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Insurance Industry Serving as Litmus Test to Global Warming

By Geoffrey A. Gordon

MANY LEADERS OF COMMERCE AND MANUFACTURing harbor deep skepticism about links between industrial activity and global warming, or indeed whether global warming itself is anything more than political bluster. Many environmental activists and politicians believe not only that global warming is here, but also that there is a direct link between industrial activity and warming. Both sides line up with arguments based on selective facts, circuitous rhetoric and ultimately are distilled down to clever sound bites. It can be hard for laymen to decide who's right or what steps should be taken.

One time-tested way to understand choices and solutions for complicated problems is to follow the money. To gain further understanding of what's up with global warming, look to the industry that has the most money on the line: insurance.

The impact on real estate and lending is clear. When risk costs increase, carrying costs for affected properties rise and property values suffer. Or worse, if insurers won't provide protection for property, lenders can't lend. And without financing, buyers can't buy and sellers can't sell. The real estate and lending trades need a healthy and competitive insurance marketplace to function profitably.

Global warming certainly has the attention of the insurance industry, and in particular the reinsurance companies where the biggest disasters ultimately come home to roost. This $3 trillion industry has more at risk than anyone, and the symbiotic relationship with lending and real estate makes understanding trends important.

Most would agree that we have entered a period of greater frequency and higher intensity storms: The 2004 and 2005 seasons witnessed more and bigger storms than historical averages. Another troubling omen has been the arrival of hurricanes in new regions. A peek into the future occurred in 2004 when a tropical storm in the South Atlantic developed into the

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first hurricane – Catarina - ever recorded there. This storm made landfall in southern Brazil, killing two and damaging hundreds of homes. Tropical storms rarely develop in the South Atlantic, but this one did and blossomed into a hurricane. In 2005, Hurricane Vince developed near the Madeira Islands off Portugal and became the first hurricane ever to strike Spain. A study just released out of University of Castilla-La Mancha in Toledo, Spain, posited that a 3 degree Celsius (4.6 degree Fahrenheit) increase in temperatures could spawn hurricanes in the Mediterranean Sea, one of the most densely populated and highly valued tourism regions in the world. Insurers and climatologists are working hard to understand how these new storms formed and whether more are on the horizon. A major difficulty with predictions is that the old methods of extrapolating historical experience to anticipate future events are proving less effective. So where does the insurance industry line up?

Not surprisingly, reinsurers, the financial behemoths that insure the insurance industry, are leading innovation and driving change. European reinsurers appear more convinced that human activity plays a role in climate change than those out of the United States. The heat wave in Europe that caused over 20,000 deaths in the summer of 2005 and the intense storms this summer may affect their perspective. Predictions of hurricanes in the Mediterranean can't be far from their minds either. Swiss Re is one company that has taken a clear position. It sponsored "The Great Warming," a 90-minute documentary shown on PBS and narrated by Alanis Morissette and Keanu Reeves. It repeatedly poses questions of climate sustainability and offers warnings for preparation. Separately, Munich Re, another European reinsurer, and Allianz SE were signatories to the June 5 "Declaration on Climate Change," which was sponsored by the United Nation's Environment Programme Finance Initiative and later presented to G8 Summit leaders. Dr. Torsten Jeworrek, member of the board of management for Munich Re, remarked, "Munich Reinsurance Co. has signed the declaration on climate change by the financial services sector because climate change is one of the greatest challenges of our time ... The latest studies show that it is cheaper to invest in climate protection than to pay for the losses that result from inactivity. It is thus prudent to act now from an economic perspective as well."

Weighing the Costs

At the very least, these companies have posed a valid question: If there could be a relationship between human activity and global warming, shouldn't we be weighing the economic costs of reducing industrial activity against the potential cost of weather related damages and displacement?

On this side of the Atlantic, companies are much more circumspect. One reason is the enormous influence professor William Gray and his team at Colorado State University wield in the science of hurricanes. In a July 26 opinion column in the Wall Street Journal, enti-

Continued on Next Page

Continued from Previous Page
tled “Hurricanes and Hot Air,” professor Gray explained the observed science and cyclical history of hurricanes, and forcefully outlined why global warming has nothing to do with increased hurricane activity.

So how are the financial giants reacting to the science and how will their actions affect us? The short answer is they are doing what consumers, building owners and lenders do: transferring as much risk as possible to others, including consumers.

The industry clearly expects increased weather-related damages going forward and has been attracting additional sources of capital to fund the expected risk. New products such as “catastrophe bonds” (the gamble for investors: no storms, you win; big storms, you lose) and “sidecar agreements” for isolating specific losses from balance sheets have attracted new capital. Insurance companies slice and dice their risk portfolios much like the securitization of bond portfolios in the lending industry, selling pieces to other investors. Hedge fund managers have found sidecars particularly attractive; multiple and divergent risk pools offer spread of risk and, in years such as 2006, terrific returns.

A trend filtering directly to the retail level is risk mitigation by property owners. If you own property in coastal Florida, you have certainly had the dubious pleasure of pricing storm shutters. Storm shutters do more than protect glass windows; when gusts blow out windows, following gusts can create such internal pressure on a building as to literally blow the roof off a house, turning a thousand-dollar claim into a half-million-dollar claim. In many parts of Florida, storm shutters are required as a condition of obtaining any private insurance.

In addition to mitigation requirements, insurers are requiring higher loss-sharing by consumers through the use of specific wind or storm deductibles. These are common now all along coastal New England. The imposition of these specific deductibles reduces the expense of many small claims to companies and provides incentives for consumers to contemplate their own mitigation strategies. My home in Norwell (which is over 3 ? miles from the coast) now has a five-figure wind deductible. Last year I paid my local tree guy to take down that big not-so-healthy tree in my front yard before a storm brings it and a much bigger bill to my doorstep. With a lower deductible, I might have given that old tree another couple of years.

So where does the money lead us? Not much money has taken a stand on the causes of global warming or any link to hurricane activity. European insurers are funding documentaries and signing U.N. statements, but U.S. reinsurers have devoted little capital to this proposition at all. But ultimately, it matters less than where there really is broad agreement that higher storm activity is likely for the next several years, and the cost of risk in all coastal regions is rising. Coastal property will continue to require greater owner participation for wind-related losses, and prices for insurance above deductibles are rising, too. Thus, the cost of enjoying cool summer easterly breezes will continue to grow for the foreseeable future, affecting carrying costs and, ultimately, property values. ■