

# RESPONDING TO CATASTROPHIC WEATHER, CAPTIVES ANSWER THE CALL

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xtrême weather events are becoming more frequent and more costly. According to Munich Re, in 2017 insured catastrophic losses were \$135 billion and total losses, including uninsured, were \$330 billion. The insurance sector is working to adapt its processes to mitigate the large losses associated with catastrophic weather events and the compounded risk that it exposes but is responding slowly. This creates the perfect opportunity for captives to step in to help shore up and create more secure coverage.

## WHAT'S GOING ON

Last year, extreme weather events became the normal, what with the intense summer heat, firestorms, hurricanes, flooding, and tornadoes all causing billions in damage. 2017 also happened to be the second hottest year on record while 2018 is projected to be the fourth hottest year on record. According to the *WMO Statement on the State of Global Climate in 2017* issued by the World Meteorological Organization, “The world’s nine warmest years have all occurred since 2005, and the five warmest since 2010, whilst even the coolest year of the 21st century—2008...would have ranked as the second-warmest year of the 20th century.”

WRITTEN BY KARRIE HYATT

The Accumulated Cyclone Energy index, which is used to measure the intensity and duration of storms in the Atlantic Ocean, reported that September 2017 was the most intense month on record. As the earth's temperature increases, the likelihood of extreme weather events will become more frequent. Last year's Hurricanes Harvey, Irma, and Maria showed exactly how disruptive extreme weather events can be to critical infrastructure.

According to the World Economic Forum's (WEF) *The Global Risks Report 2018*, "Environmental risks have grown in prominence over the 13-year history of the Global Risks Report.... Among the most pressing environmental challenges facing us are extreme weather events and temperatures; accelerating biodiversity loss; pollution of air, soil and water; failures of climate-change mitigation and adaptation; and transition risks as we move to a low-carbon future." The WEF also reported that extreme weather events, including failure of climate change mitigation and adaptation, has remained a key concern for business leaders over the last six years.

While climate change-related incidents contribute to the rising costs of damage, all natural disasters are causing more costly damage. The thing in common with all natural

catastrophes is that the world's population continues to grow even as the world becomes more interconnected leading to concentrated centers of population and businesses that rely closely on one another.

"Damage caused by these risks continue to increase dramatically," said S. Lance McNeel, vice president of Business Development, Capstone Associated. "Extreme weather events have always occurred. The five most powerful north Atlantic hurricanes to hit landfall [happened between 1924 to 2007]. While these hurricanes do not appear to have a meaningful trend over time, one thing is certain: coastal values and populations have certainly increased. Flooding and windstorm damage have increased to the point where the five most costly hurricanes on record range from Katrina in 2005 to Harvey in 2017."

**WHERE THE INSURANCE INDUSTRY STANDS**

The types of risk associated with catastrophic weather events mostly involve risk to property—wind, flood, fire, and environmental—but risks that can be equally disruptive are business and supply chain interruption. All of these risks are notoriously hard to insure with any amount of accuracy, without having a crystal ball to see the future. Predictive models on natural catastrophes can only forecast so much, and while these risks are low in frequency they are often high in severity. Getting adequate and



## CAPTIVES ANSWER

secure insurance coverage for these unlikely events is as important as it is complicated.

According to McNeel, “Because of the catastrophic potential due to the geographic concentrations of value, adequate limits may be unavailable. In many cases, federal or state programs fill the gaps in these coverages. Whether it is business interruption or physical damage, commercial policies have limited coverage in the case of these widespread disasters.”

Last April, in a study titled, “Insurance and Climate Change Risk Management: Rescaling to Look Beyond the Horizon,” by Jason Thistlethwaite and Michael O. Wood with the School of Environment, Enterprise and Development (SEED) at the University of Waterloo, the authors used information from the

NAIC’s “Climate Risk Disclosure Survey” to determine how insurers are integrating climate change into their risk management practices.

They found that the majority of insurance companies are not incorporating climate change risk management into their plans. They do so by “Failing to adopt a [climate change risk management] policy, [to] prioritize climate change risks (e.g. through senior management oversight), or [to] employ climate change models and projections to adjust premium pricing and stress-test reserves and investment portfolios.” The authors found that reinsurers are more likely to add climate change policies into their risk management practices, but only by a small margin.

While the study’s findings sound discouraging, the authors had a positive

insight on the subject, “Climate change is identified as both a threat and an opportunity for the insurance industry—a threat because losses limit the availability and affordability of coverage, and an opportunity because risk can be priced into premiums and investments, thereby creating incentives to support mitigation and adaptation strategies throughout the global economy.”

## HOW CAPTIVES CAN HELP

The insurance industry is generally a leader in adapting to changes in the financial markets. Now, facing more frequent extreme weather events, traditional insurers seem to be struggling to keep up with the changes in the marketplace created by catastrophic weather. While insurance companies work to compensate with climate change-related risk, their coverage



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often falls short of what insureds need—either by not providing the right kind of products or narrowing their coverage through exclusions.

This is where captives come in. Captives may not be the whole answer to mitigating climate change-related risk, but they can help to cover gaps in traditional insurance, foster nascent or unlikely risk, create steady coverage in a volatile marketplace, and access the important reinsurance market.

Captives are known for their adaptability in insuring emerging and unlikely risks. Insuring climate change-related risk is another area where they can outperform the traditional marketplace. Pollution events, flooding outside usual flood zones, supply-chain interruption, and similar emerging issues are all risks that can be nurtured through a captive.

By insuring unusual risks through a captive, when there is no historical data available, parent companies can build up actuarial data allowing them, after a few years, to fine-tune their coverage for that risk, or to shop that risk through the wider insurance marketplace.

Many times, even if a product is available through conventional insurance, it might not be comprehensive enough to adequately cover a company's risk. Many insurance policies have

strict exclusions that can leave gaps in coverage. A captive can help to bridge those gaps that the traditional market is unable to insure, providing excess policies that can shore up any discrepancies, so that the captive's owner has all aspects protected.

If extreme weather events continue to increase, there is a real possibility of a hardening of this sector of the insurance market. Insuring extreme weather-related risk through a captive can create more stable pricing of these types of policies for the captive owner and also offer more security.

According to McNeel, "Captives cannot smooth out the unpredictability inherent in [these] risks, but they can provide insurance coverage that is tailored to the specific risk exposures of the affiliated insureds. This coverage in turn finances these ... losses, thus smoothing out shock losses that would affect the long-term viability of the insureds."





One of the most important advantages of insuring for natural catastrophes through a captive is the access they give to the reinsurance and alternative capital markets. Access to these markets can lead to greater capacity in coverage, while spreading out the risk. The global reinsurance sector is going strong.

Over the last few years of favorable market conditions, the sector has attracted major investors and has built up large reserves of cash. Access to the reinsurance market can help captives create more secure coverage for unlikely extreme weather events.

“It is important to limit the exposure of an individual captive to catastrophic claims, spreading the risk over many risk-bearing entities,” said McNeel. “After all, risk spreading is what insurance is all about. Risk sharing can be accomplished by the insureds or the captive ceding a portion of the risk to one or more reinsurers.”

As extreme weather events are likely to increase in frequency and in damages, captives have the opportunity to step in where traditional insurance can't or won't, providing an important alternative. Captives in this volatile market can provide an extra layer of risk financing while encouraging effective climate change-related risk management. ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: [www.karriehyatt.com](http://www.karriehyatt.com).