NATCAT STRATEGIES

Structuring commercial property risks in natural catastrophe zones and offsetting extreme weather event exposures using alternative risk strategies

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Artex

WHAT'S COVERED:

- Stratifying risks between natural catastrophe (NatCat) event losses and attritional losses — application of sublimits, retention options and loss severity
- Packaging multiple risks within a captive — benefits of direct control over cost and risks retained on the balance sheet
- Inflation impact on pricing and underwriting criteria— impact of the prevailing market on commercial property insurance placement

Market context Q4 2022

The US insurance market continued to transition beyond the COVID-19 pandemic, which saw supply chains destabilized and the severity and frequency of loss increase across industries with complex risk exposures.

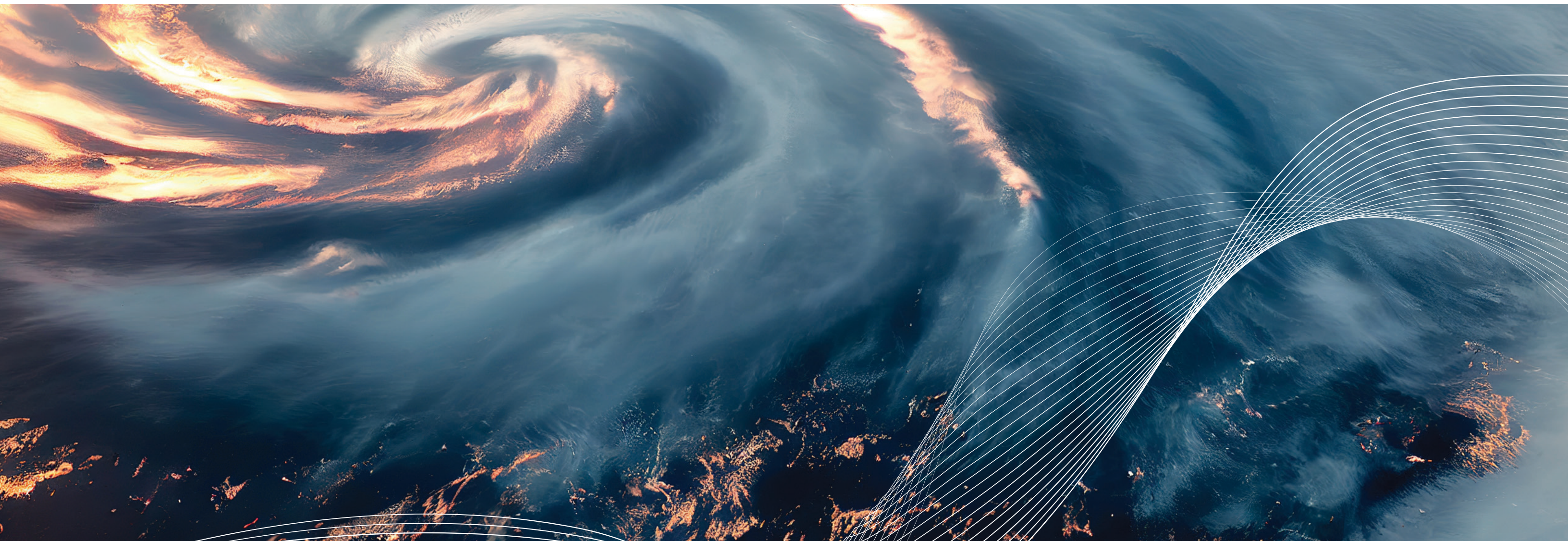
2020–2021 was a record year for claims losses relating to extreme weather and NatCat events. Tornadoes, floods, wildfires and hurricanes accounted for in excess of US$250 billion of loss (US$120 billion insured), and the second-highest claims loss incidence on record.

