Perspectives – Early 2007 Observations

January 2007

Although the New Year is young, it is not too early to reflect on developments since the November 2006 edition of Willis' *Marketplace Realities and Risk Management Solutions*, written before the official end of the Atlantic Hurricane Season.

Last year provided a welcome respite from the activity witnessed in 2004 and 2005 for both policyholders and (re)insurers. No hurricanes hit the US mainland despite consistent forecasts of increased frequency and severity for 2006. In line with this, early financial forecasts show last year to be of the strongest ever for the US Property/Casualty insurance industry, likely to generate in the area of $60 billion in net income and a combined loss ratio in the low 90 percent range.

Clearly, one favorable hurricane season does not a trend prove, and the "storm sages" of whom we spoke in our November 2006 article continue their unfavorable prognostications for 2007 (hurricane activity 40 percent higher than average according to Dr. Robert Hartwig of the Insurance Information Institute[1]). But frankly, the bloom is off the rose a bit for this group after last year's dire predictions.

Perspectives is a periodic publication of the Willis Property Resource Group, addressing timely and pertinent property risk and protection issues for the risk management professional.

January 1 Reinsurance Treaties

Another prevailing theory was generally disproved as well: that rate increases on January 1, 2007 US property cat risk reinsurance treaty renewals would match the levels seen last July. There were increases, but they appear to be 10 to 15 percent below mid-year levels. This seems to indicate there was sufficient alternative capacity to frustrate the stated goal of the Big Three – Hannover Re, Munich Re and Swiss Re – to maintain the 2006 highs. In a somewhat ironic vein, "Midwest [cat] pricing has remained competitive despite high loss frequency in this region during 2006."[2] In fact, the single largest storm catastrophe of 2006 worldwide was severe weather affecting the Great Lakes, Ohio Valley and Southeastern US.

New Capacity (with a Potential Trouble Spot)

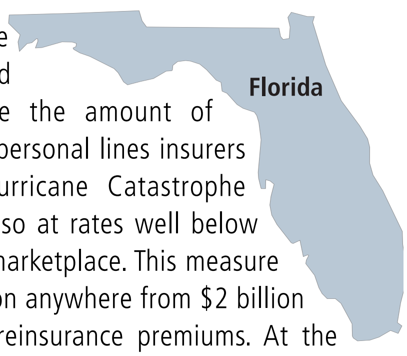
Also encouraging has been the flow of new capacity into the Property market, whether through increased capitalization of existing (re)insurers, growth in sidecars or new companies such as Ironshore, which hit the ground running. Between these factors and generally higher retained earnings by (re)insurers, 2007 seems poised to bring some relief to clients who faced the double whammy of higher pricing and lower capacity last year.

1 "2007 Earlybird Forecast," Insurance Information Institute, January 2007
2 "Willis Re – 1st View – Renewals 2007," Willis Re, January 2007

Early signs in recent renewals indicate that while underwriting pricing discipline continues (i.e., pricing remains stable to down slightly year-on-year for the same level of coverage for cat-exposed risks), more vertical cat capacity will be available for programs this year than last. It remains to be seen whether clients may have gotten used to lower levels of protection or have found ways other than insurance to fund these risks, and will therefore look closely at the price tags for additional capacity.

Worth watching will be the extent to which other (re)insurers follow Allstate's lead in circumscribing their liabilities to wind in the Mid-Atlantic and Northeast, the latter now referred to as the third "peak zone" for wind. Selective concern for this zone was expressed this time last year, but it failed to emerge as a larger issue.

Has the First "Peak Zone" for Wind Disappeared?



On January 22, the Florida Legislature agreed to significantly increase the amount of reinsurance available to personal lines insurers through the Florida Hurricane Catastrophe Fund (FHCF), and to do so at rates well below those of the traditional marketplace. This measure may take out of circulation anywhere from $2 billion to $4 billion in global reinsurance premiums. At the same time, the Legislature approved eliminating constraints on Citizens Property Insurance Corporation, the state's insurer of last resort, allowing it for the first time to compete with the "open market." The immediate impact on large commercial policyholders – other than commercial residential, already written by Citizens – is not known. But speculation is that the supply of reinsurance for these risks may now be more aligned with demand, driving premiums down both for Florida and elsewhere. The ultimate irony would be if the industry turned around and provided "competitive" reinsurance for FHCF or Citizens rather than lose the whole pot of premium.

