FACT SHEET 6

Building Sovereign Financial Resilience in Middle-Income Countries

Disaster Risk Financing & Insurance Program

SUPPORTED BY WORLD BANK GROUP

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Component 3: Market Development for Disaster Risks

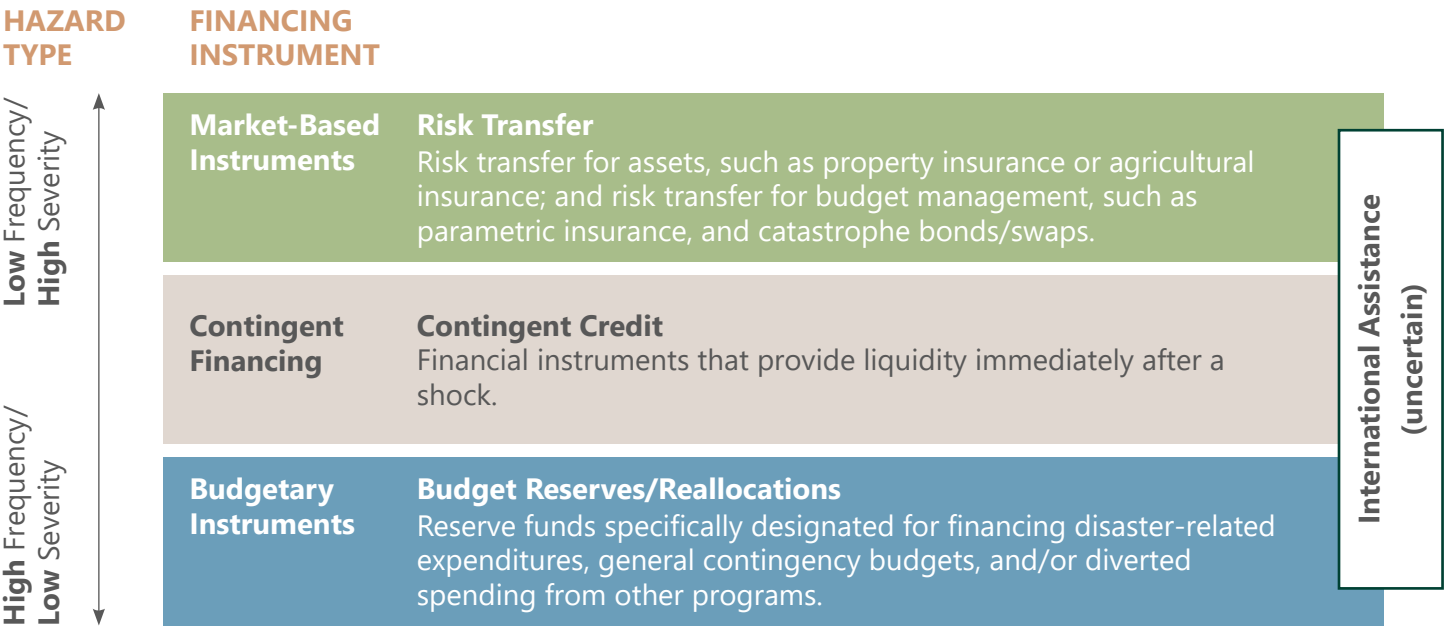
Topic 6: Catastrophe Risk Insurance Markets Development

OVERVIEW

This Fact Sheet introduces Component 3, which examines market development for managing disaster risks. As noted in earlier Fact Sheets, as countries seek to strengthen their financial protection against disaster and climate shocks, they can implement a suite of policies and use financial instruments to pre-arrange funding to deal with such shocks. These instruments are best structured using a risk-layering approach, which helps governments to match the instruments to release finance when needed in accordance with the frequency and severity of expected disaster events, as illustrated in Figure 1.

A variety of market-based instruments are available to help strengthen the financial preparedness of households and the private sector to disasters. This Fact Sheet deals with catastrophe risk insurance, focusing on property insurance; specifically, it reviews the rationale for such insurance and provides an overview of catastrophe insurance programs from various countries around the world. Sovereign catastrophe risk insurance is discussed in Fact Sheet 4 of this global knowledge exchange series[1].

