spread constraints in government spending due to pressure on fiscal budgets was compensated by new business sourced in other market segments.

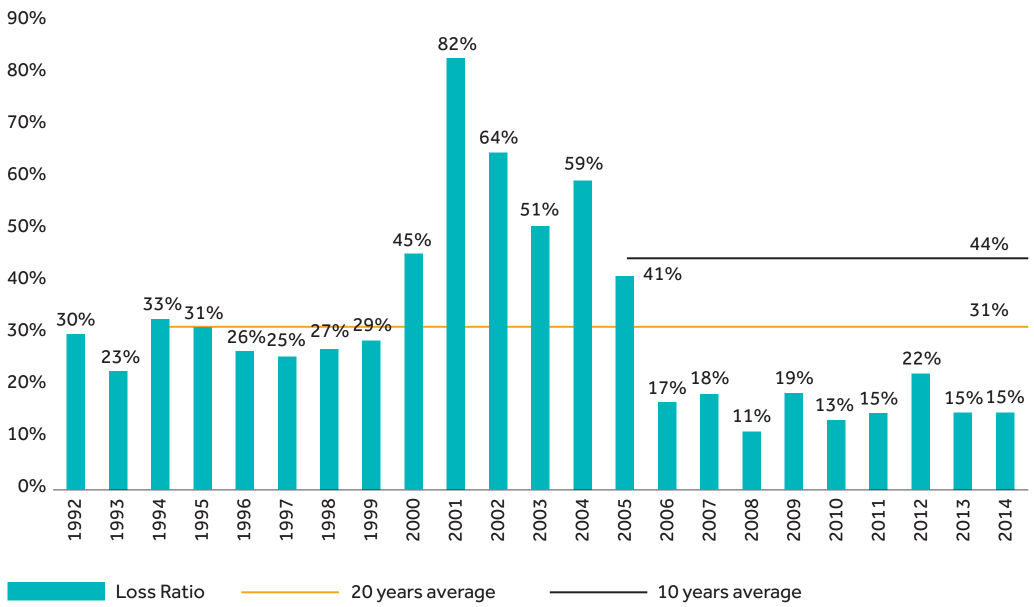
Historically, the volatility of loss ratios in the surety sector has been more pronounced than in trade credit insurance, as evidenced by high-profile loss events in the past, for instance the default of US energy group Enron Corp. in 2000. Typically, loss ratios in surety react to economic downturns with a certain time lag. Current ratios are therefore not a true or an immediate reflection of the strength or weakness of an economy. In addition, the surety industry benefits from the fact that, in times of more wide-spread financial distress, governments and banks do not have an interest in letting large businesses default.

Surety – Premiums, Claims & Claims ratio, ICISA members



Source: International Credit Insurance & Surety Association (ICISA), 2015

US surety* – Loss ratios

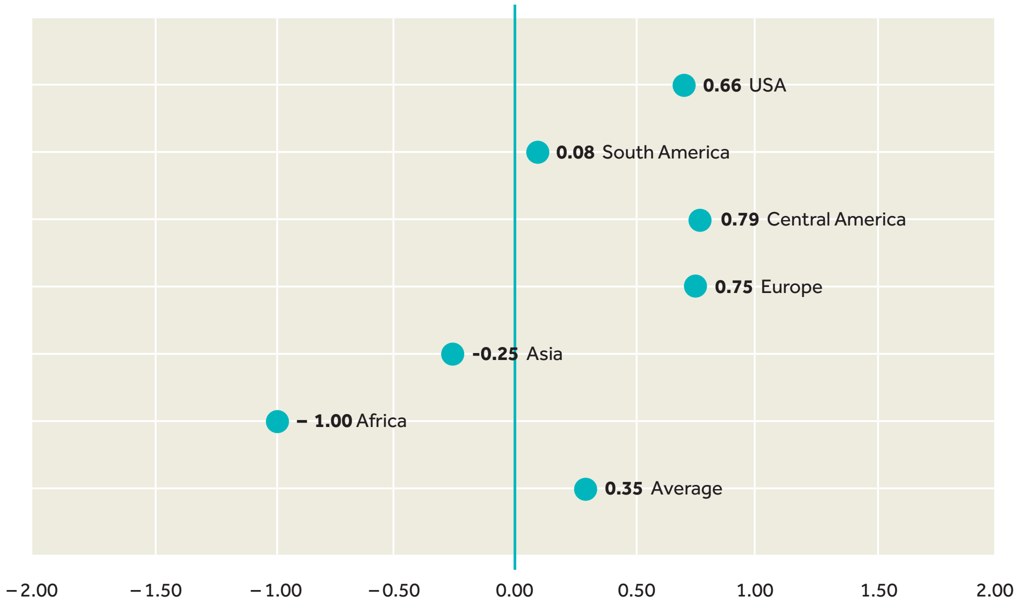


Source: Surety & Fidelity Association of America "50 Largest Writers, All Writers" 2015

*Top 50 writers

Survey results

Current market sentiment



Overall market sentiment

Global surety market remains positive

Despite sluggish economic conditions, polled executives were moderately positive about the state of their surety markets and the prevailing conditions. On a scale from +2 (very strong) to -2 (very weak), average global surety market sentiment came in slightly bullish at 0.4. The sentiment was driven by the expectation of continued economic recovery and the need for governments to invest in infrastructure, or because surety insurers increasingly tend to take on business written by the banking sector.

In addition, for many interviewees, sound business conditions in the surety sector remain intact. Typically the sector is thought to reflect the overall economy. Since many surety markets are based in emerging economies, the overall attitude is slightly upbeat, and according to the executives polled, the fundamental growth conditions in these markets remain unscathed. Furthermore, in some Asian and Latin American markets, regulation still shelters national players from foreign competition, which positively affects rates and margins.

There were, however, regional differences in interviewees' sentiment. Interviewees were more upbeat in Europe, the US and Central America, with interviewees pointing to a stronger competitive position due to tighter solvency requirements, a promising pipeline of public infrastructure projects or because of opportunities arising from banks' retreating to their core business. The outlook is also more positive as some economies show signs of recovery and rising business confidence resulting from new governments in countries like Argentina.

Latin America, Africa and Asia (Japan) were seen more negatively, where falling commodity prices and slowing economic growth are weighing on current sentiment. Even so, respondents are concerned about fierce competition as a result of low loss ratios and sluggish premium growth in those regions.

The overall perspective: Strengths, weaknesses, opportunities and threats for global surety markets

Infrastructure needs present the main opportunity

A strong and growing need for infrastructure investments is perceived as the most relevant strength and opportunity by the executives polled. This is true for both mature economies, where existing infrastructure is in need of maintenance and replacement, as well as in emerging economies where additional railroads, motorways, airports, power plants, etc. are required to sustain economic growth going forward.

The strong underlying profitability of surety business ranks second. Traditionally perceived as a profitable low loss ratio business, the industry partially benefits from the compulsory nature of the business in some markets, the rigorous procurement process for public works, and the relatively high barriers of entry where regulation limits the degree of competition. As a result, in terms of technical profitability, the surety market has outperformed most other lines of insurance business in recent years. According to Fitch Ratings, the US industry's statutory combined ratio averaged 77% between 2010 and 2014, unaffected by the higher claims activity triggered by the 2008-2009 financial crisis.

Since the surety market is closely connected to economic cycles, GDP growth is the third most frequently mentioned strength. It not only drives construction but also other sectors of the economy that need surety protection. In addition, robust economic growth tends to come with relatively low loss ratios – at least as long as discipline and risk awareness remain high.

The fourth most frequently mentioned strength or opportunity is the retrenchment of banks in many markets. Banks are facing significant pressure to deleverage and to comply with rigorous new capital requirements under Basel III. Both factors dampen their appetite for guarantee business and open up opportunities for companies in the (re)insurance industry.

Finally, survey participants highlight the surety market's overall stability and reliability as a relevant strength, with as many mentions as the opportunities from banks' scaling back their exposures.

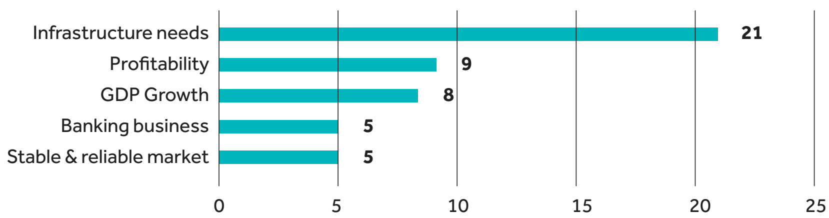
"The surety market is currently neither bearish nor bullish. We still see opportunities driven by globalisation, the growth in public-private-partnerships and an increasing focus on improved services. However, there is clearly too much capacity in the market, rates are under pressure and, as a result, we need to tighten underwriting discipline."

Michael Y. Yang, Senior Vice President, CUO, Global Specialty Lines – Surety, AIG

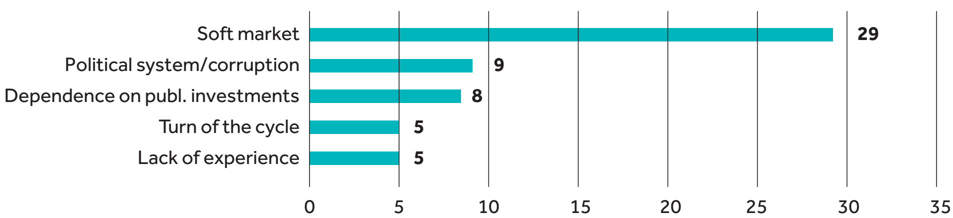
"The surety industry is starting to seize new opportunities. Due to the larger capacity that we have access to today and increased sophistication in our industry, we are able to consider large transactions, which traditionally would have gone to the banks. We are able to underwrite complex risks, and team up with partners to provide cover for the needs of global cedants."

Luc, Reuter, SVP & Head of Surety, Chubb Europe

Market strengths and opportunities, number of mentions



Market weaknesses and challenges, number of mentions



Excess capacity viewed as biggest challenge

Fierce competition in a soft market is, by a high margin, the most frequently mentioned weakness presented by global surety markets. Low loss ratios make many segments a buyers' market with declining rates, whilst – at least in the non-protectionist markets – attracting new and additional players to an already softening market. As excess capacity grows, large global insurance groups are looking for opportunities to deploy their capital, including entering regional surety markets or expanding their existing presence in markets where they are already active.

Corruption and ineffective governments rank second among the weaknesses and challenges identified by the executives polled. The deficits do not relate to the surety sector in particular, but are viewed as general factors affecting the respective countries' business environment. However, in some markets, surety companies can be affected by corrupted or intransparent procurement processes or inefficient legal systems impacting the likelihood of successful claims recovery.

