

## Special Comment



August 2007

# UK Flood Events Will Have Insurance Earnings Impact, But No Effect On Ratings

United Kingdom

## Summary Opinion

### Overview of the Flood Events

The UK has experienced a wetter than average year-to-date, with rainfall between May and July being at the highest levels ever recorded.<sup>1</sup> Two particular short periods of time – one in late June and one in mid-July – both led to substantial rainfall over selected areas of the UK. The severity of the precipitation over a short period of time, combined with already saturated land due to a wetter than average year, led to substantial flood events in the North of England (specifically Humberside, Yorkshire – end June) and South England / Midlands (specifically around the areas of the River Severn and the Avon – mid-July).

### Challenging to Estimate Claims Frequency and Size

Insurers' accuracy in estimating ultimate claim costs can be challenging for 'normal' claim events, due to the problems of estimating development costs on known (notified) claims (for example, repair costs and liability payments) as well as predicting future claims notifications.<sup>2</sup> Claims underestimation is therefore a common issue.

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<sup>1</sup> The UK Meteorological Office states that rainfall in England and Wales for May-July was 208% of the average during 1971-2000, and was the highest since records began in 1766.

<sup>2</sup> IBNR: Incurred But Not Reported



## UK Flood Events Will Have Insurance Earnings Impact, But No Effect On Ratings

With any catastrophe event, insurers' ability to reliably estimate ultimate claims costs is even less certain. With respect to the recent UK flood events, the following additional challenges exist:

- Existence of standing water: for many areas affected by the July flood, insureds face a delay in being able to contact their insurers to notify claims; Furthermore, even post notification, claims assessors may not be able to access damaged properties;
- 'Drying out': post notification, a substantial period of 'drying out' of affected properties will have to take place before damage can reasonably be estimated;
- Demand surge: similar to Hurricane Katrina, affected areas are likely to see (albeit to a lesser degree) a substantial shortage of available resource (tradesmen, materials). This leads to, at best, an increase in the cost of repairs, at worst a delay in repair and the potential for further damage to occur;
- Business interruption / liability: often one of the major heads of damage from such events relates to commercial property damage and subsequent business interruption claims. Such cases are adversely affected by all of the issues referred to above, but will by definition be much larger.

Consequently, Moody's believes that it will for some time be challenging for insurers individually or collectively to estimate a gross figure for either event. The Association of British Insurers (ABI) has initially estimated that the two events are likely to reach costs of GBP1.5 billion (June flood) and GBP1.0 billion (July flood).

Date	Location	# Claims (as at July 27)		ABI estimate - Gross Industry Cost
		Business	Household	£ billion
Late June	Yorkshire / Humberside	7,000	27,500	1.5
Mid-July	South England / Midlands - Rivers Severn / Avon	3,500	12,000	1
		10,500	39,500	2.5

Source: ABI

Interestingly, due to the timing of the events (one before end-H1, one at the start of H2), from a quarterly or half-yearly perspective the financial impact will be spread over two accounting periods.

### Analysis of UK Companies' Potential Exposure to Flood Risk

Based on experience from previous events, Moody's expects that the majority of claims costs from the two flood events will emanate from the following business lines

Personal Property	Repair to private households, replacement of contents, temporary accommodation
Commercial Property	Repair of commercial property
Commercial Business Interruption	Payments to offset periods of lost business/trade through flood inundation and repair work
Commercial Liability	Usually a limited proportion of claims as a result of liability to third parties/individuals during or following the event

Consequently, in understanding a particular insurer's likelihood of exposure to the two events, it is helpful to consider their line of business focus. The table below shows, for the major UK non-life insurance groups, a broad business line split. Such an analysis is by its very nature somewhat general as it is not able, for example, to identify those insurers with a particular geographic focus on the affected areas, however, this table can help to indicate those names which have little or no such exposure in the UK. Another important factor is the interaction of an insurer's reinsurance programme, which – depending on the nature and scale of coverage purchased – can translate a substantial gross loss into a smaller net retention.