FIGURE 1: LAYERED APPROACH TO RISK FINANCING



Source: The World Bank Disaster Risk Finance and Insurance Program

[1] https://www.financialprotectionforum.org/sites/default/files/SECO%20Factsheet%2004_Final_0.pdf

Part 1: Catastrophe Insurance: Background

This Fact Sheet focuses on catastrophe insurance for residential properties. Such insurance offers benefits to both governments and households. For example, it helps to reduce government liabilities to finance the costs of natural disasters, while also mitigating fiscal and economic shocks from natural disasters. This is especially critical given the rapidly increasing economic costs of natural disasters[2], the expected impacts of climate change, and the impact of the COVID-19 pandemic on governments' fiscal spaces and debt sustainability. It also allows for faster and fuller recovery after disasters, providing funding for people to recover and reconstruct after losing their properties, often in a more cost-effective manner than government aid programs. Catastrophe insurance programs can also encourage risk management at the policy holder level.

Despite these potential benefits, catastrophe insurance has low participation within many developing economies. Also, although several programs exist, their level of effectiveness varies. This is often due to the constraints and challenges referred to in Table 1 below, which vary according to each country's specific social, economic, political, and cultural characteristics.

[2] Swiss Re, Sigma 2/2019.

Image Credits: Jose Antonio Gallego Vázquez / Pexels

TABLE 1: SOME CONSTRAINTS/CHALLENGES IN THE DEVELOPMENT OF CATASTROPHE RISK INSURANCE

Area	Challenges
 **Government**	• Governments can drive expectations of post-disaster aid because of the political benefits of providing compensation. However, this undermines the development of the private catastrophe insurance market. • Political attitudes to insurance can change with new governments.
 **Regulatory and Supervisory**	• Supervisory requirements may limit the participation of insurers in catastrophe risk transfer (especially in case of previous market failures, thus driving a tightening of regulations). • Legal or supervisory frameworks may constrain the role of international insurers in domestic markets (impacting the availability of capital and the diversification of risk). • Low premiums may be driven by tariff constraints or competitive pressures due to unregulated competition. This in turn reduces premium income potential and limits the ability to attract reinsurance coverage, which will be priced on market terms. • The launch of new insurance may be delayed by the need for new legislation.
 **Capital Capacity**	• Domestic insurance markets may have a limited capacity to cover aggregated catastrophe risk and/or may be unable to cede excess risk to reinsurers at a cost-effective rate. Major disasters can then lead to market failures. • The cost of capital may be an issue when the financial standing (that is, the low credit rating) of domestic insurers limits the ability to raise capital. • Administration costs could be much higher, for instance, due to inefficient claims management systems.
 **Lack of Demand**	• Direct provision of government support (or expectation of this support). • Affordability of insurance. • Lack of an insurance culture and distrust of insurance (for example, driven by misperception about coverage or previous negative experience, such as a claims settlement). • Financial illiteracy, lack of knowledge of insurance concepts, and no personal experience (for example, no recent catastrophic event). • The level of property ownership and role of wider financial sectors in the provision of property financing, such as mortgages. • Lack of an established domestic/local insurance network. • Cultural and religious considerations.
 **Gaps in Understanding of Risks**	• The limited knowledge about catastrophe risks. • The lack of domestic expertise, for example, actuarial, underwriting, loss adjusting and supervisory expertise. • The lack of effective analytics to support pricing, underwriting, solvency and capital modeling, particularly for new insurance products.

Source: World Bank

Part 2: Enabling Successful Catastrophe Risk Insurance Outcomes

Issues to consider when designing catastrophe risk insurance for households

There are a variety of challenges in developing catastrophe risk insurance programs. Recognizing the large burden of disasters and their impacts on households and public budgets, governments are often engaged in designing and implementing such programs. There are many ways in which such programs are designed as they attempt to combine different and often conflicting consumer, insurer and government interests and perspectives (Table 2).