Given the close links to government investments, surety sector executives are frequently concerned with their market's dependence on external factors. First, concerns linger about some countries' fiscal prospects and their respective governments' ability to undertake major infrastructure projects. Secondly, commodity prices can be a driving force for large construction projects in that they provide governments with the necessary funds, but are widely beyond the surety market's sphere of influence. In addition, they are also a major source of public income in many emerging economies.

A general lack of experience is another relevant weakness frequently mentioned. It is also a major reason for many cedants' strong reliance on foreign reinsurers, not just in terms of underwriting capacity but also in the area of technical expertise.

"Surety business in Japan is very profitable. Since the global financial crisis, the number of bankruptcies in the construction sector has declined continuously. The flipside of this positive development is an ever increasing level of competition and pressure on prices in the Japanese surety market."

Muneki Ishimaru, Deputy General Manager & Group Leader; Reinsurance Group; Reinsurance Department, Aioi

"In Poland, the surety market was very much affected by increased losses in the aftermath of the European soccer championship (the country hosted the 2012 UEFA European Championship), when we experienced quite a number of bankruptcies in the construction industry. Since then the loss ratios have declined again and the profitability improved."

Lenart Grzegorz, Reinsurance, TUI Warta

"Guatemala's surety sector generates about USD 30 million in premiums annually. On the upside, we benefit from a steady need for investments into infrastructure and relatively high maintenance costs due to Guatemala's natural catastrophe exposure. In addition, we see the emergence of public-private-partnerships as an opportunity in the construction sector. However, on the downside, the sector is affected by increasing competition, corruption and a lack in government payments for construction work. It has proven to be a stable, profitable market, but new non-specialised competitors will increase pressure on rates as well as conditions."

Andrés Sicilia, Presidente, Aseguradora Fidelis

Business environment: Status and outlook

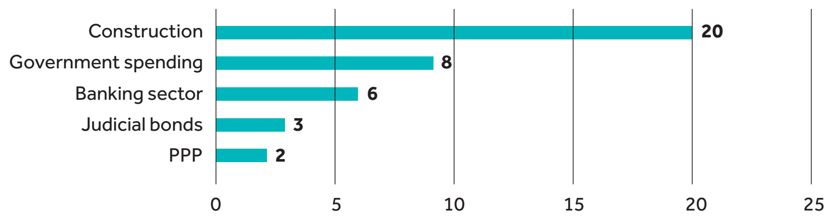
Growth in surety markets tied to the fortunes of the construction sector

Public and private sector construction activities rank first among the drivers of top line growth in the world's surety markets. Related to construction activity is the level of government spending in general, and for infrastructure projects in particular. As already stated, this is the key dilemma for the global surety industry. If neither the public nor the private sector has capital to spend, growth will be scarce. However, government intervention in the form of stimulus programs is a common remedy for an otherwise sluggish economy. As such, surety players demonstrate a high resilience in times of slower economic growth or even a stagnating economy. Japan's surety market, and certain Central and Latin American markets, are good examples where government spending on construction and the surety market's fate go hand-in-hand.

In some markets, the close ties between the surety market and the banking sector open up opportunities to generate premium income. In mature economies, but also in Chile and Brazil, banks are scaling back their activities due to capital constraints and tighter regulatory requirements. In addition, surety players have become larger, more international and, as excess capacity spills over into the surety sector, will join forces and occasionally replace banks on large and capacity intensive guarantee business.

Judicial bonds create a unique situation in Brazil. Necessary in almost all sectors of the economy, judicial bonds cover legal and tax disputes and are currently the key driver in Brazil's bond market, offering substantial growth opportunities, but possibly at a higher risk. However, in light of the country's current economic recession, and amid high-profile corruption allegations, judicial bonds are highly sought after by corporate clients.

External drivers of top line growth (number of mentions)



The fifth most frequently mentioned driver for growth is public-private-partnerships (PPPs) which are gaining in popularity in both mature and emerging markets. Survey participants see great potential for PPP contracts, in which private sector companies provide a service previously the domain of the government and often assume substantial financial, technical and operational risk in the project. PPPs are attractive to governments as they harness the private sector's expertise and efficiency. In addition, PPPs are usually structured in such a way that the private sector, and not a public entity, issues the debt associated with the project.

"We have seen claims on the rise in Brazil in 2015 and expect a continuation in 2016. Although this is partly due to the economic environment and a rise in corporate defaults, it is also a reflection of a growing awareness and understanding of the value of surety bonds in the marketplace. We thus see the rising claims ratio also as an indication that our product is being used. That is an altogether positive sign."

João Di Girolamo Filho, Head of Surety Brazil, Swiss Re Corporate Solutions

"Mexico's surety sector is currently passing through a phase of transition as the country's oil industry has just been privatised after almost 70 years of state-owned monopoly. Subsequently, 2015 was a year of stagnation, in which the surety industry had to come to terms with the new reality. For 2016 we expect to return to growth as Mexico will remain a manufacturing hub for the US and Europe and will require continued investments into construction and infrastructure."

Jorge Rodriguez Elorduy, Director General, Afianzadora Sofimex

"Colombia's surety market is currently not in a strong condition. Although surety premiums have grown by 9% over the last 12 months, exposures have increased even more rapidly. As a result, Colombia's surety insurers shoulder more risk at a lower rate."

Jorge Andres Mora Gonzalez, Vice President Sales and Services, Seguros Mundial

Robust infrastructure investments in mature economies, slowdown in emerging markets

According to executives polled, global infrastructure investments have remained relatively stable over the past 12 months. The mature economies of the Northern hemisphere developed most dynamically.

Japanese insurers cited massive public spending under "Abenomics" to boost economic growth by way of infrastructure investments. In addition, the need to restore facilities destroyed by the 2011 Tohoku earthquake and tsunami was a further factor that contributed positively to an otherwise rather bleak market environment. In the US, and also some European countries, surety markets benefited from economic recovery, a large backlog in infrastructure investments due to the severity and length of the past recession, plus robust private sector activity. This actually preceded the public sector activities which have only recently started to pick up.

In the emerging markets of South America, Africa and to a lesser extent Central America, a marked economic slowdown and declining commodity prices took their toll on the construction sector, with activities generally contracting.

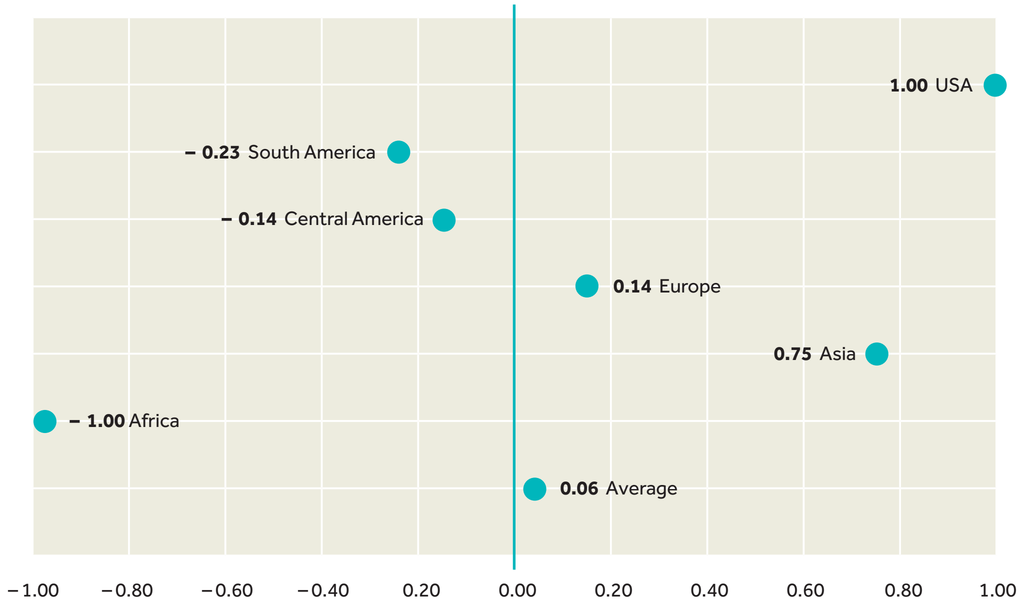
"The Israeli surety market fundamentally benefits from a legal requirement according to which each real estate developer needs to secure a performance bond or guarantee. Demand is strong due to a buoyant housing market, reflective of immigration, but also as a result of low interest rates which encourage property investments. In addition, public spending on infrastructure development in rural areas in particular has been robust over the past few years".

Roie Geva, Manager Surety Department, Harel

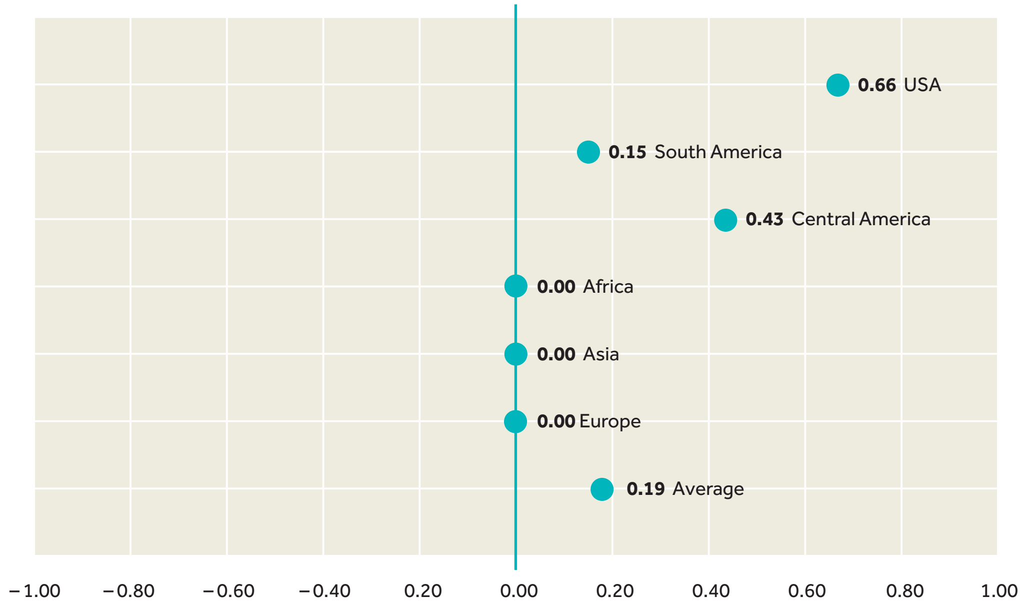
"The fastest growing products will be in Construction."

