

Catastrophe Pool as an Effective Risk Management Mechanism

By **WERNER G. BUGL**

Asia Catastrophe Pool Practice Leader, Asia Capital Reinsurance Group

With changing weather patterns resulting in unprecedented frequency and severity of natural disasters in recent years, Asia faces strong catastrophe exposures and losses. This is exacerbated by rapid population growth, asset concentration and an increasing reliance on intricate technologies in major cities and other exposed locations.

Asia's susceptibility will continue to grow and increased frequency of losses is a permanent threat to economic stability and progress of Asian countries. In fact large economic losses from catastrophic events will set-back the national economic developments of the countries when the gap between economic losses and insured losses grows too big for governments to cope with. This spurs the need for Asian insurance industry players to work together for a catastrophe solution where coverage is priced and benchmarked on Asian terms and conditions.

The devastation experienced by the Philippines in September and





Werner has extensive experience in the management of life and non-life insurance companies throughout Asia, with special interest in catastrophe pool management. He is also a member of a High-Level Advisory Board of the OECD which provides intellectual leadership to an International Network on the Financial Management of Large-Scale Catastrophes to promote and provide state-of-the-art expertise, policy advice and options among policymakers, industry and academia.

October last year caused by the killer typhoons Ondoy and Pepeng proves the preceding statement and highlighted the vulnerability of the country to natural disasters. The economic loss is estimated to be approximately Ph.P 206 billion, of which only about Ph.P 10 billion or 5% was insured. With a total fire premium income of the Philippine insurance industry at approximately Ph.P 9 billion (of which Ph.P 1.9 billion or 20% is the premium income charged for natural catastrophe insurance) not even one natural disaster event like Ondoy can be covered. And this is even as it takes about 5 years to recover from such a single event if it were to be paid for by the cat risk premium income, as it should be.

More than any other lines of business, cat risk (re)insurance and management requires “risk partnership” and technical approaches and handling. Public awareness, education, loss prevention and minimization and the role of the state are important aspects. The only sustainable economic solution for insurance industries is to isolate cat

risks from non-cat risks and charge risks adequately based on technical rates.

Insurance Pools have found acceptance and recognition worldwide and proven their worth as the most effective mechanism for risk transfer, risk aggregation and diversification. The Philippines insurance industry gradually realizes that typhoons are not freak natural events with a low frequency and high severity characteristic but have become fairly regular disasters of high frequency and high severity.

Catastrophe risk management will be one of the greatest challenges for insurance industries in developing and industrialized countries prone to natural calamities.

Persistent inadequate pricing of natural perils cover and cross-subsidization poses a serious risk to the ability of insurers to cope with volatility. Insurance regulators should focus more on solvency and whether companies have taken on too much risk versus their capitalization. Retentions against capital is often irresponsibly huge because the cost of buying more reinsurance can

amount to up to 60% of premium income.

The current situation in the Philippines clearly underscores the need for a function that can be performed with the establishment of a **National Pool for the handling of Natural Catastrophe Insurance**. A good example to follow and which could serve as a role model is PT Asuransi MAIPARK Indonesia.

MAIPARK is a joint market undertaking of the Indonesian non-life insurers and reinsurers to:

- Build sound national reinsurance capacities for earthquake insurance for the local insurance industry
- Promote discipline and proper handling of earthquake insurance
- Set a benchmark for earthquake insurance pricing
- Collate statistics and data base to arrive at an appropriate national earthquake tariff with technically justified premium rates

A National Cat Pool is a sustainable business model in catastrophe risk management. The Asia Catastrophe Pool (ACP) supports the establishment of such Pools and already cooperates with the National Pools of Turkey and Taiwan. These Pools have social-economic and business rationale as well as huge growth potential. Most of these National Pools were established after their countries experienced major natural catastrophes. It is now the Philippines’ turn to act – time waits for no man!

Managing Asia’s Catastrophe Risks

Asia Catastrophe Pool (ACP), a risk initiative managed by Asia Capital Reinsurance Group (ACR), was set up in January 2009 to address this need with the vision of providing a regional platform for catastrophe risk aggregation and management across the Asia-Pacific region.

As a catastrophe pool reinsurance function, ACP is designed to separate catastrophic from non-catastrophic risks and works on the



basis of risk-sharing amongst Asian insurers and reinsurers with participation arranged through a Quota Share Agreement. Asian insurers and reinsurers cede their undiversified natural catastrophe accumulation risk to the Pool. In return, Pool Members receive a well-diversified, well-balanced book of Pan-Asian natural catastrophe business which is largely uncorrelated

Continued on Page 13

Managing Asia's Catastrophe Risks (continued from page 11)

with their respective own risk portfolios.

ACP risks are accepted on a right of refusal basis. Likewise, for Pool Members there is no compulsory cession into ACP as there is no obligation for cedants to be a Pool Member. The Quota Share Treaty, in which Pool Members participate, is placed on a unit basis. Spill-over risk as well as credit risk is absorbed by ACR. In compensation for this and other operational costs, ACP as Pool Manager is paid a ceding commission.

ACP applies underwriting best practices in all its techniques and processes and risk management is a key strength of ACP which forms an integral part of the underwriting strategy. ACP strongly believes in

strict pricing discipline as a means for risk selection and to achieve superior economic performance in order to ensure fairness in risk-sharing.

This groundbreaking, pioneering initiative combines socio-economic and commercial rationale and the fundamental economic value proposition lies in the more efficient use of capital and risk diversification, providing mid- and long-term benefits to participating pool members and cedants.

In fact in 2009, during the maiden year of ACP, the Pool got off to a very encouraging start. Despite the numerous major natural disasters which occurred in Asia, such as Typhoon Morakot in Taiwan, the Typhoons Ketsana and Parma in the Philippines, the Padang earthquake in Indonesia and floods in

Istanbul, Turkey, ACP's performance for calendar year 2009 was in accordance with its robust business model. In 2010, the second business year of ACP, the industry support from partners throughout the Pan-Asian region has grown even stronger. The number of pool members rose from 17 to 26 from 10 Asian countries.

The growth potential of catastrophe insurance penetration in Asia presents a significant business opportunity and we believe Asia is big enough to create and sustain a balanced catastrophe risk portfolio. Dedicated to Asia's catastrophe needs, ACP's vision is to become Asia's premier catastrophe reinsurance facility and contribute to the stability of the region.