Jim's Perspective…

Severe Tornado Outbreak

The Friday, April 26, extreme weather was so sad, discouraging and stressful. Governor Pillen reported that 450 homes in eastern Nebraska were destroyed. It has been reported that a lot of this destruction was in the Elkhorn, Bennington and Blair area near Omaha. Lincoln also had a damaging tornado, but it struck mostly around the northeast edge of town. All of this is extremely disconcerting because we are still in the early phase of Nebraska's storm season. We've still got a good three months of potential extreme weather events. Subsequent to the Friday severe storms, it was also not good to hear the National Weather Service, Omaha-Valley, issue a storm alert on Tuesday, April 30th, for the area of southeast Nebraska including Tecumseh and Auburn. The Weather Service reported 60 mile-per-hour wind and large hail. Not good for roofs, siding and cars. I only hope all of this is an unusual series of storm events and that it does not portend numerous additional severe storms during the storm season. May we experience blue skies, a soft breeze and mild summer temperatures!

The Friday tornado outbreak is an excellent example of the need and the value of reinsurance in the property and casualty insurance marketplace. Reinsurance is fundamentally divided into two categories; facultative cessions and treaties. In facultative reinsurance, each subject of insurance (risk) is usually underwritten individually. Under treaty reinsurance, the reinsurer underwrites an entire class of risk that is to be reinsured. It might be the entire homeowners program of the primary insurer. It could also extend to various commercial property programs. Under treaty reinsurance (also called an "excess of loss contract"), the primary insurer retains a certain level, or percentage of the risk of loss under all of the insurance programs subject to the reinsurance treaty. Loss costs above the primary insurer's risk retention are paid by the reinsurer up to the coverage limit.

The Friday tornado storm event would usually be reinsured under an excess of loss reinsurance contract This type of reinsurance coverage is called catastrophe reinsurance. Within the insurance industry, this type of reinsurance is typically referred to as "cat coverage". Cat coverage would involve a retention by the primary insurer of cat losses of perhaps up to $30 million. The reinsurance coverage would apply to cat losses in excess of the $30 million retention. Often the reinsurance coverage is organized in layers of reinsurance coverage. There might be a $20 million layer of reinsurance coverage on top of the retained $30 million. Above that there might be two or three more layers of reinsurance coverage. Of course, the higher layers will be negotiated at a lower price since they are less likely to be triggered by a catastrophic storm. Also, for cat coverage to apply to a weather event, the weather event must be designated as a "catastrophic storm" that then triggers application of the cat coverage to the storm. I am not sure who determines whether a storm is a catastrophic storm. It might be the National Weather Service.

A problematic issue with treaty reinsurance, cat coverage, is that once the cat coverage is accessed and used in a catastrophic storm, the treaty has been used, and it is then terminated, and the primary insurer must negotiate another cat coverage reinsurance program with the reinsurer. Sometimes, however, the treaty reinsurance agreement contains a reinstatement provision that allows the treaty to be reinstated based on certain terms of new coverage. The new cat coverage treaty, or reinstated treaty, is often more expensive to purchase or reinstate after the first treaty has been used. The primary insurer will also probably have a higher level of retention of loss costs incurred in a catastrophic storm event. I am sure new cat coverage or reinstated coverage for insurers who used their cat coverage for last Friday's and Tuesday's storms will be expensive since we are still in the early stages of the typical Nebraska storm season. Also, I am not sure how, or if, the Tuesday storm would be covered by the cat coverage that applied to Friday's storm.

Part of the value and purpose of reinsurance is that it is intended to keep the primary insurer's loss ratio at a level, or stable, year to year, figure. Most property and casualty insurers try to keep the year to year loss ratio at around 70 to 75 percent of earned premium for the year. The expense ratio of the insurer (wages and other expenses such as buildings, machinery and equipment) typically should run around 25 to 30 percent of earned premium. If the loss ratio for a given year is 70% and the expense ratio is 25%, then the insurer has a "combined ratio" of 95% which results in an underwriting profit of 5% of premium written. That is considered a very good year! The other item that also has to be considered in the property and casualty insurer's profit or loss for the year, is investment income. This is a long-time contentious issue within the P&C industry. If investment income is part of the equation in determining the combined ratio, then this allows the insurer to have a higher loss ratio and yet still show a profit for the year. The argument against considering investment income, is that this revenue is subject to significant change every year. One year the insurer may have some positive investment income, but the next year the insurer could lose a lot of money on investments.

If the frequency and severity of catastrophic weather events goes up, as you know, the cost of insurance for consumers will ultimately go up. It is already happening. I am sure you have seen some of the news items describing the frustrations of insurance consumers. And too, the management teams of primary insurers are likewise very frustrated with the reduced coverage because of higher retention of loss costs by the primary insurer, and the higher cost of reinsurance. Under excess of loss reinsurance, the retention required by primary insurers continues to get bigger. This creates a bigger risk exposure for primary insurers, and increases the risk of insolvency. Not a good thing.

Finally, I did see a first quarter (2024) publication from insurance broker, Marsh, that showed U.S. property insurance rates increased 8% (See Ted Besesparis, PIA National Newsline, Wednesday, May 1.) This is much better than the second quarter (2023) which showed property insurance rates had increased 19%. Again, I hope the rest of the storm season is quiet, and property insurance rates level off and things remain more stable.

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