Martín Delgado, Vice President Surety, Internacional de Seguros

Investments in infrastructure (public and private) over the past 12 months



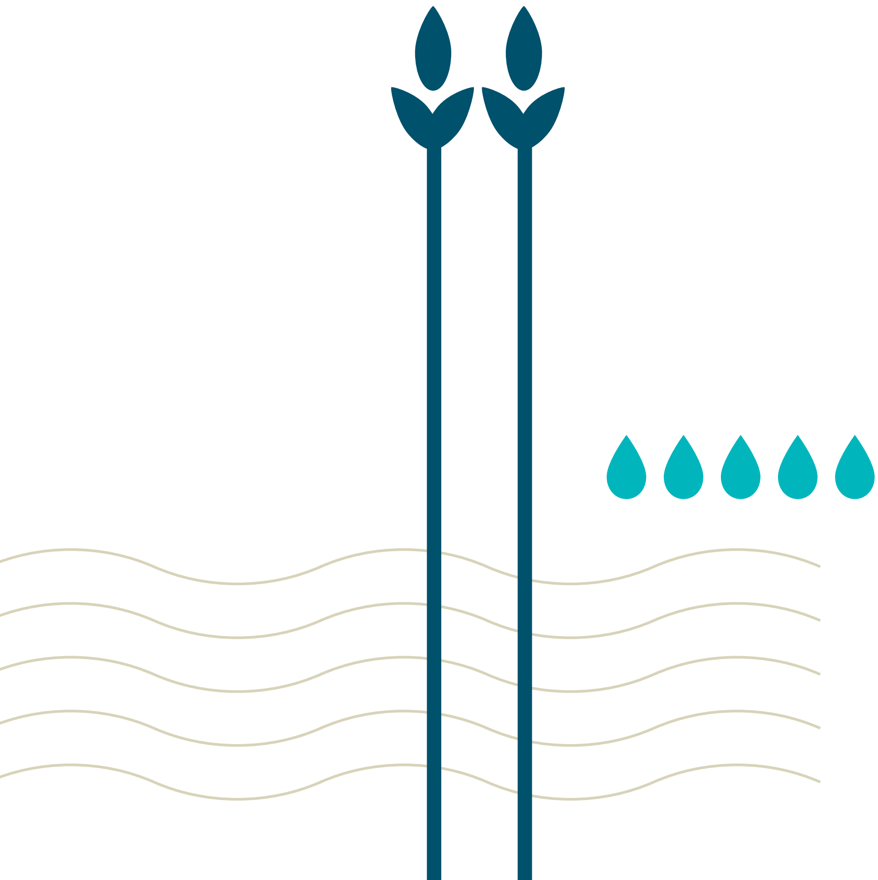
Expected investments in infrastructure (public and private) over the next 12 months



Consistent global outlook: Infrastructure investments to remain stable or increase moderately

The outlook for infrastructure investments for the next 12 months is moderately positive. Interviewees believe public spending will increase – in particular where investments in infrastructure have been stalled for quite some time. However, economic recovery is still fragile and while optimism outweighs pessimism, many expect current austerity programs to prevail for quite some time. While no region expects a contraction of spending, the Americas, in particular the US, expect to see a minor expansion.

Fiscal consolidation in Japan is likely to result in a reduction in infrastructure spending, but this could be offset by investments for specific larger projects, in particular the 2020 Tokyo Olympics. The outlook for Latin America is mixed: New governments, such as in Argentina, are viewed favourably, while the sentiment in Brazil is most negative. A recovery here is expected in 2018 at the earliest. Spending in Europe is anticipated to mirror the muted outlook for economic growth, whereas in the US the public sector is expected to increase spending in line with growing tax revenues.



Market: Status and outlook

Premium growth: Surety markets set to continue on growth path

Surety premiums are expected to grow over the next 12 months. Half of all interviewees predict an increase in premiums, while only 10% forecast a likely decline in premiums. In fact, all regions, apart from Asia (Japan), either expect stable or rising premiums.

The US and Europe most consistently predict premiums to increase, driven by investments in construction, but also through further new business coming from the banking sector. The outlook for South and Central America is also quite favourable. Insurers in Argentina were hopeful for a change in government (which had not yet been elected at the time of the interviews), while in Brazil insurers expect to continue to benefit almost exclusively from the current boom in judicial bonds. Chile is particularly positive because the country is fundamentally in a strong economic position and foresees further infrastructure investments.

In Central America further investments around the Panama Canal are a key driving force, while in Mexico the strong manufacturing industry and a recovery following the privatisation of the country's energy sector will positively impact the surety industry.

Conversely, Japanese insurers are sceptical about the government upholding the strong investments of the past, while the economy continues to stutter along. In Africa the surety industry is seeing the impact of the region's strong dependence on commodity prices and its consequences on government spending.

"As the US economy improves, we expect a slight increase in losses and defaults. This is a typical phenomenon during recovery when after a long period of recession and stagnation the players in the construction business want to grab the opportunities that arise as the economy picks up. However, some get it wrong and consequentially we see a few more failures."

John F. Welch, Surety President, CNA

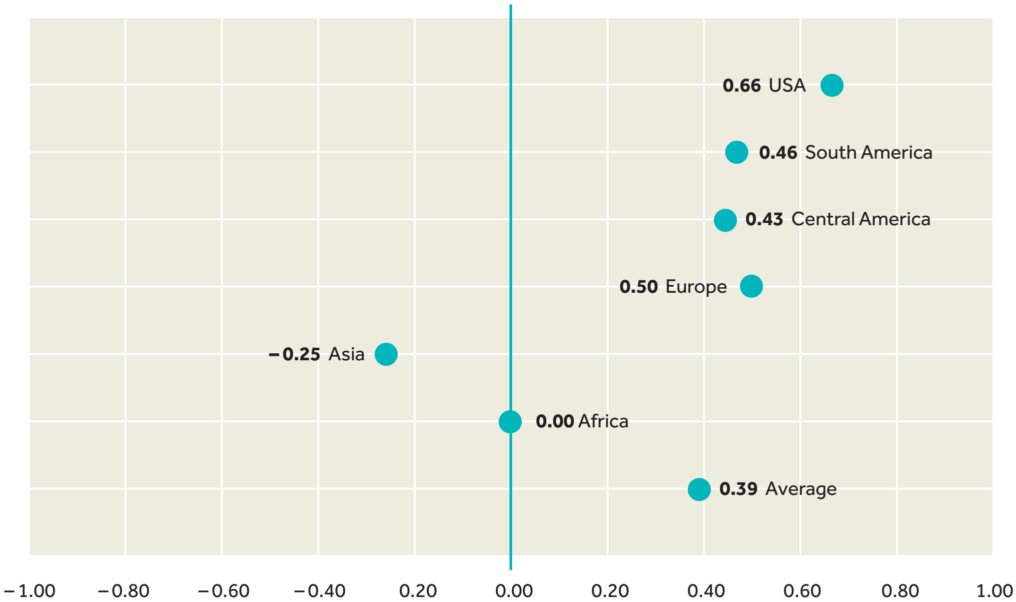
"Following the financial crisis and the subsequent slump of Ireland's construction industry, the surety sector experienced a 1 in 100 years loss event. Currently, the industry is recovering from that event. Although the market has rationalised since its contraction, awareness of the benefits of surety products is still high and cedants remain rather risk adverse. As a consequence, demand for surety protection still exceeds supply."

Kevin O'Brien, Managing Director Surety, Construction Guarantee

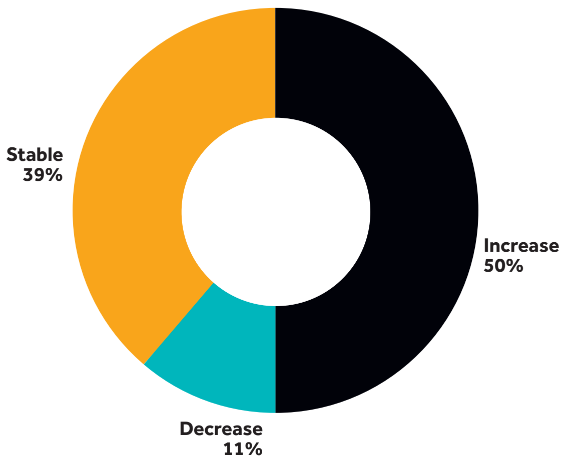
"The Japanese surety market is dominated by performance and customs bonds. As such, the sector is driven by government spending on construction work, international trade and changes to sales taxation. All these factors played out positively over the past few years and benefited the surety insurance market in Japan."

Fuminori Nihashi, Deputy Manager, Tokio Marine & Nichido Fire Insurance Co., Ltd.

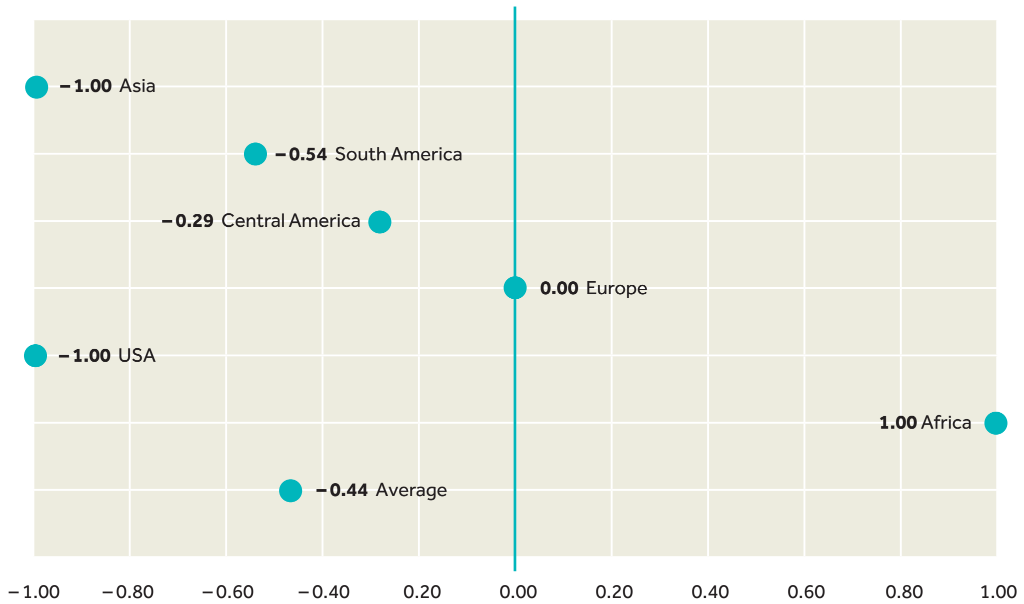
Expected premium growth over the next 12 months



Expected premium growth by number of mentions



Current level of rates against the average of the past five years



Rates: Excess supply and favourable loss experience put pressure on surety prices

While premium income is expected to rise, rates are low and at best will remain stable. With the exception of Africa, where rates are still comfortable, all other markets perceive current prices as average or below average, compared with the past five years.

