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Storm Damage

As Hurricane Season Begins, Disaster Insurance Runs Short

Price Increases by Reinsurers Pass Down to Consumers; Wal-Mart Covers Itself

Warren Buffett Makes a Bet

By LIAM PLEVEN, IAN MCDONALD and KAREN RICHARDSON
July 10, 2006; Page A1

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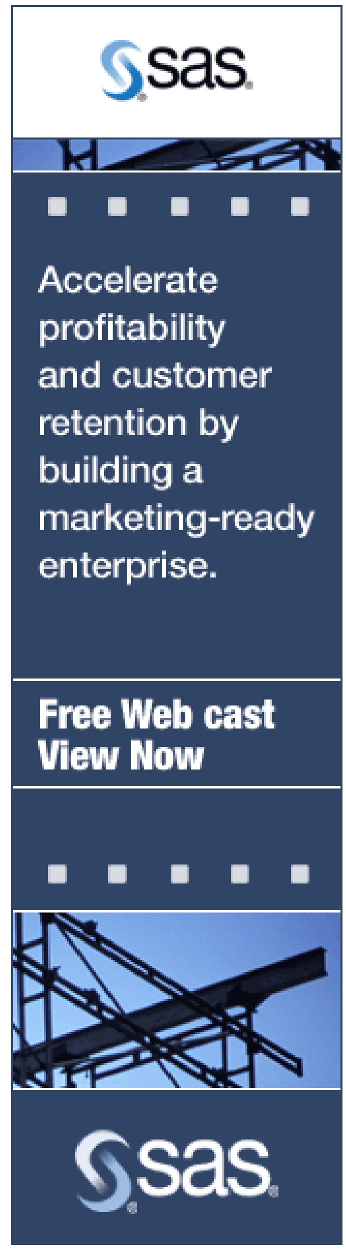

Last year's violent hurricanes continue to roil a vital corner of the insurance industry: Demand for disaster coverage is far outstripping supply, and the consequences are rippling through the economy.

The crunch isn't coming just because companies and individuals are buying more insurance. Insurers themselves, anticipating future destructive storms, are trying to buy more coverage on the policies they write -- a crucial segment of the business known as reinsurance. But reinsurers, which also paid out billions last year, are wary of getting hit hard again and have raised their rates substantially. Businesses and homeowners are paying the price.

Mark McComiskey

TODAY'S MOST POPULAR

In late January, a private-equity fund called First Reserve Corp.

discovered firsthand how much the market has changed. The Greenwich, Conn., firm wanted to buy an oil-and-gas platform in the Gulf of Mexico. During a conference call with colleagues in Houston, the fund's executives learned that insuring the project would cost about $25 million a year, not the $2 million they'd expected.

"That kind of shut the room up," says Mark McComiskey, a managing director at First Reserve. The firm decided to kill the deal.

In the wake of Hurricane Katrina, billions of dollars poured into the insurance industry from investors hoping to profit from rising premiums. After hard hurricane seasons, such cash influxes often buoy insurers and help stabilize premiums.

But this time, the new capital was insufficient to soak up the increase in demand. "There's just this loud sucking sound in the market now," says J. C. Sparling, an executive vice president at Mercator Risk Services Inc., an insurance brokerage.

Disaster-insurance rates have risen so sharply that businesses with exposure to hurricanes are canceling projects, paying more for whatever coverage they can get, and in some cases, going without insurance altogether.

CDC Publishing LLC, a Vero Beach, Fla., firm that publishes construction-industry data, says it's spending 12 times as much for hurricane insurance as it did last year. Pinnacle Entertainment Inc., a Las Vegas-based hotel and gaming firm, cut its weather-catastrophe coverage from $400 million to $100 million after suffering extensive damage at a Biloxi, Miss., casino last year.

And Wal-Mart Stores Inc. said in May it would drop its coverage for severe windstorms because it had become too expensive. Instead, the retailer will cover losses from such storms out of its own pocket.

Some insurance players are stepping into the void. Hedge funds and private-equity firms are pouring billions of dollars into new and risky investment vehicles that provide capital to back coverage for specific risks. In addition, Warren Buffett's Berkshire Hathaway Inc. seems to be betting big on reinsurance even as other investors pull back.

"If you like to watch football, you probably enjoy the game a little more if you have a bet on it," says Mr. Buffett. "I like to watch the Weather Channel."

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COMPANIES

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Pinnacle Entertainment Inc. (PNK)

PRICE	29.32
CHANGE	-1.47
	7/7

Wal-Mart Stores Inc. (WMT)

PRICE	46.00
CHANGE	-0.72
	7/7

Berkshire Hathaway Inc. Cl A (BRKA)

PRICE	90,200.00
CHANGE	-50.00
	7/7

Marsh & McLennan Cos. (MMC)

PRICE	26.66
CHANGE	-0.01
	7/7

Benfield Group Ltd. (BFD.LN)

PRICE	356.25
CHANGE	1.75
	8:14a.m.