Although many NatCat events fit within climate change and general underwriting expectations, the consensus amongst insurers, (re)insurers and business owners is the priority to adapt to meet a rapidly evolving agenda. With roughly 50% of losses being non-insured, urgent change and a review of placement strategies is now required to close the gap and restabilize the commercial sector coverage. Built-in flexibility offered by a captive makes them a viable option for managing (ideally mitigating) climate change-related risk exposures.

STRUCTURING CAPTIVES TO MANAGE COMMERCIAL PROPERTY RISKS IN NATCAT ZONES

A captive can be used to good effect to structure a portfolio of complex commercial property insurance in a higher risk geography. This may involve stratifying the risks between NatCat (or CAT) event losses versus what we term as "attritional losses."

A good starting point is applying a size threshold from a predicted loss standpoint including attritional losses.



Steve McElhiney, SVP and Director of (Re)insurance at Artex, provides more context:

"Fire and fortuitous type events are viewed differently from CAT losses. Insurers, generally speaking, tend to be more forgiving when catastrophe-related losses occur because of their severity in nature as a driver of losses. For CAT losses, insurers employ portfolio management and structure the program with coverage sublimits.

There is a certain degree of randomness involved with CAT losses and the expectation that they could recur. From an insurance protection standpoint, the client's insurance program can provide some level of protection for CAT losses within the captive's insurance program. Again, some of this cover may be sublimited or have separate retentions apply just for certain CAT type risks."

HOW DOES THIS PRINCIPLE APPLY TO SPECIFIC RISKS SUCH AS FIRE INCIDENTS, WHICH MAY BE CLASSED AS EITHER NATURAL OR ATTRITIONAL LOSSES?

The risk of fire-related incidents is a reasonable expectation for commercial property portfolio owners. When these incidents occur multiple times, there needs to be a robust evidence of what happened ideally backed by supporting data and analysis. This includes setting out the controls implemented and risk management frameworks developed following each loss event to mitigate that risk in the future.

Third-party engineering analysis provides a ground-up estimation by reviewed location of the estimated maximum foreseeable loss (MFL) and the probable maximum loss (PML) that is estimated based on an analysis of the facility, its exposures, its fire and other protections, and other factors. Using that data, the program's insured (or (re)insured) limits can be constructed for the placement.

A claims history involving multiple claims loss events can create capacity issues. Trying to access capacity in traditional insurance markets can be problematic when considering larger catastrophic events. This sits alongside a trend of commercial property insurance market pullback in recognized catastrophe zones such as Florida and Louisiana, particularly over the past 12 months following a wave of NatCat events.

These are referred to in the insurance industry as **"loss-effected accounts"** versus **"loss-free accounts."** Placement options and capacity for accounts that are loss-effected and also operate in peak NatCat zones are more likely to involve tougher placement discussions with tighter underwriting scrutiny.

Thus, a dichotomy evolves in the market between loss-affected accounts and those with no recent insured losses, as well as heavily NatCat-impacted accounts versus those that reside in more benign NatCat regions. In turn, capacity and pricing will be further impacted by certain classes or occupancies of risk that might be also further challenged.

The NatCat type of loss is based on a cycle of actual events, and their severity and impact, which changes the scope of the placement strategies during annual renewal discussions. In addition, the market cycle is harder, and continuing to harden, for exposures such as tornado- and cyclone-related events as certain patterns are evolving.

In contrast, attritional losses such as a company with repeated fire losses and risk management failures over a five-year period creates a problematic scenario that is going to be looked at very carefully by insurers. Weighing the impact and consideration for fortuitous events such as floods and storms versus events that happened due to a lack of oversight speaks directly to loss control practices.

Introduction of sublimits on selected risk exposures. Another prevailing trend involves carriers, whether they're primary, excess or (re)insurance, implementing sublimits on certain types of exposures where they may have not existed in the softer market. If we take flood risk as one example, you might have a US$500 million corporate tower where the flood component is now sublimited US$50 million.

As one example, for Louisiana wind- and hurricane-related risks, the same sublimits may be applied in addition to certain deductibles. In those instances, we are seeing retentions being put in place for peak activity NatCat zones to appropriately adjust the risk exposure.