TABLE 2: VARIOUS PERSPECTIVES ON CATASTROPHE INSURANCE

Regarding insurance, consumers are looking for...	From the government's perspective, catastrophe insurance should...	From the insurer's perspective, such insurance program should...
 Highest possible pay-out after a disaster at the lowest possible product price.	 Be sustainable and have low credit risk because insolvent insurers will not pay any claims.	 Be able to avoid adverse selection, fraud and a high concentration of risk.
 Fastest possible claims assessment.	 Cover many households.	 Be able to secure mass participation in the program and continuous growth.
 Transparency of insurance pay-outs	 Not represent high financial responsibilities to the government (with most programs across the world having some sort of government support to offer affordable and high-quality products).	 Make a profit. Therefore an insurer should be able to charge actuarially sound insurance rates for the insurance policy that would cover administrative costs, the costs of capital and reinsurance, and at least allow for a small profit margin.

Source: World Bank

Part 3: Examples of Catastrophe Risk Insurance Programs

Over the past few decades, governments have increasingly implemented catastrophe insurance programs for residential properties. Many of these programs have been prompted by the occurrence of a disaster combined with a market failure to provide sufficient catastrophe risk insurance, such as the Northridge Earthquake's influence on the formation of the California Earthquake Authority; the Marmara Earthquake and the Turkish Catastrophe Insurance Pool; and the Taiwan Residential Earthquake Insurance Fund established following the Chi-Chi Earthquake. Some examples of such programs are detailed in Table 3.

TABLE 3: EXAMPLES OF CATASTROPHE INSURANCE PROGRAMS

Organisation	Acronym	Country/State
California Earthquake Authority	CEA	USA/California
Consorcio de Compensacion de Seguros (Insurance Compensation Consortium)	CCS	Spain
Earthquake Commission	EQC	New Zealand
Flood Re	Flood Re	United Kingdom
Florida Hurricane Catastrophe Fund	FHCF	United States of America (USA)/ Florida
Iceland Catastrophe Insurance	ICIF	Iceland
Inter-cantonal Reinsurance Union	IRV	Switzerland
Japanese Earthquake Insurance/Reinsurance	JEI or JER	Japan
National Flood Insurance Program	NFIP	USA
Norsk Naturskadepool	NNPP	Norway
Natural Disaster Insurance Scheme (includes Caisse Centrale de Réassurance (CCR), a government reinsurer)	NDS	France
Romanian Catastrophe Insurance System	PAID	Romania
Taiwan Residential Earthquake Insurance Fund	TREIF	Taiwan
Texas Windstorm Insurance Association	TWIA	USA/Texas
Turkey Compulsory Insurance Pool	TCIP	Turkey

Source: World Bank

Key differences between the programs (discussed in more detail below) include:

Structure of the Program including:

- Governance
- Financial relationship with the government
- Relationship with the insurance market

Operations management of the Program including:

- Premium collection and claims management
- Risk management and transfer

Product offering of the Program including:

- The requirement to insure and take-up of coverage
- Coverage limit, assets and perils covered
- Premium assessment

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Structure

Governance

Some differences between the various catastrophe insurance programs arise from their governance structure (these programs can be public, private, or a public-private partnership). Most programs are government managed or controlled, having some degree of financial independence and management. However, they are also being subject to considerable governmental oversight.

TABLE 4: GOVERNANCE EXAMPLES

Entity	Country/State	Form
CEA	California/USA	State managed, privately financed
CCS	Spain	Government-owned enterprise
EQC	New Zealand	Government agency
FHCF	Florida/USA	State-administered trust fund
Flood Re	United Kingdom	Industry-owned and managed reinsurer
ICIF	Iceland	Government-owned enterprise
IRV	Switzerland	Public corporation
JER	Japan	Private company
NFIP	USA	Government-administered plan
NNPP	Norway	Government-supervised industry body
NDS	France	Government program
PAID	Romania	Private company
TREIF	Taiwan	Government-owned enterprise
TWIA	Texas	State-supervised industry body
TCIP	Turkey	Government-owned enterprise

Source: World Bank

Image Credits: Jonathan Ford / Unsplash

Financial relationship with the government

The extent to which Program will rely on government funding varies. All programs have pre-disaster income streams through premiums, and many also have other mechanisms to replenish their post-disaster funds. For example, under its legislation, the United Kingdom's Flood Re can impose a second levy on insurance companies to cover a shortfall. In another case, after the 2010 Canterbury earthquake, the New Zealand Government trebled the EQC's flat premium rate. Indeed, it has since quadrupled it.

