Mark Twain once observed that climate is what we expect, weather is what we get. Authors Howard C. Kunreuther and Erwann O. Michel-Kerjan give readers a plan to control, if not the weather, at least the losses that result from it. In the preface to their book, they explain that their purpose is to "examine alternative long-term sustainable strategies for reducing losses from natural disasters and providing financial support to victims of these events." Both know their way around this subject. Dr. Kunreuther is a professor of decision sciences and public policy at the Wharton School of the University of Pennsylvania, and Dr. Michel-Kerjan is managing director of the Wharton Risk Management and Decision Processes Center.

Citing demonstrations of inept leadership following such catastrophes as Hurricane Katrina and the Indonesian tsunami, the authors argue for a coherent strategy to ensure sustainable recovery from large-scale disasters.

Managing Large-Scale Risks in a New Era of Catastrophes

by Dev Strischek

At War with the Weather: Managing Large-Scale Risks in a New Era of Catastrophes

by Howard C. Kunreuther and Erwann O. Michel-Kerjan.

Published by MIT Press, 2009.
write in order to quantify the hazards faced by the insured and to encourage commonsense, cost-effective measures to reduce their vulnerability.

- Any special treatment for low-income or otherwise disadvantaged homeowners has to come from general public funding, not from insurance premium subsidies.

The text’s 15 chapters are organized into four parts. The first part explains why the damage from natural disasters has escalated since the 1990s. Blame it on urbanization in the wrong places. Between 1950 and 2000, the number of people living in cities rose from 30% to 50% of the world’s population of 6 billion. Demographers project the numbers will be 60% of 8.3 billion by 2025.

Worse, much of the population growth has been in hazardous locations. In 2003, some 53% of the U.S. population lived in the 673 coastal counties, an increase of 33 million since 1980, and despite the risks posed by hurricanes, another 12 million are expected to be on the beach by 2015. Consider the additional peril in the appeal of sunsets to retirees and the associated medical costs of dealing with their more fragile physiques.

The second part of the book explains why homeowners choose low deductibles and still underestimate risk; it also describes the price sensitivity of insurance. In the four states studied—Florida, New York, South Carolina, and Texas—the amount of insurance purchased drops by the same percentage as its increase in price. Despite 545 presidential disaster declarations during the 1996-2005 period, homeowners in disaster-prone areas don’t seem to perceive any personal risk to themselves. In this state of denial, homeowners simply don’t recognize that higher premiums signal greater risk. They react strongly against risk-adjusted premiums, which, of course, should not be surprising to bankers trying to negotiate higher pricing with riskier borrowers.

The book’s third part tackles affordability. The problem is that poor people will buy insurance but cannot afford to bring their homes up to code. Nevertheless, even small-expenditure improvements such as storm shutters significantly reduce damage. The authors’ recommendations include tax credits, grants, building code enforcement, and discounted insurance premiums to homeowners who practice some preventive maintenance.

The final part of the book offers advice on strategies to encourage people to buy enough insurance and urges more investment in infrastructure, mitigation, preparation, response, and recovery. It also suggests such options as the establishment of a coastal hurricane zone, a national catastrophe fund, federal-government-sponsored auctioned reinsurance contracts, and private-sector alternative risk-transfer instruments. All of these recommendations require a more integrated, coordinated private-public approach than what FEMA currently offers.

**Why Read This Book?**

So why should a banker read this book? First, one way or the other, we will be asked to finance the acquisition of assets that our bank will certainly want protected by insurance. Second, some of the proceeds of our working-capital loans probably go to pay insurance premiums.

In a banker’s perfect world, borrowers have enough insurance at a reasonable price to repay their loans in full. At odds with this perfect world is the supply of and demand for catastrophe insurance. The price of catastrophe insurance is usually high relative to expected claims because of the large variance in losses that can be costly because of the insurer’s need to allocate extra capital to provide protection. Catastrophic losses following major disasters then reduce the available supply of insurance and drive up premiums.

The key to restoring the supply-demand balance is to convince policyholders to take higher deductibles so that insurers can provide more coverage—which should incline policyholders to adopt more preventive measures because of their higher stake in the potential loss. Read that as more self-insurance, and more risk for lenders; figure higher insurance premiums and less cash flow to service debt.

Nevertheless, if our borrowers choose to live, work, and operate in risky places, we need to make sure they plan accordingly. And we need to make sure that our repayment sources are protected too, with enough insurance to keep our borrowers in business and our collateral covered. At the very least, review your own bank’s collateral insurance requirements and your disaster-preparedness plan. The book makes the point that much damage can be avoided with some inexpensive preparation and mitigation.

The value of this book is the insight the authors provide on how to quantify the costs and benefits of catastrophe insurance. As Ben Franklin wryly observed in his 1735 Poor Richard’s Almanac, “Some are weatherwise, some are otherwise.” If you are otherwise, then read this book.

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