The frequency and severity of commercial property claims losses has steadily increased over the past two years as the hardening market cycle continues to evolve, and a high percentage of the NatCat losses have been remodeled based on the probability and likelihood of a catastrophe event occurring. Peak catastrophe loss zones such as Florida and Louisiana continue to receive increased underwriting scrutiny. We will continue to monitor this situation over the next 12–18 months to consider the broader impact of these events.

NATCAT-RELATED CAPACITY WILL CONTINUE TO BE REVIEWED CLOSELY

The markets are reviewing capacity in the context of the recent round of NatCat losses, which is likely to temper their underwriting appetite for the next year or two.

One advantage of a syndicated third solution captive is that you benefit from having a number of (re)insurers in each layer providing different views of the risk profile, which in turn provides opportunities on pricing to deliver the best possible outcomes. Further, there is greater stability with the structure as opportunities will arise over time to increase the participation of one (re)insurer, should another reduce capacity.

Increasingly, a number of our clients are turning to parametric products that offer a nontraditional insurance solution, where we may elect to strip out some of the NatCat-related elements, package the risks that way and access the solution through a captive.

We are finding that the (re)insurance component leans toward a lockstep arrangement, aligned with general underwriting appetite and prevailing market themes and challenges. As one example, Louisiana wind capacity over the past 12–24 months has faced deeper underwriting scrutiny with insurers having a similar view on rates and pricing. While other major NatCat exposures such as California earthquakes are evaluated and carefully assessed through modeling and underwriting, there is a tendency for recent events to have an immediate impact upon capacity and pricing decisions in the next renewal, given the losses sustained and portfolio realignments the carriers and (re)insurers are undertaking.

That said, there is room for marginal upward or downward movement across various markets, which supports our overarching strategy to leverage optimal pricing in the market. In that way, arbitrage can be beneficial to a company looking to structure a captive solution.

USE OF CATASTROPHE BONDS (CAT BONDS) IN NATCAT ZONES

For companies and corporations with multiple properties that may, for example, include theme parks and large entertainment spaces with multiple NatCat exposures, a growing trend is the consideration of CAT bonds. For large corporations, being able to access CAT bonds offers a vehicle to obtain alternate forms of risk protection.

THE ART OF RISK

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Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.

FURTHER INSIGHTS

UNDER PRESSURE

Capitalizing on alternative risk solutions in the face of a hardening Commercial Property market

