CCI **Client Information**

*Bulletin*

No.2 November 2001

# Insurance and Reinsurance post September 2001

## Why Catholic Church Insurances offers security and stability for Church in uncertain circumstances.

### Message from Peter Rush General Manager Catholic Church Insurances

*No doubt, all of us recall the horror as we watched the tragic events of the terrorist attacks in the USA unfold before our very eyes and our sympathy goes out to all who have been affected by this brutality. Like most people, it has not been easy to return to our normal work routine and to focus on everyday issues.*

*The purpose of this paper is to communicate our preliminary views on the impact of this disaster on the insurance industry, Catholic Church Insurances and the Church in general. More than ever, the security of the insurance industry will be tested and I want to reassure you that the protection provided by Catholic Church Insurances is unquestionably sound.*

*However, the entire global insurance market will reel from the effects of this disaster and unfortunately, Catholic Church Insurances will not be immune. This comes at a time of a lack of consumer confidence in the Australian industry following the collapse of HIH and insurers will have to work hard to restore that confidence.*

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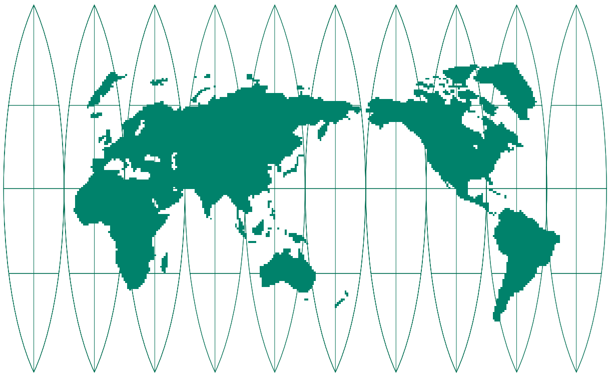
# The likely impact on the global insurance market



Without doubt, the attacks on the World Trade Centre will be the most significant event in the history of the insurance industry. Loss estimates are rising, with consistent estimates in the range of $US40 billion to US$50 billion and the loss of human life estimated at more than 5,000. To put this into perspective, prior to this event, the largest single catastrophe was Hurricane Andrew in the USA in 1992 at US$17 billion.

Among those missing, we have been terribly saddened to hear that many fellow insurers, including Marsh & McLennan and Aon Risk Management whose offices were in the World Trade Centre, have suffered terrible losses. Aon is responsible for the placement of our reinsurance program each year and we are close business partners with them. One of their Australian colleagues had recently moved to the USA for her 'dream job' at Aon and was on her second day there. She has not been seen since the disaster.

Our thoughts and prayers are with our colleagues and friends and their families.

## International Reinsurance Market

The impact from an insurance point of view is almost unimaginable – most insurers and reinsurers will take some time before they can even accurately quantify their loss. The magnitude of the loss establishes its own parameters in most classes of insurance:

- the largest workers' compensation loss
- the most expensive aviation disaster
- one of the largest property losses
- probably the most expensive business interruption loss
- the largest life insurance catastrophe, and
- one of the largest potential liability claims in history.

Previously, it was difficult to comprehend how so many classes of insurance could be affected by one single event.

To understand the total scale of the event, it is necessary to provide a little background on the nature of the insurance industry.

All insurers (to varying extents) rely on the protection provided to them by reinsurance companies. Put simply, a reinsurer accepts some part of the original risk underwritten by the insurer in each class of business and this acceptance will differ from insurer to insurer and from class of business to class of business.

Reinsurers are global in nature and, in part, protect their own business by this natural global diversification. To financially protect their capital, reinsurers in turn purchase another 'layer' of protection for the risks which they then have accepted from those insurers. This final level of protection is referred to as 'retrocession' and is purchased from specialists in a very limited international market.

Policy holder → Insurer → Reinsurer → Retrocessionairre

Both insurers and reinsurers rely on diversification as their predominant risk management strategy. This is often referred to as the theory of "risk independence", the notion that a loss in one country / location will not affect policies written in other markets but likewise, that losses will not arise in (say) both the property portfolio and the workers' compensation portfolio from the same event. Most insurers and reinsurers will not buy protection against "risk independence" unless the exposure to this scenario is obvious.

In an event such as occurred on September 11, where multiple losses in different lines of business will arise from the same underlying cause, the principle of "risk independence" does not work effectively and therefore, insurers and reinsurers may have an accumulation of claims which they had previously not considered and had not purchased protection against. If insufficient cover is purchased, any unprotected losses will ultimately have to be protected by the capital of either the insurance or reinsurance company.

