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THE INSURANCE NEWSLETTER

Winter 2012/2013

Sandy's Impact on the Insurance Market

Three weeks after Sandy hit the coast of New Jersey and New York some 60,000 people were still reportedly without power. Damage from the storm was huge, with current estimates suggesting it may rank as one of the three costliest natural disasters in recent history. Governors from the states most affected have come out with damage estimates that approach $100 billion. This might at first look like an event that would have a major impact on the commercial property and casualty insurance market, but its worth taking a closer look and drilling down a little to see what's really happening.

Let's peel the onion: much of the reported damage from Sandy was to public infrastructure, roads, bridges, subways, power lines and poles, public utilities, etc. Most of that property, owned by governments and utilities, is not insured, so damage to it, however severe, does not impact the insurance market directly. Also consider that most of Sandy's worst damage was from wave action, storm surge and flooding. By now it's pretty well understood that standard property policies do not cover flood loss; most flood damage, if it is insured at all, is covered by policies from the National Flood Insurance Program (NFIP). It appears only a small part of Sandy's flood damage was insured outside of the NFIP.

There was of course a considerable amount of insured wind and other damage. Of the damage to privately owned (and insured) property, the larger portion of it was to personal property, homes, vehicles, boats and such. The insurance business is divided into personal insurance and commercial insurance segments. A severe loss, as with Sandy, to the personal lines part of the industry will have relatively small spill over effect on the commercial insurance side of the industry.

While total Sandy losses are certainly severe estimates of insured losses are currently running between $12 and $25 billion, only a fraction of the estimated total cost of damages from the storm that are being reported. Of that, most of the loss will be in personal lines of insurance, not commercial. So, all hype aside, how will Sandy affect your commercial insurance premiums in 2013? Succinctly, probably not all that much.

Insurance companies fund for catastrophe losses; they expect a certain number of major events each year, and build the assumption they'll have to pay for them into their premium calculations. By industry definition a catastrophe is an event that results in more than $25 million in insured losses affecting many policyholders and insurers at once. Here in the U.S. we are prone to suffer such events as hurricanes, tornados, wildfires, and to a lesser extent (from an insured loss perspective) winter storms and blizzards, floods and earthquakes.

Over the past couple of decades total insured catastrophe losses have average around $10 billion annually. That experience fluctuates from year to year. Most recently 2009 and 2010 both ranked well below average for catastrophe losses; 2011 was poor, but up until Sandy 2012 was on track to be another good year. Industry analysts are reporting that insured losses (not counting NFIP flood losses) from Sandy would have to hit $50 billion before impacting insurance industry capital; so far we seem to be nowhere near that number. Even if insured losses come in at the higher end of current estimates, average total catastrophe losses for the recent past are still within norms.

The major impact from Sandy will be on the NFIP. Reports are that the NFIP will run out of money to pay for Sandy flood claims. Expect to see reports that they ask Congress for an increase in their borrowing authority so they can pay their claims. Otherwise, property insurance in general will likely see an impact from Sandy; homeowners insurance costs will certainly continue to rise, and underwriters will be taking a closer look at commercial property lines, continuing an already developing trend.

Insurance Market Conditions

So, what to expect in the broader commercial P&C market this year? Prior to Sandy the insurance market had turned harder over the past year, but only moderately. Premium increases have averaged, over all lines and all regions, only mid single digits year over year since the market turned. So far there is no indication that this trend is showing any sign of accelerating; it seems to be holding to a slow and steady pattern with modest year over year rate increases.

There are a few factors at play here. First of all, unlike most prior hard market turns, this market can best be characterized as an income statement hard market, not a balance sheet hard market. Put another way, insurance companies are still quite adequately capitalized; what they are not doing is operating profitably. Loss experience slowly eroded over the past few years until they are now paying more in claims than they are collecting in premium. In the past investment income on funds held in reserve provided a cushion for poor underwriting results, and actually allowed insurance companies to write policies for premiums below their actual costs and still turn a profit. Investment returns these days are paltry, so there is no longer any help there. As a result insurance companies are focused these days on charging high enough premiums to pay claims and expenses, but this is more of a slow walk than a stampede.

The economy plays a role here, too. Insurance companies live in the same world we do, and they know how their customers are doing; any inclination to push for higher increases is substantially tempered by economic conditions. And finally, there are no other external factors that are really driving an acceleration in hard market conditions. A storm like Sandy gets a lot of publicity, but insurance companies factored the possibility of events like this into their pricing models several years ago. We are keeping an eye on this, though. Insurance companies tend to be herd animals; if a few decide Sandy is a convenient excuse to seek bigger rate increases, others could follow and rate increases could accelerate.

All things considered, from a 50,000 foot view and with a cloudy crystal ball there seems to be no current reason to expect any dramatic changes in broad, general insurance market conditions. There are two very important exceptions to this. The first is workers compensation, which has recently proven to be the biggest money loser for insurance companies in most parts of the country. Expect changes here, and possibly significant changes. You'll find that to be especially true if you have not been paying attention to safety and loss prevention, if your loss experience is below par or if your operations are particularly hazardous. Large, complex or catastrophe exposed property risks are the other exception, for obvious reasons. Property insurance renewals should be started much earlier this year; early indications are that underwriters countrywide are seeking higher premiums and deductibles, pulling back on coverages offered, and generally tightening up.

