

Shaping the future of insurance law

Parametrics: the next big thing?

7 JUNE 2019

AT A GLANCE

- Parametric insurance products are becoming increasingly common as they give insurers a way to resolve risk-transfer concerns.
- The product is attractive to both insurers and insureds because the events are typically low frequency, the claims are paid quickly and premiums cost less.
- The success of these products depends on the accuracy and objective nature of the parameters set and a deep understanding of the potential exposures.
- Insurers in Australia also need to ensure the products offered satisfy the requirements of an 'insurance product'.
- Financial lines insurers would benefit from understanding how parametric insurance operates and its potential interaction with financial lines and property policies that could provide cover for similar events.

Globally, there has been a significant rise in the number of parametric insurance products on the market. Parametric insurance doesn't indemnify pure loss but offers insureds pre-agreed payments if a parameter-defined event occurs – such as a natural disaster or agricultural crop loss. This type of cover is starkly different, and refreshingly simple, compared to more traditional products that cover actual losses established by the insured, subject to the specific and often detailed policy wording.

The parameter relates to an index regarding the event. The index measure has to be transparent, consistent and independently verifiable, such as the category of an earthquake, delay lengths of time or temperature thresholds. For example, if an insured purchased parametric insurance to provide coverage for an earthquake of magnitude 3.0 or larger in their location, then they would get a pre-agreed payment if that event occurred but not if an earthquake of magnitude 2.9 occurred. The payment would not depend on whether the insured incurred any actual loss.

Parametric insurance is offered by insurers as way of resolving risk-transfer concerns. It is not designed to be stand-alone but rather to complement broader insurance programs. The product is attractive to both insurers and insureds

because the events are typically low frequency, the claims are paid quickly, and premiums cost less given the product does not require loss assessment and premiums based on liabilities and risk-sharing.

However, the success of these products does depend on the accuracy and objective nature of the parameters set and a deep understanding of the potential exposures. It also requires that neither the insurer nor the insured can influence the event or its measure.

Parametric insurance can potentially help plug the coverage gap that's widening as climate-related natural catastrophes increase in frequency and impact. While this is a good thing, insurers do need to be careful to ensure the parametric offering is actually an 'insurance product' under Australian law. Because claim payments are triggered by predetermined criteria, it has been argued that the product is a financial product and not an insurance product. To address this, insurers must assess whether the pre-determined event is sufficient to meet the insurance requirement. Currently, we understand that insurers and regulators alike are operating on the basis that the cover is an 'insurance product'.

Parametric insurance products provide insurers with an exciting potential new line of business, provided they can bring precision to risk forecasting. Insurers also need to ensure the parametric product offered satisfies the requirements of an 'insurance product'.

Need to know more?

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