

Marsh News



Global financial turmoil to affect insurance market conditions

Turmoil in global financial markets is likely to contribute to the beginning of a global correction in commercial insurance rates for businesses after several years of soft conditions, said David Bidmead, Pacific CEO of Marsh, in his address to the insurance industry summit on 27 October.

Mr Bidmead told the summit in Sydney that while competition in our local insurance market remains strong, there are signs of subtle changes.

"The global financial crisis *will* impact the availability of risk capital in several ways. Insurers are being hit with sub-prime-related claims, such as Directors' and Officers' liability claims in response to financial write downs and sub-prime related losses," Mr Bidmead said.

Claimed investor losses in the United States (a strong determinant of settlement size) in cases filed in the first half of 2008 had a median value of US\$800 million, significantly higher than the 2005-2007 median of US\$350 million. This doesn't take account of claimed losses in the second half of 2008, which could push the median value even higher.

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Cost of risk to deliver water rises, despite falling rates

Despite a trend of falling insurance rates for water companies in recent years, the total cost of risk (TCR) per mega-litre of water delivered to customers increased in 2007 for the second year running. This reflects the significant impact of the decline in water volumes delivered by water companies in recent years, pushing this TCR measure upwards.

The data was contained in the 2008 Water Industry Report, recently released by Marsh, which surveyed water companies across a number of countries including Australia, the USA, Europe and the UK about risk management and insurance buying patterns.

Total Cost of Risk (TCR) is calculated by aggregating insurance premiums, retained losses, some risk management costs and brokerage fees, less the sum of insurance and claims recoveries.

The report analysed TCR against three measures:

- TCR as a percentage of Operating Income
- TCR as a percentage of Insured Assets
- TCR per Mega Litre of Water supplied

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“The deteriorating capital position of insurers is likely to impair capacity in the insurance market and, on top of this, we are expecting the industry to face rising reinsurance costs,” Mr Bidmead said.

Some analysts have suggested that risk capital has been depleted by upwards of US\$100 billion over a 12 month period.

“All of this may stimulate a more conservative approach to the management of the current cycle – it may reduce competition and contribute to the beginnings of a market correction.

“It is important to note, however, that we are likely to avoid a more acute correction, which was a hallmark of the changing insurance cycle in the 1990s,” Mr Bidmead said.

This view is supported by strong evidence of prevailing competition in the local Australian market right now, with Marsh data revealing flat insurance renewal outcomes, on average, for the September renewal season.

“Another significant issue is customer confidence. In this environment, customer confidence, or the lack of it, will affect conditions,” Mr Bidmead says.

“In recent times, there has been a trend toward consolidating deeper, more meaningful relationships with insurers, reducing the total number of underwriters on a program.

“Customers are now questioning the ongoing suitability of this approach and they are likely to consider syndicating

their risk to a broader panel of insurers to achieve greater economic and geographic spread, reducing their counter-party exposure to any one particular insurer.”

Mr Bidmead also warned the insurance industry against losing sight of the need to develop appropriate product responses to emerging risk issues on the horizon, such as climate change.

“There’s a danger we could lose sight of this challenge in the face of the current economic turmoil,” Mr Bidmead says.

“Remaining silent on new and emerging risks either because they are difficult to quantify or until a major loss occurs is unacceptable in an age of contract certainty.”

Cost of risk to deliver water rises, despite falling rates

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This allows for direct comparison of Total Cost of Risk regardless of company size.

The Total Cost of Risk as a percentage of Operating Income has trended upwards over the last five years (although it has fallen somewhat from its 2005 peak), reflecting the tightening revenues of corporations in the water sector. This is contrasted by the trend of a decreasing ratio of Total Cost of Risk as a percentage of Insured Assets. The downward movement has primarily been a result of soft insurance market conditions which have delivered year-on-year reductions in insurance rates.

According to the report, the correlating measure of the price of water has also increased in all regions surveyed, with an average global increase of 5.32%. This trend of increasing prices is expected to continue, with regulators approving further price increases in a number of regions across Australia.

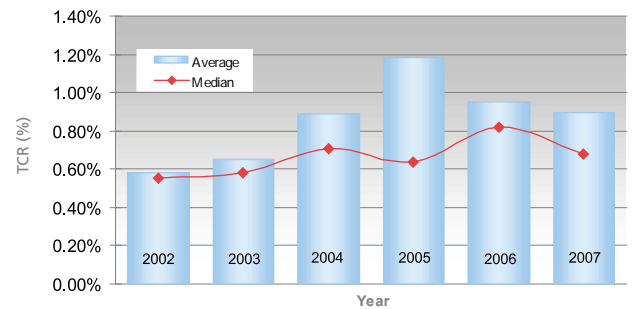
The report also tracks the most commonly identified risk issues for the water industry. For the fourth year running, the failure of water assets and contamination of water supplies continued to rank as the highest risk categories, highlighting concerns about ageing infrastructure, regulatory obligations and stakeholder expectations.