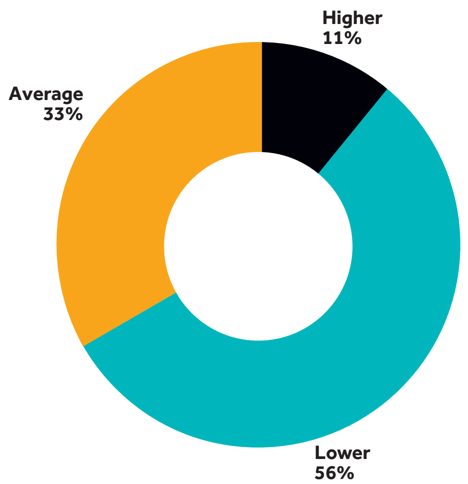
Excess capacity, in combination with low loss ratios, has exerted downward pressure on rates. This is particularly true for the highly competitive US market, as well as for surety business in Japan, which has been virtually loss-free over the past few years. In contrast, pricing erosion is seen to be more moderate in Europe.

Excess capacity does not consistently affect all lines or client segments. Typically, the more generic products that require less differentiation are more competitive. Also, client segments with low loss ratios tend to be lower priced, still leaving insurers with a commensurate margin. Another exception may be markets where first demand bonds drive a price premium.

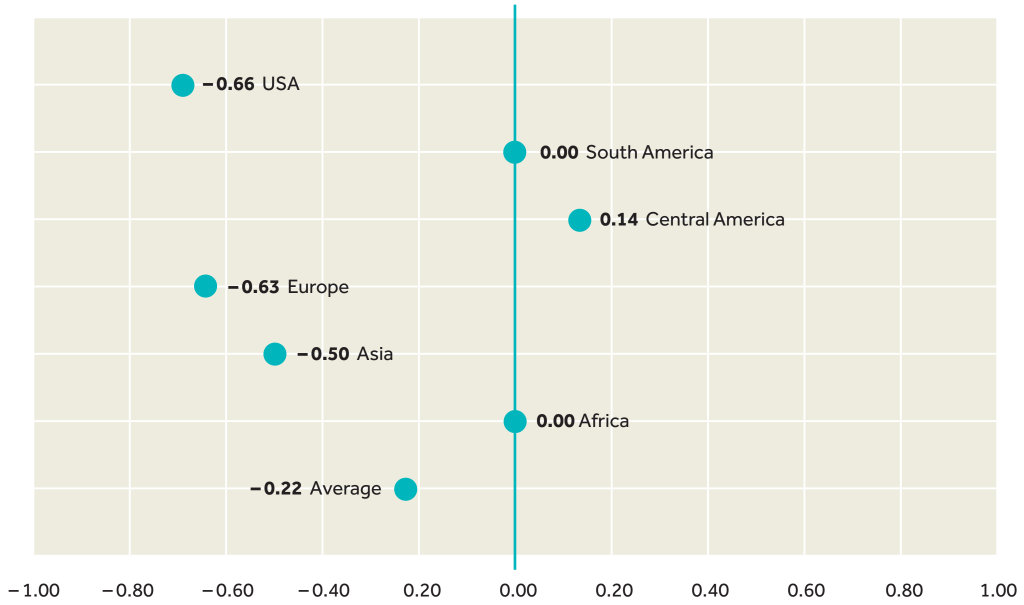
"In Brazil's current recessional economic environment, judicial bonds are the fastest growing surety product. Since we still lack professional pricing tools or models, rates are determined through commercial and competitive considerations. Therefore, pricing reflects ongoing changes in supply and demand. However, underwriting discipline is improving, and once the economy recovers, judicial bonds will retain an important position in our portfolio."

Bruno Camargo, Head of Corporate Business, Fairfax

Current level of rates by number of mentions



Expected level of rates over the next 12 months



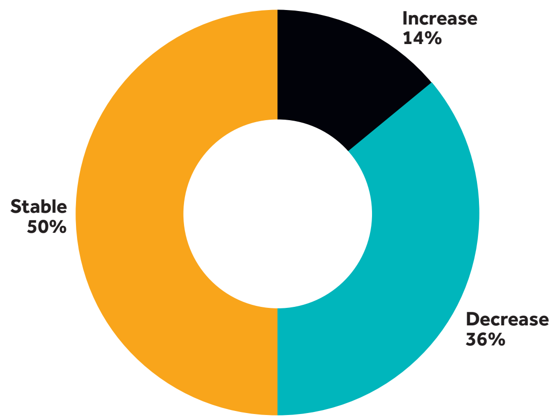
Outlook: Surety rates mostly expected to remain unchanged

Half of interviewees expect surety rates to remain stable for the next 12 months. However, the share of those expecting a decrease is higher than the share of those foreseeing an increase in rates.

For mature surety markets, the pricing outlook is relatively negative which is primarily due to the continued influx of additional capacity flowing into the market from multi-line insurers. Again, the picture varies according to product and client segment, with SME products achieving a higher price compared to large risks where competition is more pronounced.

In Central and South America, the pricing outlook is more optimistic given regulatory pressures and rising loss ratios. Brazilian surety suppliers in particular are most upbeat about rates, as current demand for judicial bonds might outstrip supply, keeping rates high.

Expected level of rates by number of mentions



Terms and Conditions: No dramatic changes

Similarly, from an insurer's point of view, terms and conditions are perceived as average to soft compared with the past five years.

The most pressure on terms and conditions was recorded in the US and Europe, for example in the shape of longer bond durations. However, in comparison to rates, terms and conditions seem to be more resilient, as some interviewees point out, because wordings are often enough highly standardised.

In mature markets, in particular, risks tend to become larger and more international – cutting across territories – while contract wordings reflect the increased complexity and, as such, are less flexible. Furthermore, in large construction projects, the public entity acting as the obligee determines the bond wording, including the conditions under which a contractor's default has occurred.

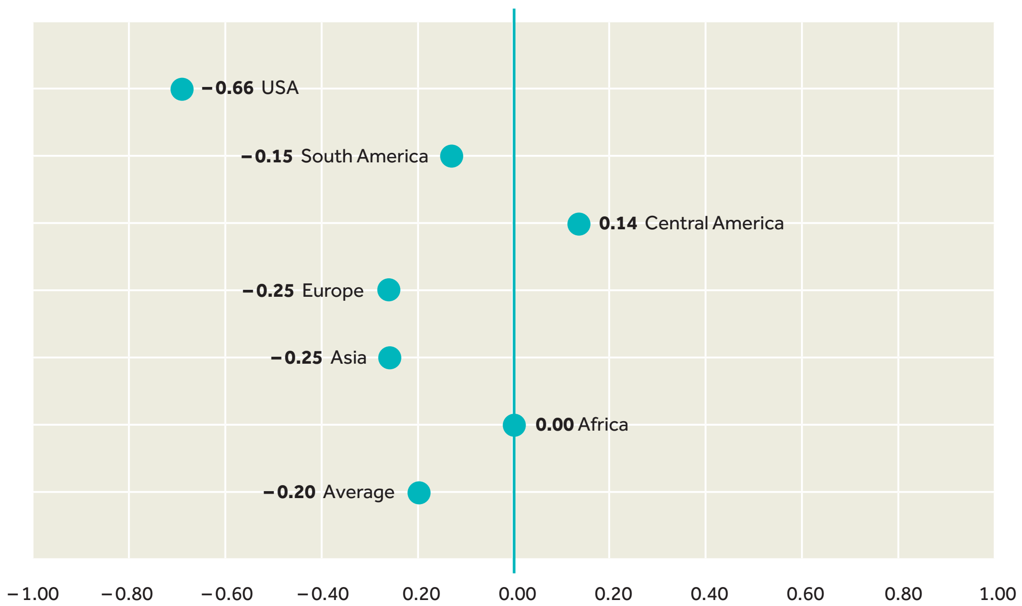
Still, variations also apply to terms and conditions with regard to product and client segment, following pretty much the same pattern as for rates. While policy wordings for large risks or big infrastructure projects may allow some flexibility, those used for specific or SME-related risks are tighter.

Central America is an exception to the rule because of the high prevalence of first demand bonds, which do not leave room for a softening of terms and conditions.

> *"The terms and conditions of the performance bonds written in Panama are fairly tight and not subject to significant change. As for public contracts, the wording is legally defined. Although this wording is currently under review, we don't expect a substantial change in terms and conditions, since a tight wording is in the government's interest."*

Ricardo Palomo, Gerente Técnico, Aseguradora Del Istmo

Current status of terms & conditions against the average of the past five years



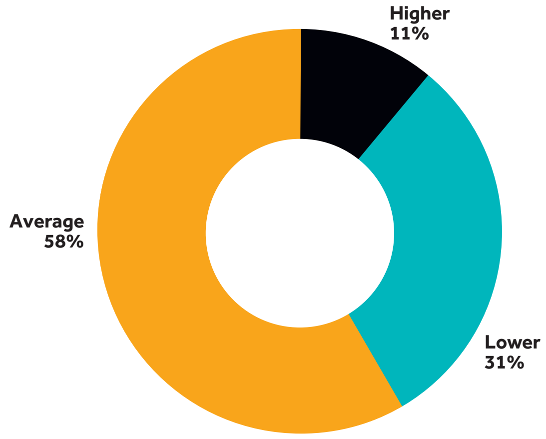
Outlook: Terms and conditions under pressure

Going forward, 47% of respondents expect terms and conditions to soften, i.e. to become more attractive for policyholders, which is likely to favour beneficiaries also. The same proportion, however, foresees no change at all. In fact, terms and conditions are not expected to tighten in any region.

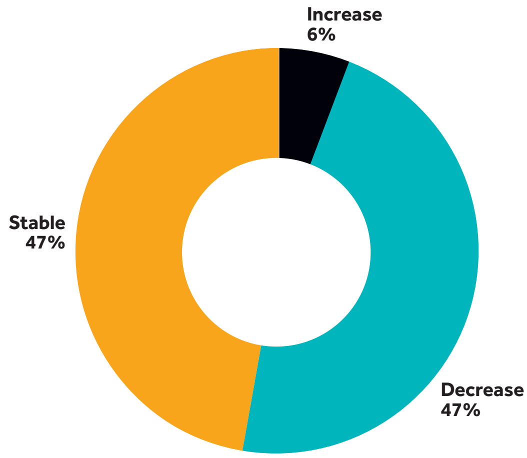
The loosening trend reflects the general softness of the market, as well as insurers' desire to grab market share from their competitors.

Conditions remain stable in those niches where the insurer confronts less competition, where regulation or the obligee allows no variation, or where the obligee's risk awareness remains high and the principal has to pay a higher price for the protection.

