Insuring the uninsurable: design options for a climate change funding mechanism

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The Two Big Challenges of a Future Climate Regime

Avoiding the Unmanageable

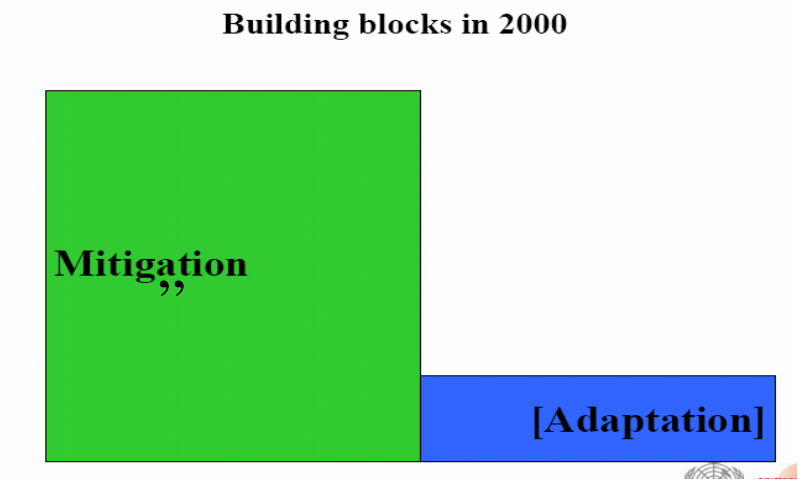
Avoiding dangerous climate change (Art. 2, UNFCCC)

Managing the Unavoidable

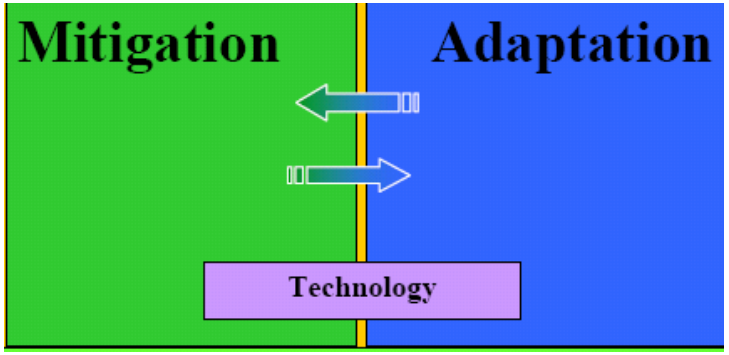
Adaptation Strategy

Adaptation: Managing the Unavoidable

- ***New order of magnitude***
- ***Binding***
- ***Self-financing climate regime („polluter pays“)***
- ***Combination with poverty reduction strategies***
- ***Create appropriate incentive structures***
- ***The role of governments, local entities, private actors and community based adaptation***
- ***Support for risk sharing instruments (common but differentiated responsibility)***