Some governments provide guarantees to catastrophe insurance programs. For example, the Japan Earthquake Insurance (JEI) is guaranteed up to ¥5.5 trillion (about US$ 60 billion). The Taiwanese Government guarantees bank loans negotiated by the Taiwan Residential Earthquake Insurance Fund (TREIF), but if total claims exceed a set amount, settlement will be proportional. New Zealand's Earthquake Commission (EQC) has unlimited government excess of loss guarantee, which can only be used after risk retention and reinsurance layers are exhausted.

Programs that do not have the benefit of a government guarantee to ensure their financial viability adopt other measures, such as issuing revenue bonds financed through post-disaster funding by insurance companies and policyholders (for example, in the US, the Florida Hurricane Catastrophe Fund [FHCF] and the Texas Windstorm Insurance Association [TWIA] programs) or by sharing claims costs among insurance companies (such as the case of Norway's Norwegian Natural Perils Pool [NNPP] program).

Image Credits: Jose Antonio Gallego Vazquez / Unsplash

Relationship with the insurance market

The reviewed programs use the insurance market in three primary ways: to provide coverage, administer the fund, and/or manage and settle claims (Table 5).

TABLE 5: RELATIONSHIPS WITH THE INSURANCE MARKETS

Entity	Insurance Coverage	Policy Administration	Claims Handling
CEA (California)	✔	✔	✔
CCS (Spain)	✔	✔	
EQC (New Zealand)	✔	No policy issued	✔
FHCF (Florida)	✔ (as reinsurance)		✔
Flood Re (UK)	✔ (as reinsurance)		✔
ICIF (Iceland)	✔	No policy issued	✔ (partial)
JER (Japan)	✔ (as reinsurance)		✔
NFIP (USA)	✔	✔ ("write your own" program)	✔
NNPP (Norway)	✔ (as a pool)	✔	✔
NDS (France)	✔	✔	✔
PAID (Romania)	✔	✔	✔
TREIF (Taiwan)	✔	✔	✔
TWIA (Texas)	✔		✔
TCIP (Turkey)	✔	✔	

Source: World Bank

Image Credits: oloruntoba john / Pexels

Operations

Premium collection and claims management

Premium collection arrangements follow the structure of each program. In most cases, the coverage is provided through insurance companies that collect premiums and then pass them on to the program. New Zealand's EQC operates a monthly bordereau[3] system, and pays a nominal commission of 2.5 percent to cover insurance company expenses; the Iceland Catastrophe Insurance (ICIF) operates similarly. The schemes that operate as reinsurers, such as Flood Re and the FHCF, receive their premiums directly from their insurance company clients.

As shown in Table 5, almost all programs have outsourced their claims management to insurers. The programs that operate as reinsurers settle claims based on the liability of their client companies for a single event, in accordance with the reinsurance arrangements.

France (NDS): Claims are triggered by the issuance of a Ministerial Decree that a qualifying disaster has occurred. Claims handling is done by the insurance company that issued the policy also handles the claims, including the payment of compensation. This is all processed in accordance with the terms and conditions of the private sector policy (apart from the deductibles, which are set nationally).

Iceland (ICIF): The ICIF may delegate claims handling to insurance companies or appoint its own assessors and engineers. After the 2006 Selfoss earthquake, the ICIF allowed insurance companies to settle claims for contents, but it used independent structural engineers for building claims. An online claims management system provided for centralized administration.

Japan (JER): Policyholders in Japan make claims under their earthquake damage endorsement through the insurance company holding their fire insurance. These companies are responsible for assessing and settling the claim, the full amount of which they can then recover from the JER. Insurance companies have developed a joint cooperation plan in the event of a large disaster. The plan is administered by the General Insurance Association of Japan, which supports it with exercises and training.