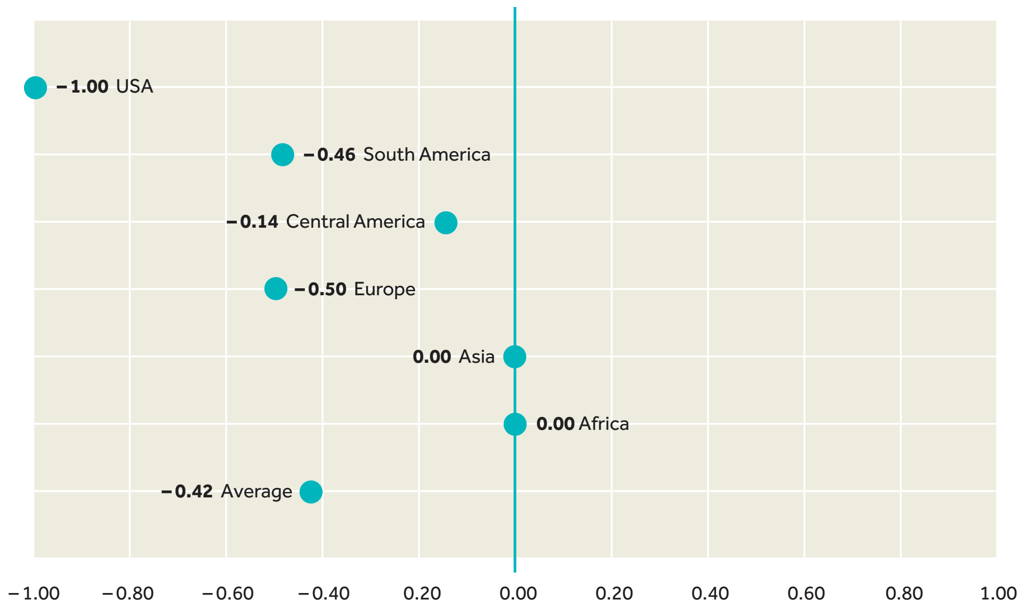
Current status of terms & conditions by number of mentions



Expected status of terms & conditions by number of mentions



Expected evolution of terms & conditions over the next 12 months



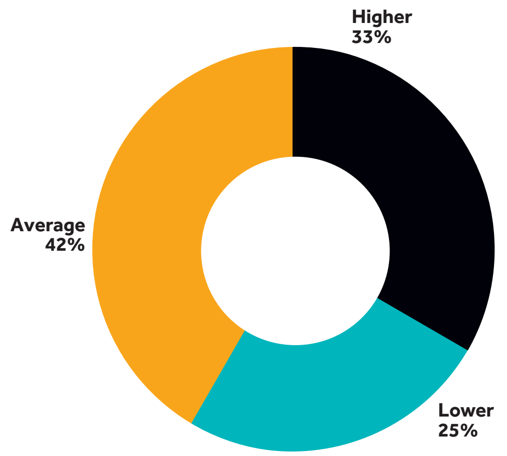
Claims: Current claims ratio broadly in line with five-year average

Of the executives polled, 42% believe that current loss ratios are in line with the average of the past five years. One third of interviewees feel that claims are higher than the average of the past five years. One quarter, however, say that loss ratios are lower.

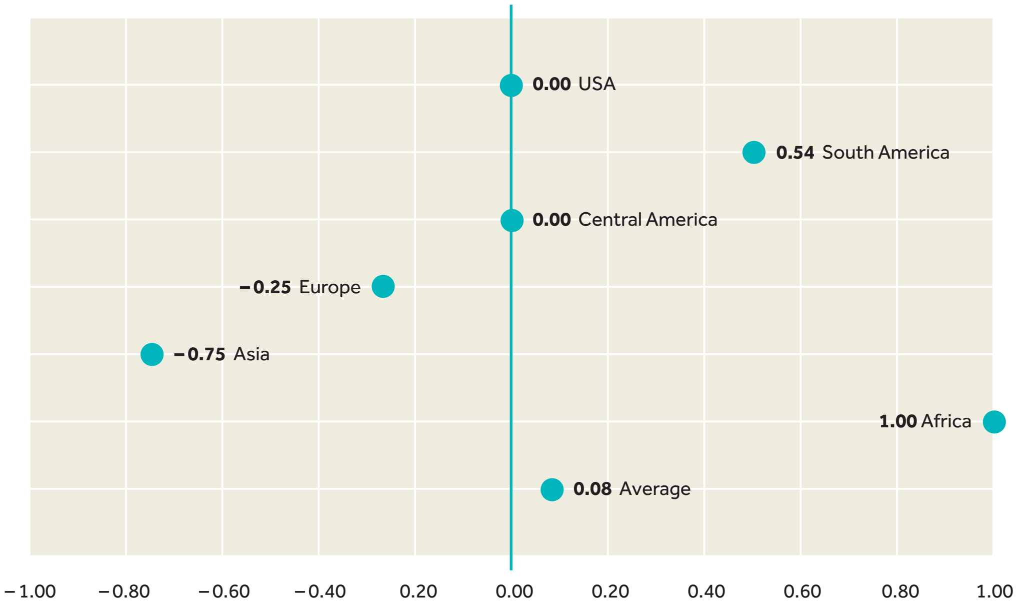
In Europe, Japan and the US, current claims ratios are perceived as below or in line with the five-year average. Default rates have declined since the peak of the financial crisis and are now relatively low, as the mature markets start benefiting from improvements in the economy. In fact, in the US, where the economic recovery is most advanced, there are early indications that clients are starting to take on more business risk. Consequently, corporate defaults may grow, driving insurers' claims upwards.

In contrast, claims in Latin America are perceived to be average or even high. On the one hand, this reflects the impact of the current economic downturn triggered by the decline in commodity prices. On the other, many executives point out that political instability creates a direct correlation between higher or rising claims and the ability or willingness of governments to fulfil their contractual obligations.

Current claims ratio by numbers of mentions



Current claims ratio against the average of the past five years



Stable to positive outlook for global surety loss ratios

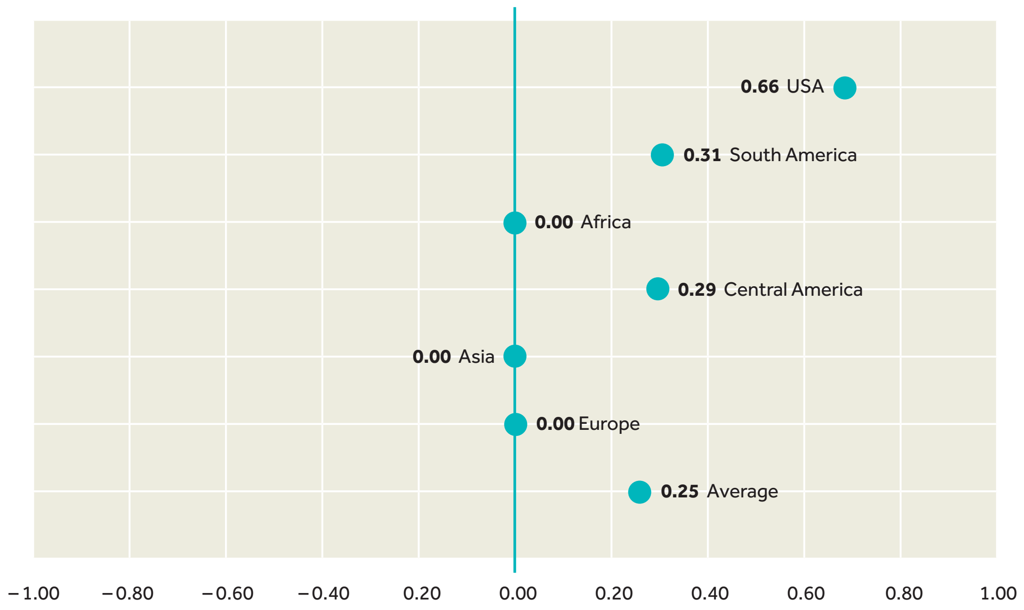
42% of survey participants believe that claims ratios will tend to be higher over the next 12 months. The same proportion expect no change. Only 16% believe that claims ratios are set to improve.

On a global scale, the economy is at a turning point. Economic improvements will go hand in hand with a propensity for higher risks to lead to increased claims. However, the weak recovery in some markets and sluggish growth in some developing markets might also cause some large-scale corporate defaults, as industry sectors and corporations with floating debt rates are at risk of defaulting once interest rates start to rise.

In Latin America the outlook remains challenging, as it will take time for political stability to be restored. Until governments start to honour their obligations and pay contractors in time, or until highly prominent corruption cases, such as the Brazilian Petrobras investigation, are concluded, interviewees do not expect claims to decline.

Fraudulent claims do not seem to pose a problem for surety companies in the current environment. Less than 10% of all interviewees actually perceive a potential risk for fraud in their market. The majority felt that risk management measures meant that the risk was under control. And where there were cases, they were seen as isolated incidents.

Expected claims ratio over the next 12 months



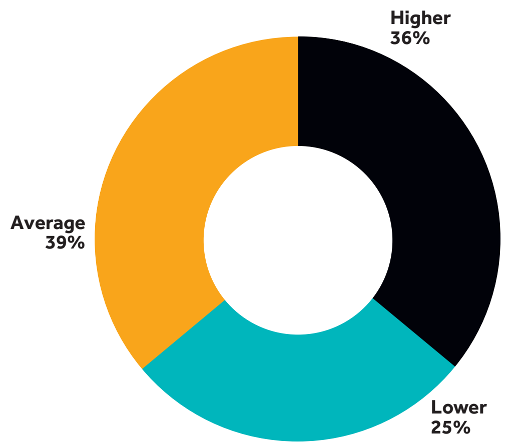
Robust levels of current profitability

The global surety market is still profitable. Of the executives who participated in the survey, 39% see current levels of overall profitability as being in line with the average of the past five years, while 36% see these as being above the average over the same period. The profitability drivers are largely identical to the factors that determine loss ratios.

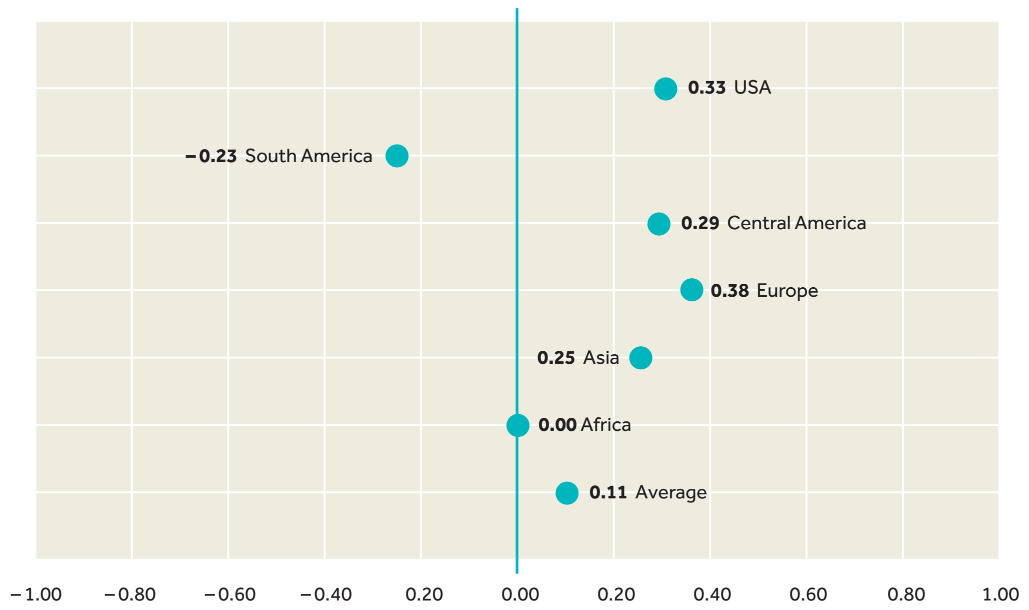
Clearly, as rates erode, competition has an increasing impact on insurers' performance and is eating into margins. Although claims are slightly above average, loss ratios are holding up and allow surety providers to continue to generate a decent return. One US player, citing data from the country's Surety and Fidelity Association, noted: "Over the last 49 years, the loss ratio was 35% across the whole surety industry. In 2014 the industry's loss ratio was even 18%." Similar statements were made by interviewees from other markets too, highlighting that stable loss ratios are a key asset of the sector.

However, in many markets, players emphasise that they have to go the extra mile to achieve an attractive return, either by taking on more risk – for instance with the current boom in judicial bonds, as Brazil's surety players state - or by being more proactive in their underwriting and client management.

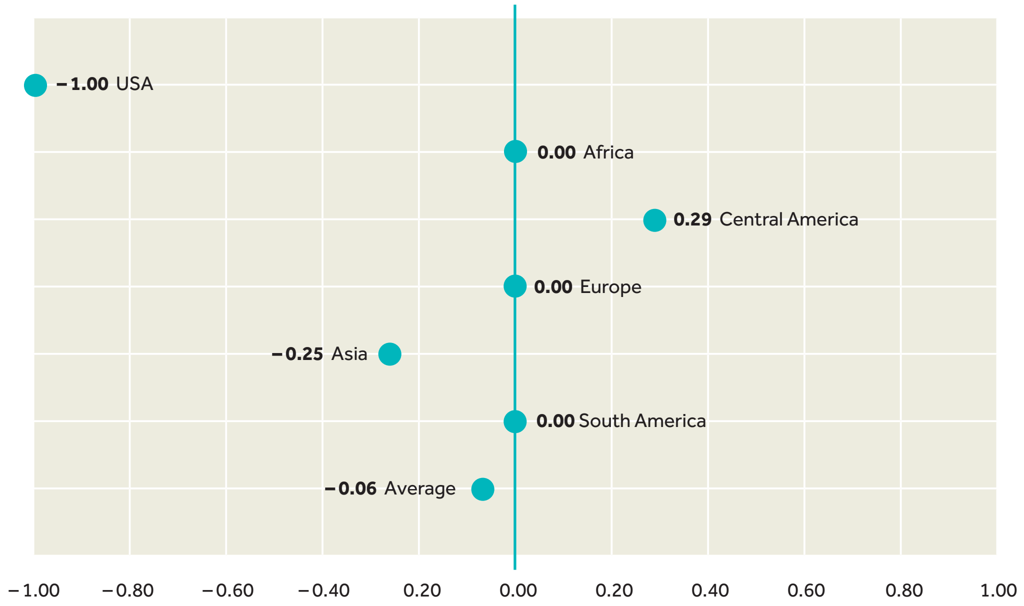
Current level of profitability by number of mentions



Current level of market profitability against the average of the past five years



Expected level of market profitability over the next 12 months



Modestly positive outlook for profitability

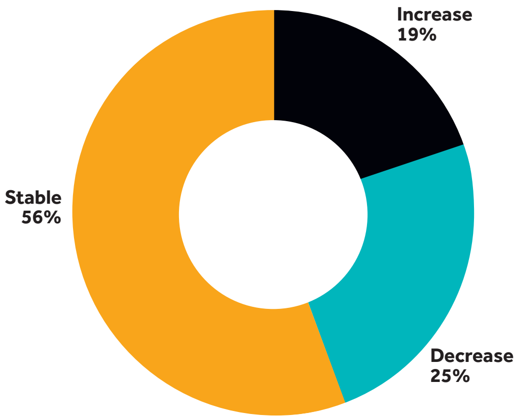
As claims are expected to rise and rates decline further, the outlook for the sector's technical profitability is slightly muted. 56% of respondents do not expect any change to current levels of profitability over the next 12 months. 19% believe that profitability will improve while the remaining 25% are prepared for lower profits.

The outlook is bleakest for the US, where pressure from excess capacity spilling over from other lines is probably felt the strongest. Despite such adverse trends, profitability is still expected to be attractive. In Asia and Europe, the picture is more balanced, although insurers are concerned that losses might rise and that rates do not allow for further erosion.

In Latin America the outlook is rather mixed. Argentina, with its change in government, expects profits to improve, while Brazil predicts that the "car-wash scandal" will weigh heavily on industry profits overall. In Colombia, due to increasing competition from foreign insurance groups pushing into the market, exposure levels may rise and thus profits fall.

Central America is mildly positive. Robust order books in the construction industry and a strong manufacturing sector in Mexico positively affect profits. In addition, regulatory action is expected to tighten control and thus impact profitability.

Expected level of profitability by number of mentions



Strategic corporate responses

Surety insurers focus on underwriting discipline and greater diversification

Most surety players are faced with the same challenge: External factors, like public sector investments and commodity prices, typically determine an insurer's performance. Regulation is often designed to protect national markets. Innovation and alternative sources of income are limited beyond the classic contract and customs bonds.

Consequently, the options to buck the general market trend and take a different course are limited. It therefore comes as no surprise that the most frequently mentioned strategy in the current environment is the strengthening of underwriting discipline. Under pressure from competition and declining rates, while growth opportunities remain scarce, insurers feel that an even stronger focus on technical excellence is required to maintain current levels of profitability.

Prudent risk selection and tight underwriting guidelines are seen as the most effective remedy to manage market volatility and to avoid risk-prone growth, and therefore, potentially higher losses. Market players state that they intend to increase investments in underwriting quality, people and technology in order to trim their portfolio.

Those players deploying state-of-the-art risk management, manage their portfolio through a careful selection of clients and risk. Insurers that follow this strategy typically aim to upgrade their client services – such as expanding points of contact with clients, being more agile and responsive, providing additional product-specific training to brokers and customers, and increasing their pricing flexibility.

In the current environment, insurers are also seeking to expand their client mix. Although many surety markets are localised, insurers often move into neighbouring territories, thereby expanding their client base. Frequently, the shift also includes approaching smaller clients, SMEs, which might increase distribution cost, but also improve risk diversification, as claims will be less severe, but more frequent.

Similarly, insurers are also seeking to diversify their product mix, either by introducing solutions from foreign markets or by adapting bonds to specific client segments, such as SMEs. The strategy of some European insurers to target surety risks traditionally underwritten by banks requires adjustments too. Insurers have to be able to provide large per risk capacities to support their bigger clients across geographies, potentially globally, requiring different skills sets as well.

"In order to prepare for the future we are enhancing our technical approach to client segmentation, pursuing select opportunities for geographical expansion and investing in our risk management capabilities, e.g. in sophisticated early warning tools."

Mads Løgstrup, CEO, Tryg Garanti

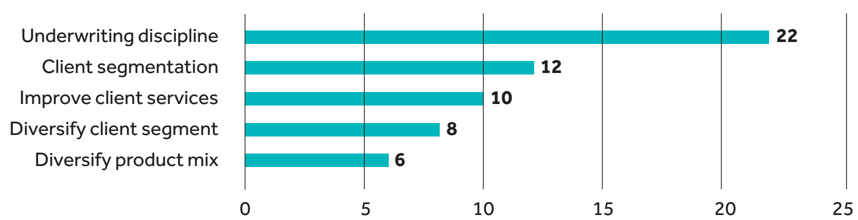
"In a difficult and volatile economic environment like Argentina, we invest in technology and in the professionalism of our team to best cope with and reduce our exposure to the sudden swings of this economy. In addition, we believe it is key to never lose sight of the most important asset in an insurance relationship – to remain focused on providing excellent service to the customer. That is probably the most powerful weapon in a challenging environment."

Santiago Seigneur, Chief Underwriting Officer, Fianzas y Credito

"Ecuador's economy is rather exposed to the price of crude oil. Subsequently, government spending in construction has declined rapidly in 2015. In response, we have become more active in targeting the private sector with new products and, in particular, improved our distribution to small and mid-sized businesses – a market segment largely untapped in Ecuador."

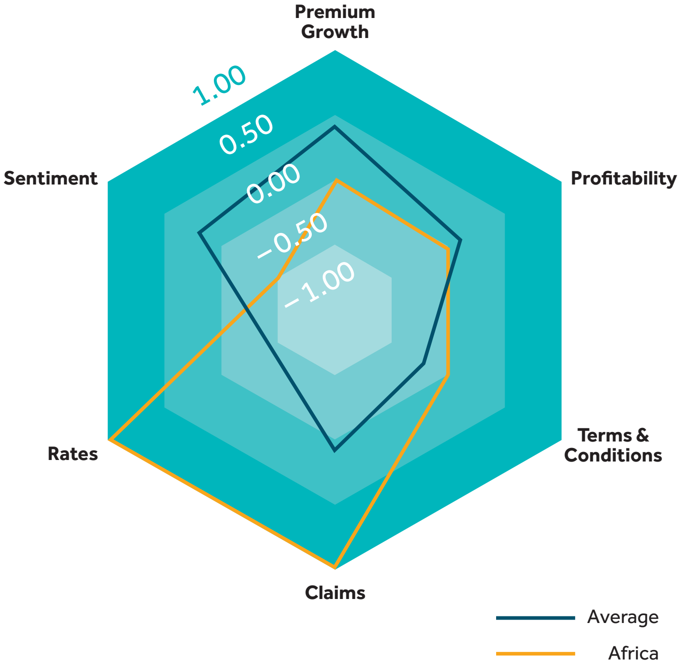
Esteban Cadena Naranjo, Subgerente General, Seguros Oriente