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2006 GPW as % of UK total	Allianz Cornhill	Aviva UK	AXA Insurance Group (UK)	Royal and Sun Alliance	Zurich Insurance Company (UK Branch)
<b>Insurance Financial Strength Rating</b>	<b>A1</b>	<b>Aa3</b>	<b>Aa3</b>	<b>A3</b>	<b>A1</b>
<b>Retail/Personal</b>					
- Property	7%	18%	11%	14%	16%
- Motor	8%	17%	8%	15%	18%
- Other	21%	15%	41%	3%	1%
<b>Commercial</b>					
- Property	15%	9%	16%	18%	16%
- Consequential Loss	3%	1%	1%	2%	2%
- Liability (Employers, Public and product) and Professional Indemnity	11%	6%	11%	14%	23%
- Motor	16%	7%	6%	17%	15%
- Other	16%	3%	4%	8%	7%
<b>Marine, Aviation &amp; Transport</b>	3%	0%	1%	6%	0%
<b>Treaty Reinsurance</b>	0%	25%	1%	3%	2%

Source : UK FSA returns, Form 20A

NB Aviva combined consists of aggregated GPW figures for legal entities Aviva International Insurance (All), Norwich Union Insurance Limited and Gresham Insurance Company Limited. Treaty business relates to internal proportional reinsurance of Group UK business that would be eliminated on consolidation. Internal treaty business consists of Accident & Health (11%), Motor (46%) and Property (31%)

Line of business descriptions: Retail property - Cat. 160, Retail motor - Cat. 121-123, Retail other - Cat. 111-114, 181-187, Commercial property - Cat. 261, Commercial consequential Loss - Cat. 262, Commercial liability - Cat. 271-273, Commercial motor - Cat. 221-223, Commercial other - Cat. 263, 274-284, Marine, Aviation & Transport - Cat. 331-350, Treaty Reinsurance - Cat. 610-700..

### The Impact of Reinsurance

Moody's understands that the floods will be treated as two separate catastrophe events by reinsurers, given the separation by time.

Consequently, we believe that the financial impact of these floods on UK insurers will be mitigated to an extent by reinsurance protection, but that the brunt of the insured losses will be borne by primary insurers. The fact that the floods constitute two separate catastrophe events means that these primary players will be using the extent of their retention levels twice in order to initially absorb the losses, and will also incur costs for the reinstatement of reinsurance protection. Furthermore, the retention levels of reinsureds have generally been increasing in recent times. The majority of catastrophe reinsurance business in the UK is written on a non-proportional basis, an exception being motor, but insured losses from this business line are expected to form only a relatively small part of the total.

Reinsurers will undoubtedly meet some of the cost of the UK floods, although the impact on them will be much less than if it were just one event. In general, and based on current information, we would be surprised if the Q2 and Q3 results of reinsurers are significantly impacted by the floods.

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### Earnings Impact, But Manageable

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As a backdrop to the flood events, most UK non-life insurers have seen strong levels of operating performance in the past few years, driven by a combination of benign financial markets and top-of-cycle levels of insurance premium rating. Consequently, many UK operating companies and indeed insurance groups with material UK non-life exposure have seen consistently improving levels of capitalisation. The industry's ability to deal with events of the size currently estimated is therefore far stronger than was the case in the early part of this century, and although we expect UK non-life operators' 2007 earnings to be diminished by the flood events we do not expect capitalisation to be impacted.

Overall, we therefore expect the following as a result of the flood:

- At least GBP2.5 billion gross cost to the industry in aggregate;
- The primary insurance industry bearing the brunt of the insured losses, leading to a noticeable earnings hit for the full year but no capital impact;
- To a lesser degree, some impact borne by the reinsurance industry, although well within the typical allowance for such events globally and, at most, a relatively small impact on annual earnings;
- No impact on credit ratings of UK primary insurers or global reinsurers.

### Looking Ahead: Impact on UK Insurance Premiums

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A natural consequence of any catastrophe event is an increase in premiums for cover for the region and risk type affected (witness the increase in US catastrophe premiums after hurricanes Katrina, Rita and Wilma (KRW) in 2005). Furthermore, Moody's understands that for some time UK flood risk has been systematically underpriced relative to the 'technical price' indicated by flood modelling agencies.

Moody's therefore expects that property-related premiums are likely to experience upwards rating pressure at next renewal, not only for flood-affected areas but more generally for the whole of the UK. Furthermore, significant rate increases may become evident for areas now judged to be significantly flood-prone and allowing for the potential impacts of continued global warming. Although the industry has tacitly agreed that 'red lining' (e.g. creation of postcode areas where flood cover will not be offered at any price) for flood protection is not industry practice, a repeat of such events would be likely to see some form of co-ordinated industry response in order to mitigate excessive exposure to future events.

## UK Flood Events Will Have Insurance Earnings Impact, But No Effect On Ratings

### Moody's Related Research

#### Industry Outlook:

- UK Property & Casualty Insurance: Industry Outlook, February 2007 (102113)

#### Insurance Statistical Supplement:

- UK Non-Life Insurance, November 2006 (100319)

#### Rating Methodology

- Moody's Global Rating Methodology for Property and Casualty Insurers, September 2006 (98046)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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