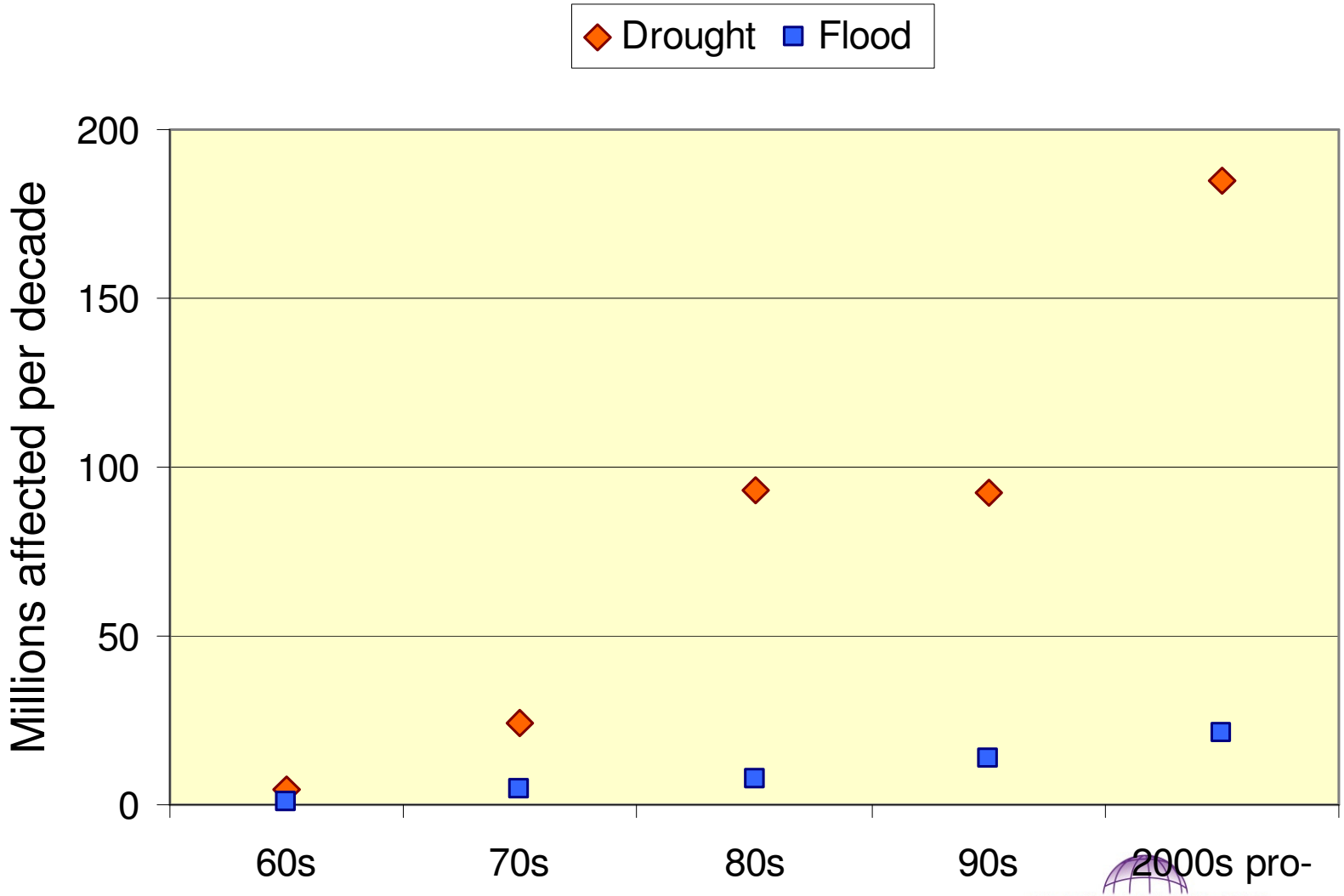


Building Blocks 2007



Source: UNFCCC

Increasing number of people affected by natural disasters in Africa



Noble, Worldbank, 2006

