2013

PROPERTY

STATE OF THE MARKET

PROPERTY CATASTROPHE INSURANCE INSIGHTS

A Baldwin Krystyn Sherman Partners' Report

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insight beyond insurance

PROPERTY INSURANCE MARKETPLACE UPDATE

Overview

Hurricane Sandy was one of the country's biggest insured catastrophe losses, but the overall impact on the property catastrophe insurance market has been relatively muted.

The price of property catastrophe insurance was flat to slightly higher in early 2013 for accounts with no adverse loss history, and the momentum for further price increases has continued to weaken. With plenty of capital in the market, insurers may become increasingly competitive, but buyers should not expect sharp price reductions.

While the property catastrophe market has been fairly stable, the market for frame habitational risks is in disarray. Plagued by frequent claims, insurers have been exiting the market.

As businesses prepare for their insurance renewals, experienced brokers can offer insight and guidance that can help buyers achieve favorable outcomes. Even in an environment where prices are stabilizing, brokers with in-depth market knowledge can still help buyers to strategically structure programs to provide enhanced coverage and pricing.

After nearly two years of rising prices, the property catastrophe insurance market enters 2013 with an abundance of capital and the potential for growing price competition as the year progresses.

Prices typically move higher in response to major industry losses. But global insured catastrophe losses last year were moderate –in spite of Sandy– and the insurance industry remains very well capitalized.

While insured losses from Sandy were estimated at up to $25 billion, those losses amounted to only about 5% of policyholders' surplus. The storm, therefore, has had only a limited, local impact on insurance pricing. With policyholders' surplus of nearly $600 billion, the market is so well capitalized that catastrophe losses have to be quite sizable before they have a more widespread impact on pricing.

The Takeaway

After nearly two years of rising prices, the property catastrophe insurance market enters 2013 with an abundance of capital and the potential for growing price competition as the year progresses.

In the absence of any new, significant catastrophe losses, insurers are likely to hold prices flat or even reduce prices later this year, depending on the class of business, location and loss history.

While Sandy's impact on insurance pricing has been limited, the storm has forced insurers to reconsider their catastrophe exposures in the Northeast as they try to determine the new norm. In the next few years, catastrophe models, risk assessments and pricing in these regions will move to become more in line with current practice in the Southeast region.

Insurers have long been worried about a hurricane hitting the Northeast. Although rare, hurricanes in the mid-Atlantic and Northeast have been highly damaging. With extensive development along coastal areas in recent decades, the risk of a significant loss has grown dramatically. In 2011, the Northeast region got a wakeup call with Hurricane Irene, which first made landfall in North Carolina, becoming the first hurricane to make landfall in the United States since Hurricane Ike in 2008. Irene then went on to make landfall again in the Little Egg Inlet, New Jersey, and New York City.

A little more than a year after Irene, Sandy made landfall near Atlantic City, New Jersey. Even though Sandy was not designated as a hurricane at landfall, the damage was devastating. While Sandy's winds fell short of hurricane-strength, the storm generated a storm surge that resulted in severe flooding. The storm surge at Battery Park in Lower Manhattan, for instance, reached a record 13.88 feet.

In the days following the storm, estimates of insured damage moved higher as assumptions about electric and utility losses, commercial flood insurance penetration and homeowners' deductibles had to be revised. The National Hurricane Center's decision to downgrade Sandy to a post-tropical cyclone had an impact on insurers' hurricane deductibles. Unlike standard deductibles, which require policyholders to pay a set dollar amount, hurricane deductibles are typically set at 1% to 5% of a property's insured value. In the days after the storm, officials from a number of coastal states ruled that insurers could not impose those deductibles.

Insurers are now considering how to manage exposures in the Northeast. Accounts located in the mid-Atlantic and Northeast may see more restrictive policy terms and conditions in coming months. Insured's with no adverse loss history are likely to see a stable market that may become increasingly competitive on price. Businesses that have experienced significant losses may see some additional price increases and may have increased difficulty in obtaining coverage for flood or windstorms. Those accounts may obtain improved coverage and control their costs by re-marketing their programs and by demonstrating strong loss control efforts.

