How Parametric Insurance Helps Reduce the Total Cost of Risk

Many organizations express frustration with traditional insurance solutions from two standpoints. When insured events occur, the insurance recovery process can take a long time. On top of this, the recovery may only cover a portion of the economic loss experienced. These factors create a "protection gap" between the exposure and what is insured, requiring insureds to retain more risk than they would otherwise prefer to do. To address these challenges, more organizations are looking to innovative products, such as parametric insurance, as a solution to better address their risk exposures.

Parametric insurance is an inherently simple solution. These policies pay out when a triggering event occurs, as validated by an independent third party, without the need for a claims adjustor.

In the absence of a dispute, organizations often receive parametric benefits in a matter of weeks, not months or even years, as sometimes can be the case with conventional insurance if there is a claim dispute. The payout structure is pre-negotiated and formulaic, determined before the policy is issued.

Risk managers who understand their total cost of risk can use parametric insurance to make certain uninsurable risks insurable and complement their traditional indemnity programs. Parametric insurance can help organizations match insurance capital to their specific risk profiles, providing more liquidity exactly when they may need it the most.

Which Events are Best Suited for Parametric Insurance?

Parametric insurance has a variety of applications and can conceptually be available for any issue where an index can be developed based on independently verifiable and transparent data, and when an insurer is able to model the risk exposure.

While the problems for which parametric insurance can solve is growing, organizations tend to use this solution for three broad categories of risk:

Natural disasters

Earthquakes and hurricanes are the most common application, due to their potential to cause volatility combined with the insurance industry's understanding of the exposure.

Extreme weather

Risk issues created by adverse temperature and precipitation trends can be more easily parameterized, allowing insureds to transfer the potential impact.

Other exogenous events and non-damage business interruption

By using data that is verifiable, transparent and consistent, insurers can underwrite parametric policies that address events such as drops in tourism volumes, supply chain disruptions, and pandemics, all situations where there is an impact from the events regardless of any physical damage to the insured.

The number of applications for parametric insurance is expected to rise. The most significant roadblock organizations may face in adopting parametric solutions is developing an institutional awareness of the concepts and a desire to transfer the risk accordingly.

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How Does Parametric Insurance Enhance Resilience?

On Jan. 26, 1700, **an earthquake with a magnitude 8 or more** tore through a 600-mile stretch between Vancouver Island, British Columbia, and Cape Mendocino, California. Since then and especially more recently, people in earthquake exposed regions are increasingly worried when the next "big one" will hit, especially risk managers with operations and people in those locations. While traditional indemnity-based insurance products, as a general matter, efficiently address property damage that could occur, resiliency extends far beyond physical assets.

Parametric insurance has helped these clients better mitigate the earthquake risk by complementing traditional insurance to broaden and accelerate the coverage response. Should a triggering event occur, the parametric policy is designed to pay more quickly than a traditional policy, ideally providing a liquidity boost to help manage costs to get operations back on line. The proceeds can be used to help recover from a number of economic losses, such as uninsured "black swan" impacts on employees, customers, and supply chain issues. Given the low frequency of these in-scope events, it is difficult to precisely estimate how costly recovery will be, making parametric solution an effective solution to help manage exposure to cost of risk.

The challenge in designing the solution is developing triggers that correlate to the exposure, matching recoveries to catastrophic events, while keeping the coverage cost-effective. But by working with qualified industry leaders, clients are able to quantify their risk exposure by location and create parametric triggers customized for their situation.

Additionally, as parametric insurance tends to be a multi-year policy, the solution hedges traditional insurance market volatility while matching the capital to the risk. The overall result is a generally more flexible insurance program that seeks to generate cash faster than with traditional insurance during extreme uncertainty if an earthquake occurs, providing resilience to help face the future.

How Can Parametric Insurance Reduce Total Cost of Risk?

Risk managers should expect to see increased popularity of parametric insurance as more organizations couple these policies with traditional indemnity programs. Parametric insurance provides a different way to think about risk and how to mitigate it, especially if conventional products aren't meeting an organization's needs.

While parametric insurance can be seen as more expensive than traditional policies and contributing to additional premium spend in isolation, these solutions can nevertheless lower total cost of risk if used wisely. For example, the inclusion of the parametric capacity may allow the company to be more comfortable taking a higher retention on additional traditional indemnity risk for hurricanes, which by itself could fund the cost of the parametric solution. On top of this, all else being equal, by having the parametric solution, less non-traditional risk is retained, ideally freeing up capital for other uses and lowering the cost of risk.

But beyond the impact on cost of risk, parametric insurance provides an important strategic tool where organizations can partner with insurers to solve additional complex business problems. Many exogenous, non-damage business interruption events, such as COVID-19, are not readily addressed by existing insurance solutions. As the industry collectively works to better enhance resiliency to these events and other emerging risks, parametric insurance can be a key tool to better match capital to risk.