Steve McElhiney,
SVP and Director of (Re)insurance

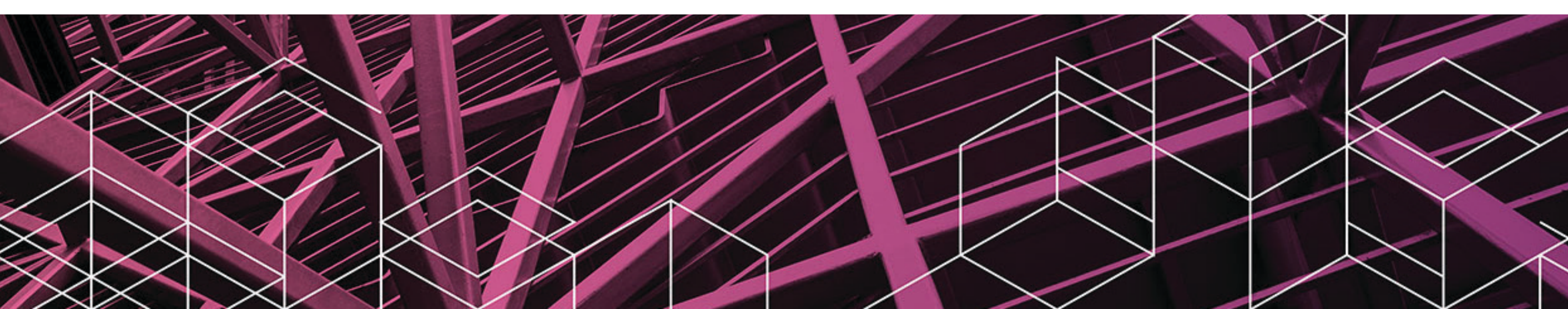
A BALANCE SHEET ACT

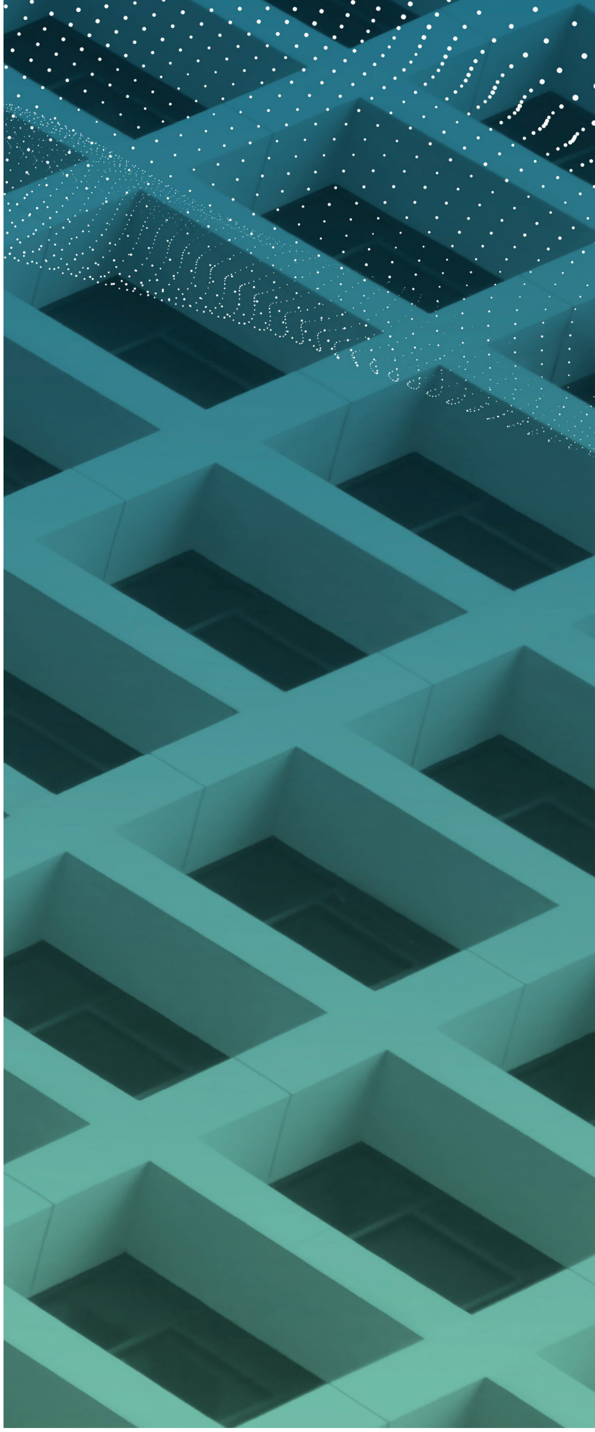
Assessing balance sheet risk tolerance and claims loss impact within a captive program to offset inflationary premium pressures

Jeff Kurz, Captive Insurance Specialist at Artex

STEVE MCELHINEY,
SVP and Director of (Re)insurance

Steve heads (Re)insurance for Artex Risk Solutions with his Dallas-based team by way of the 2019 acquisition of EWI Re, Inc., where he was CEO as well as serving as chief risk officer for Contran Corporation and president of their Vermont captive. Steve is a senior vice president and global director of (Re)insurance for Artex globally. Steve's insurance industry experience spans more than two decades with several global insurance groups such as Allianz, Transamerica, Argo Group and Overseas Partners RE. He has served in the roles of CFO, corporate treasurer, (re)insurance executive and board member. In 2021, he was named to the Captive Review Hall of Fame.





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