

HOW PARAMETRIC PRODUCTS BENEFIT CATASTROPHE-DRIVEN RISK TRANSFER

CONTACT

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ABOUT THE AUTHORS

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Parametric insurance, also known as index insurance, is an innovative product that functions differently than traditional insurance. As agents and insureds continue to look for ways to differentiate their programs and ensure they've secured the most efficient way to protect their assets, the parametric landscape has and will continue to play a major role in catastrophe-driven risk transfer.

In its simplest form, a parametric product is one that pays an insured based on certain defined events (i.e. "triggers") that occur within a defined geographic territory. They can pay out with or without the insured actually sustaining a loss, and they do not normally have restrictions of excluded perils or property covered that would be found in traditional insurance policies. In addition, payout can be very quick, often within just a few days of the triggering event. For these reasons, they are often used as supplements to traditional coverage, rather than as a replacement of traditional coverage.

Many types of insureds can benefit from utilizing parametric insurance, including those with exposure to weather volatility – such as coastal wind, earthquake, wildfire, drought, flood, or heavy snow – and those with the potential for business interruption or direct physical loss. It is also beneficial for businesses that value immediate cash flow in the event of a claim.

The flexibility to design the coverage triggers and subject geographies is one of the key advantages offered by parametric products. For example, an insured could have exposures in multiple counties close together, across an entire state, or across several states, and the parametric product and its coverage triggers can be designed for payout around those areas.

Expertise in this segment is very important for agents to ensure the product is clearly defined and understood by the buyer. The markets in this space are very analytically-driven; therefore, knowledge of modeling and how those figures can and will move, depending upon the slightest adjustments in the structure, is paramount.

FACTORS IN DESIGNING A TAILORED PARAMETRIC PRODUCT

Unlike a traditional insurance policy, there are many levers to pull in designing a specific parametric product for any one insured's needs. These levers afford the opportunity and flexibility to provide a menu of options at many different price points, often providing a more competitive product than is available in the traditional market. Additionally, the flexibility in structuring allows for the mitigation of any basis risk, thus limiting downside when compared to a traditional policy.

Parametric products aim to complement insurance programs and buyers' balance sheets in the following areas:

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CLAIMS

Since the parameters for coverage are pre-defined, the claims process for parametric products is quick and easy. Insureds complete a simple form, calculate the loss amount and submit to the carrier themselves. Claims adjusters are not required, so cash flow needs are addressed in a timely manner. This quick cash payout is often not possible with a traditional insurance product.

TRIGGERS

Coverage trigger mechanisms are defined prior to any event, including measurement sources and threshold structure for payout. The specific geography of the subject area is determined based on the unique insured's needs and can be established using a variety of parameters, including latitude/longitude coordinates, counties, and zip codes. Boundaries are then established around the coordinates in order for the coverage to be triggered.

For example, if heat index, measured rainfall, and hurricane wind speed thresholds, meet the pre-agreed trigger measurements within any geographic boundaries set, the coverage is triggered for payout. However, broader boundaries may affect pricing.

STRUCTURING

There are two options for structuring a parametric product: one that is indemnity-based, which is subject to actual losses, and one that is derivative-based, which is subject only to the trigger being met.

The indemnity-based option is usually more competitively priced, as it functions in the same manner as true insurance, in which the insured is indemnified for their loss and no more. The derivative option pays strictly based upon the parametric trigger, regardless of whether the insured has a loss or not. This structure is usually more expensive. Both options pay out extremely quickly, which is something a traditional insurance product cannot match.

As an example of the differences in structuring options, let's consider an insured who has an exposure in tri-county Florida. The geographic trigger areas would be designed around these three counties for hurricane exposure, and various payout options would be set at different thresholds for the limit purchased (i.e. – various types of percentage of limit payouts at CAT levels desired, including 100% payouts for any and all categories).

- Indemnity-based option: In the case of the Cat 1 threshold, for wind to force a payout for a limit purchased of \$3M, the indemnity option would require the insured to provide a statement that they had, as an example, \$2M of loss. The coverage would then pay for the \$2M of loss.
- Derivative-based option: The derivative form would simply pay out the \$3M limit, regardless of the size of the loss.

LIMITS

Limits can be purchased as binary or stair-stepped payouts. The limit that the insured purchases does not affect the structuring of the product. The pricing is typically Rate on Line (ROL) based for the limit purchased. Therefore, if the limit is increased, the ROL typically doesn't move. However, the dollar spend would increase

ATTACHMENTS

Parametric products can attach ground-up or with a deductible. The deductible amount often doesn't affect pricing, due to the product makeup and carrier appetites within this space. A zero-dollar deductible is usually preferred, as this is often not available with traditional products.

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CONCLUSION

Access to ever-improving modeling techniques and overall historical data capture has allowed for the growth of parametric products. As agents and insureds look for the most efficient and flexible ways to protect their assets, the parametric landscape has increasingly played a major role in catastrophe-driven risk transfer. The number of carriers – and their willingness to be innovative – has also increased.

The Alternative Risk group at AmWINS continues to explore state-of-the-art options for customers, with a focus on hurricane/wind, earthquake, wildfire, temperature and various precipitation. Our specialists have extensive reinsurance backgrounds, as well as strong relationships and experience with various types of markets in the space. Our market access and expertise allow us to leverage the best products at the best prices.

