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How insurance can support climate resilience

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Insurance is gaining in importance in and beyond the climate negotiations and offers many opportunities for improving climate risk management in developing countries. However, some caution is warranted, if the current momentum should lead to genuine progress in making the most vulnerable more resilient to climate change.

Was 2015 "the year of climate insurance"? Statements emerging from the G7 leaders and COP21 in Paris certainly suggest so. Article 8 of the Paris Agreement includes "Risk insurance facilities, climate risk pooling and other insurance solutions" as areas of action.[1] Earlier in the year, at their summit in Germany, the leaders of the G7 launched a new Initiative on Climate Risk Insurance (InsurResilience), pledging to bring climate insurance to 400 million currently uninsured individuals in poor countries by 2020. In many ways the G7 initiative and the Paris Agreement are the culmination of a long process to establish insurance as an accepted climate adaptation instrument.[2, 3, 4]

High hopes and expectations…

The supporters of climate insurance point to increasing losses from weather extremes – such as floods, droughts, and typhoons – where the absence of insurance can have negative implications for the scale and duration of the economic impact of disasters, the resilience of businesses, individuals and governments, and speed of recovery.[5] Insurance can shift the mobilization of financial resources away from ad hoc post-event payments, where funding is often unpredictable and delayed, toward more strategic and, in many cases, more efficient approaches that were set up in advance of disastrous events.[6] Making these tools available to the most vulnerable appears attractive. A number of regional risk pools such as the African Risk Capacity (ARC), the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI), and the Caribbean Catastrophe Risk Insurance Facility (CCRIF), as well as new pilot schemes, such as index-based agriculture micro-insurance, are offering financial protection to a growing number of governments and individuals across the world.

…but some skepticism remains

Any new insurance scheme in developing countries needs to overcome difficult challenges, including lack of risk data, limited financial literacy, and weak financial infrastructure; it also needs high levels

of support to make it viable for people with very low incomes. Many of the new pilots and pools have been designed with this in mind. However, utilizing insurance for adaptation and poverty reduction faces even more challenges: how can a scheme reach the most vulnerable, and how does it cope with and address changing risk levels? As the intensity and frequency of climate extremes increase,[7] is it fair to shift responsibility on to those who are the least responsible for climate change, the least able to shoulder the premiums, and in many cases the least able to reduce their losses?

Without substantial external support, insurance could shift the burden of climate-related impacts to the most vulnerable in society, by requiring them to pay insurance premiums rather than offering them direct help and support. Subsidized premiums are one answer to this; other solutions include publicly funded reinsurance arrangements and technical support – each of which indirectly reduces premiums. For this purpose, discussions on the G7 initiative include the potential of global and regional facilities financed by wealthy countries to absorb a high layer of risk and support local insurance arrangements in the most vulnerable countries, as suggested early on by the Alliance of Small Island States (AOSIS). However, external support, especially direct subsidies, raises the question of value for money. Some critics point out that traditional insurance is an expensive mechanism with high transaction and capital costs, making premiums far higher than expected losses. This suggests that adaptation funds might be better spent on other types of safety nets rather than on buying insurance cover from international insurance markets.[8]

Critics further caution that subsidized insurance can dampen incentives to reduce risks. A recent study for the Climate Investment Fund[9] suggests that climate insurance can play an important role in climate adaptation. But it also warns that inappropriately set up insurance schemes can have unwanted consequences and may neither benefit the poor nor foster climate resilience. This echoes the IPCC report on managing the risk of extreme events.[7] This report concludes that insurance can be a tool for risk reduction and for recovering livelihoods, particularly in the face of extreme weather events, but it also warns that insurance could also provide disincentives for risk reduction, if not correctly structured.

There are no “one size fits all” solutions for climate insurance, and insurance is not suitable for certain risks, such as slow-onset events like sea level rise. However, insurance does offer many benefits, particularly compared to reliance on post-disaster aid. We therefore believe that there is a role for carefully designed and supported insurance instruments, such as index-based micro-

insurance where pay-outs are based on triggering of certain weather parameters like rainfall, and sovereign insurance pools in which national governments are covered against the impacts of natural hazards on their annual budget. But their success will depend on making them fair and affordable to the poor, and on integrating them into an overarching adaptation and development strategy.

