The Impact of Japan's Earthquake and Tsunami on Insurers

On March 11, 2011, Japan was struck by a 9.0 magnitude earthquake and a subsequent tsunami which caused widespread devastation across the country's northeast coast. According to *Kyodo News*, the official death toll exceeded 9,000 as of March 22 and another 13,500 individuals are missing. While assessments of the full impact of the event are still preliminary, major rating agencies have expressed their views of the potential for losses at insurance companies and the potential impact on financial strength ratings. The following is a summary of the views published by A.M. Best Co., Moody's Investors Service (Moody's), Standard & Poor's (S&P), and Fitch Ratings.

Estimate of Potential Losses

Property/Casualty – Modeling firm AIR Worldwide has estimated that insured property/casualty losses associated with the earthquake in Japan to equal between $15 billion and $35 billion. Their estimate does not include losses associated with the tsunami or life/health claims.

Life – Moody's has estimated the incremental claim losses for life insurance and "third-sector" policies (which included accident and health, medical, nursing care, and supplemental health and cancer policies) to be between $3.75 billion and $5 billion. This estimate is based on an expected death toll of about 20,000.

Direct Effect on Insurers

S&P stated that three types of companies will bear most of the cost of the earthquake/tsunami:
1) Domestic Japanese property/casualty insurers
2) Global reinsurance companies
3) Global multiline insurers

All of the rating agencies have expressed the view that despite the fact that this event could ultimately be the largest insured loss in history, insurers and reinsurers should be able to absorb the losses without widespread solvency problems or major financial strain.

The non-life sector is highly concentrated among Japanese domestic insurers, with three groups accounting for nearly 90% of the market.

Japan's life insurance market is the second largest in the world behind the United States. In forming its loss estimates for life/health insurers, Moody's said that the population of the three most affected prefectures is about 5.7 million, or 4.5% of Japan's population. Their estimate of losses at $3.75 billion–$5 billion is far lower than the industry's capital, which stands at approximately $125 billion, and as a result do not expect any of these entities to be downgraded. Moody's-rated Japanese insurers are geographically well-diversified in Japan, and foreign insurers with operations there have diversification outside the country. Neither group has an overly concentrated amount of policy coverage in the affected areas. However, the domestic life insurers with greater market share will be more meaningfully impacted than the better-diversified international companies operating in Japan.

Fitch Ratings asserts that the financial impact for Japanese life insurers will be less severe than Japanese non-life insurers. Most Japanese life insurers focus their business on cities where the areas stricken by the earthquake and tsunami are primarily nonindustrial areas. Additionally, most Japanese life insurers purchase catastrophe reinsurance, which limits their risk to a specific number of lives due to a single event, to protect capital.

Domestic life insurers with a larger share of the market will be impacted more heavily than international companies with operations in Japan, which are better-diversified. According to Citigroup's Colin Devine, the impact on North American insurers should be modest. MetLife (20% of total earnings), Prudential (42%), AFLAC (70%), and Manulife (22%) have the largest businesses in Japan. AFLAC's business is largely concentrated in health insurance.

Indirect Impacts of Earthquake/Tsunami

The consequences of two related items are unclear at this time:
1) The potential for a meltdown at the Fukushima nuclear plant
2) The potential for a severe economic recession in Japan

If a meltdown were to occur and/or the impact for increased radiation exposure is widespread, the impact would likely occur over a longer period of time and would have a greater effect on companies with concentration in supplemental medical policies. Modeling of increased losses due to radiation exposure is difficult to estimate and therefore is generally excluded from loss estimates or projected rating impacts.

Long-term impact to Japan's economy is still unknown at this time. However, the rating agencies do not generally anticipate a severe economic recession in Japan and do not expect meaningful long-term losses. While asset values have declined in the immediate aftermath of the earthquake (the Nikkei index declined 16.5% from March 11 to March 15), Moody's believes domestic insurers have sufficient liquidity to deal with losses and will not be required to sell investments at depressed prices.

