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Risk in Context Podcast

Episode 9: Managing Catastrophe Risk via Insurance

Mike Rouse:

Hello. I'm Mike Rouse, Marsh's US Property Practice Leader.

Welcome to *Risk in Context*, which features conversation with Marsh colleagues, risk professionals, and others intended to help you better understand key risks, build more effective insurance programs, and think creatively about what is possible in a world of risk.

We're going to continue our focus today on natural catastrophes. Hurricanes, wildfires, and other natural catastrophes can have high costs for businesses. So it's critical that risk professionals understand the insurance coverage available to them.

This episode features a discussion between me and Chad Wright, leader of Marsh's Alternative Risk Transfer Group in the US and Canada, on property, business interruption, and parametric insurance options for businesses.

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Mike Rouse:

Chad, thanks for joining us today.

Chad Wright:

Thanks for having me.

Mike Rouse:

So, Chad, when I think about the cost of natural catastrophes over the last two years, in 2020, we saw $210 billion of overall losses which was up significantly from 2019, which was $166 billion. Only half of those losses in 2020 were actually insured.

We've seen an active hurricane season forecast for 2021 by NOAA and the Colorado State University.

Wildfire obviously continues to be a threat around the world and a significant threat for businesses.

How are we seeing clients utilize parametrics and why are they becoming more popular to solve for some of these risk factors?

Chad Wright:

Well, let's talk about some of the differences in how property, and BI, and parametric policies really actually work. I think therein lies the real advantage to a parametric.

Really, on a standard property policy, as you know, losses are reported and you go through a pretty lengthy assessment or adjustment process, whereas a parametric really has a predefined trigger and the claims process is really straightforward. As soon as the event happens, as soon as you reach the trigger you receive payment.

You're going to provide some evidence that you've had a loss, but it's not going to be anywhere near the forensic accounting exercise that you would see on a standard policy. So, the claims process is by far and away the biggest difference. And then the way you get paid — staggered payouts are more common under a traditional property policy, whereas with a parametric you receive more of the payment faster than you would on a standard policy.

Mike Rouse:

Chad, what are the main benefits, though, from a parametric policy?

Chad Wright:

I'd say probably the biggest benefit is the cost efficiency, especially as this commercial market becomes more challenging and continues to be a challenge. The fact that you receive payment a lot faster, there are fewer claims disputes.

Parametric coverage can really be a good fit for insureds whose exposures are actually greater than their physical values. For example, if you have a lot of exposure to infrastructure — like ports, rails, bridges, airports — you could be in a professional services business where your office values are not really representative of what your exposures are, you could have macroeconomic exposures that are greater because you might be located in a metropolitan area.

So, for that reason, let's say you were in retail, where there is potential economic fallout because of some type of catastrophic event that leads eventually to some belt-tightening with consumers. As you see that drop off in consumer spending, the concentration exposure itself can be a real problem.

Hospitals and healthcare, that might need to bear substantially higher extra expense to provide post-event services, is another great example.

Mike Rouse:

Thanks, Chad.

Even though there could be some value in parametric cover, there are some advantages to a traditional property policy. If an insured wants to be 100% sure that their physical damage will be indemnified, there's still nothing better than a property policy.

Parametrics also generally can't be used for fire. Replacing conventional coverage with parametric coverage may mean taking more fire and AOP risk, in exchange for more efficiently transferring your CAT risk.

Chad, can parametric solutions replace traditional property and BI coverage or are they best used to complement them?

Chad Wright:

Well, yeah, that's a good question, Mike.

And, truthfully, in deciding whether to purchase property BI coverage, or a parametric policy, or a mix of the two, an important consideration is to really understand what you're trying to cover, understand where there is a real possibility of economic loss, and how insurance recoveries might apply. So, generally, a mix is where we see the biggest advantage.

But in a property policy, you think about the concept that most everything is written into the coverage form. The policy indemnifies for physical damage and associated business interruption, subject to deductibles, exclusions, and sublimits. The policy may be silent on some economic losses, like non-physical damage business interruption.

On a parametric basis, it's not as explicit but it is a byproduct of preadjusting a parametric policy in defining a payout before the event occurs. In some cases, the total economic loss can be far greater than what the policy states it will pay for an event.