Allstate Corp. (ALL)

PRICE	55.03
CHANGE	0.21
	7/7

Harrah's Entertainment Inc. (HET)

PRICE	66.70
CHANGE	-2.90
	7/7

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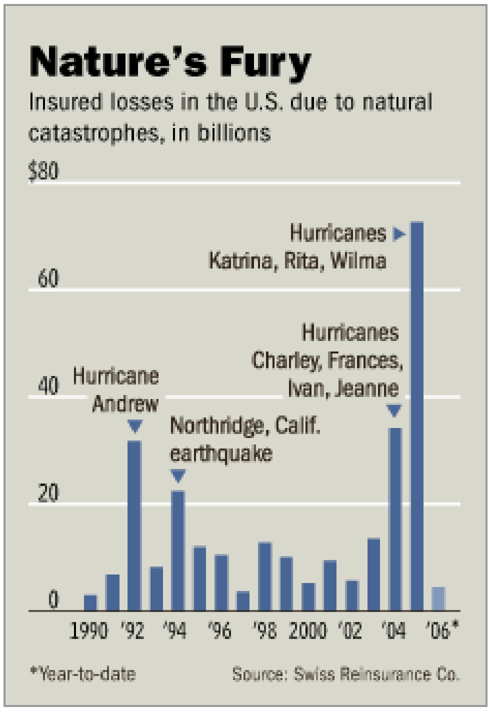


After last season's devastating hurricanes, companies that predict the cost of storms rolled out new computer programs that foretold a mounting toll from future hurricanes. In addition, rating services such as A.M. Best Co. Inc. changed their approaches to judging the financial strength of insurers that write catastrophe policies. As a result, many insurers have to keep more cash in reserve to back up their policies.

After seven costly hurricanes in two years, insurers also are questioning how much risk they want to take in vulnerable coastal areas. The shortage of available coverage is particularly acute in the reinsurance sector, where insurers buy coverage against the policies they write. Hurricane Katrina caused nearly $40 billion in insured losses, and reinsurers covered more than half that total, according to Guy Carpenter & Co., a reinsurance brokerage unit of Marsh & McLennan Cos.

The cost of property-catastrophe reinsurance is projected to rise 25% this year, according to Robert Hartwig, chief economist at the Insurance Information Institute, a trade group. In hurricane-prone areas, rates are rising as much as fourfold, he says.

"There have been times where no matter what the price was, we've had a difficult time finding the [coverage] we need," says Dee Megna, the vice chairman of Guy Carpenter. "It's similar to the situation we saw post-Hurricane Andrew in 1993 and post-9/11, but this is actually worse than those two."

The depth of the shortage has taken the industry by surprise in recent months. Paul Karon, chief executive of Benfield Inc., a U.S. reinsurance broker owned by the United Kingdom's Benfield Group Ltd., says prices for renewals rose about 25% on average on Jan. 1. By contrast, he said, June 1 prices doubled compared with the year earlier.

Allstate Corp., one of the nation's largest property insurers, bought significantly more catastrophe reinsurance than it had in the past. In last year's third quarter, the company registered a $1.55 billion hurricane-related loss. Earlier this year, it paid $400 million for $2 billion worth of reinsurance coverage for losses from hurricanes and other catastrophes.

Last year, U.S.-based insurers purchased about $37.5 billion in catastrophe reinsurance coverage, according to Benfield. This year, they will buy about $47.5 billion worth, a 27% increase, the firm says.

Allstate is aware that such coverage is getting harder to find. Referring to its deal earlier this year, Michael Trevino, a company spokesman, says: "I would guess we couldn't get it today."

There are many indications that Mr. Buffett's Berkshire Hathaway, which had $115.5 billion in cash and invested assets on hand at the end of March, is stepping into the fray. Berkshire boasts rare and coveted top ratings from services such as A.M. Best, Standard & Poor's, and Moody's.

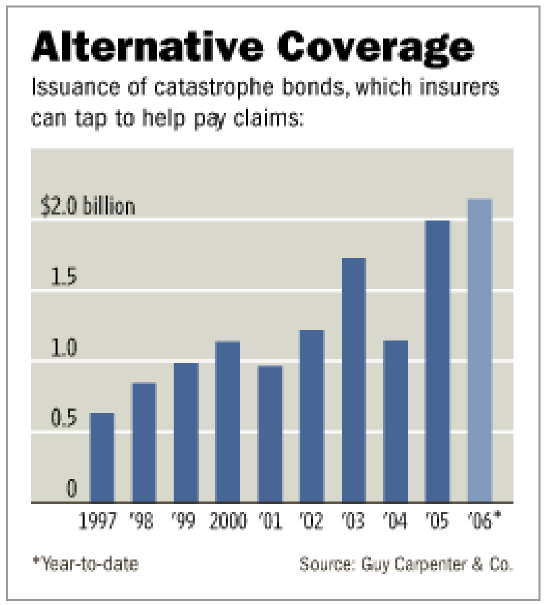
The company's exact commitment to the hurricane business can't be learned, but people familiar with Berkshire's business say it's writing more reinsurance on oil rigs than in previous years. In addition, others in the insurance industry say they've noticed the company's increased presence.

