March 12, 2012

Catastrophe Frequency Tests Insurers

Increased Catastrophe Frequency Could Define a New 'Normal.'

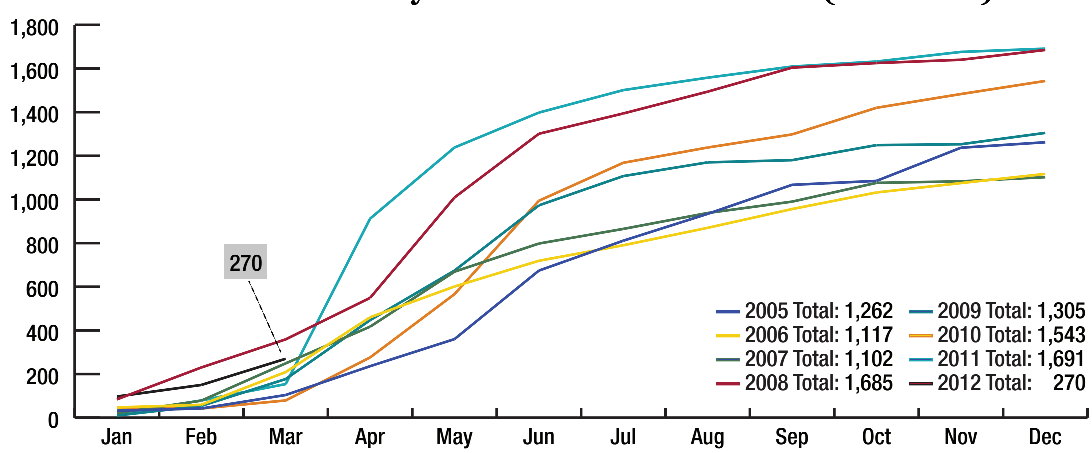
The insurance industry continues to be tested as catastrophic weather events have recently become more common and more severe. An uncharacteristic series of devastating natural disasters prompted 2011 to be labeled, "the year of the cat." While many are expecting catastrophe events to return to a more normalized level in 2012, it is questionable what "normal" is. In addition, it is clear insurers should prepare for the possibility that the event frequency of 2011 may be repeated.

Until 2011, tornadoes typically were not considered one of the larger risks for the insurance industry in total. But according to Munich Re, tornadoes were the costliest type of U.S. natural disaster in 2011. It had been rare for a series of tornadoes to inflict more than $1 billion in losses, but according to Swiss Re, insured losses for tornado and hail damage in the United States reached $14 billion in 2011. The impact of 2011's increased tornado activity prompted many insurers to accelerate their pace of rate increases, reduced limits and policy exclusions. Some insurers reconsidered what risks they were willing to write and withdrew from certain climate-change challenged markets altogether.

The 2011 trend of significantly damaging weather events appears to be continuing into 2012. There were 1,700 tornadoes recorded in 2011, less than the record of 1,817 tornadoes set in 2004, but well ahead of the annual average of 1,300 set over the past decade. In February 2012, AccuWeather.com reported that an active severe weather season with above-normal incidence of tornadoes is expected in 2012. The National Oceanic and Atmospheric Administration (NOAA) has recorded 270 events through March 5, 2012, which is higher than the seven-year average of 123, but slightly less than the accumulated number recorded during the same period in 2008, another highly active year (see **Exhibit 1**).

Atypical of historical trends, tornado activity has begun early in 2012, with the peak months of U.S. tornado activity yet to come. This was exacerbated by the preliminary count of 107 tornadoes associated with the devastating March 2 and 3 storm system that impacted the Midwestern and Southeastern United States, and destroyed homes,

Exhibit 1
U.S. Annual Trend of Yearly Accumulated Tornadoes* (2005-2012)



Source: National Oceanic and Atmospheric Administration (NOAA).
*Preliminary tornado data retrieved from the National Weather Service local storm reports.

Analytical Contacts
Richard Attanasio, Oldwick
Matthew Coppola, Oldwick

Editorial Management
Carol Demyanovich, Oldwick

businesses and autos. Based on share of direct premiums written, the top five insurers together write more than 50% of homeowners policies in the seven impacted states (see **Exhibit 2**).

March 2012 has now become the most active March for tornado activity since records started being kept in 1950. It is now tied with January 1999, which previously held the distinction as being the most active month for tornadoes this early in the season.