In recent years, climate change and water scarcity have quickly emerged as growing concerns for the industry with climate change risks, including future liabilities, increased regulation, diminishing water and drought, increasingly identified by participants as priority risks requiring strategic attention.

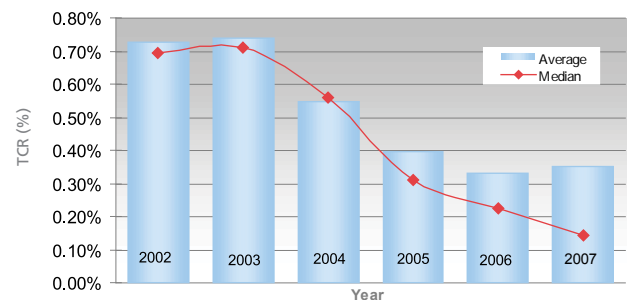
Overwhelmingly, respondents acknowledged that climate change was one of the factors likely to affect water availability in the future, and that climate change would force the water industry to seek alternative means of harvesting water. Nearly all respondents agreed that decreased water supply would mean industries using water in high volumes will need to curb consumption while water restrictions for households would need to continue to address the shortage.

The survey also revealed consensus in the industry, showing that water companies recognise climate change as a real threat to the future availability of water globally and that the industry must seek alternative means of harvesting water.

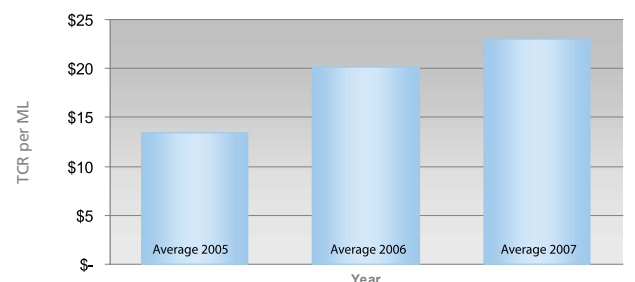
Total Cost of Risk as % of Operating Income over time



Total Cost of Risk as % of Insured Assets over time



Total Cost of Risk per ML of Water Supplied



Losses from Hurricanes Ike and Gustav to rise



The latest figures from recent hurricane activity in the United States indicate that insurers are facing higher than expected claims losses.

According to catastrophe risk specialist, ISO Property Claims Services, the eleven catastrophes that affected 22 states during the third quarter of 2008 have resulted in the fourth-largest insured property loss in a decade. The damage caused by Hurricane Ike alone when it swept through Texas and other southern US states, is thought to be the third costliest hurricane in US history.

Hurricanes Katrina in 2005 and Andrew in 1992 rank as the two costliest hurricanes in history, with insured losses of \$43.6 billion and \$22.9 billion respectively.

To date, damages incurred by homeowners and businesses as a result of Hurricane Ike have been estimated at between US\$13 billion to US\$21 billion based on 1.7 million claims. This is despite initial catastrophe modelling which estimated losses of \$7 billion to \$12 billion from the September 13 hurricane.

According to Jamie Cook, Senior Vice President with risk specialist Guy Carpenter, the upward revision of losses will have a significant affect on insurance claims.

"Our preliminary analysis and market commentary indicate that many clients have

seen actual losses that are multiples above the modelled loss estimates," he said.

While these sums are unlikely to be sufficient enough to influence price and capacity of the property reinsurance market, the overall effect of these losses, combined with low returns, depressed equity values and shrinking available capital in the wake of the financial crisis, increases the likelihood of an upward movement in reinsurance premium rates.

