Weighing the Losses and New Cat Covers

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Reinstatement covers and cat excess aggregation covers provide a way to ease the pain of $1-billion cat losses over each of the past three years.

Years 2009, 2010 and 2011 will go down as the first time ever that the Canadian insurance industry has experienced three consecutive years of billion-dollar catastrophe losses. And to help transfer the risk of these losses, buyers of reinsurance should be aware of two reinsurance products — reinstatement covers and cat excess aggregation cover.

RECORD LOSSES

The world has been in the midst of an exceptionally active period for natural catastrophe losses in recent years, the last two globally, the last three in Canada.

The first quarter of 2010 saw devastating earthquakes in Haiti (Jan. 12) and Chile (Feb. 27). Later in the year (Sept. 2), a Magnitude 7 earthquake hit Christchurch, New Zealand.

But the record for insured losses set in 2010 Q1 would prove to be short-lived. Christchurch was hit by yet another quake on Feb. 21, 2011. Though less powerful than the first, the second quake (a Magnitude 6.3) proved devastating, razing structures weakened by the first event. And while the first quake took no lives, the 2011 event killed 181 people. Insured damage has been estimated in the $9-billion to $12-billion range.

Similar to the one-two punch that came with Haiti and Chile in 2010 Q1, the second Christchurch quake combined with the Japan earthquake/tsunami event of Mar.11, 2011 delivered yet another left jab-right hook combination. The event in Japan claimed more than 15,000 lives and triggered insured losses of approximately $30 billion.

In addition to the seismic activity in 2011, (re)insurers have had to contend with a spate of spring tornadoes in the United States, with insured losses estimated to be as high as $5.5 bil-

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lion. Hurricane Irene losses are also estimated at up to $5.5 billion. In terms of other miscellaneous losses, there have been additional hurricane losses, wildfire events in Texas and elsewhere, as well as typhoon losses in Asia, to name just a few.

All told, 2011 currently sits in second place for insured losses due to natural catastrophes with $67 billion in claims, says Swiss Re. The year 2005 — the year of Hurricanes Katrina, Rita and Wilma — still holds the top spot, of course, with a total of $90 billion in claims. However, the year 2011 does go down as the most expensive for economic losses, with 2005 in second place.

The notable thing about the records set in 2011 is that the records were equaled before the year was even half over. This was the case globally and for Canada as well.

This year will go down as the worst on record for Canadian insurers since 1998, the year of the ice storm. The May 15, 2011 wildfire in Slave Lake, Alberta triggered insurance claims of $700 million, making it the second most expensive insured natural catastrophe in Canadian history and the most expensive wildfire in Canada by far. Storms in Ontario in March; in Ontario and Quebec in April; spring flooding and hail, tornadoes and wind in the Prairies; a tornado in Goderich, Ontario on August 21; and Hurricane Irene all put Canadian insured catastrophe losses up over the $1 billion mark, and the year is not yet over.

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BLIP, TREND OR THE NEW NORMAL?

Although the Canadian insurance industry experienced a $1 billion-plus catastrophe year in 2005, the next three years — 2006, 2007 and 2008 — proved to be quiet. Then in 2009, the industry experienced another billion-dollar year, again repeated in 2010. Thus, 2009, 2010 and 2011 will go down as the first time ever that the Canadian insurance industry has experienced three consecutive years of billion-dollar catastrophe losses.

As a result of this string of catastrophes, two reinsurance products have factored in to many discussions between insurer, reinsurance intermediary and reinsurer. They are worthy of brief discussion here.

REINSTATEMENT COVERS

The first product relates to reinstatement covers. At renewal, insurers not only have to make decisions about first event cat covers, they must also decide whether to purchase reinstatement cover(s) as well. Reinstatements afford the company another ‘go-ground’ on their first event covers should they “blow through” their limits before the year is up.