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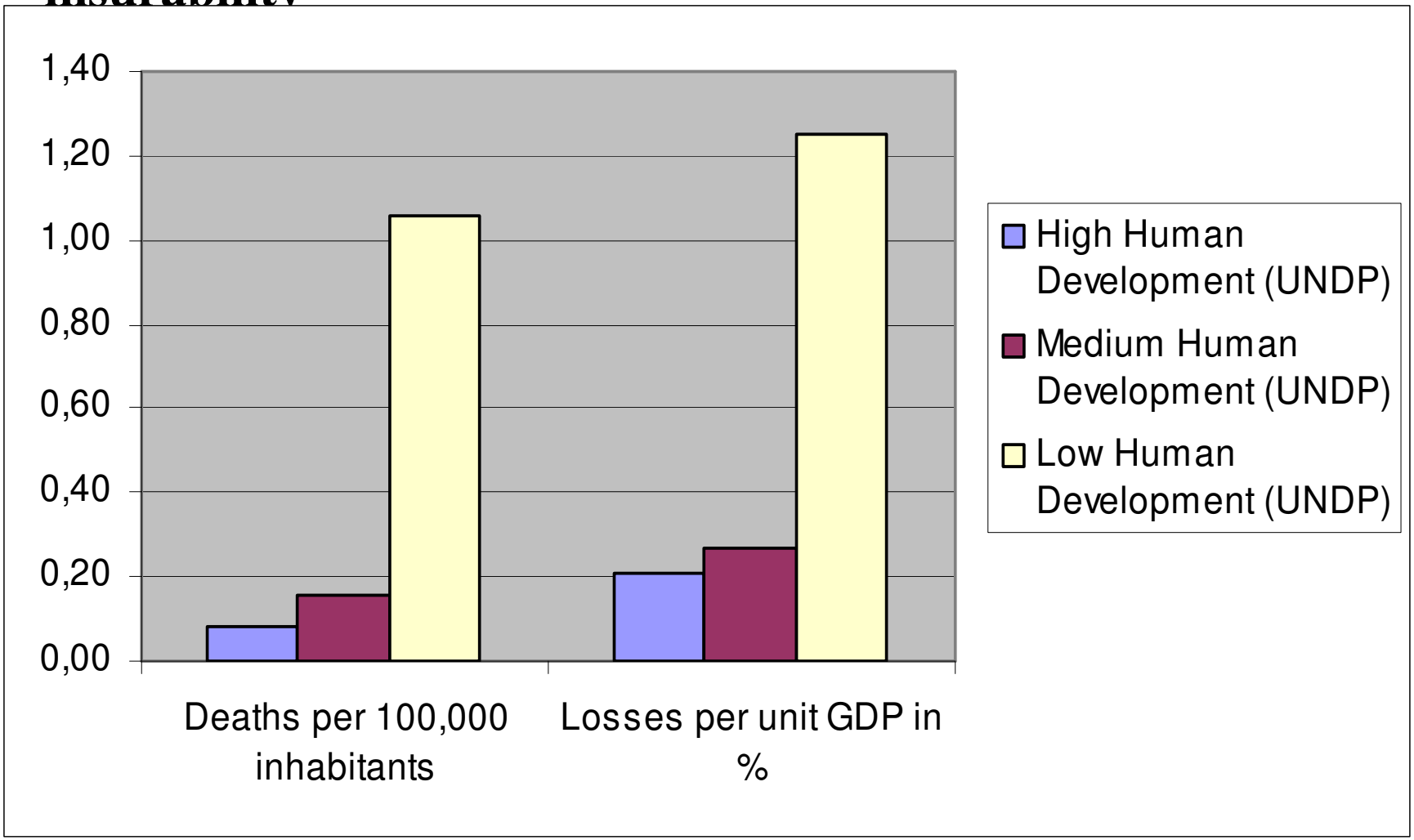
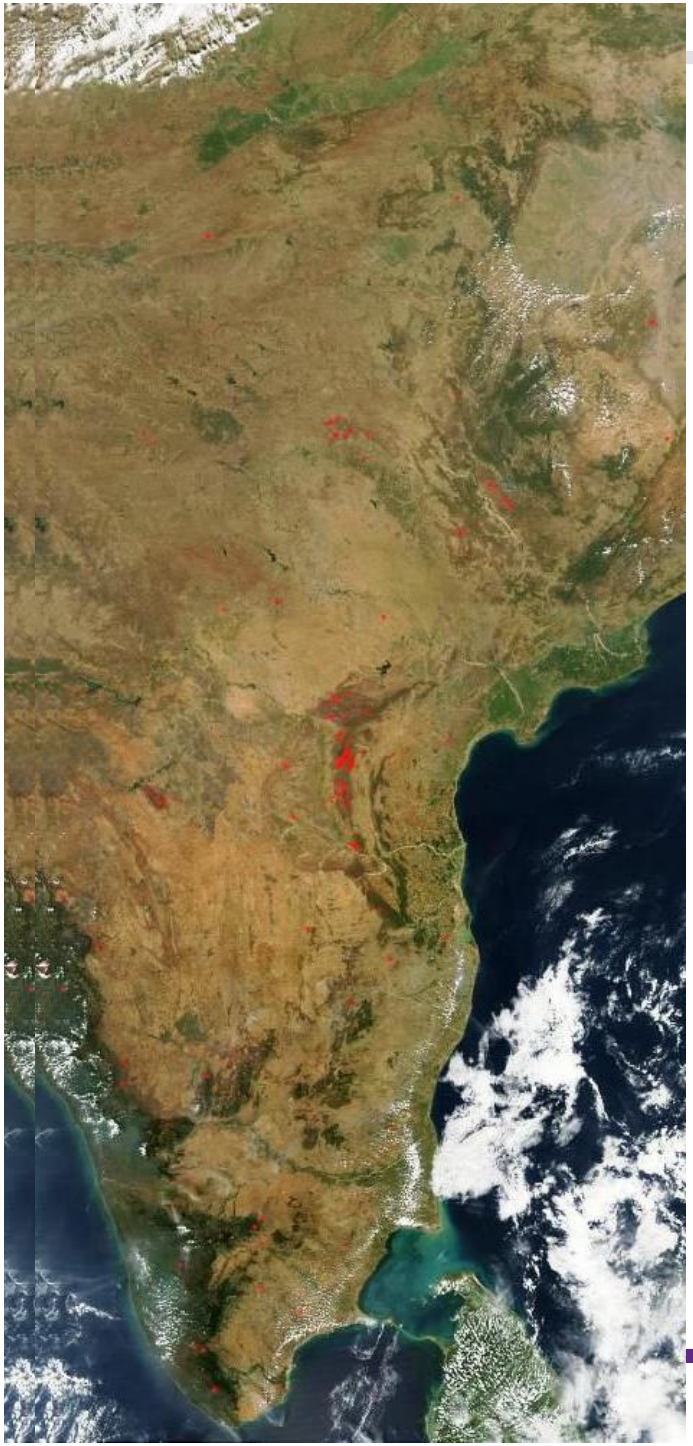
Low human development means high vulnerability and low insurability