*Developed in conjunction with BKS-Partners' property insurance intermediary partner, NAPCO, LLC

REVIEW & OUTLOOK

Before the arrival of Hurricane Sandy in late October, the insurance industry had been on track to deliver solid financial results for 2012. Despite the catastrophe loss in the fourth quarter, policyholders' surplus remained near record high levels.

- **Net income was expected to decline 23% to $20.4 billion in 2012** as a result of Hurricane Sandy in the fourth quarter.
- **U.S. insured catastrophe losses totaled $43 billion in 2012,** including losses from Hurricane Sandy and other events, including tornadoes, severe thunderstorms, hail and wildfires.
- The **statutory combined ratio –** a key measure of losses and other underwriting expenses per dollar of premium – **improved slightly in 2012 to 106.2% from 106.5% in 2011.** Even so, the combined ratio was still considered high based on its relationship to conservative investment income expectations.
- **Policyholders' surplus was expected to grow 1.5% to $575.8 billion** at year-end.

Global insured catastrophe losses in 2012 came in at just half the level of 2011 in spite of Hurricane Sandy.

- **Global insured catastrophe losses totaled $65 billion**, down from $119 billion in 2011.
- **The largest insured loss in 2012 was Hurricane Sandy.** Insured losses have been estimated in a range from $18.75 billion by Verisk's Property Claim Services to up to $25 billion by RMS, a level that would make Sandy the second most costly U.S. natural disaster in terms of insured losses after 2005's Hurricane Katrina. The worst losses from Hurricane Sandy were caused by a storm surge that extended along the coastline from New Jersey to Massachusetts. There was comparatively little wind damage.
- The second major loss event of 2012 was a drought in the Corn Belt of the U.S. Midwest.
- In its early December forecast, Colorado State University's research team said the **United States has been in an active era for Atlantic basin tropical cyclones since 1995 and expects that to continue in 2013.** One of the big uncertainties for the 2013 hurricane season is whether or not El Niño will develop. El Niño never fully developed in 2012. The first quantitative forecast for 2013 will be issued on April 10.

Property catastrophe reinsurance prices rose about 10% for loss-impared accounts but were flat to down for those accounts that had no adverse loss history.

- The reinsurance sector entered 2013 with **ample dedicated capital and stable pricing.**
- The price of property catastrophe reinsurance moved higher for programs impacted by Hurricane Sandy. **Rates for property-catastrophe business were up about 10%** on accounts that were loss impaired. Programs not impacted by losses were risk-adjusted flat to down 5%.

REVIEW & OUTLOOK

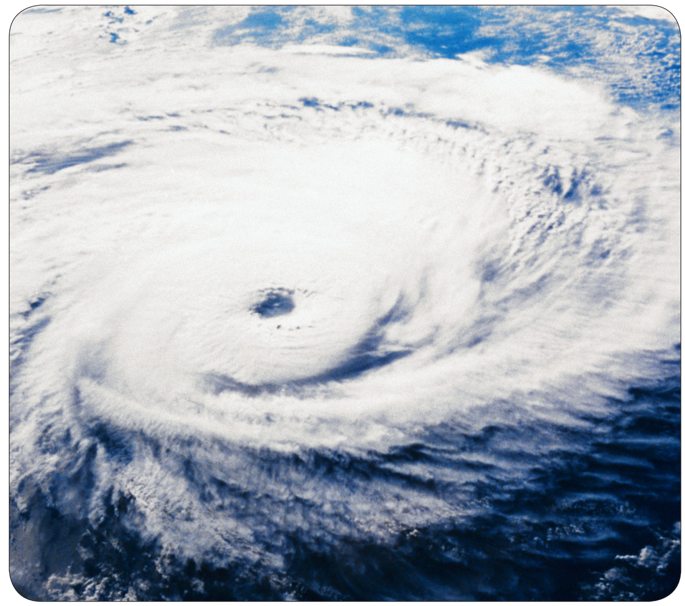
Catastrophe models are playing an increasingly important role in insurance pricing. The industry has relied on models for earthquake and windstorms for some time, but new models for other catastrophe risks are in development.