A policy may be triggered, for example, by a 6.5 earthquake in magnitude in a specific region. In most cases, that would capture the most efficient point between the frequency and severity for the loss occurring. But a smaller magnitude 6.0 earthquake directly underneath a critical asset could severely damage it without triggering a parametric policy.

So, basis risk can and needs to be mitigated through the trigger design — for example, using shake intensity rather than magnitude as a trigger. Basis risk in a parametric is not necessarily greater than in a conventional property program, but it has more uncertainty around it.

So, there are many advantages to a parametric solution that use more simplistic triggers even if it means greater basis risk.

Mike Rouse:

Thanks, Chad.

When I think about some of the challenges that are happening right now in the marketplace, contingent business interruption is definitely a big focus from the market and, certainly, for our clients as well.

Is it possible, do you think, in certain instances, for a client to utilize a parametric trigger to cover their contingent business interruption risk?

Chad Wright:

Yeah, that's a good question, Mike. We have a number of clients that are thinking about that today.

I think the pandemic in and of itself highlighted the need for... in certain circumstances where you might not have actual physical damage, but your supply chain has been interrupted because of shutdowns in factories around the world. So, yeah, a parametric can be a very creative way to look for those places where you might have not just natural catastrophe exposure, but non-physical damage business interruption.

And those that are concerned about contingent business interruption, contingent time element exposure can definitely contemplate the use of a parametric to meaningfully cover that risk. And we're working with a number of different companies right now in that space, helping them assess their supply chain risk but, in addition, designing a product that can be triggered for contingent business interruption and contingent time element.

Mike Rouse:

Thank you.

Right now, the market… and we hear it from carriers quite oftentimes talking about secondary perils and when we think about that, as we sit here in the first 30 days of the Atlantic hurricane season, obviously. Traditionally, parametrics have historically been used, typically, for earthquake and windstorm exposure.

What are some of those secondary perils that we're starting to see some products that are available to clients in the parametric space?

Chad Wright:

Really good question.

There are a couple of folks that are focused on wildfire now and that's really important. You can certainly look for the property damage and business interruption coverage with a wildfire parametric solution. The harder thing is to solve for the liability exposure and that one hasn't quite been solved for yet.

There are a number of other meaningful solutions — hail has become very prominent. There are a couple of different markets that are providing hail coverage. We actually placed one of the first-ever convective windstorm and hail-triggered parametrics, the first of its kind, this year. So, typically, when you have convective windstorm you will have hail accompanying that.

So those are the ones that are that are probably newest and most interesting to a lot of our clients. But obviously you can do rainfall, flood, lack of rainfall, snowfall, lack of snowfall — all are meaningful solutions that exist. Then, of course, there are a number of agricultural applications to parametrics as well.

Mike Rouse:

With all that in mind, let's wrap up with some recommendations for risk professionals.

Chad, anything to add?

Chad Wright:

Yeah, really, to choose the right insurance, you really need to understand how much risk you can take. And one of the most helpful things is really to sit down and really work through, with your organization, what you feel like their risk tolerance is. Within the firm we do risk-bearing capacity analysis, which can be a real helpful piece of the puzzle.

Also, understanding the advantages between a parametric solution and a standard property policy is really important. Most importantly, the speed of payment and simplicity of claims may be worth more than really getting every dollar out of every loss event that occurs. In that case, a parametric would be a really good fit.

On the other hand, if an organization really doesn't have a high risk tolerance and really needs every dollar from a physical event, conventional property coverage might be a better choice.

At any rate, if you're going to look at parametrics you should really, no matter what, spend time with a broker that specializes in this form of coverage and knows how to structure a parametric policy.

Mike Rouse:

Thanks, Chad.

The other thing I would just add is it's all about data quality.

Obviously, having complete data characteristics with respect to exposure to make sure you get the most accurate modeling results is really critical.

So leveraging all parts of an insured's organization to really understand the risk, to make sure there's a comprehensive understanding around the data and the quality of the data, I think is also really important when we think about structuring parametrics and really just placing any type of traditional all-risk cover.

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Mike Rouse:

That's all for this edition of *Risk in Context*. I hope you enjoyed our discussion today, and I thank you for listening.

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