Insurance/
Reinsurance

July
2011

AUSTRALIAN 2010-2011 WEATHER EVENT LOSSES

London

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Rouen

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Hong Kong

Shanghai

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Melbourne

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Perth

Since our January 2011 briefings on the Queensland weather events at the start of the year, there have been severe natural catastrophes in New Zealand, Japan and, more recently, in southern USA which, to an extent, have turned the markets' attention away from the Australian losses. However, there have been a number of developments relevant to those losses and their impact upon the local and international insurance and reinsurance markets and in this briefing, we update our earlier reports. We also report, following presentations we made in London to a number of brokers, underwriters and market bodies, on how the London market is responding to the losses. These presentations gave rise to very informed and lively exchanges, on which we comment below.

Recent developments

The second earthquake in Christchurch, the Fukushima earthquake and tsunami and, to an extent, the North American tornadoes, are likely to affect both adjustment and settlement of losses from the Australian weather events and the conditions in which insurance and reinsurance is conducted in Australia. In particular:

1. Loss adjusting and forensic resources which would otherwise have been engaged in Queensland have been re-allocated. In some cases, this will serve to delay further the forensic analysis (and settlement) of the Australian losses.

2. The interruption to Japanese steel and other industrial production, following the tsunami, will be a factor in adjusting the business interruption losses of Australian mining (and other export) businesses affected by the floods/weather events.

3. The attritional effect on insurers and reinsurers exposed to Japan, New Zealand and North America, as well as 2010-2011 Australian losses, may affect their resources, ability and appetite to settle claims promptly. This will pose challenges to domestic Australian insurers, bearing in mind their own codes of practice (when dealing with policyholders)

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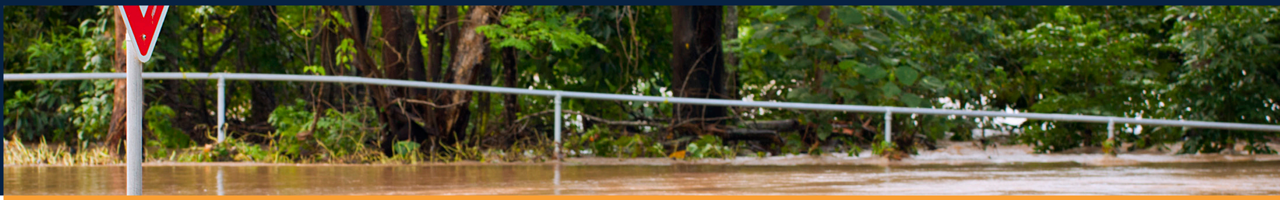


and APRA's prudential standards as regards recovery of their reinsurance assets.

4. The New Zealand, Japanese and North American losses, cumulatively with the Australian losses, appear to be "market-changing", insofar as they have affect the terms on which insurers and reinsurers offer cover, going forward. There is a perception, articulated by certain major reinsurers that Australasia is more exposed to natural catastrophes, and the frequency thereof, than had previously been understood. Terms have hardened. Insurers will be faced with more expensive reinsurance, on tighter terms, or with higher loss retentions, or a combination of all three.

Number of events/occurrences

Determination of the number of events, and their respective impact, can have enormous financial consequences for policyholders and underwriters. Notwithstanding the presence of "hours clauses", the difficulties in breaking down periods of sustained heavy rainfall over many weeks and months into different "events" or "occurrences" (and the inter-relationship between different sequential weather patterns such as Cyclone Yasi and the flooding in Victoria) to allocate and aggregate losses and to apply deductibles and policy limits, will be well known to many, particularly those interested in the Queensland flood losses from 2008-9. The Insurance Council of Australia commissioned hydrologist reports (released in March 2011) which identified three weather events which affected the lower and upper Brisbane River areas and four events which affected Ipswich. HFW learned from representatives of some London market insurers that they have also commissioned hydrologists reports, the contents of which are not yet known. The reports are not necessarily binding, but it will be interesting to observe the extent to which their findings are consistent and whether they are accepted or challenged.