Whether this type of insurance legislation (which some would call activist) becomes a trend is something to be watched, as there are legislators in Connecticut and Maryland who are making noises that echo their peers in Florida.

Keep an Eye on the Legal Ball

Also worth watching are the outcomes of Hurricane Katrina litigation. While much of this involves personal lines, it is in such cases that legal precedent for commercial lines is often set. In an August 2006 judgment, Judge L. T. Senter, Jr. of the US District Court for the Southern District of Mississippi rejected Nationwide's use of an anti-concurrent causation clause to deny coverage for wind damage when flood also occurs. But he simultaneously upheld the validity of its flood exclusion.

Subsequently, plaintiffs were awarded $2.5 million in punitive damages against State Farm, and this carrier was reported to have entered into a $1 million settlement with a policyholder on the eve of another trial, both in Mississippi. In the first instance, State Farm may have contributed to its own woes by acknowledging that insured wind damage occurred – but failing to quantify and pay for it. In the second, perhaps to avoid the stigma – though not the financial pain– of another punitive damage award, State Farm is said to have settled for an amount roughly equivalent to actual damages claimed (less than $100,000) plus the maximum award of punitive damages allowable.

On January 24, State Farm reached agreement with Mississippi regulators to settle 640 homeowners' lawsuits, with some claimants receiving the full value of their policies, and to reopen tens of thousands of claims previously settled, if requested by their policyholders. "Under the agreement, State Farm will pay an initial $130 million and perhaps several hundred million more by the end of the year . . ."[3]

> "Clearly, one favorable hurricane season does not a trend prove . . ."

Later that week, Judge Senter rejected this settlement, citing lack of assurances that policyholders would be treated fairly. As of this writing, regulators, plaintiffs' attorneys and State Farm remain optimistic that the Judge's concerns can be overcome. If finalized, the agreement is predicted by some to be a model for other insurers who are facing litigation in that state.

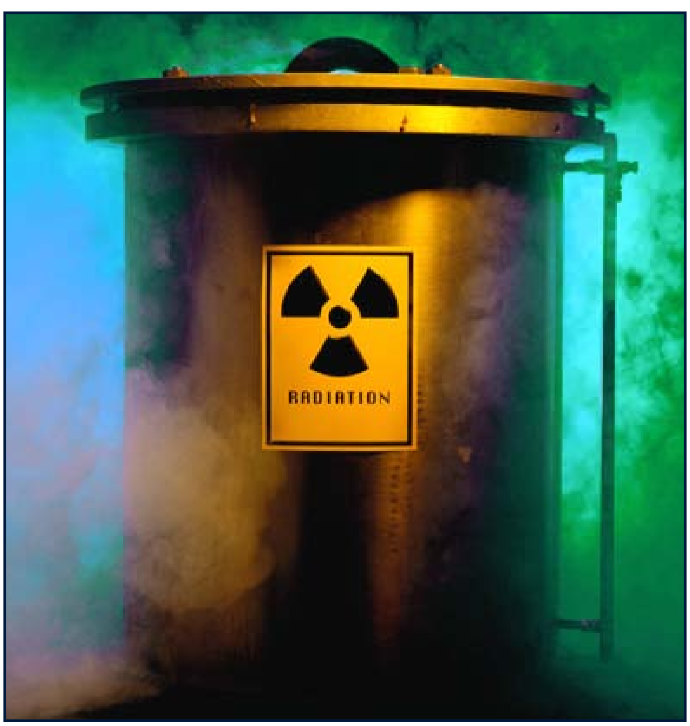
3 "Big Insurer Will Pay 640 Katrina Claims," Joseph B. Treaster, The New York Times, January 24, 2007

Here We Go Again?