Insurance and improving climate resilience

The limited experience available suggests that climate insurance can enhance resilience,[10] but only if it is part of a wider adaptation strategy, rather than being considered in isolation or, worse, as an alternative to adaptation. In other words, if we don't address the underlying issues then risks will become uninsurable because of lack of supply (availability of cover) or demand (affordability of premiums). This is a key lesson emerging from existing insurance schemes in Europe and the USA, where flood insurance especially is already under heavy pressure from rising risk levels due to misguided building and land use practices, as well as environmental and climatic changes. Recent figures emerging from the UK, highlighted by the Bank of England,[11] show that climate change and socioeconomic risk drivers are expected to widen the gap between "affordable" flood insurance premiums and premiums that reflect the technical price of flood insurance. For developing countries in particular, this means that climate insurance should be considered only if it is closely aligned and integrated within an equitable and efficient strategy to address climate risks.

How to make it work?

With the new momentum created by the Paris Agreement, now is a critical time to put together the right mix of measures to facilitate climate-resilient development. The extent to which insurance can feature in this is risk- and country-specific and dependent on local risk appetite and demand, as well as societal values.[12] The political commitments coming from G7 and the Paris Agreement have been supported and welcomed by several insurance companies and industry initiatives such as the Munich Climate Insurance Initiative, ClimateWise, and the Geneva Association. Harnessing the potential of insurance for climate-resilient development does require collaboration between public and private actors, but will the current appetite from the private sector be sustainable? This will depend on a range of factors – most importantly on securing the right enabling conditions for insurance and enhancing the underlying climate adaptation efforts.

Before implementing insurance we thus need to better understand its enabling conditions, especially those that could provide benefits beyond risk transfer. One example is our understanding of current and future risks. Data collected for insurance purposes need to be fed into national

assessments and to inform the design of climate adaptation measures. Projections of weather risks, such as those performed in scenario studies at the national or local scale,[13] can provide indications of future impacts as well as the actions required to curb trends in ever-increasing losses and keep risks insurable. An increasing number of investment and development organizations now require risk assessments to include such climate scenarios to allow them to plan more robustly for the future.[14] The insurance industry itself, as the world's largest institutional investor, clearly has a role to play here. Ironically, investment decisions by insurers do not usually consider the climate risk knowledge gained on the underwriting side. Far too often infrastructure investment decisions go ahead without any reflection on climate risks. Addressing this would in turn make climate insurance more viable and thus create new markets and opportunities. This has been recognized by several companies, and it is the subject of a range of new initiatives such as the R!SE Initiative[15] and the industry's pledge at the UN Climate Summit in New York in 2014 to increase its climate-smart investments.

Furthermore, it is important to consider how to incorporate climate change into the design and operation of insurance. Some new schemes are aimed at temporary changes in weather patterns (e.g., forecast insurance and El Nino cover at seasonal timescales), but the vast majority is providing cover for current risks, usually on a year-by-year basis. However, reflecting on future risk trends (not just the climate, but also socioeconomic dynamics) is crucial when designing a scheme to be available beyond the short term. In practice, insurers and governments tend not to incorporate future risk trends or conditions for reducing risks when assessing the viability of new schemes or reforming existing insurance offerings.[16] There are a number of innovative approaches addressing this, such as the HARITA pilot in Ethiopia, where farmers "earn" the subsidized insurance cover through community work aimed at improving overall climate resilience. At sovereign level, the ARC is introducing conditions for member countries that create the minimum standards for climate risk management. This looks promising, but it is too early to tell how effective it will be in fostering climate-resilient development. Effective monitoring systems will be needed and should be an integral part of any new scheme being proposed and implemented.

Establishing an insurance scheme does not mean that we can take the climate challenge more lightly. This would be the wrong message. The G7-proposed insurance cover for 400 million uninsured individuals can support climate change resilience for the poor only if the premiums are directly or indirectly subsidized. However, this will only be viable if insurance is linked to adaptation efforts that address the underlying risk factors, otherwise climate insurance will be short-lived and far from cost - effective. Funding climate resilient infrastructure, establishing data collection and

monitoring networks, adjusting agricultural practices – these are all important elements that insurance can complement but not replace.

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