"They were more active with us in the U.S. than they've ever been," says Mr. Karon of Benfield.

Mr. Buffett declined to comment specifically on how much Berkshire is underwriting. In his latest annual letter to shareholders, Mr. Buffett said he was willing to take on billions of dollars in risk if he got paid enough.

"If prices seem appropriate, however, we continue to have both the ability and the appetite to be the largest writer of mega-cat coverage in the world," he said.

One indication of Berkshire's activity: Berkshire Hathaway Reinsurance Group reported a 19% increase in the premiums it receives for writing catastrophe reinsurance in the first quarter, to $425 million. That increase follows a 22% increase in the previous quarter, compared with a year earlier.



Berkshire also sells insurance directly to businesses. Harrah's Entertainment Inc. went to Berkshire directly last December when it was facing a shortfall in coverage from other insurers after suffering big hurricane damage.

"They were one of the very few who were able to take a lead, primary position on an account such as ours," says Lance Ewing, risk manager for the company.

The reinsurance business is also getting a helping hand from Wall Street. Some firms are using a financial vehicle known as a sidecar. With sidecars, investors -- often hedge funds -- provide capital to back coverage for very specific risks, such as damage to gas rigs or Florida homes. Investing in a reinsurance company exposes investors to all kinds of insurance risks; a sidecar allows them to be more choosy.

If disaster strikes, the capital is tapped. If not, investors get their money back, plus premiums paid by policy holders. Benfield set up a sidecar with partners that raised about $310 million, which backs up policies it has taken on. Since Katrina, investors have sunk more than $3.2 billion into sidecars.

"You're betting on three months of weather, and then you're out," says Mr. Karon.

Benfield's sidecar proved very useful to Dale Hammond's company. His Homewise Insurance Group of Tampa, Fla., insures about 35,000 homes in Florida, largely against hurricane damage. The sidecar made possible 17.5% of the reinsurance the company wanted. "It was a good, creative solution using the financial markets," says Mr. Hammond.

Another, more-established route is catastrophe bonds. Investors get their cash back and an allotted return -- these days in excess of 10% -- if storms don't hit at a certain place and time. If a storm hits and losses rise above a stipulated level, insurers can tap investors' money to pay off claims. Insurers have raised about $2 billion so far this year through catastrophe bonds, as much as in all of 2005.

While creative, none of these solutions can keep up with demand. On May 9, an Atlanta, Ga., insurer, RSUI Group Inc., a part of Alleghany Insurance Holdings LLC, told agents it had not bought all the reinsurance it wanted. As a result, it wouldn't offer new hurricane insurance along the coast between North Carolina and East Texas, with a few exceptions.

Homeowners have had similar experiences in places like Florida, but individuals in many states have a backstop. In Florida, they can buy insurance from Citizens Property Insurance Corp., a state-created insurer of last resort that sells coverage to individuals who can't find it elsewhere.

For companies, on the other hand, the crunch could get costly. Wal-Mart's chief financial officer, Tom Schoewe, told analysts in May that storm coverage offered to the mammoth retailer this year was "substantially more limited and higher-priced" than previously.

Mr. Schoewe said buying coverage "did not make sense for Wal-Mart." Instead, the retailer is insuring itself. Wal-Mart wasn't specific about how it would do that -- and a spokesman declined further comment -- but typical options include paying for damage out of pocket or setting up its own insurance business.

If Wal-Mart had self-insured during its financial year ended January 31, 2005, that would have cost the company two cents in earnings per share, due to that year's storms. In fiscal 2006, the impact would have been four cents, according to Mr. Schoewe. That would have cut the company's net income by an estimated $168 million, or 1.5%, according to investment bank Goldman Sachs Group Inc.

Casino-operator Pinnacle Entertainment is taking risks beyond cards and roulette. After Hurricane Katrina, the company's Biloxi casino barge was found several hundred feet from the water on the other side of a highway, according to company disclosures at the time. Back then, Pinnacle had $400 million in coverage per storm, according to regulatory filings. Last month, the company told shareholders that due to tighter supply and higher rates, effective April 1 it has only $100 million per storm in weather-catastrophe coverage.

"It is unlikely that Pinnacle will obtain any additional coverage covering these risks this year," the company said in a filing with the Securities and Exchange Commission. A spokeswoman declines to comment.

The insurance industry is "going to drive commercial enterprises out of certain areas in this country," says Bill Black, president of CDC Publishing, which has three offices in Florida.

Last year, the company paid $10,000 in premiums for hurricane and business-interruption coverage. This spring, the premiums went up to $120,000. Another jump of a similar magnitude, Mr. Black says, could force him to consider relocating his Florida offices.

--Kris Hudson and Jon E. Hilsenrath contributed to this report.

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