Strategic corporate responses and priorities, number of mentions

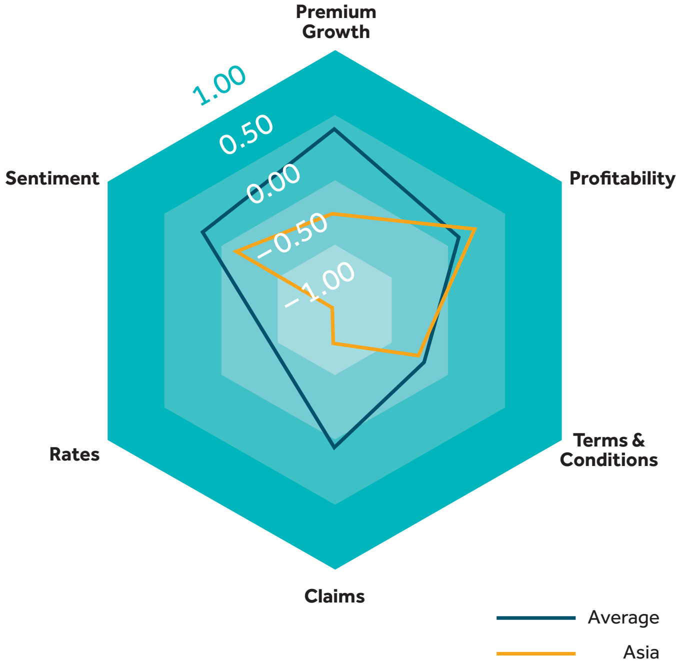


Key indicators

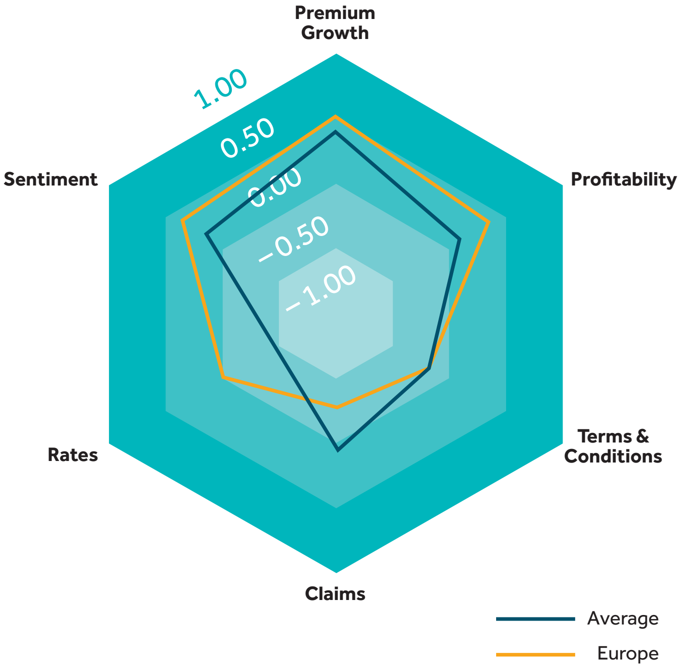
Africa



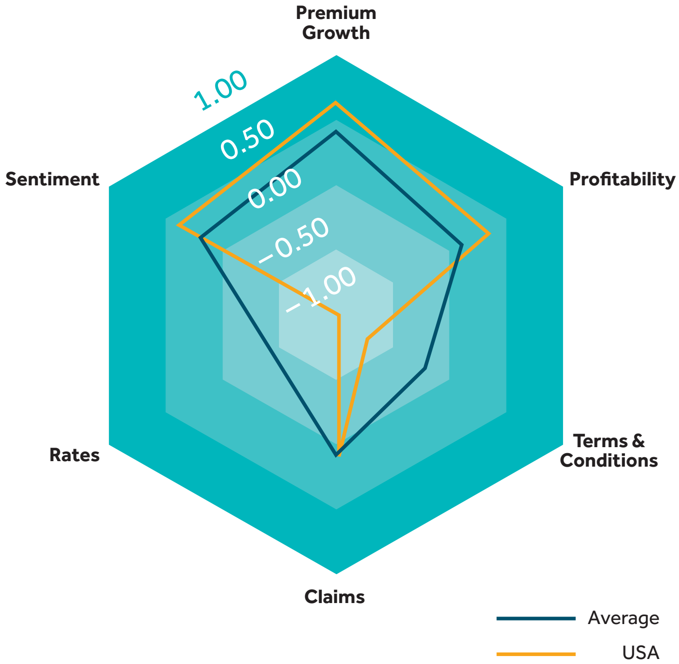
Asia



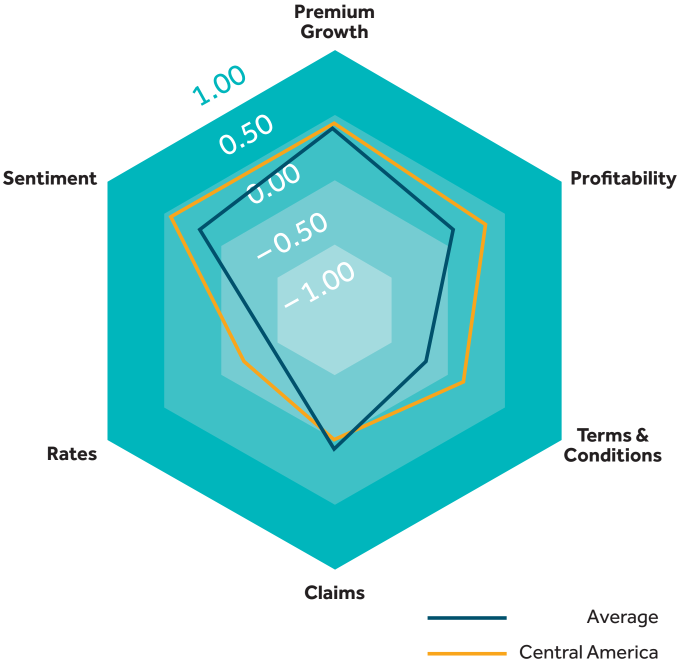
Europe



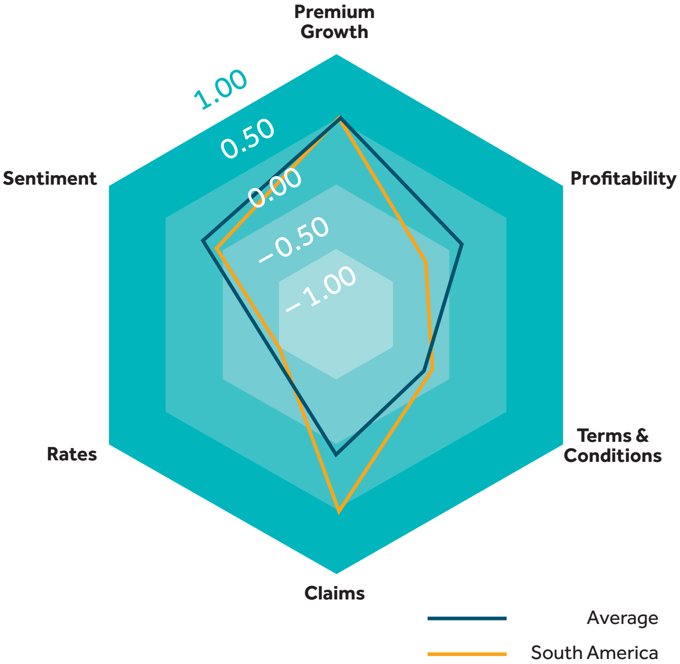
USA



Central America



South America



Reinsurance purchasing

Drivers for reinsurance

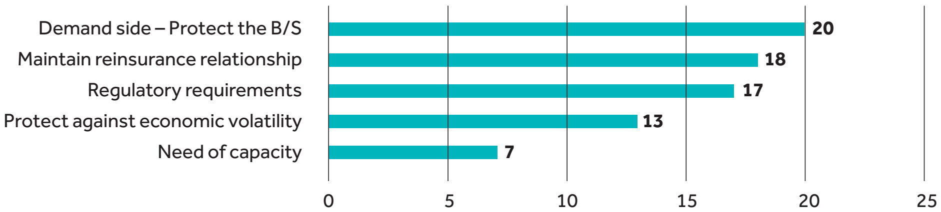
When asked about the three main reasons for purchasing reinsurance protection, surety insurers most frequently stated the need to protect their balance sheets against large loss events. This outcome reflects the low frequency/high severity characteristics of the surety business.

In fact, high levels of specialisation have always been a characteristic of this line of business and many surety players are mono-liners. As a consequence, the balance sheets of surety players are not strong enough to absorb all the risk they take on. Without reinsurance protection, most surety insurers are often not able to efficiently perform in the market. Access to reinsurance capacity – in particular reliable capacity – therefore ranks high on their agenda.

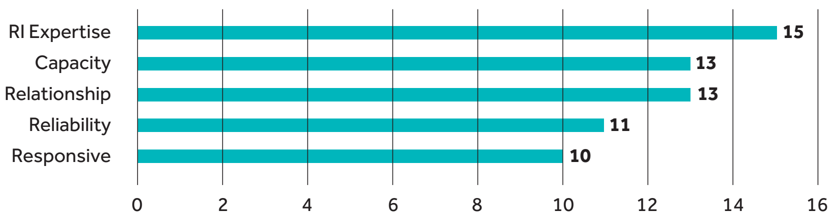
The desire to maintain reinsurance relationships ranks second, reflecting the particular emphasis cedants attach to transacting business with committed and knowledgeable reinsurers. Support throughout market cycles, access to flexible capacity, as well as to technical expertise and global market knowledge, matter greatly to surety reinsurance buyers, in particular since many have remained local market players, with the reinsurers as their eyes and ears in the other markets.

The third most frequently mentioned reason for buying reinsurance is regulation, either the direct result of market-specific requirements or indirectly as a result of solvency capital rules.

Reasons for buying reinsurance



Expectations from the reinsurer



Expectations of the sureties

First and foremost, surety companies expect to deal with knowledgeable reinsurers that bring specific local or global expertise to the table. More specifically, they rely on reinsurers' technical support as well as advice in product development and innovation.

Second in line, and given the limited size of their balance sheets, is the stable and reliable supply of capacity. The quality of the relationship ranks third. Surety reinsurance is seen as a long-term commitment with the ability to offer bespoke services. Primaries emphasise that in a specialist market such as surety, both sides need to invest in the relationship, which should be lasting and able to accommodate their potentially growing demand for capacity and services. Responsiveness when requesting quotations or payment for large claims is a key ingredient for a successful reinsurance relationship.