As we have mentioned before, underwriters are also underwriting these days; they are taking a closer look at all their accounts. You may be asked more questions, may have to compete applications you never did before, and you'll likely find the renewal process more involved and time consuming than it's been in the past. That aside, with the two major exceptions noted above expect your costs to be up a bit, but still relatively stable.

Excess & Surplus Lines; What are they?

One symptom of changing market conditions is the flow of insurance business into or out of the excess and surplus lines insurance segment. It's worth spending a few words talking about what this segment actually is, and what it does.

Standard or admitted insurance companies write most insurance in the U.S. These are insurance companies that are licensed by their state of domicile and are authorized to write specific lines of insurance. These companies are bound by state rate and form regulations, and are strictly regulated to protect policy holders from a variety of illegal and unethical practices, including fraud and insolvency. Admitted carriers also contribute to state guarantee funds which pay for losses if an insurance carrier does become insolvent.

Excess and surplus lines (E&S) carriers, sometimes also referred to as non-admitted carriers, are not required to be licensed by the state but are allowed to do business there. They can't write insurance that is typically available in the admitted market and may usually only write a policy if it has been rejected by admitted carriers. Policyholders are not protected by the state guarantee fund, and may also pay higher taxes.

Most top E&S carriers are financially stable companies. They are not bound by most of the rate and form regulations imposed on standard market companies, which gives them great flexibility to change coverages offered and rates charged without the time constraints and financial costs associated with the formal filing process admitted carriers are subject to. This can be good for both the company and the policyholder who is faced with the need to find insurance coverage for an unusual or difficult to place risk.

If you are presented with an E&S quote, it will likely be because:

- Your risk does not meet the guidelines of the standard market due to age, location, loss history, policy cancellation or some other factor;
- The policy limits you need exceed what's available in the standard market;
- Your risk is "outside the box" of what the standard carriers are comfortable writing. Lloyds of London is famous for insuring noses, limbs and other body parts; other examples might include pet insurance, coverage for event cancellation (see the last topic), etc.;
- Your risk is one that standard carriers are just not comfortable covering. Usually these are large exposures with high potential for loss such as carnivals or amusement parks, demolition contractors, and so forth.

Your insurance will never be placed with an E&S company without you first receiving a written disclosure. E&S insurance companies fill an important niche in the commercial insurance world and, properly used, can be a valuable resource for you.

National Flood Insurance Program Changes

One little noticed part of the recent congressional reauthorization of the NFIP was a provision requiring the program to begin to move toward charging actuarially sound rates for insurance on flood exposed properties. Recent losses from Sandy, and Irene last year, only serve to emphasize the need for this change.

People have been relatively free until now to go ahead and build, buy and live in properties in areas exposed to real risks from flood. With all its shortcomings, the NFIP still provided quite inexpensive flood insurance, even on properties that are very exposed to the possibility of flooding, and often on properties that had been repeatedly flooded in the past.

No more. Starting in January and phasing in over five years the rates the NFIP charges for flood insurance will begin to reflect the actual risk of flood in a given location. People will still be free to build and live in flood exposed areas, but if they want flood insurance they'll have to pay a premium for it that reflects their true level of risk.

Event Cancellation Insurance

Here's an interesting side story that emerged from Sandy, and illustrates some of the creative ways insurance can be used.

The New York Marathon was scheduled to be run on November 4, six days after Sandy struck New York. This, the major annual event of the NY Road Runners Club, is billed as the world's largest marathon, and represents from one third to one half of their annual income, some $23 million annually. Registration and membership fees average $250 each for the 60,000 runners who register for the race, with ticket sales, licensing fees, broadcast rights, sponsorship fees and such making up the rest.

Organizers planned to run the race, but the public outcry was so great (millions were still without power, thousands were displaced and public services were already strained coping with Sandy's aftermath) they yielded and cancelled two days before the race, even though runners had gathered, resources and plans were in place and the race could have been run.

There was an event cancellation insurance policy in place, written through Lloyds of London (an E&S market). These policies typically cover out-of-pocket costs incurred by the insured prior to cancellation, interruption, or postponement of an event. Lost profits and revenues may also be covered under an event cancellation policy, including such things as lost advertising or broadcasting revenue, lost ticket sales, or amounts paid to reimburse individuals who had already purchased tickets.

There are complicated issues in this case. The event could have been held, even though it might have been a public relations disaster. Money had already been spent to run the race and revenues had mostly all already been received, so the financial loss could have been avoided. Runners entry fees are clearly described as non refundable, so there is no obligation to return them. And event cancellation policies typically include a mitigation clause, a provision obligating the insured to take all reasonably practical steps to minimize (or mitigate) financial losses resulting from a cancellation of a covered event.

These policies are all nonstandard policies so there is no way to know what this policy says and all parties involved are keeping mum while claim negotiations are going on. Lloyds has already reportedly authorized a sizeable payment, so there is apparently some acknowledgment of liability. How much they will pay of their limit, or whether the limit the Club bought is enough, are not known. Nevertheless, this remains a good example of how a nonstandard, excess or surplus lines policy can be used to fill an important insurance need. It's no overstatement to say that the continued existence of the NY Road Runners Club, and the future of the New York Marathon, could well rest on the fact that someone was wise enough to buy this type of insurance.

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