At this point, it appears that the early March storm system – which Eqecat expects to generate up to $2 billion in insured losses – will have more of an impact on primary insurers than reinsurers. Despite the increased frequency, with a typical month's worth of tornadoes touching down in one week, each individual event appears to have been of weaker intensity, likely generating smaller losses compared with those occurring in 2011.

Primary insurers have been mitigating reinsurance pricing by increasing their retentions. As a result, they are somewhat more susceptible to these types of "smaller" loss events. Increased per-event retention levels leave primary insurers vulnerable if high-frequency, low-intensity storms continue. If the intensity of tornado activity increases over the next few months, reinsurers could be susceptible, as aggregate covers are more likely to be triggered.

A.M. Best's outlook for the personal lines segment remains stable. A.M. Best believes that the personal lines segment is adequately positioned to handle a "normalized" weather year without a corresponding change in the outlook. While some geographically and property-concentrated writers may continue to come under rating pressure, A.M. Best believes maintaining the stable outlook on the segment is appropriate at this time. This is based on the segment's adequate risk-adjusted capitalization, despite recent property volatility and on-going stable performance in the automobile line. However, it should be noted that a continuation of frequent and severe weather events in 2012, which are beyond expectations, will likely lead A.M. Best to re-evaluate the segment outlook.

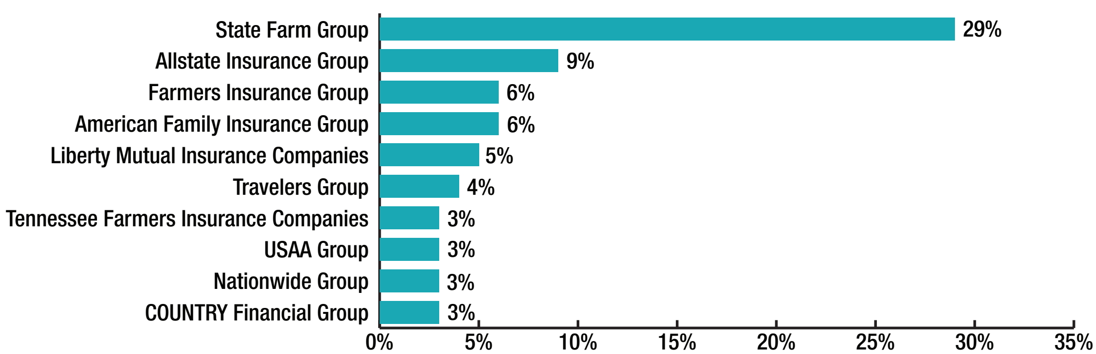
Reinsurers' Response

Increased capital retention and the initiation of enterprise risk management (ERM) practices enabled reinsurers to remain well capitalized despite the major events of 2011. With investment returns impacted as interest rates are expected to remain low for the next two years, reinsurers are seeking higher rates to improve results.

Exhibit 2

U.S. Property/Casualty – Homeowners Market Share in Tornado-Impacted States (2010)

By DPW in Kansas, Kentucky, Missouri, Illinois, Tennessee, Alabama, and Indiana.



Source: A.M. Best Co.

According to Towers Watson, the Jan. 1 renewal period was characterized as "on the firming side of stable," with rates for U.S. property/casualty reinsurance firming in a range of -5% to +5% on an overall basis led by property catastrophe business. Because of the rash of tornadoes in recent years, aggregate excess-of-loss covers, which would mitigate the impact of multiple smaller losses, have seen higher prices.

A.M. Best's rating outlook on the global reinsurance segment is being held at stable, supported by continued strong risk-adjusted capitalization, prudent ERM practices and an improving pricing environment across a broadening spectrum of business classes. A.M. Best believes these strengths should enable reinsurers to successfully navigate future obstacles that may arise from the increasingly uncertain and turbulent global macroeconomic conditions currently confronting the industry.

In the event that reinsurance premiums soften, low investment yields and a limited cushion of loss-reserve releases would prompt A.M. Best to consider revising the reinsurance outlook to negative, as pressure on ratings would be expected to mount.

A.M. BEST COMPANY
WORLD HEADQUARTERS
Ambest Road, Oldwick, N.J. 08858
Phone: +1 (908) 439-2200

NEWS BUREAU
830 National Press Building
529 14th Street N.W., Washington, D.C. 20045
Phone: +1 (202) 347-3090

A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400

A.M. BEST – MENA, SOUTH & CENTRAL ASIA
Tower 2, Currency House, DIFC
P.O Box 506617, Dubai, UAE

SR-2012-B-397