Norway (NNPP): Insurance companies that are pool members of the NNPP settle claims directly with their insured, and they are allowed to cover their expenses with an overhead charge. The insurance company has the discretion to decide the method of settlement, but the Claims Committee of the pool directs uniform practice. In this regard, it may take over a claim from an insurance company.

New Zealand (EQC): The EQC expends considerable resources, including financial resources, on its catastrophe response planning. Following the Canterbury earthquakes of 2010-2012, the EQC finalized an agreement with insurance companies under which the companies manage the EQC claims in return for a fee. This system was in force during the 2016 Kaikoura earthquake.

Spain (CCS): The CCS utilizes its own staff for the holding of claims, as it has regional offices throughout the country. The CCS appoints its own loss adjusters and settles directly with its claimants. After some large storm events this century, the CCS agreed to a protocol with the insurance industry under which companies manage certain types of claims and obtain reimbursements from the CCS.

[3] Bordereau systems refers to reports by insurance companies providing, in this case, premium data

Risk management and transfer

Catastrophe risk models are used by some programs as an aid to risk rating. New Zealand's EQC and Taiwan's TREIF have developed their own models to assist with planning, claims management and reinsurance placement. The JEI (Japan), the NFIP (USA) and the NDS (France) and others make use of hazard maps. In Turkey, commercially available models were used to produce a seismic hazard map from which five separate zones of risk were identified. These were then combined with three categories of construction to produce a rating structure. Mapping is also utilized in Japan and the USA to differentiate risk regions that may warrant separate premium rates.

The programs all adopt tailored approaches for transferring risk, often using a combination of reinsurers, capital markets (through catastrophe bonds) and/or retaining risk themselves. In Spain, the CCS retains all its risks, reasoning that its guarantee from the Spanish government transfers the responsibility for managing risk to the government. In addition, the CCS itself has greater financial strength than the reinsurance companies available for its protection. The CCS has never had to call on its guarantee. The EQC also is supported by a government guarantee. However, over many decades, the EQC has placed one of the largest catastrophe reinsurance programs onto the international market and included reinsurers down to a financial strength rating of A- (the EQC has a AAA rating). The EQC called on its guarantee for the first time following the Canterbury earthquakes of 2010-2012.

The ICIF of Iceland purchases a reinsurance program that covers only its earthquake exposure. The other perils are deemed manageable within its own financial resources, including the post-event provisions for borrowing and levying. The Norwegian, Romanian, and Turkish schemes have catastrophe excess of loss programs on the global reinsurance market.

In the absence of any government guarantee, the California Earthquake Authority (CEA) engages in extensive risk transfer, utilizing both the traditional catastrophe reinsurance market and the capital markets in the form of catastrophe bonds issued on its behalf.

The Florida reinsurer, FHCF, does not transfer any of its retained risk. However, the Swiss Inter-cantonal Reinsurance Union (IRV) and the French CCR do engage in retrocessions/ risk transfers to the global market. The Japanese system for insuring residential property is insular, with the government playing a major role in the transfer of risk from the JER to special reserves.

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Product

Requirements to insure and buy coverage

The degrees of insurance purchase compulsion vary between the programs. Some insurance programs are voluntary; some are compulsory additions if a customer purchases a standard insurance policy; and some insurance programs are compulsory for all asset owners. For example, various compulsory programs include the compulsion to insure with the program (Iceland); the compulsion to purchase disaster insurance if taking on other forms of insurance (New Zealand); the compulsion to offer coverage with an option whether to accept (California); and the compulsion associated with private lending markets (for example, the insurance requirement associated with mortgage finance). Table 6 provides an overview of the programs based on their mandatory or voluntary nature of insurance purchase.