- **E.g.: India:**
  - Small farmers most vulnerable
    - Driven by immediate needs (safety first)
    - Least able to afford proactive adaptation measures that mitigate risk (diversification)

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Noble. Worldbank. 2006

Could micro and index based farmer insurance be part of the solution for most vulnerable small farmers?

Opportunities

- **For donors**:
  - Calculable annual commitment to a risk-transfer system for the unpredictable granting of post-disaster aid.
- **For farmers:**
  - Amount of help not dependent on number of TV-cameras
  - Rapid post-disaster or even pre-disaster support
  - Insurance contract can be a more dignified and secure means of coping with disasters than dependency on the *ad hoc* generosity of donors.

Challenges

- **Affordability:** Most of the people would not have the money to pay for risk adequate insurance premium. Given the costs of insurance instruments, it is not surprising that their uptake in developing countries of Africa, Asia and Latin America is far less than in North America, Europe, Japan and Australia. But quick development of micro insurance.
- **Lack of insurance** tradition and understanding of the mechanism: ´need of capacity building esp. in LDCs
- **Risk of moral hazard:** In spite of potential positive role of deductibles - often not well designed or difficult to control. Political difficulties to introduce conditionality.
- **Changing risk trends**: Are they taken into account?

Transform the risk of moral hazard into the opportunity of incentive structure

- Public Support should not destroy crucial role of insurance: discover the price of risk (of weather extremes). No co-financing of the risk part of the premium. Focus on high level risk.
- Well-designed insurance products impose a ”price” on their clients, which creates incentives to engage in loss-reduction activities, or adaptation.
- But: It might create political problems, if insurance coverage is conditional on adaptation activities.

Weather indexed insurance

- Provides a basic form of risk spreading widely available to farmers in the developed world
- Low overheads; rapid payment
- Low moral hazard

- Need of an appropriate index
  - Simplistic rainfall triggers often leave farmers dissatisfied
- Need of local data
  - Accurate & secure
  - changing trends???

Mongolia
Managing Dzuds (severe winter weather)

- Index based on mortality of adult animals by species
- Three layers of risk management
  - Small losses that do not affect the viability of their business are retained by the herders
  - Larger losses are transferred to the private insurance industry (Indexed on mortality of adult livestock)
  - **Catastrophic risks backed by contributions from all insurers; guarantee at least in early years by Goverment and Donors (World Bank)**

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Sources: Noble, Worldbank; Joanne Linnerooth-Bayer

Other Examples

- The World Food Programme has issued a novel parametric weather derivative to assure sufficient funds to the *Ethiopian government* to protect the livelihoods of Ethiopia's vulnerable populations who are at risk to severe and catastrophic drought.
- The *Caribbean island states,* with support from the World Bank, have recently formed the world's first ever multi-country catastrophe insurance pool to provide governments with immediate liquidity in the aftermath of hurricanes or earthquakes.

Potential Role of UNFCCC

- UNFCCC-Parties could address opportunities and challenges with a global strategy for making affordable and sustainable climate related insurance instruments available to farmers, (small businesses, households and governments) of highly exposed developing countries.
- Starting point: Common but differentiated responsibilities and respective capabilities
- Risk sharing not only between affected people but also between annex I and non-annex-I countries;
- This strategy would be developed and implemented collaboratively with governments, the private insurance industry, international development institutions, NGOs and other partners. MCII has pledged support.

Practical Proposal: Regional Facilities

- One practical proposal: creation of global or regional climate insurance and adaptation facilities specialized in enabling public/private insurance initiatives.
- These facilities would *not* directly provide insurance to households, farmers or governments.
- Rather, as multi-donor operations, they would offer capacity building and financial support to nascent micro- or index based farmer insurance programs.

Potential Role of Donors (from Annex I)

- Providing existing meteorological and risk related information (Re-insurance, WMO ...)
- providing technical assistance (e.g., regional risk assessments or weather stations)
- pooling small insurance programs that have uncorrelated or negatively correlated risks, brokering reinsurance deals
- absorbing upper layers of risk (high risk) or even providing premium subsidies - based on level of adaptation activitities.