In addition, Moody's expects Japan to experience a recession in second quarter 2011, with growth to resume in second half 2011. The government can afford the costs of this disaster, and domestic investor confidence will stay strong due to extraordinary liquidity support from the Bank of Japan, the central bank, and the deep funding market available to support the government's reconstruction efforts. The banking system will remain liquid and stable. The worst-affected sectors are insurance and utilities, with other industries experiencing a more limited adverse impact.

Ratings Impact

None of the rating agencies expect widespread rating actions on life insurers as a result of the earthquake and tsunami.

Moody's Investors Service – No rating changes for Japanese insurers are anticipated. The ratings impact could be significantly different if an uncontrolled nuclear meltdown with widespread effects were to occur. Moody's says AFLAC would be the most vulnerable of North American insurers to a downgrade due to its business concentration in Japan.

Standard & Poor's – It does not expect to take widespread rating actions on insurers because the industry is in a position of capital strength at the present time. However, they did acknowledge that if insured losses exceed current estimates, some companies could experience meaningful capital erosion which could result in downgrades.

Fitch Ratings – Negative rating actions are not expected. Losses reported by insurers and reinsurers that are viewed by Fitch as "minor" earnings events will not result in a rating action. If losses are considered by Fitch to be a "capital event" such that ratios fall below Fitch's previous expectations, an assessment by Fitch of the event's impact will take place.

A.M. Best – Company analysts are evaluating early information and the impact on rated companies. While they are obtaining loss estimates from companies, A.M. Best says it will use that data cautiously. However, A.M. Best said its initial view is that local insurers can likely absorb losses incurred from the earthquake and tsunami.

Impact to Carriers

M Financial Group has contacted each of the M Carriers and inquired about their exposure and potential for losses related to the event.

M Carriers
ING – ING does not sell any property/casualty or other non-life insurance products in Japan. Nor do they sell any reinsurance in Japan. In terms of the life insurance activities in Japan, ING sells primarily corporate-owned life insurance in the country. ING cannot provide any information on financial impact as the scope of the disaster is not yet clear.

Lincoln Financial Group – Says they are analyzing the implications of the events in Japan on the company and if that analysis yields information that would require disclosure, they would publicly disclose it. Since Lincoln is a US-only company, the events in Japan do not affect their business operations.

Manulife – Does not expect property and casualty reinsurance claims related to the earthquake and tsunami to be material to full-year financial results nor to exceed C$150 million after-tax.

Nationwide – Exposure is limited to life insurance written on insureds in the United States who were in Japan at the time of the event. Nationwide has no concentration of Japanese life insurance clients.

Pacific Life – Has negligible exposure on the death benefit side.

Prudential – No public comments at this time. Moody's says Prudential's combined operations place it in the top ten in Japan. They estimate Prudential's market share to be 6% in life insurance and 5% in third sector policies. Based upon their calculations on the company's inforce block, Moody's believes that claims related to the earthquake and tsunami will be "moderate" and should be less than $100 million after-tax.

Sun Life – No public comments at this time, but has told us that they have "no material exposure."

Other North American-related Carriers
AIG – Expects pre-tax insurance losses of $700 million from non-life subsidiary Chartis Inc. In the first quarter of 2011, various natural catastrophes are expected to cost Chartis a pretax insurance loss of US$1 billion, or US$900 million after taxes. This represents 1.1% of AIG's total shareholders' equity as of Dec. 31, 2010, net of reinsurance recoverables for 2011's first quarter. The estimate includes catastrophe losses related to the New Zealand earthquake, U.S. winter storms, floods and Cyclone Yasi in Australia, and Brazil floods AIG said.

MetLife – Moody's commented that the company purchased American Life Insurance Co. (ALICO) from AIG in November 2010. ALICO's market share in Japan is approximately 4% for life insurance and 6% for the third sector. Moody's stated that based on the company's inforce block, claims should be less than $100 million after-tax and well within the company's capital and liquidity resources.

M Financial will continue to monitor developments and publish related communications as warranted.

For more information, please contact:

Eric Hieber
804.549.4166
ehieber@bcgco.com

Chris Mikita
804.549.4164
cmikita@bcgco.com

Daniel Gunderman
804.549.4161
dgunderman@bcgco.com

Jeri Turley
804.549.4169
jturley@bcgco.com