TABLE 6: MANDATORY VERSUS VOLUNTARY PURCHASES OF INSURANCE

Entity	Country/State	Voluntary	Compulsory Addition	Compulsory Purchase
CEA	California	✔		
CCS	Spain		✔	
EQC	New Zealand		✔	
FHCF	Florida			✔
Flood Re	United Kingdom			✔
ICIF	Iceland			✔
IRV	Switzerland			✔
JEI	Japan	✔		
NFIP	USA	✔		
NNPP	Norway		✔	
NDS	France		✔	✔
PAID	Romania			✔
TREIF	Taiwan		✔	
TWIA	Texas	✔		
TCIP	Turkey			✔

Source: World Bank

However, even where Programs and insurance coverage is mandated, this does not always lead to higher market penetration. Thus, some countries have taken further steps to encourage increased insurance participation. For example, the Insurance Pool against Natural Disasters of Romania (PAID) engaged in a public education campaign. The Turkey Compulsory Insurance Pool (TCIP) also has a formal responsibility to educate homeowners about the prudence of insuring. For its part, the CEA of California also expends considerable resources in taking mitigation measures, which includes sufficient insurance coverage.

Another way of encouraging insurance through facilitating affordable premiums is the provision of reinsurance facilities that utilize a government's advantages over the private sector, including the lower (or absent) distribution costs, such as agency commissions, tax relief, and the lack of a profit motive or need to service capital. This could be, for example, organized as an obligation to reinsure with the government entity, which guarantees the maximum spread of businesses. This can be seen in Florida, where insurance companies are obliged to reinsure with the FHCF at a significantly lower cost than private sector reinsurance. The United Kingdom's Flood Re is also designed to influence insurance pricing and availability through reinsurance.

At the same time as governments are faced with the need to achieve increased market penetration, governments must decide how to deal with providing post-disaster financial and other support to uninsured households. This issue is especially important for nascent schemes with low insurance penetration. Societal or political pressures may arise to assist the uninsured, discouraging the purchase of insurance. The extent of the disaster and the existence of alternative forms of financial compensation, such as charities or international aid, will also influence outcomes for penetration.

Image Credits: Nugroho Nurdikiawan Sunjoyo / World Bank

Coverage assets, perils and limits

All programs reviewed in this Fact Sheet provide insurance for physical damage to residential property. Most of the programs cover such perils as earthquakes, storms/hurricanes or floods, with some covering variations or all three. France's NDS program focuses on the consequences of any natural disaster rather than the type of catastrophe. The UK's Flood Re provides reinsurance coverage to flood insurance (see Annex 1 for policies covered).

Some schemes provide cover on a first-loss basis, under which there is a maximum insured amount that is not designed necessarily to achieve full financial compensation; rather, it will provide a first layer of coverage. Such schemes include New Zealand's EQC, Romania's PAID, Taiwan's TREIF and Texas' TWIA.

In Norway, coverage is up to full replacement value or a nominated sum, including a provision for an average if this sum is insufficient. The Icelandic scheme is based on indemnity values that are also subject to averages. In insurance parlance, "average" applies to a form of co-insurance. Turkey's TCIP sets a value per square metre according to construction type and a building cost index.

Premium assessment

Most programs that insure different classes of property (for example, residential and commercial) apply different premium rates to these classes. Risk ratings (that is, premium settings) for the perils insured — as opposed to flat rates irrespective of rating factors such as location and construction ("solidarity") — are determined by the factors indicated in Table 7.

TABLE 7: MAIN RISK-RATING CRITERIA

Rating criterion	CEA	FHCF	Flood Re	NFIP	JEI	PAID	TCIP	TWIA
Location	✔	✔	✔	✔	✔		✔	✔
Construction/design	✔	✔		✔	✔	✔	✔	✔
Age of structure	✔			✔				
No. of stories	✔							
Foundation type	✔							
Occupancy		✔						✔
Seismic resistance					✔			
Options selected	✔	✔						✔

Source: World Bank

Part 4: Lessons Learned

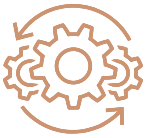
Whereas every country's political, economic, and social environment will differ, some common challenges faced by most, if not all, countries in designing risk insurance programs include the following:

Careful consideration needs to be given to balancing premium affordability, insurance payouts and program sustainability. In various programs, "solidarity" or the "risk-based' principle is applied when developing insurance rates and payouts. However, it is not clear-cut, and hybrid structures are possible (for example, by using risk-rating for commercial properties and solidarity for residential properties, or by differentiating risk more broadly by utilizing a risk rating table with a few criteria). Premium and payout structures need to be balanced with the sustainability of the program, recognizing that the premium costs increase with the size of risk taken. A program's success lies in closing the penetration gap, but it largely depends on the public perception of how fair its premium structure is.