- Catastrophe-modeling firms are expected to recalibrate their models in coming months in response to Hurricane Sandy.
- RMS is expected to release an updated version of its U.S. hurricane model suite in July. RMS Version 13 is expected to include changes to assumptions related to hurricane landfall rates over the medium-term –the next five years– and the phenomenon known as "leakage," or the payment of flood losses on policies that actually do not cover the peril.
- **The RMS hurricane model has not been revised in a major manner since 2011,** but the impact of that change continues to ripple through the market, especially in conjunction with the increased attention now being paid to Northeast hurricanes.
- Catastrophe-modeling firms are seeking to enhance models for risks such as flood, wildfires and tornadoes. New models often bring a better understanding of the risk and the potential for losses. While that could lead to higher prices for some accounts, **credible new models also bring price stability to the market.**

The price of property catastrophe insurance was flat to slightly higher in early 2013. The upward trend in pricing, however, has begun to stall.

- **Rates on property catastrophe risks were flat to up about 10% percent in early 2013,** depending on account, location and loss history. Price increases were higher for those accounts with heavier losses.
- Although prices did not move sharply higher in response to Sandy, the storm may have delayed a downturn in prices. The storm put price competition on hold.
- With **reinsurance rates stable and policyholders' surplus near all-time highs**, competition may begin to heat up later in the year. Even so, prices may not have much room to fall. With combined loss ratios still elevated and investment income low, insurers are forced to pay more attention to underwriting. Insurers also have become more conservative in their investment philosophy.

Insurers are considering revisions to terms and conditions for properties in Northeast coastal areas after Hurricane Sandy.



- Some insurers have increased their windstorm deductibles for the Northeast from $10,000 to as much as $100,000, and several are considering changing from hurricane deductibles to **named windstorm deductibles.**
- Insurers are considering named windstorm deductibles for coastal areas of the Northeast. These are deductibles that are a percentage of the asset values involved in a loss, typically 1% to 5% depending on the location of the risk.
- Certain insurers have expanded their definitions of Tier 1 counties, where windstorm risk is considered high. Before Sandy, Tier 1 counties included coastal areas from Chesapeake, Virginia, to Texas. One insurer expanded its Tier 1 definition from Virginia up to Maine, and others are considering whether to make the same change.
- Insurers are also considering a **catastrophe surcharge** or a "catastrophe load" for accounts in the Northeast, just as they have in the Southeast.
- More insurers are seeking to include storm surge in the definition of flood and are seeking to reduce exposure to flood in high hazard areas, especially if they believe their aggregate exposure is too high. Insurers increasingly request more details about flood exposure and confirmation of losses from the most recent storm.
- Although flood insurance is readily available, due to its high relative cost, many insured's are reluctant to purchase the coverage standalone or are forced to cut back on their purchased limits of liability within their property program. Lenders, however, may require insured's to carry more flood coverage.
- Discussion of **privatizing the federal flood program** has been going on for some time. The private insurance market, however, is unlikely to have much of an appetite for this risk, in part, because of concerns about the politics surrounding policy language.

REVIEW & OUTLOOK

The insurance market has been known for its cyclical nature. New developments may be changing that.

- Insurance market cycles, the peaks and valleys that characterize insurance pricing, may be starting to moderate as a result of catastrophe model's predictability and the rapid influx of new capital whenever there is a loss. If market cycles are flattening, this would be good news for insurance buyers as it would bring greater stability and predictability to the insurance market.
- The last hard market showed signs of starting in 1999 and picked up steam with the loss from the September 11 attacks and then wound down in 2003. Previous hard markets ran from 1984-1987 and 1975-1978.
- **The interval between hard markets has been lengthening.** It took 13 years between the 1984-1987 and 2000-2003 hard markets, but before that, hard markets used to come about every three years or so.