> *"The financial strength and credit rating of a reinsurer are of utmost importance."*

Yajhaira Rangel L., Head Surety Relations, Banesco Seguros

> *"We expect an efficient, open, transparent and smooth communication with our reinsurers."*

Manuel F. Sarmiento Sánchez, Country Head Surety, Seguros del Estado

> *"We expect our reinsurers to have a good reputation and a proven balance sheet. They should accompany and support us in underwriting our risks."*

Carlos Carrasco Avendaño, Deputy Head Reinsurance, Fortaleza Seguros y Reaseguros

Composition of the reinsurance panel

Similarly, it is the reinsurers' responsiveness, the quality of their security and their professional know-how that determine the composition of primaries' reinsurance panels. Quick access to advice, feedback, support and the reinsurers' decision-makers are key not only during the renewal process, but also when handling claims.

Surprisingly, the strength of the security is mentioned most frequently as a precondition for taking a seat at the table, but rarely is it stated as a decisive factor – contrary to the quality of the relationship and reinsurer's responsiveness. Pricing also seems to play less of a role when determining a reinsurance relationship. It is predominately soft factors that seem to drive the surety's purchasing decision.

However, this can vary according to the size of the buyer and its region. The larger the primary, the more important the reinsurers' rating and price becomes, while the relationship diminishes in relevance; access to knowledge is less of an issue to a global multi-line insurer than to a smaller, national mono-liner, which represent the majority of the surety companies.

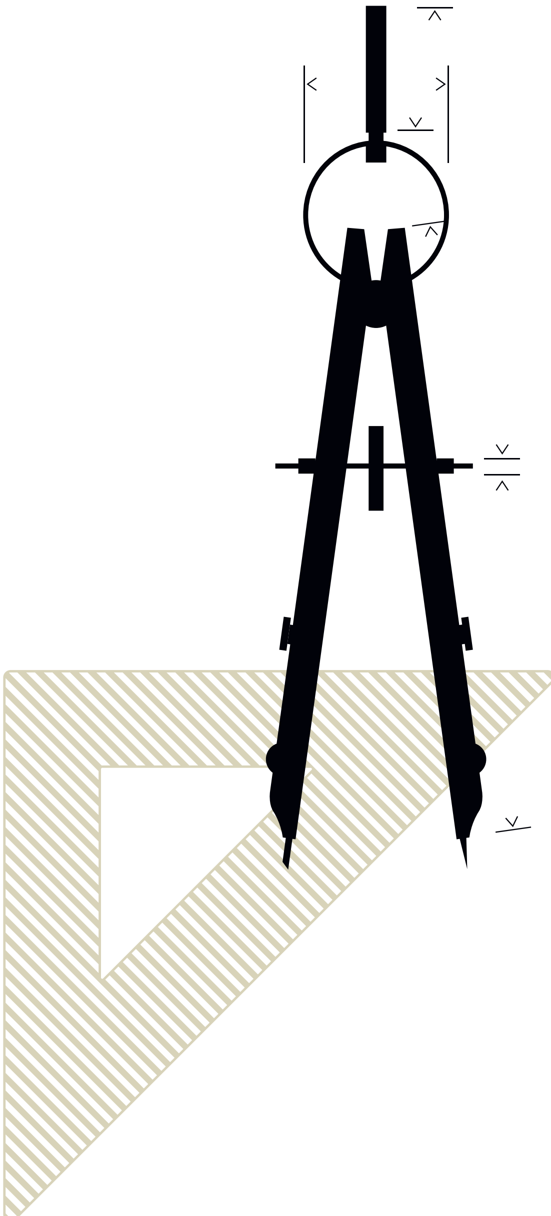
Growth and decline of cession rates

Cession rates have remained relatively stable over the past 12 months. Only 16% of all interviewees stated that they ceded fewer premiums than in the prior year, basically to retain more risk themselves and to improve their returns as a result. 56% of the interviewees maintained their existing cession rates, while 28% actually ceded more volume than in the year before.

Those who have opted for higher cessions cite regulatory pressure from Solvency II or similar regimes. Few have actually taken advantage of lower premium rates as a motivation to cede more risk for the same price. Overall growth in primary business was cited as the main driver for increased premium cession to reinsurers. However, this did not necessarily affect cession rates.

The relative stability of cession rates actually suggests that surety insurers manage their reinsurance relationships on a long-term basis. Soft factors, such as access to know-how and capacity, as well as a tight handle on counter-party risk, seem to matter more than price and short-term market changes. Going forward, more than 90% of all interviewees expect to keep their cessions unchanged for the next 12 months.

Stability and continuity are also key criteria when it comes to the size of the reinsurance panel. For 66% of participating surety executives, the reinsurance panel size has not changed over the past 12 months. 28% and 6%, respectively, have expanded or cut back their panel of reinsurers. Those who deal with a larger number of reinsurers mention their desire for diversity as the most important motivation. Overall, the findings demonstrate that there is no trend towards panel consolidation in global surety reinsurance. That is also true going forward, where again, more than 90% expect an unchanged panel and only a small minority are aiming to reduce their panel.



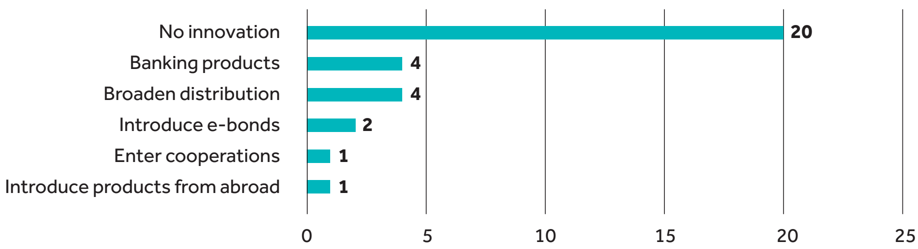
Innovation in surety insurance

The vast majority of interviewees do not consider surety insurance as an innovative market segment. The business is seen as stable and largely driven by exogenous factors. Performance bonds continue to be the dominant product class of surety insurance, offering protection from financial losses if a contractor, primarily in the construction industry, fails to fulfil its obligations. There is a certain trend towards diversification into legally required bonds, such as court or tax bonds. This, however, is not viewed as genuine innovation.

Where potential innovation is mentioned, it often refers to banking-type products and new forms of distribution (such as electronic bonds). This reflects new opportunities for insurers willing to cooperate with banks by offering back-to-back solutions, which require increased capacity to capture business traditionally written by banks with their large balance sheets. Innovation may also come from the digitalisation of the value chain. In addition, some respondents mention PPPs and subcontractor default insurance as specific areas of innovation.

Some respondents are wary of innovation. Historically, it seems to have gone hand in hand with higher risk as innovation turned out to be detrimental to underwriting standards, for example the expansion into financial guarantees. To some extent this is also true for banking-type products as the obligation to pay the issuing bank is typically a stringent one.

Innovation in reinsurance



Globalisation in the surety sector

Globalisation of the insurance sector has a very limited direct impact on the surety sector. Of the executives polled, 70% have seen no increase in the number of global players writing surety in their market over the past 12 months.

Europe is the only region where interviewees observe a slight expansion of global insurers' footprint and where they are entering markets to meet the demand of large clients on a global scale.

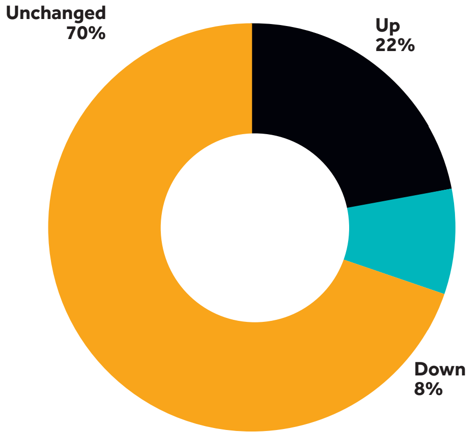
In other regions, pressure and increasing competition from global players is not uniformly visible. While in some markets, like Japan and in certain Central American markets, global insurers have no access, or at least no easy access, to the market, in others, like Chile and Ecuador, they enter by acquiring local players rather than establishing a local presence themselves.

Competitive pressure, however, is also being exerted by multi-liners, which are expanding into the surety sector, which historically has had a high bias for mono-line specialist insurers.

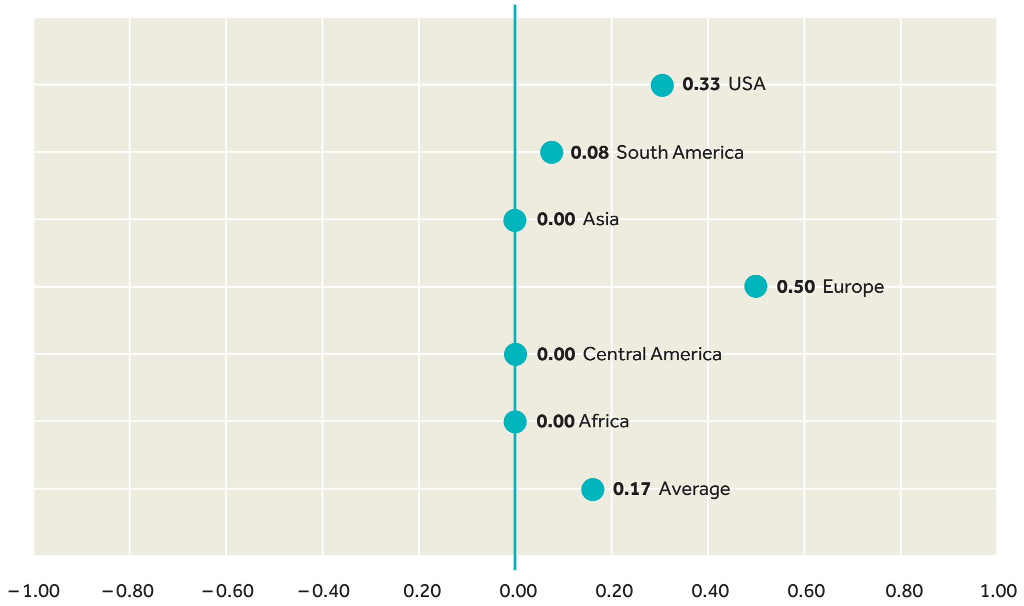
In Brazil, but also in South and Sub-Saharan Africa, global insurers actually retreated during the past 12 months due to competitive pressure or because they decided to allocate their capacity elsewhere more effectively.

Going forward, the majority of the executives we inter-viewed expect global insurers to make greater inroads into national surety markets and to grow their market share. In particular, for large infrastructure risks that require adequate insurance capacity, global insurers are better placed because the local champions will struggle to procure sufficient risk-taking capacity. In addition, primaries prefer global players for their expertise, which puts them in a strong position when large-scale projects are tendered internationally.

Impact of globalisation in the surety sector by number of mentions



Globalisation in the surety sector outlook, next 12 months



MAKE YOUR WORLD GO
xlcatlin.com