Water management systems

The role of the Wivenhoe Dam management in relation to the floods in and around Brisbane has been in issue since January 2011, when it was asserted that the dam managers delayed too long before releasing water and this resulted in excessive (and avoidable) flooding. The positions of the dam operator (Seqwater) and insurers exposed to property damage (with potential interests in subrogation) are now being drawn more clearly. The hydrologist report commissioned by the ICA asserts that the dam releases caused the river level to rise by 10 meters (although it does not say how much of this could have been avoided). Seqwater, for its part, has produced a report of around 1100 pages absolving itself of any responsibility whilst criticising the accuracy of BOM weather reports.

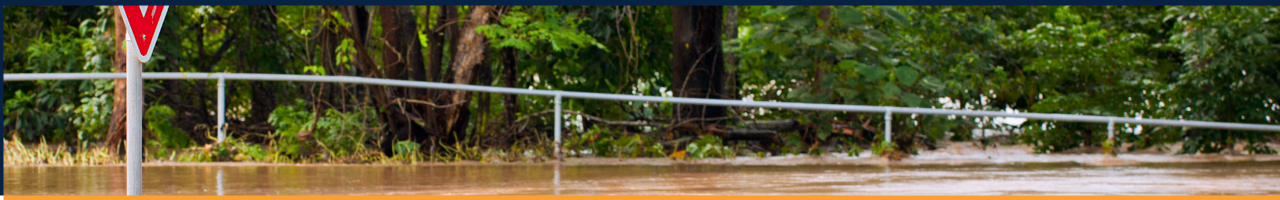
The Commission of Inquiry, commissioned by Queensland's Premier Anna Bligh, has been tasked with (among other things) investigating the dam's release strategies, whether the floods were avoidable and the insurance industry's performance of its claims payment obligations. The Commission's hearings are about to conclude but notably, the Commissioner has commented that the dam's operating manual was "a bit of mess". The Commission's interim report is due on 1 August and a final report is due by 17 January 2012. Whilst the Commission's findings will not be not be determinative (in distinction from a court's findings), where the performance of obligations is found to be lacking, its findings are expected to be relied upon by plaintiff groups. Already, one Brisbane MP (Graham Perrett, from the ruling Labour Party) has referred to what may be the "biggest class action in Australia's history".

New federal natural disaster inquiry - what is the role of the insurance industry?

The extreme weather events of 2010/2011 have focused attention on the conduct of the insurance industry in relation to natural disasters. In particular, there has been media scrutiny over the responsiveness of insurers in handling claims, the confusion of some insureds in relation to the coverage of their insurance policy, and the timeliness of processing claims. The issue is set to gain further momentum with the recent announcement of a new Parliamentary inquiry into the insurance industry's response to the 2010/2011 natural disasters.

Some key issues under consideration by the inquiry include:

- The accuracy and usefulness of information provided to consumers.
- Timeframes for processing claims by the insurance industry.
- The impact of engaging third party experts and external consultants on claims processing.



- The effectiveness of the insurance industry's Code of Practice.
- Conduct of internal and external dispute resolution processes.

The findings of the inquiry, which like those of the Commission in Queensland (above) will not be legally binding, are anticipated to be finalised in early 2012.

Relevant to personal lines insurance, in addition to alleged inconsistencies in the treatment of flood victims (insurers are being criticised in some quarters for their delayed response and settlement of some claims), is a 10 point plan of action proposed by the Insurance Council. This recommends a standard definition for flood, improved product disclosure by insurers, agreement by the Government to provide flood mapping information and removal of insurance taxes to encourage greater personal responsibility.

In early April, the Federal Government issued a discussion paper proposing a standard definition of "flood" which the Insurance Council has indicated it will support - to be fair to insurers, they suggested a standard definition in 2007, which the Government rejected because it was felt to be anti-competitive. If adopted, the new definition of flooding, whether included or excluded, would be:

"The covering of normally dry land by water that has escaped or been released from the normal confines of any lake, or any river, creek or other natural watercourse, whether or not altered or modified, or any reservoir, canal or dam."

As has been pointed out, this proposed definition still focuses on the source of the water, rather than the fact of the inundation: notably, it would not necessarily include, for example, storm water runoff, or tidal surge.

Another difficult issue appears to be the availability of flood mapping - also within the remit of the Commission of Inquiry. It is not (yet) clear that the federal state & local governments will agree to make available to insurers the flood mapping information which they hold and which insurers say is necessary for them to price the flood risk. However, even if the information were made available, some insurers (IAG's Mike Wilkins being one) have indicated that even with the information, they would be reluctant to cover flood risks (or in certain areas at least). If IAG's approach is shared by others, then government(s) will have to consider alternatives to cover available on the insurance market. It may also bring into question the planning processes which permitted development in flood prone areas. The question of mandatory flood cover has also been raised and (vigorously) opposed by the Insurance Council, by Suncorp and by IAG.