As a simple example, let's assume that an insurer sustains losses totalling US$100 million in the collapse of the World Trade Centre, of which 80% is protected by reinsurance. The 'net loss' to the insurer is therefore US$20 million. The same insurer might have issued workers' compensation policies covering employees in the same buildings which result in claims for US$40 million, of which only USD$25 million might be covered by reinsurance – so the net loss here to the insurer would be US$15 million.  The accumulation of net losses to the insurer from these two classes of business would then be US$35 million, whereas the insurer might have previously assessed its highest exposure at only US$20 million from one class. Of course, this unprotected accumulation could be further increased by the number of unrelated classes of business affected by the same event.

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|---|---|
| Insurers loss on property | $100 million |
| Amount protected by reinsurance | $80 million |
| Net Loss to insurer | $20 million |
| Insurers loss on workers' compensation | $40 million |
| Amount protected by reinsurance | $25 million |
| Net Loss to insurer | $15 million |
| Accumulated Net Loss to insurer | $35 million |

There is the very real threat that some insurers and reinsurers may have insufficient protection for the business they write. Again, any amount that is not covered will have to be protected by the capital of the company – if that capital is insufficient, the company will in all probability fail.

In the situation where a reinsurer fails, any amount which the insurer expected to recover from that reinsurer will have to be met by the insurer, which of course, puts pressure on their own financial reserves.

Coping with claims on this scale is unprecedented. The ability of the insurance and reinsurance market to accommodate these claims will test the prudential standing of each individual company - most will cope, some will not. Insurance companies will be liable if their reinsurance arrangements fail. These may be companies that were already weak financially, or have done business with poorer-quality reinsurers who can't pay, or have simply accumulated intolerably high loss exposures from the event. Whenever a very large loss such as this occurs, somebody somewhere is likely to be unable to cope.

Any discussion on the possibility of insurers and reinsurers failing must be treated with extreme caution. The vast majority of companies in this industry are either sufficiently well protected with good security or have such large financial reserves that there can be no question that they will survive. While this catastrophe will be 'enormous' by any measure, most insurers and reinsurers will remain financially viable and recover to previous levels of profitability and security.

So what will be the effects of this disaster? The most immediate effect will be the cost of reinsurance protection. It is expected that reinsurance and insurance pricing will rise significantly, for a number of reasons:

1) insurers are now aware of (a) new types of accumulation of risks which were previously considered independent of each other and (b) the magnitude of potential losses and they will set pricing to take into account these new exposures;

2) the amount of capital required to support insurance / reinsurance risks is greater than formerly understood;

3) it is likely that the overall capacity which reinsurers offer will be reduced (ie: they will seek to write smaller amounts of business) and this will affect the price of that available capacity – the simple rules of supply and demand will apply;

4) due to the prospect of poor returns, investors will seek to dispose of shares in insurance companies and the subsequent drop in share price will affect the value of those insurance companies;

5) the global investment market, also affected by the disaster, will further diminish the ability of insurers to earn income.

Reinsurers will also be affected by insurers looking for the best quality reinsurance available. While the larger 'AAA rated' reinsurers may gain additional business in the short term, it will be at the expense of the smaller and less secure reinsurers. Strangely, this flight to quality will put further pressure on those highly rated reinsurers who at the same time will probably be seeking to actually undertake less risk now that they have had the ability to measure their ultimate exposure.

Reinsurance is a truly global business and it will not only be USA based reinsurers who will be affected. For example, analysts are predicting that Lloyd's of London, which was already struggling from poor results in recent years, is likely to be the most seriously affected market because of the size of its own capital base and the volume of business which it underwrote in the USA market.

There is expected to be an increased demand for all types of insurance, especially property policies as building owners reassess their potential losses and the dangers of under insurance. The estimated replacement cost of the World Trade Centre is reportedly US$5 billion, but there was, also reportedly, only insurance for US$3.3 billion. This has not been substantiated yet.

It is impossible to ignore the seriousness of the impact of the tragic events in the USA in September. The effect on the insurance market of the cascading losses through the insurance and reinsurance industry will take many years to measure and overcome. Given the unprecedented nature and complexity, it will take some time to even compile accurate information and to understand the full extent of this event.

### International Investment Market

Over the past year or so, there has been a lot of volatility in the international investment markets caused in part by the slowdown in growth of the American economy and the uncertainty of a worldwide recession.

This year, major interest rate cuts and tax cuts have been introduced in America to stimulate the economy and indications were that this should have taken effect by the end of this year.

However the World Trade Centre attack caused the largest market drop in the history of the stock market in America and caused the New York Stock Exchange to cease trading for three days. Whilst there are indications that the market is slowly recovering it will be some time before markets attain pre-attack levels. Historically, markets have rebounded from previous major crisis within six to nine months.

## The likely impact on the Australian Insurance market

### Australian Insurance and Reinsurance market

There are very few Australian-owned insurance companies in this market. Most of the commonly known companies (CGU, Royal & Sun Alliance, Allianz, etc.) have overseas parents and most, if not all, of these parent companies will have some exposure to the disaster through their global operations.

In the list of Australia's top 20 insurers, there are 4 locally owned companies which underwrite most classes of insurance business – the QBE Group, IAG (formerly NRMA), Wesfarmers and Catholic Church Insurances. QBE has already released its expectation of a net (after reinsurance) loss of A$250 million from the event and it is likely that IAG / NRMA will have some exposure through its reinsurance arm which writes business out of London.

Catholic Church Insurances' lack of exposure to losses in the USA either directly, through a parent company or via reinsurance will certainly place us in the better position than most (if not all) of the companies in this top 20 list.

The insurance and reinsurance landscape will change dramatically over the next 5 to 10 years as the total cost and ramifications of this event become known. Even prior to the events, there was considerable upward movement in the cost of insurance and reinsurance for all classes of business as the global market attempted to recover from the serious financial losses which it incurred in the late 1990s and 2000. Severe underpricing caused many companies to make losses not only from their underwriting operations (broadly claims exceeding premiums) but also "bottom line" losses after investment income was taken into account.

Early indications of what Australian insurers can expect in the renewal of their reinsurance programs (most of which occurs on 30 June annually) will appear when the London market renews its program in December 2001 and the Japanese market in April 2002.

Ignoring for the time being the direct losses suffered by insurers in this event, the most immediate impact on insurers will be fourfold:

- the increase in the cost of reinsurance
- a reduction in the availability of reinsurance
- a restriction in the cover available against terrorism
- a reduction in investment income

and no insurer will be immune from these outcomes.

At the moment, it is difficult to predict what the escalation in the cost of reinsurance will be – but it will be ‘significant’. Following Hurricane Andrew in 1992, the cost of catastrophe reinsurance increased in the order of 15% to 20% but that was an event which only affected the ‘property’ classes of business – as distinct from liability, workers’ compensation and so forth – and was generally restricted to personal lines business (house, contents and motor vehicle). As reinsurers measure the cost to all of their commercial lines portfolios from this event, the prices which they charge for protection will increase across the board.

There is no doubt that these world events and the massive losses suffered by reinsurers will reduce the availability of reinsurance coverage, which in turn will force up the cost of reinsurance substantially. Reinsurance has always been a global industry and the cost of reinsurance and hence insurance in Australia cannot be quarantined from overseas catastrophes.

It is inconceivable that the sheer magnitude of this catastrophe will not lead to the failure of some insurers and reinsurers, although we expect that this will be limited to those companies who were already financially insecure and/or heavily exposed to the losses. As companies fail, there will be less insurance and reinsurance capacity available in the market. Additionally, there will be a flight to quality to AAA rated reinsurers and this will result in the reinsurance from those reinsurers being sold at a greater premium. We believe that no insurers will be able to absorb the impact of those costs which will have to be passed onto policyholders.

The attack on the World Trade Centre is likely to prompt reinsurers to reassess their exposure to major losses especially from many classes of business, further squeezing overall capacity.

Within a month of the disasters, we are already witnessing a downgrade in the security rating of some of the smaller reinsurers and insurers by Standard & Poor. Put simply, this means that their ability to transact new business or to renew their existing covers is hampered as buyers seek better security. Of course, this further weakens their position.

Some of the AAA rated reinsurers have already imposed restrictions on their reinsurance cover, eliminating protection against terrorist acts and this is already becoming widespread amongst reinsurers worldwide. Without reinsurance protection against this risk, insurers will similarly be forced to restrict cover. In Australia, the full impact of this restriction will become obvious on the renewal of business from January 2002.

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# The likely impact on Catholic Church Insurances

## Our Insurance Business

Catholic Church Insurances is well placed with no direct financial consequences and with the best AAA reinsurance security available in the world market. Depending on the class of business being examined, up to 90% of our reinsurance protection is purchased from the world's most secure reinsurers and the balance comes from the best available "second tier" reinsurers.