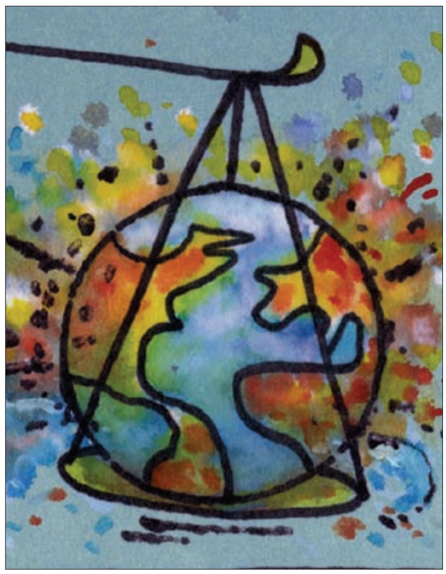
Don Callahan, president and CEO of Guy Carpenter Canada, explains. “Essentially, reinstatement provisions trigger an additional premium to the reinsurer equal to the original layer premium, pro-rated by how much the loss bears to the limit of the layer,” he says. “So if the layer is fully hit, the reinstatement premium is 100%. If only half the layer pays — for example, a $15-million, ground up loss to a $10-million-excess-$10-million layer — then half of the original premium is payable. Reinstatement provisions are designed to be an immediate payback vehicle for the reinsurer. They are also a means of limiting the total amount payable. In exchange, the full limit is reinstated. But usually only once."

Some insurers had burned their first and second layers at Slave Lake, paid the full reinstatement premium and were sitting with much of the year remaining — including the often-active summer wind and hail season — with a single limit left, Callahan noted. "If they were to blow these limits in a July storm, their capital would be fully exposed to the layers they had exhausted," he says. "Furthermore, reinsurance capacity would be down and the cost of buying a new cover in the middle of the year could potentially be multiples of the original premium. So a few insurers wisely purchased a second reinstatement in April to avoid being in that vulnerable position. I'm not aware of any insurers who chose not to purchase an additional reinstatement and were left exposed after the Alberta hailstorm, but it's possible that there were one or two. We had clients that purchased the reinstatement of the second limit right after Slave Lake and I think they clearly did the right thing. The year was not over."

A simple Reinstatement Protection contract makes decision-making easier for reinsurance buyers, Callahan says. "With this, an insurer can pay a premium at inception for protection that pays the reinstatement premium in the event of a cat," he says. "We also have cat option covers that let a company choose to buy protection at the start of any quarter at a predetermined premium. This can lower the cat retention during the course of the year and provide protection when upper-layer reinstatements are exhausted. We've been working with these sorts of ideas for many years and have tailored a few for savvy clients. I think we will see more interest in this going into 2012."

PREVENTING 'DEATH BY A THOUSAND CUTS'

A second, oft-discussed reinsurance product of late is cat excess aggregation cover. The years 2005, 2009, 2010 and 2011 typically featured one large loss event worth several hundred millions of dollars and a collection of other events of various sizes. The big events



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were usually large enough to trigger cat reinsurance. But many of the smaller events, dubbed 'mini' cats or secondary cats, were not and consequently many insurers took them net on the balance sheet.

One solution to the mini-cat problem can be a product known as an aggregate XS cover, which is explained in detail by CCR's Rob Finnie in *Canadian Underwriter*'s November 2010 issue. The need for a reinsurance product to address the mini-cat problem is still in its infancy. Although it will take time to gain traction, it appears interest in the product is gaining speed.

"Aggregate covers can help in high frequency cat years," Callahan says. "These contracts let the insurer choose how many 'mini-cats' it can tolerate. Once these cats reach a certain aggregation, the reinsurance kicks in, often on a layered basis. So, for example, we might structure an aggregate that pays once cat events greater than \$2 million but less than \$10 million accumulate to a total of \$40 million. From that point forward, the aggregate contract pays for the additional activity subject to its own limits and layering. The idea is to protect the client from aberrational cat frequency. I'm aware of about eight aggregate contracts in this market and I think every one of them got hit this year. These are obviously proving difficult to price and structure and they are going to be tough to renew. Reinsurers are on the fence as to whether 2011 is an exceptional year or just the new normal."

ONLY TIME WILL TELL

No one can ever say for certain how a year will play out from a cat loss perspective. Is it a 'blip,' a trend or is this the way it's going to be — at least until another 'new normal' rears up? The decision-making surrounding the purchase of cat cover is not always clear or easy.

Yet, it is encouraging to see reinsurance intermediaries and reinsurers are working closely to ensure that buyers of cat cover have many customizable options and new products available to them to address the uncertainty that comes with managing risk in an age of unpredictable natural catastrophes.

Ultimately, it's okay to be on the fence, as long as there are safety nets in place in case you fall.