The view from London

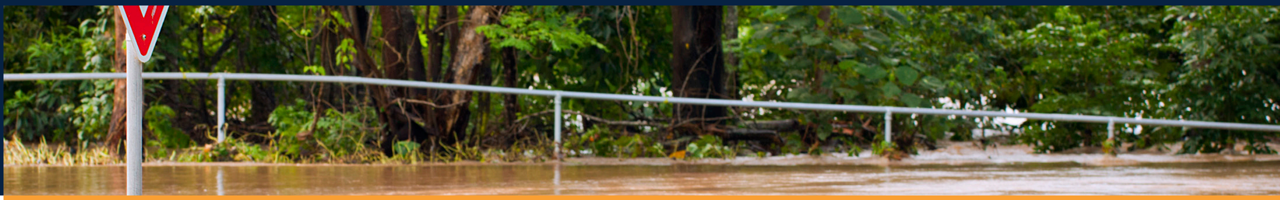
Notwithstanding the size of the losses in Australasia in 2010 and 2011 (hailstorms, floods, cyclones and earthquakes) followed by the Fukushima earthquake and tsunami, there was broad consensus that:

1. There remains substantial underwriting capacity in London which is interested in writing Australian business.
2. Conditions for forthcoming (June 2011) renewals would harden.
3. Those underwriters who have exhausted their reinsurance may have difficulties extending their existing cover.
4. Market conditions may harden to the point where reinsurance buyers will look at alternative methods of reinsurance/risk transfer. Media reports to the effect that Australian domestic underwriters are "running the numbers" on cat bonds bears this out.

Many London underwriters noted with some surprise the volume of Australian case-law on the interpretation of "flood" or "flooding" and the degree to which insurers' appetite for flood risks varies. However, we found them to be well informed about:

1. Issues relating to denial of access to flooded property, interruption of supply and other areas of contingent business interruption.
2. The relationship between "insured damage" and "insured peril" and establishing loss causation.
3. The difficulties in identifying relevant events or occurrences for the purposes of allocating and aggregating loss – this was a topic which was repeatedly raised.
4. The potential exposure of liability/casualty sector, in respect of the managerial responsibilities and pollution risks.
5. Water management systems and their suitability - in the context of mines affected by the weather events, some underwriters were particularly interested in this area.

In the context of business interruption claims arising from weather event



losses, there were particularly interesting discussions as to:

1. The suitability of current insurance products which respond per event, or occurrence or catastrophe, when there can be so many difficulties in identifying and determining the number of events.

2. The sustainability of "loss of profits" or "loss of income" as the basis of providing BI cover, in circumstances where interruption in supply caused by the weather events in question impact the price. This is particularly acute given the recent rise fluctuation in commodity prices.

   Some underwriters believe that BI cover based on pre-agreed value (or formula to determine the applicable value) which could protect policyholders fixed and marginal costs exposures is a more sustainable product and less likely to generate disputes with policyholders. Possibly some form of combined parametric triggers could be used.

Conclusion

Many of these issues are still evolving. The larger reinsurers (such as Swiss Re and Munich Re) have reported substantial first quarter losses. Lloyd's anticipates its losses from Australian 2010/2011 floods will be $650 million, with a further $1.9 billion for Japan and $1.2 billion for New Zealand. Berkshire Hathaway has reported a significant drop in earnings as a result of their investment in Swiss Re and reduced earnings are likely to be experienced by P&C reinsurers generally, who still face the bulk of the USA 2011 weather events. Some may try to raise new capital and seek to recover their losses during forthcoming renewals. At the same time, governments will put pressure on insurers to pay claims quickly - in part because it deflects from their own positions. This is certainly the case in Australia, and possibly in Japan.

HFW will continue to follow the issues we have outlined in this and our earlier briefings. For more information about please contact Andrew Dunn, Partner on +61 (0)2 9320 4603 or andrew.dunn@hfw.com, or Richard Jowett, Partner on +61 (0)3 8601 4521 or richard.jowett@hfw.com, or your usual HFW contact.

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