In addition, being an unlisted public company, our shares are not traded in the market and we have therefore not experienced a reduction in share value as investors seek more predictable investments.

## Our Reinsurance Business

Catholic Church Insurances will, however, be indirectly affected by any substantial increase in the availability and cost of reinsurance and by the failure of any reinsurers. Again, because of the global nature of this business, we cannot immunise ourselves against the consequences of such a financially devastating event.

Catholic Church Insurances has transacted reinsurance business with most of our current participants for more than 25 years and we have always sought a partnership with those reinsurers. Unlike other companies, we have recognised the value in long-term and stable relationships where emphasis is placed on mutual understanding and benefit. Most insurers would espouse similar virtues, however we have made a conscious effort to ensure that the interests of our reinsurance partners are always taken into account. This, coupled with our good historical results and our stable and predictable risk profile, will assist in the future placement and pricing of reinsurance – but we will not escape the effects of this hardening market.

Almost certainly, Catholic Church Insurances will not be able to absorb the higher reinsurance costs we expect to see, while maintaining capital adequacy required to meet the pending regulatory requirements. Premium increases will unfortunately be unavoidable for all insurers. However, as always, Catholic Church Insurances will look at ways of constraining those increases where possible.

Since being established in 1911, Catholic Church Insurances has continued to protect the Church and that history has produced a portfolio which is both stable and predictable. It follows therefore, that the reinsurance business we transact is less volatile than many of our competitors in the market who write diversified portfolios. While the results of some classes of our business have deteriorated in recent years (eg. liability class), these are measurable and provide reinsurers with a clearer window to the future development of these areas of our business. This predictability will likewise assist the renewal of our reinsurance program, as some degree of uncertainty of future trends and expectations will be eliminated.

As with the collapse of the HIH group of companies earlier this year, the attacks on America also highlight the value to the Church of having its own insurer. With all of these considerations, Catholic Church Insurances is better placed than most insurers to face the turbulent times ahead. This is a demonstratable benefit of maintaining the prudential management of this section of the Church's finances within the Church.

## Our Policy Coverage

Catholic Church Insurances' Industrial Special Risks (ISR) policy carries an exclusion which reads:

"Exclusions for: War, invasion, act of foreign enemy, hostilities or warlike operations."

While this exclusion does not currently exclude terrorism per se, all insurers have received early warning that reinsurance protection will specifically exclude this cover in the future. If that is the case, insurers will be unable to offer this protection without reinsurance support.

For Catholic Church Insurances, while we are taking steps to delay the introduction of this exclusion, it is likely to start to come into force from January 2002.

## Our Investment Business

Following the World Trade Centre attack Catholic Church Insurances has taken immediate defensive measures to reduce our exposure to the equity market and we are now well placed to cope with the expected tougher market in the near future.

Similarly, with the in-house management of our investments on a daily basis, we are able to take advantage of the ups and downs of the currently volatile investment markets.

There is no doubt that the downturn in the equity markets will affect Catholic Church Insurances' investment performance results for this financial year. The poorer investment result may also influence our capacity to maintain the rate of dividends we have enjoyed in past years and to make other distributions at customary levels.

## Conclusion

Despite the uncertain circumstances we all find ourselves in, there remains some certainty, security and stability. Catholic Church Insurances continues to be a sound, prudently managed company, and to the extent to which we can, we are controlling matters which concern the placement of insurance and reinsurance following these attacks.

The insurance industry is in a difficult phase with great apprehension and unchartered waters ahead. For those companies whose shares are traded, there is the added pressure from shareholders seeking adequate returns on their investment and consequent reductions in share price where expectations are not met.

To maintain security, Catholic Church Insurances has always sought the best reinsurance security available and we will continue to do so. While this comes at a cost, our long-term relationships with our reinsurance partners and our past good performance will hold us in good stead when negotiating future pricing with them.

We would encourage you to take extra precautions and be vigilant at this time. With the increased possibility of acts of vandalism and malicious damage against Church properties, it is timely to review your sums insured to ensure they are adequate. We will shortly publish advice on how you might pay special attention to security matters in the immediate future.

The emotional implications of the terrorist attack on America will continue for many months and years. Even after they have subsided, the financial effects will continue and the commercial landscape will never be the same. Please be assured that the Board and management of this company are determined in our efforts to minimise the impacts on the Church from this tragedy.

Of course, Catholic Church Insurances will provide updated information once we have a further assessment of the situation.

Continuing to serve you.

**Peter Rush**
General Manager
Catholic Church Insurances

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