Are you ready to run the hurricane gauntlet?

Ryan Ogaard runs through a final pre-season systems check for (re)insurers

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As summer approaches, all (re)insurance eyes are on the US hurricane season. The largest concentration of (re)insurance capital in the world faces its annual gauntlet. Whether the coast is battered or is passed in relative silence, we know that the global market for risk capital will be shaped by the season's outcome. This is not passive anticipation. There is a wide array of actions, products and strategies for dealing with hurricane risk, and the set of options continues to grow. In particular, improved forecasting has bolstered the viability of live cat products, rendering imminent threats less menacing. Still, there is no substitute for long-range planning and analysis. A company's outcome of the season is often determined by decisions and actions taken outside of the season.

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Be prepared

Over the long term, luck favours the prepared. Companies with accurate exposure data and active risk portfolio management will have less to fear as storms arise throughout the season. However, mastering the details of planning, analysis and risk management can take years. Even with a concerted, long-term effort, 'accurate' risk analysis is not a guarantee. Nasty surprises can still come from the intersection of estimated loss and real exposure.

To bolster their risk management decisions, carriers are using new, high-powered software tools to refine their understandings of exposure data and gain new perspectives on possible loss scenarios. Further, several vendors offer exposure data testing and even cleansing. However, changing a risk portfolio requires time. As the season approaches, it may be too late to adjust the portfolio but there are still plenty of other risk management alternatives available.

Even with state-of-the-art portfolio management, most companies writing business in US hurricane regions hedge their risks with reinsurance. For those with June or July renewals, a decision must be made about coverage levels.

Several factors seem to drive demand. Capital adequacy is a primary consideration but the differences between market price and the internal cost of capital may also contribute to buying decisions. If cover is cheap, reinsurance may be more cost effective than retention. Finally, there is an emotional aspect. If a carrier is not confident in its risk data and modelling, it may elect to secure some extra cover. This is not necessarily a sign of inadequate risk management. Perhaps the carrier's book of business has changed significantly over the past year — for example, through acquisitions — and there has not been time to 'digest' the new exposure information. Further, many risk-bearers are still haunted by the storms of 2004 and 2005, when many diligent modelling efforts failed to anticipate the real losses. Whatever strategy drives buying, the vast majority of reinsurance is in place by early July.

In the short term, we watch and wait. Little risk or capital management can happen as the months of July, August, and September pass. If a system seems likely to hit the coast, though, a frenzy of analysis ensues. Modelling teams work nights and weekends to anticipate a myriad of scenarios and send the results to management. Again, companies who have done their homework are positioned best for the rapid and accurate turnaround of information.

Risk-bearers can do more than wait and hope — immediate term hedging is feasible, with an increasingly creative array of live cat products. The market for these imminent-storm risk transfer tools becomes active as the storm approaches. As it draws closer — and the peril seems more likely — the odds begin to favour insured losses, and pricing changes appropriately. Eventually, only the slightest of shifts in the wind will either render this cover unnecessary or put it "in the money".

Modelling loss

An interesting new option in the live cat space is emerging as short-term hurricane forecasts become more sophisticated. WSI, for example, has developed forecasting capabilities that look 10 days ahead, five days further than the predictions offered by the National Hurricane Center. Using cutting-edge meteorological models, WSI predicts the direction, intensity and duration of a named storms or hurricane, along with US landfall probabilities. This improved view of an individual storm's likely behaviour enables the development of new products to facilitate securing ultimate net loss, modelled loss or parametric cover when a storm is getting close.

As individual storms subside, insured losses are determined, and the claims processing machinery goes to work — often aided by analysis to estimate number, location and severity of claims — even before real claims have been filed. Long-term reinsurance coverage might need an adjustment. Limits might be exhausted. And, carriers return to the business of anticipating risk and protecting their portfolios. The next storm might be on its way. re