Insurance market for frame habitational risks is in disarray.

- **Insurance carriers have been reducing capacity and raising rates for frame habitational risks,** such as garden-style apartments, especially at the primary level where deductibles are low and claim frequency is high. Other insurers have exited the market for these risks, which have been under-priced for many years.
- **The price of insurance for habitational risks is up sharply,** as much as 50% to 100% in the Midwest, principally as a result of huge wind, tornado and hail losses across the region.
- Many insurers are raising all-other-peril (AOP) deductibles up to $100,000 and even $250,000 from $2,500, $5,000 or $10,000. By accepting these higher deductibles, insureds have access to a greater number of markets and can better control their premium cost.
- Because of lender requirements, buyers sometimes need a lower deductible. Deductible buy down and deductible reimbursement policies can reduce the program deductibles, but can add greatly to the overall cost of risk transfer. Deductible indemnity agreements, though sometimes difficult to obtain from the carriers, provide another way to satisfy lenders.

INSURANCE PLACEMENT CONSIDERATIONS

The property catastrophe insurance market may be nearing a turning point after a nearly two-year upward trend in pricing. Insured's seeking coverage in coastal areas of the Northeast, flood coverage or frame habitational insurance, however, may still face challenges in securing capacity an affordable price. Knowledgeable brokers can help insurance buyers improve their ability to obtain capacity on the most favorable terms possible.

- ***Start the renewal process early.*** By starting as early as 90 to 120 days before the current program expires, retail brokers and their clients can obtain important preliminary feedback from insurers about rates, capacity and any potential issues regarding their program. This also gives brokers and clients time to respond to any questions underwriters might have about the risk and allows for an opportunity to develop strategies if there is a need to make adjustments to a program or replace capacity. While it is good to get an early start, many underwriters may not be willing to negotiate programs until 30 to 45 days before policy expiration.

- ***Understand the significance of catastrophe models on the renewal process.*** Insurance carriers rely on risk modeling to assist them not only in managing their aggregations, but also as a valuable underwriting tool. The initial stages of a placement are a time when the skill of a broker can make a significant difference in the outcome of a placement. How quickly a broker can get an account into an underwriter's model queue is something of an art. By getting an account into the queue early, brokers can then work with the underwriter to resolve any model-related problems that might emerge along the way.

- ***Be prepared with thorough, accurate data.*** More insurers are using more than one catastrophe model when pricing policies. Most underwriters are now using Internet tools, such as Bing Maps and Google Earth, to verify underwriting criteria as they intensify their focus on exposure and engineering data. Credible data is key. Without complete, updated, and concise data, accounts will not get favorable attention from underwriters. Most underwriters are also focusing on accurate "insurance to value." Questionable building values can weaken a negotiation position from the start.

- ***Explain large claims and loss mitigation measures.*** A large claim or frequent claim activity can be a red flag for insurers, who will look at an account's loss history to determine pricing and the amount of capacity to make available. Accounts should explain any large claims and discuss any loss mitigation measures to reduce the risk of additional similar large claims

- ***Consider pricing objectives. Incumbent insurers have been under pressure to hold the line on price.*** While they may be unwilling to reduce prices, new unencumbered capacity may be willing to offer a better deal. Accounts may be able to reduce their overall costs by re-marketing their insurance programs. Before doing so, however, it is important to consider the value of maintaining an existing relationship, especially at a time when some insurers have been reducing capacity for property catastrophe risks. As always, accounts should not rely too heavily on any one insurance market. Having multiple insurers involved, principally in difficult primary layers, helps to protect an insured from the effect of any single carrier's decision on price or capacity.

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