Investors beware — your *Katrina* bullishness could be misplaced

Edmund Megna tells a cautionary tale for financiers who think reinsurance is ripe for quick returns following *Katrina*

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There has been much discussion in our industry about Hurricane *Katrina*'s impact, from the size of the loss, to litigation on coverage issues, to adequacy of reinsurance limits. But perhaps the most far-ranging impact of *Katrina* will be in terms of capital.

In my view, the providers of capital can be expected to be cautious with catastrophe insurance and reinsurance. They are likely to seek higher prospective rates of return for their investments, which will then place strong pressure on primary and reinsurance rates in catastrophe-prone areas.

Following a major catastrophe, investors typically become bullish on the financial prospects for (re)insurers. They believe that the loss in capacity following a major insured event will lead to a less competitive market with higher pricing and greater profit.

As of early October, this bullish market assessment appeared dominant, and many stock analysts were issuing positive evaluations of the industry.

I anticipate this viewpoint could change with respect to property/catastrophe reinsurance. We remain concerned with the potential losses from *Katrina* and *Rita.* Past experience teaches us that initial estimates of losses from mega-catastrophes tend to be low.

Katrina's unique circumstances have raised contentious issues over flood cover. Any legal setback on this issue could lead to a large expansion in payouts.

Furthermore, the very size of the loss is self-generating. Given the widespread damage to infrastructure, it will take a long time to adjust claims, and rebuilding will be slow. In this period, costs are likely to escalate, and extra damage may occur as structures remain unprotected from the elements. As potential investors witness this escalation in costs, it is likely that the current sanguine assessment of the industry may begin to erode.

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Looking further ahead, if the latest assessments of the *Katrina* loss are more accurate, potential investors in the industry may increase their estimates of the potential severity of catastrophic loss suffered by the (re)insurance industry. An upward revision in prospective severity is likely to be compounded by the increase in frequency of large losses.

The southeast of the US has now experienced six major hurricanes in two years. In 2004 alone, the industry was challenged by frequency, with four storms hitting Florida. In 2005 the industry is being challenged by severity. Indeed, had Hurricane *Rita* not shifted east and diminished in strength just before landfall, the industry would now be coping with at least two mega-catastrophes in the current season.

Finally, there is increasing evidence that we are experiencing a period of increased tropical storm activity in the North Atlantic. This activity began in the mid-1990s and is expected by the US National Hurricane Centre to last for 25–40 years. Thus, for at least the next 15 years, we may see catastrophe reinsurance losses outside of historical ranges. Estimates for probable maximum loss and cover limits were developed in a period of reduced activity and, more importantly, at a time of much less coastal exposure. In this context, we can also expect increased scrutiny of the methodology used by the modelling companies. Increasingly, there is likely to be a concern that models do not adequately allow for a paradigm shift in tropical storm activity.

The rating agencies will also be assessing the level of risk for insurers and reinsurers. Their response is likely to be a call for more capital for the same level of exposure. But if an insurer adds capital, it will lower its rate of return. The result: pressure to raise rates even more to deliver an equitable return to investors.

As the twin pressures of capital costs and rating agency concerns play out in the marketplace, attention will switch to the underlying exposure. Insurance availability problems for coastal exposures will grow, as will calls for state and/or federal solutions. Hopefully, sensible policies on mitigation and land use will emerge from the debate. If, on the other hand, it is dominated by politics, the availability problems could mushroom. Regardless of how this plays out, capital markets will have performed their role in communicating the increased cost of natural disasters.

In its needs for extra risk capital, the industry is fortunate in that there are now many investment professionals who are knowledgeable and experienced in financing insurance ventures. Venture capitalists, investment bankers and now hedge funds have personnel who understand insurance exposures and can readily address industry needs in a relatively short time frame.

This means that the key issue for the industry will not be *if* capital is available, but rather *whether* and *when* rates in catastrophe-exposed areas are adequate to reward the necessary capital inflows. re

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