Implications of premium support on increasing the affordability of climate risk insurance solutions

KEY MESSAGES

1. **Targeted direct premium support is essential for making climate risk insurance accessible for extreme poor and poor**
2. **Targeted direct premium support should be reliable, flexible, minimize incentive distortions and make the client aware of the true risk cost**
3. **Indirectly reducing premiums through investing in risk reduction measures and an enabling environment has long-term co-benefits for building a comprehensive disaster risk management framework**

Background

Well-designed climate risk insurance, if embedded into comprehensive risk management strategies, can provide poor and vulnerable people and countries with a buffer against climate shocks, lessen financial repercussions of volatility and create a space of certainty within which investments, as well as planning and development activities, can be undertaken. However, premium costs represent a major obstacle regarding the accessibility of insurance products in developing countries. Therefore, measures to increase affordability for poor and vulnerable people and countries are paramount to the success of an insurance scheme and also important with regards to concerns of equity. This document summarizes the outcomes of an MCII Expert Workshop, discussing the implication of premium support on increasing the affordability of climate risk insurance solutions and how this can be organized. It addressed individual insurance solutions on the micro level as well as sovereign schemes on the meso and macro level. The workshop took place on 16 August 2016 in Bonn and gathered risk insurance experts from the private sector, academia, think tanks and civil society. The document captures three key messages of the discussion:

1 Targeted direct premium support is essential for making climate risk insurance accessible for the extreme poor and poor

Pilot projects are demonstrating that market-based insurance can be a viable option for protecting the poor against climate shocks. However, experts assert that few, if any, insurance related approaches specifically targeted towards the extreme poor and poor (< 3.1 USD PPP/day) have been started and sustained without premium support.[1] The financial power of this group is too weak to engage an effectively driven market-based approach if pursued without targeted premium support, accompanied by measures to reduce premiums indirectly (see key message 3). Insurance premiums usually comprise of two major cost factors:

- The risk-based part reflects the actual costs (expected average annual loss) of insuring some percentage of the exposure. In climate risk insurance, this part is determined by:

  a) A baseline risk for the geographical area to be insured;

  b) An add-on risk due to climate change.

- The mark-up part includes:

  a) Implementation costs, i.e. costs for setting up the insurance scheme (e.g. demand studies, product development, marketing, set-up of sales infrastructure);

  b) Transaction costs;

  c) Administration costs;

  d) Capital/reinsurance costs.

In developing countries, mark-ups are often particularly high because of a lack of necessary data, insufficient risk assessments, underdeveloped capital markets, etc. Because of the many uncertainties, there is a lack of relevant investments.

In providing targeted premium support for viable products, considering concerns of equity, discussants noted that donors and governments should take the following points into account:

- There are consequences to applying direct premium support which need to be actively managed (see key message 2).
- Indirectly reducing premiums through investing in risk reduction measures and an enabling environment should complement direct premium support to make insurance accessible for vulnerable people above 3.1 USD/day (see key message 3).
- Public support for insurance products can tie in on different levels, channeling funding (e.g. loans or grants) either directly to the insured (subsidy for the premium), to the insurer (subsidy to lower the premium for the insured and making the product affordable), or to governments and organizations (financial means for DRR measures and enabling environment conditions). Different forms of support have specific advantages and disadvantages.
- From a cost-benefit perspective, insurance might not always be the best solution to address climate risks for the extreme poor and poor. Donors and governments should only provide premium support for insurance products that are needs based, adjusted to the local context and embedded into holistic risk management and resilience building strategies.

2 Targeted direct premium support should be reliable, flexible, minimize incentive distortions and make the client aware of the true risk cost

In employing premium support discussants highlighted the following principles:

(a) Reliability: Reliable external support that ensures a long-term perspective for the insurance product is a precondition for the engagement of private sector actors in the market development for the very poor segment of society in vulnerable countries. Moreover, discussants highlighted that providing reliable support to those with little adaptive capacity, being affected disproportionally by climate change, is key in responding to issues of equity and responsibility.

(b) Flexibility: Premium support needs to be adjustable to factors that determine affordability of the insurance product for the beneficiary, in particular changing income levels, resilience or hazard exposure. Effectively implemented product management plans can help to adjust premium support to the factors listed, decreasing or increasing it accordingly, phasing it out when beneficiaries are in a situation to cover increasing levels of the premiums themselves.

(c) Incentives and true risk cost: Targeted premium support should minimize incentive distortions and make the clients aware of the true risk cost. While addressing questions of increasing affordability through donor or government support will be necessary to get schemes up and running, discussants emphasized that efforts need to be made to make sure that support strategies do not negatively affect risk behavior.

- Ideally, that includes premium support for only parts of the premium in a first step. For example, covering only the mark-up part while the beneficiary pays most of the risk based part of the premium.
- However, an insurance product might not be affordable without addressing the risk based part of the premium. Existing examples show that innovative measures that are consistent with a disaster risk management framework can help to make the risk adequate premium affordable. One example are insurance-for-work programmes in which the insured pay part of the premium by their labor. They can work for risk reduction projects, which in return have positive effects on decreasing the needed risk premium.[2]

3 Indirectly reducing premiums through investing in risk reduction measures and an enabling environment has long-term co-benefits for building a comprehensive disaster risk management framework

Besides direct costs for premiums, there are measures that can indirectly reduce the premium level of an insurance product. Some of them target costs that are needed in the process of setting up an insurance system or framework conditions to accommodate insurance products for the poor and vulnerable. Some target the reduction of the risk itself by incentivizing and applying prevention measures. They include:

- Investments in infrastructure and technology (data, weather stations, risk modelling);
- Investments in awareness raising and information campaigns, educational programs and capacity building efforts to address financial and insurance illiteracy;
- Providing incentives for the insurance industry (e.g. tax waiver on index/microinsurance products);
- Fostering regulation and policy frameworks;
- Investing into, and providing incentives for risk reduction and loss prevention, resilience building and adaptation through e.g. legal frameworks, contingency plans to facilitate additional channels of assistance or provision of services;
- Investing in identification, targeting and payment systems to improve timely and targeted payouts.

The measures listed above do not only reduce premiums indirectly; they can also provide long-term co-benefits by contributing to the creation and strengthening of an enabling environment for insurance solutions as well as increasing the resilience of beneficiaries.

Discussants therefore advised to:

- Generally support the set-up and implementation of climate risk insurance schemes in developing countries with measures to reduce premiums indirectly and primarily apply direct premium support to make insurance solutions accessible for the poorest segment of the population (<3.1 USD/day).
- Gear investments into items that reduce premiums indirectly towards the development of risk management frameworks and actively work on linking the insurance products to those frameworks.
- Keep an eye on the costs and benefits of insurance solutions, fostering products that respond to the needs of poor and most vulnerable.

Endnotes

[1] For the academic discussion see: Mecheler, R./Linnerooth-Bayer, J. 2006: Disaster Insurance for the Poor? A review of microinsurance for natural disaster risks in developing countries. For an assessment of different types of premium support for insurance schemes for the poor and vulnerable see Schaefer, L./ Waters, E./ Warner, K./ Zissener, M./ Ramm, G./ Mani, T. (forthcoming): Climate risk insurance for the poor & vulnerable: How to effectively implement the pro-poor focus of InsuResilience. Munich Climate Insurance Initiative: Bonn.

[2] R4 is a good example where farmers have the option to pay for the insurance either per cash or using their labor through the "Insurance for Assets (IFA) scheme". The scheme engages them in risk reduction and resilience building activities for their communities.

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