Managing Catastrophe Exposures: Risk of a Big Event Getting Bigger

Climate and catastrophe risk experts are bracing for a wave of extreme weather events in the coming months and years as the current El Niño system strengthens to unprecedented levels and the potential for stronger seismic events in the United States increase.

El Niño, which causes flooding, drought, wildfires, and winter storms, to name a few, is showing no sign of cooling after causing $12.6 billion in natural catastrophe losses during the first half of 2015. For example, on Nov 8, 2015, the El Niño index, a measure of Pacific Ocean temperatures, set a record of 2.8, the warmest in recorded history, according to the National Oceanic and Atmospheric Administration.

Meanwhile, catastrophe risks experts are also concerned about recent scientific studies evidencing an elevated risk of seismic activity in the United States. According to new research, the New Madrid fault line, which has been more active in recent years, has a greater range of potential earthquake magnitude than previously imagined. The New Madrid Seismic Zone extends through parts of Missouri, Arkansas, Tennessee, Mississippi, Kentucky, Indiana and Illinois.

Another study produced by NASA’s Jet Propulsion Laboratory is also disconcerting. It predicts a high probability of a significant earthquake striking the greater Los Angeles area within the next three years.

Given these concerns, USI’s middle market clients are stepping up their catastrophe risk management programs going into the New Year. In the Industrial sector, for example, USI has been working with manufacturers of varying sizes to quantify and plan for not just a Black Swan event, but for more frequent and costly natural catastrophe events.

Following are four catastrophe risk management solutions many Industrial clients are implementing with the support of the USI ONE Advantage®, a unique approach to managing clients’ risks:

**Setting Proper Limits Based on Catastrophe Modeling**

Catastrophe modeling simulates a natural disaster event using a client’s location and building information to measure the potential loss that could occur.

USI relies on this modeling approach in its pre-underwriting process to establish appropriate limits for the client based on actual risks. In addition, the company’s risk specialists, supported by data from USI’s proprietary OMNI engine, negotiate with carriers to place the structured coverage into the market.

**Clarifying Catastrophe Deductible Wording**

Standard application of percentage-based deductibles for catastrophic claims can be punitive at the time of loss. This is often due to the fact that a common CAT deductible applies a percentage (3-5%) against all values, and sometimes the property is valued after the loss occurs.

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The chief financial officer of a distributor, which owns and operates multiple warehouse locations throughout the West and Northwest, engaged USI to review its property insurance program. It was not clear to the CFO how his percentage deductible would work in the event of an earthquake. A prior earthquake loss had resulted in a deductible amount that was 25% larger than he expected, impacting that year’s profits significantly.

To address the CFO’s concerns, USI evaluated the existing deductible language and determined that the deductible applied against the total values at an impacted location regardless of the number of buildings damaged. The worst case scenario was found to be 5% of $30 million or $1.5 million. USI refined the policy wordings to create a deductible that was manageable financially, provided certainty for the CFO and improved the worst case scenario to $350,000.

**Flood Definition Clarification**

During El Niño, floods are more common and can impact properties that are not affected by flood during normal weather cycles. Failure to recognize this risk and properly define what constitutes a flood can result in uninsured losses.

Companies located in low flood hazard areas typically rely on the standard flood limit of $1-to-$5 million to protect their assets since flooding is highly unlikely. In El Nino years, however, the standard offering may not be sufficient to protect assets. USI negotiates a broad definition of flood and evaluates the value of property at risk to set proper limits and help the client avoid uncovered loss.

**Contingent Business Income Protection**

Companies can experience loss of income caused by a shutdown of operations that is beyond their control. This could happen when key suppliers or customers are forced to cease operations due to an earthquake or flooding event. In many cases, this exposure is not automatically insured under standard policies.

A manufacturer of industrial motors for the oil and gas industry, with annual revenues of $40 million, went through this experience a few years before it became a USI client. The company at the time depended heavily on a California-based company as its main parts supplier.

Following an earthquake, the supplier’s plant was shut down for 6 weeks. Consequently, the manufacturer sustained significant loss of revenue because it could no longer obtain the custom designed parts it needed from the supplier to continue production. In addition, the manufacturer’s property policy was not customized to its actual risk and excluded contingent business income loss.

When USI partnered with the company, it evaluated this exact exposure and determined that the total amount of lost income should this supplier shutdown again from another earthquake would be $150,000 per week. USI negotiated contingent business interruption coverage, which eliminated the company’s uncovered loss exposure to earthquake of $150,000 per week.

To learn more about the solutions discussed here and the USI ONE Advantage® contact a USI consultant.

2014 National Seismic Hazard Map

The U.S. Geological Survey National Seismic Hazard Maps display earthquake ground motions for various probability levels across the United States. The map represents an assessment of the best available science in earthquake hazards and incorporate new findings on earthquake ground shaking, faults, seismicity, and geodesy.

Source: earthquake.usgs.gov