

Insurance: Will insurance recover?

March 2011 is doing its best to harden insurance and reinsurance pricing. 2010 was not exactly a loss free year. 2011 starts with more of the same: floods in Australia and a second (larger) earthquake in Christchurch, NZ. Then within weeks one of the largest earthquakes in history has hit Japan – within shaking distance of Tokyo. Many insurers are protected by extensive reinsurance programs – but that is only good ... if the reinsurer can and will pay!

March 12, 2011

BRAVE Partner, Christopher Cloke-Browne, has strong connections to Japan. He has worked there, visited frequently for many years and worked for one of the largest Japanese banks. The talk in hushed rooms, which one was always careful not to be too blatant about, is that Tokyo was overdue for another big one. Well it wasn't Tokyo that got the big quake – it was further north, but it was a big earthquake. The magnitude 8.9 quake was the 5th largest in the world since 1900 and struck around 250 miles north east from Tokyo. The quake hit close to the town of Sendai on the Japan coast. Damage was caused by both the ground shaking and a large tsunami that also shot across the Pacific, threatening other coastlines.



Shaking all over

The Japan earthquake is quite a rare event in itself. The real rarity though is the fact that it comes in the same year (in fact the same month of the same year) as another large earthquake and shortly after major floods in Queensland, Australia.

Events in 2010

Moreover, 2010 saw several large insured losses.

Floods in Australia

The floods in 2011 were where just the same storms that had devastated parts of Queensland in 2010. The only difference was that it was a different insurance year – which in simple terms means a new limit on a reinsurance program and more potential loss for the reinsurers.

New Zealand quake

The year 2010 also saw a large earthquake in New Zealand, although not nearly as destructive as the 2011 quake. There was a 7.1 magnitude earthquake near the town of Darfield, 40km west of Christchurch. Insured loss estimated for this event alone are around NZD 3bn (\$2.25bn).

The Japan and Christchurch events are rare in themselves. The really rare thing is to have two large earthquakes and major flooding all in the same year and all that in the year after major floods and two other large earthquakes (New Zealand 2010 and Chile).

Chile quake

Late February 2010 saw a magnitude 8.8 earthquake off the coast of the Maule Region of Chile. Whilst the economic loss from this event is estimated at around \$30bn, the insured loss is thought to be in the region of \$8.5bn.

The dynamics of reinsurance

Insurers use reinsurance to control their large, catastrophic exposures. As these natural catastrophes have rolled in, insurers have all stated that their business is well reinsured and so there is not an issue for their business.

Reinsurance does not eliminate liability

It is extremely important to understand the legal construct and business dynamics of reinsurance. Reinsurance does not eliminate or transfer the liability of the primary insurer. A primary insurer that has purchased reinsurance is still completely liable to pay the claims from all of its policyholders. Reinsurance, simply creates a claim for the primary insurer against the reinsurer.

Promise to pay

Perhaps the most critical aspect of reinsurance is that (as with insurance) it is simply a promise to pay. The claim is not funded or collateralised in any way – so the day that an insurer goes to its reinsurer and makes a claim, if that reinsurer is unable to pay then the primary insurer has a problem. The primary insurer is still totally liable for all of its own claims. If it is not able to collect from its reinsurer, then the primary insurer's financial position will be put at considerable risk.

If a reinsurer is unable to pay then the primary insurer (the reinsured) has a problem.

Willingness to pay

We will leave aside the issue of willingness to pay in this commentary. However, it should be noted that insurance is infamous for its legal construct and the insurance defences to payment. Often insurers or reinsurers will seek to avoid, reduce or delay payment of claims. The best known example of this is the court case over the

claim on the World Trade Center following 9/11. The issue at stake was whether the claim was one event or two. There will be substantial disputes on the claims from all of the 2010 and 2011 events. There has already been some debate as to whether the New Zealand quakes were one event or two. There will be a number of issues around nuclear exclusions in Japan and several other issues.

Reinsurance recoverables

As insurers pay out claims, their balance sheet remains intact as they also build up reinsurance recoverables which are the anticipated claims against their reinsurers. However, a reinsurance recoverable is a balance sheet item and not a cash item until the claim is: actually made by the primary insurer; accepted by the reinsurer and then actually paid by the reinsurer. A lot can happen in that process.

Credit risk

Insurers can run significant credit risk on their reinsurance recoverable portfolio. In an environment where there is a spate of losses and reinsurance claims, two things happen:

- The reinsurance recoverable balances risk as there are more pending claims.
- The creditworthiness of the insurers and reinsurers diminish as their balance sheets come under pressure from the high claims.

The diversification game

Reinsurers will be particularly susceptible to the current run of events. Reinsurers take large, catastrophic losses, but mitigate their risk through diversification. A reinsurer will seek to take risk on floods in Australia and earthquakes in Japan on the basis that it is highly unlikely that both will occur in the same year. It just did – along with a bunch of other things ...

Be afraid ... be very afraid

It is only March, so 2011 is far from over. We still have the main event to come:

US Hurricane season

Most of the largest insured losses in history have been created by hurricanes hitting the eastern United States. Hurricane season runs from June 1 to November 30. Despite many forecasts of active seasons, there has not been a major strike since Hurricane Ike in 2008. 2011 could be the year and that might topple a few reinsurers already weakened by a number of claims.

Japan II

Furthermore, New Zealand proves that earthquakes do not come in ones. Moreover, it is always earthquake season. BRAVE Partners predicts that whilst the devastation is tragic and the loss of life could be huge from the current earthquake – talk in Japan was always about a Tokyo quake. An earthquake of a similar size under central Tokyo would generate enormous losses – some estimates are up to \$100bn. Earthquake activity does tend to propagate along faults. A large quake at one point relieves pressure there, but it can build up pressures further along the fault.

2011 is not over

There are several possible large events that could still happen in 2011 and with the reinsurance industry weakened by large reserve releases, poor investment returns and a number of natural catastrophes – it might not take too much to push some into bankruptcy.

“With the reinsurance industry weakened by large reserve releases, poor investment returns and a number of natural catastrophes – it might not take too much to push some into bankruptcy”

Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

BRAVE Partners services

BRAVE Partners is a boutique investment bank that specialises in the insurance and reinsurance business. The partners of the firm have considerable experience in analysing reinsurance recoverable and the credit risk on these. The partners have previously structured an innovative transaction for a major Bermuda insurer to protect its balance sheet from the credit risk associated with reinsurance recoverables. This transaction was reported in the Financial Times.

BRAVE Partners can assist insurers and companies to protect against the inability to pay of their insurers and reinsurers.

Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on commentary@bravepartners.com

If you would like to comment on the content of this piece, then please send an E-Mail to discussions@bravepartners.com

- The major earthquake in Japan is disastrous and devastating in its own right.
- However, this event is the latest of a chain of major catastrophies that have led to large insured losses that perhaps started a year ago with an earthquake in Chile.
- Whilst insurers are protected by their reinsurance this protection is only as good as the reinsurers ability to pay.
- The constant call on reinsurer resources will put pressure on their balance sheets which are already weakened by a soft market and low investment returns.
- Insurers face substantial credit risk to their reinsurers.

- BRAVE partners is expert in structuring and placing transactions to mitigate the credit risk that insurers face from their reinsurers.
- The BRAVE partners have previously structured such a transaction following the 2004 and 2005 hurricane seasons when certain insurers faced the same issue.

enquiries@bravepartners.com

www.bravepartners.com

[OFFICE: +44 1962 808099](tel:+441962808099)