Closing the insurance market penetration gap is not a straightforward process. Some type of compulsion is often introduced to ensure a high participation rate in the insurance program. However, even for programs that contain a degree of compulsion, this does not necessarily lead directly to high insurance penetration. The success of different programs depends on the effectiveness of compliance policing. There is also a need to communicate the benefits of insurance. Another way of encouraging insurance through facilitating affordable premiums is the provision of reinsurance facilities that utilize government's advantages over the private sector.

Governments should plan on how to deal with uninsured households. This is especially important for nascent schemes with low insurance penetration. The provision of government aid to uninsured households will likely discourage households from purchasing insurance.

Long-term financial sustainability needs to be considered. Many programs faced challenges building up and managing their finances. It is important to define in advance what liabilities can be sustained based on adequate risk and analytics. It is also important to explicitly define government's role in covering these liabilities.



Post-disaster operations require planning. Centralizing the disaster insurance protection of most of the properties in a country or state presents the challenge of dealing with a high number of simultaneous claims following an insured catastrophe. Many programs have been amended in some way following operational experiences and dealing with disasters. The tendency is to design a program to cope with what has happened in case the same thing reoccurs. In this context, programs have often been changed with the occurrence of new events that were not foreseen by the original legislation. Planning in advance for managing large number of claims will make catastrophe insurance programs more sustainable.

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Image Credits: jim gade / Unsplash

Annex 1: Perils Included in National/State Catastrophe Risk Insurance Programs

Entity	Country/ State	Earthquake	Earthquake Fire	Volcanic	Tsunami	Landslide	Storm/ Hurricane	Flood	Terrorism	Other
CEA	California	✔								
CCS	Spain	✔	✔	✔	✔	✔	✔	✔	✔	Meteorite, terrorism
EQC	New Zealand	✔	✔	✔	✔	✔	Land only	Land only		Fire also following all of the other listed perils
FHCF	Florida						Declared hurricane			
Flood Re	UK							✔		
FONDEN	Mexico	✔	✔	✔	✔	✔	✔	✔		Any natural disaster
ICIF	Iceland	✔	✔	✔		✔		✔		Snow avalanche
IRV	Switzerland	✔	✔			✔	✔	✔		Avalanche
JEI	Japan	✔	✔	✔	✔	✔				
NFIP	USA				✔			✔		
NNPP	Norway	✔	✔	✔		✔	✔	✔		
NDS	France									
PAID	Romania	✔				✔		✔		
TREIF	Taiwan	✔	✔		✔	Caused by earthquake		Caused by earthquake		Land deformation etc.
TWIA	Texas						✔			
TCIP	Turkey	✔	✔							

Source: World Bank

FACT SHEET 6: CATASTROPHE RISK INSURANCE MARKETS DEVELOPMENT

Test your understanding and record your insights through this easy Work Sheet!

Activity 1: Identify which statements about catastrophe (CAT) bonds are true or false.

#	Statements	True	False
1.	Catastrophe insurance helps to reduce government liabilities. It assists in mitigating fiscal and economic shocks from natural disasters.	○	○
2.	Catastrophe insurance helps to provide funding for recovery and reconstruction, and it is often more cost-effective than government aid programs.	○	○
3.	Catastrophe insurance has a very high penetration within many developing countries due to its potential benefits.	○	○
4.	Catastrophe insurance programs can also encourage risk management at the policy holder level.	○	○
5.	Catastrophe insurance is a budgetary instrument.	○	○

Activity 2: Can you identify some of the challenges in the following areas that you may face in implementing sovereign catastrophe insurance in your country?

#	Area
1.	Government
2.	Regulatory and supervisory
3.	Capital capacity
4.	Lack of demand
5.	Gaps in understanding

Activity 3: Reflections

[1] My Top 2 Takeaways from this Fact Sheet are:

[2] Two concepts/ideas I would like more information on are: