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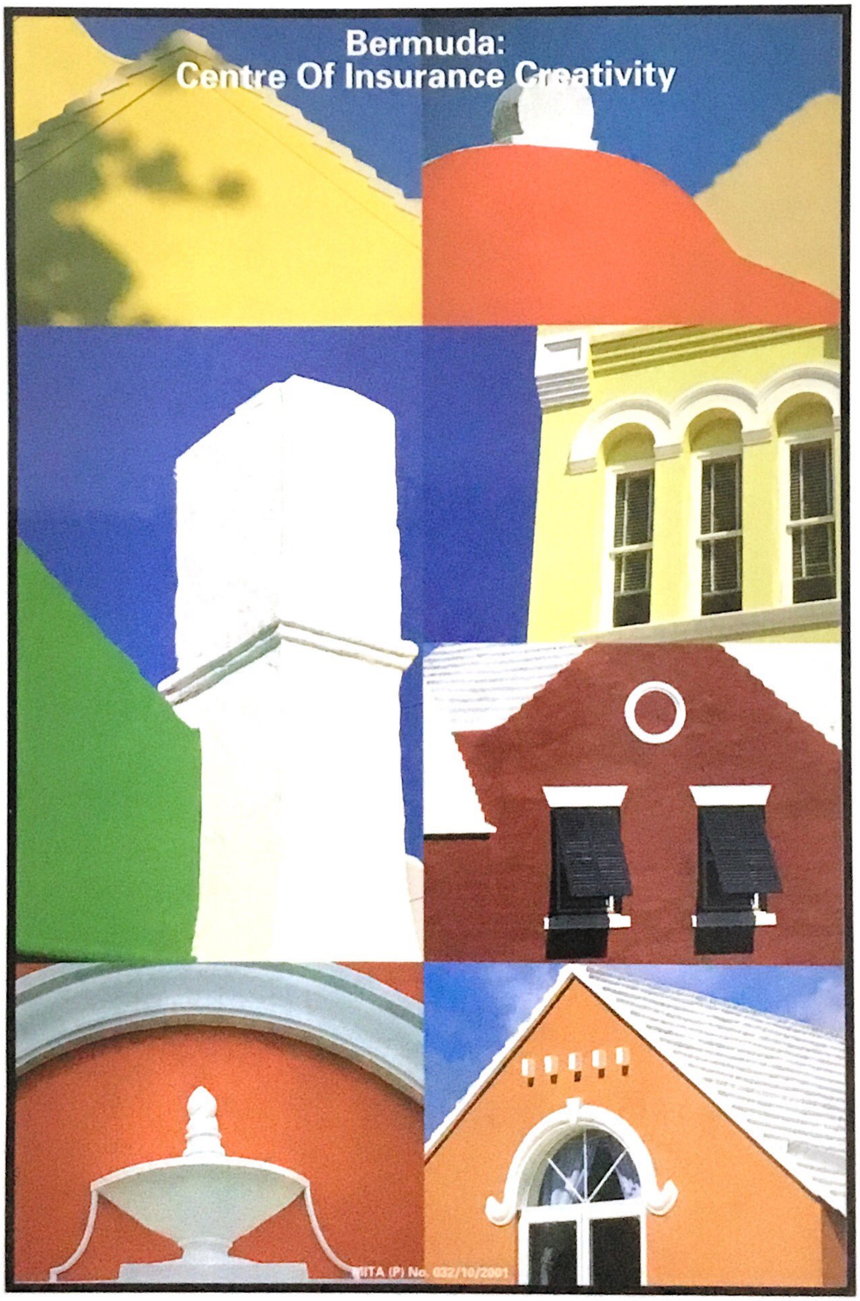

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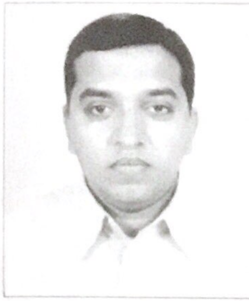


11 September – A Catalyst For An Industry Transformation?

Mr S R Warrier, Senior Consultant in the Domain Competency Group of Infosys Technologies Ltd, Bangalore, India, and visiting faculty for the National Insurance Academy, Pune, looks at the far-reaching changes that 11 September has triggered off as well as analyses the impact on the industry while looking at the likely response.

The tragic events on 11 September 2001 have forever changed the way we live. A new dimension has been added to the dangers to which we are exposed. It has irrevocably changed the way we conduct business as well; especially one such as insurance which handles risks.

Largest Insured Loss

It is the largest insured loss in history, displacing the impact of Hurricane Andrew which then amounted to US$20 billion in 1992. This is in the multitudes of that sum, and the accurate insured loss is yet to be assessed. Industry experts know that, with immense possibilities for direct and indirect liability, the claims will take years to mature. From the preliminary updated information available, majority of the analysts estimate $50 billion as a reasonable. Though asbestos liability claims may cross this loss in time to come, this is happening over a period of time unlike the terror attacks.

Can The Insurance Industry Absorb The Strain?

Generally the feeling is that the industry, being well-capitalised, will be able to withstand an enormous financial hit without threat to the overall stability of the system. The National Association of Insurance Commissioners is on record as assuring the policyholders that they can rest assured knowing the US insurance industry is an $850 billion market with assets of over $3 trillion. They have also expressed confidence in the financial capability of the insurers to fulfill contractual obligations. The well-developed reinsurance methods, which have evolved during the last decade as a result of high-risk exposures which worry insurers, should be good enough to take care of the loss strain, though not without problems.

Other Immediate Concerns

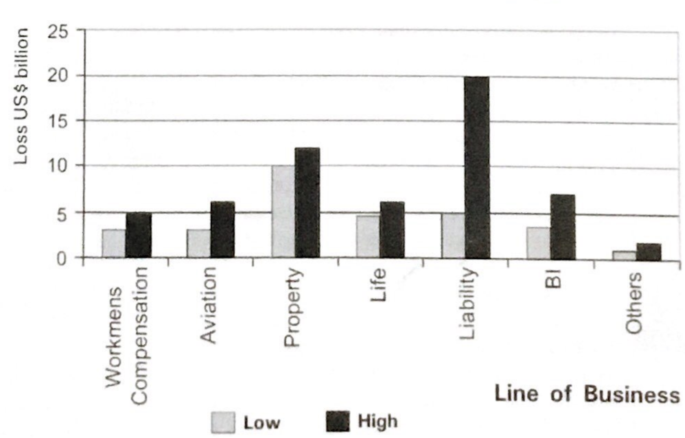
An area of immediate concern for insurance companies and customers is the policy conditions. In many policy clauses, terrorism is an excluded peril along with war risks. The response of the leading insurers in the US suggests that that they will be liberal in interpreting policy conditions when dealing with 11 September claims. It is a testing time for the insurers which will like to be seen as representing an industry that takes a liberal attitude to helping people in the wake of a national catastrophe.

The question on whether the terrorist attacks on the World Trade Center comprise "one event" or "multiple events" will take some time to resolve. This is a critical question which will decide the financial impact of the events on the primary insurers. If the event is considered as one since the two aircrafts hit the towers within just a few minutes between them, the direct insurers will have the advantage of having only one retention on their net account. Otherwise, they may have multiple retentions on their net account. However, the level of protection has to be adequately high to take care of the full interest of the companies in the case of a "single event".

The extraordinary nature of the attack will necessitate special claims-settling procedures such as the waiving of death certificates. Insurers had to put in place procedures to handle the high volume of claims flowing in and to ensure quick response especially in view of the publicity and emotional angles.

The regulatory requirements of providing loss reserves will be a challenge to cope with. The claims which are very obvious at the moment are those pertaining to property, aviation, direct liability, workmen's compensation, accident, business interruption, life and health coverage. Though information is sketchy, time-tested methods of claims provisioning

World Trade Center: Estimated Loss



Source: Tillinghast-Towers Perrin

can be adopted for handling these. But liability claims pose a distinct problem – the full scenario is difficult to construct more in view of the potential indirect liability claims. To cite an example, one of the insurance industry analysts reported that the National Football League has coverage to take care of losses from game cancellation that could approach $100 million.

Reinsurers – Down But Not Beaten

Reinsurance has been the worst-affected side of the industry. The strength and character of the market was severely tested by the 11 September catastrophe. The leading reinsurers were heavily affected by the losses and the renewal did show rate revision, although some felt that was not enough. Some reinsurers are also developing new loss models for the future.

The first fall-out of this major catastrophe is the sudden hardening of the reinsurance market. Reinsurance protection has been very much underpriced for years. The markets had just started showing indications of hardening. The process has been accelerated leading to a quick and drastic change. The renewals showed much higher rates and the more stringent conditions. Terrorism risks were excluded in the main.

The big problem which reinsurance companies will face is likely to be the capacity reduction in the retrocession market. With companies very careful not to get caught in "spirals", retrocession support will be hard to come by. The shrinkage of the retrocession market can be expected to be much more than that of the reinsurance capacity.

Getting the best out of alternate risk solutions is another area which is attracting attention. The bad financial market conditions are not helping the industry to leverage on the capital market resources. However, it will certainly be a serious option to consider.

The rate hikes and capacity crunch in reinsurance markets will ultimately translate into higher insurance costs for the consumers. The rates for property and casualty coverage are already showing upward trends in the US and the indications are that other markets will soon follow.

The early renewals of 2002 did try to find ways to successfully implement these changes without putting the primary insurer in a tight spot. Contrary to what we have seen in the soft market conditions during the recent years, reinsurers are likely to call the shots in the next renewal.

Non-Life Insurance – Proactive Changes Needed

It is hard to imagine a portfolio in non-life insurance which has not been affected by the terrorist attack on the World Trade Center. Insurers are reviewing their underwriting and reinsurance strategies to gear up to handle potential losses owing to terrorist attacks. The first step which they need to take is identifying potential exposures and developing specific underwriting methods. Revising the existing products and designing special products for terrorist attacks may also be required. Policy wordings, especially the war exclusion, needs to be reviewed to avoid ambiguity in case of large terrorist attacks.

The PML (Probable Maximum Loss) evaluation models will require revision. The "worst case scenarios" will have to be simulated more accurately. Collapse of both towers of the World Trade Center will certainly have been beyond the PML scenario imagined. The companies may have to re-design their reinsurance programme with a view to managing "clashing retentions" when several portfolios are affected by the same incident.

The available reinsurance limits call for revision based on newly developed loss estimates. Changing market conditions have also triggered a sudden shrinkage of reinsurance capacity. Capacity shortfall is expected due to reductions in capital available for support as well as the change in the risk-taking approach of the market. The likely consolidation of the market may also be a contributing factor for shrinkage. Many insurers will be desperately looking for reinsurance support for their "not so profitable" arrangements.

Life Insurance – Not "Hard Hit"

The direct impact of the event on life insurance has been less severe. However, the life reinsurance market is undergoing substantial changes which will prompt the primary insurer also to amend its rates. Though mortality assumptions remain unchanged, the term assurance market which is driven by reinsurers will definitely see an increase in rates.

Insurers offering variable and equity-linked products have to be more careful in offering assured benefits. They have witnessed a continuous drop of fund values on account of weak equity markets. The impact of the 11 September events is likely to further affect the performance of the investments of life insurance companies. The structure of variable and equity-linked products may see some change in the near future.

New Ideas

The insurance industry may have the financial capacity to bear the losses and remain stable but the event has forced the insurers to change their risk perceptions, revise the reinsurance programmes and re-look the underwriting strategy. The necessity to cope with difficult times will be an incentive to think off the beaten track. Insurers, reinsurers and customers will be seen travelling on previously unexplored avenues.

Carriers have already floated the concept of governments being the "insurer of last resort". US lawmakers are debating and finalising the details of how the Federal Government can buffer big losses hitting the industry. Other countries like the UK have already begun to think along these lines.

Getting the best out of alternate risk solutions is another area which is attracting attention. The bad financial market conditions are not helping the industry to leverage on the capital market resources. However, it will certainly be a serious option to consider.

An Overview Of Responses Which Can Be Expected

The impact of the recent terrorist attacks has been so severe that the industry may be expected to respond at once. The possible repercussions which can be expected are shown in Table 1.

Insurance – A Resilient Industry

The events of 11 September have given a much-needed shakeup for the industry. It has brought about the upward trend in rates. It has also changed the way insurers and reinsurers evaluate and underwrite risks. The logical consequence of all this is a stable and efficient insurance market capable of offering adequate protection as well as managing the rising risk exposures.

The insurance industry has proved its resilience and innovativeness in tiding over crisis situations in the past. There is every reason to believe it will do so in the present juncture as well.

Table 1: Possible Repercussions Of The WTC Attacks

Market/Player	*Likely Response*
Insurance	• Tight underwriting; • Higher premium; • New risk evaluation/PML assessment models; • Revised policy terms and conditions; • More effective reinsurance programme.
Reinsurance	• Higher rates; • Shrinking capacity; • Revision of reinsurance protection conditions; • New PML simulation methods; • New methods of providing terrorism protection.
Customer	• More careful evaluation of potential exposures; • Wider coverage; • Captives/Pooled funds.
Government	• More active involvement in risk bearing; • Playing the role of "insurer of last resort" more often than ever before; • Directive legislations.