We were overly optimistic in thinking that catastrophe models would remain unchanged. Risk Management Solutions (RMS) is scheduled to release RiskLink v7.0 in the late first or early second quarter. Early word is that a few modeled results may decrease slightly but most will stay constant. Data has been updated for floating casinos and for New Orleans storm surge, based on lessons learned from Katrina and Rita, although their effects on modeled results are not yet certain. Stay tuned.

It's Now or Never for TRIA

There is significant optimism about TRIA's extension, given the pronouncements of the now-Democratic leadership of the relevant committees in both the Senate and the House of Representatives. Although the chambers have differences in approach, both look for an early decision on how to bring the government backstop forward at least for the near term. Still, the lack of certainty on either the length of the extension itself or its terms has created some market angst that has been reflected in the reappearance of "pop up" endorsements. Perhaps the most significant issues to be dealt with seriously (this time) are nuclear, biological, chemical and radioactive contaminations – for which there is little reinsurance support. The modeled risks for these exposures are well above the insurance industry's ability to handle and survive. Perhaps it is time once again to look across the Atlantic to see how other governments handle these exposures.



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Plain Language Policies?

Those reading this update are probably insurance professionals who clearly have a better understanding of coverage language than the general citizenry. Even so, we should ask ourselves if industry-wide policy wording changes are not in order to achieve more contract certainty regarding the treatment of wind, storm surge and flood – terms that are often used but seldom consistently defined.

In the citations that follow, we have added emphasis to certain words and phrases through the use of *italics*:

A certain commercial property policy includes the following definition of wind: "the direction action of wind including any *substance* driven by wind." There is no definition of "substance" in the policy, but a standard desktop dictionary defines it as "a physical material from which something is made or which has discrete existence." Water, therefore, would be considered a substance.

RMS defines storm surge as: "the rising of the mean water level caused principally *by the action of persistent high winds* driving a bulge of water ahead of a major windstorm that can become amplified along a shelving coastline."[4] (We admit we have seen no insurance policy define this term, even when we have seen it used in a policy. That practice is not particularly helpful.)

Now look at a definition of flood within the same policy: "flood; surface waters; *rising waters*; waves; tide or tidal water; the release of water, the rising, overflowing or breaking of boundaries of natural or man-made bodies of water; or the spray therefrom; or sewer back-up resulting from any of the foregoing."

Is it any wonder there is confusion in many policyholders' minds?

It might seem easy to say simply that wind should include storm surge, but not other flood. But it is not altogether certain that storm surge damage can always be differentiated from other flood damage (where did the storm surge stop and inundation from other wind-related water begin?).

4 "Flood Risk in New Orleans," Risk Management Solutions, 2006

Another alternative is to redefine wind to read: "the direct action of wind including any substance other than water driven by wind." But this would exclude damage that would otherwise be covered as wind – e.g., wind tears a hole in the roof, allowing rain accompanying the wind to damage the interior of a building and its contents.

How about: "the direction action of wind including any substance driven by wind other than water as included in flood"? I have a sense this might not always work either.

For commercial policyholders, an alternative may be to have wind (or at least wind events categorized as tropical storms and hurricanes) include flood resulting from wind. No need to segregate damage, and the same limit would apply to both. The downsides: no ability to pyramid limits where that may exist now and, in a Tropical Storm Allison-type event, the usually higher wind deductible would apply to the flood damage.

From a (re)insurer's perspective, while wind and storm surge can be modeled, flood cannot – to date. So the question may be how much more liability is being assumed by them using the above approach unless a flood sub-limit is maintained. If it is, we are back to square one – and likely back in the courtroom – in terms of segregating damage between the two perils.

Of course, for policy forms that are subject to state regulation (the preponderance), any changes will be long in coming. And policy language changes could lead to the loss of much legal precedent and the setting of new.

No quick or easy fixes here – but it doesn't mean we should stop trying.

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