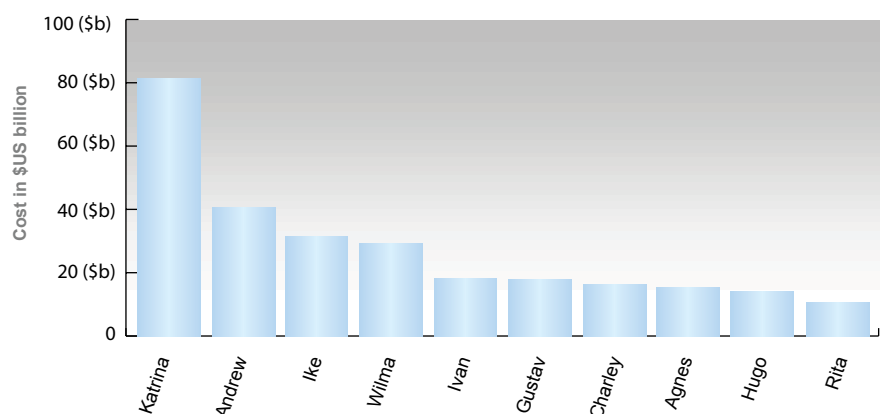
"Feedback from this year's Baden-Baden Reinsurance Symposium and the PCI¹ Annual Meeting indicates an overall stabilisation of the reinsurance market but certain segments, especially where losses have attached, can expect increases," Mr Cook said.

However, Mr Cook adds that while reinsurers have outlined various reasons for why they expect property pricing to level or firm heading into 2009, historical context suggests that we are not coming from a pricing level in 2008 that indicates that prices "must" rise to be technically adequate.

"Should unexpected natural peril and asset loss events converge over a short period of time, reinsurers could indeed face potentially acute capital pressure. As we stand today, however, reinsurers are coming off a period of historically strong profitability and subsequent relative over-capitalization by many traditional measures," he said.

¹ Property Casualty Insurers Association of America

Ten costliest Atlantic hurricanes*



*Total damage cost

Source: National Hurricane Centre and others

News Bites

Combating the cost of copper theft

The global rise in the incidence of copper theft in recent years poses a significant problem for businesses and government. The problem has been attributed to the increasing price of scrap copper, which has doubled in Australia since 2004, mirroring the experience in the rest of the world.

In Australia alone, the estimated cost in materials and business interruption caused by copper theft is around \$100 million a year. The financial cost of the problem is exacerbated by the considerable disruption to business and services.

While there are some factors (e.g. remoteness of location or ease of access), which make some industries more vulnerable to theft, the problem is broad, and addressing the issue of copper theft is high on the agenda for many businesses.

According to Dallis Raynor of Marsh Risk Consulting, there are a number of practical ways companies can minimise the impact of the problem.

"Prevention is, clearly, always preferable," Mr Raynor said.

"One benefit of the widespread cost and inconvenience of copper theft is that the problem has prompted significant industry investment into research and development," he said.

One new tool, developed jointly by the CSIRO and private industry, now enables companies to encode its copper at the molecular level, making identification of copper possible. Reports of reductions in copper theft suggest that this has helped to discourage theft from occurring.

Mr Raynor adds that companies looking to protect their business from the cost and disruption of copper theft can employ basic risk management principles to minimise risk.

"Organisations need to think carefully about where their risks lie and what they have exposed. Given the level of creativity involved in recent thefts, some lateral thinking may be required," he said.

Mr Raynor advises that contingency plans should also be implemented to allow companies to recover following theft. Companies should also consider minimising financial impacts through appropriate insurance arrangements.

Recent incidents of copper theft highlight the disruptions to business and services that may follow theft:

- Suburban trains were held up in Melbourne in January 2008 because overhead railway cables had been stolen
- The Blue Mountains experienced a blackout in May 2008 after 16 power poles were cut down and 4.2km of power line was stolen

Expanded polystyrene: Understanding the risks to your property

Properties which utilise polystyrene material, or EPS, now face even tighter insurance conditions as a result of recent adverse losses. During the last June renewal period, insurers significantly reduced capacity or sought higher excess of loss positions on placements, with some insurers declining to renew EPS risk altogether.

Market appetite for EPS risks has always been limited as EPS is known to increase the severity of building fires, however, over the last renewal cycle, insurance capacity

had reduced further with Marsh observing rate increases of up to 200%, often coupled with significant increases in deductibles.

James Keneally, Principal of Marsh Risk Consulting, advises businesses with EPS construction to carefully consider the mechanisms they have in place to reduce the risk of fire.

"Many of the risk reduction activities are low-cost, easy to implement and most significantly, they offer considerable reduction in the risk of fire", he said.

Key areas of risk management include:

1. Close attention to fire prevention
2. Maintenance of panel integrity
3. Prevention of premature panel failure
4. Prevention/minimisation of core material involvement
5. Location and proximity of plant and equipment

"Additionally, establishing, maintaining and communicating the existence of risk management systems is critical when managing the expectations of an insurer during placement of Industrial Special Risk insurance policies," said Mr Keneally.

Disclaimer: This newsletter is only for general information. It is not a substitute for specific advice and should not be relied upon as such. We accept no responsibility for any person or corporation acting or relying on this information without prior consultation with us. 08/0134

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