Overcoming barriers to close the protection gap
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Chapter 1: Introduction

Disaster Reduction and Recovery

The devastation that comes from the immediate impact of a major natural disaster will usually draw the attention of the world’s media. Images of buildings flattened by hurricanes, infrastructure wiped out by earthquakes or communities displaced by drought often receive global media coverage. Turning the eyes of the world to the consequences of natural disasters can lead to positive and generous responses as governments, non-governmental organisations (NGOs) and the private sector rally to help those affected.

What receives much less coverage, however, is the weaknesses in disaster resilience which left the buildings, infrastructure, economic resources and the communities that depend on them so vulnerable in the first place.

Why does one community have infrastructure that can withstand a disaster while their neighbours do not? Why does a drought in one country lead to huge displacement of a population while communities within its similarly drought-hit neighbours are able to weather the crisis? A nation’s wealth, quality of governance and the levels of international support it receives might seem to be the obvious answers to this question, however in reality there are a much broader set of factors that determine a community’s capacity to prepare for and recover from disaster.

The global community has recognised the importance of increasing disaster resilience in emerging economies. The UN’s Sustainable Development Goals set a 2030 target to:

- Build the resilience of the poor and those in vulnerable situations and reduce their exposure and vulnerability to climate-related extreme events and other economic, social and environmental shocks and disasters. (UN Sustainable Development Goal 1.5)

This goal becomes even more challenging as climate change results in increases in the frequency and intensity of weather-related natural disasters. The reality is that emerging economies are, in general, still far more vulnerable to the impacts of natural disasters, and are in a weaker position to recover from the aftermath than richer nations.

The Protection Gap

The risks of natural disaster are not new and, of course, they are not limited to vulnerable communities and emerging markets. However, most developed economies have greater levels of resilience and are often able to recover quickly following a destructive weather event.

A central part of this disparity in resilience and recovery between the world’s wealthier nations and its emerging markets is the protection gap. Simply put, the protection gap is the difference between insured and economic loss. In the context of disaster risk financing and resilience, the protection gap is broken down into 3 categories: the underdeveloped markets, the underinsured and certain or chronic risks that are exacerbated by climate change and or geopolitical volatility.

The circumstances that lead to this protection gap are a varied combination of political, economic and technical factors. A lack of reliable risk analysis, unrealistically high levels of risk transfer and financing costs for the target market, and a lack of experience working with the insurance industry within some governments have all played a part. The consequences of this disparity in insurance penetration are so significant, however, that these causes of the protection gap must be understood and overcome. It is important to note that whilst much of the conversation around disaster risk financing is focused on assets and physical impacts the humanitarian consequences need to be considered as part of any solution or instrument.
The real-world impact of this protection gap is clear. In 2017 more than 70 percent of losses incurred from weather-related disasters were uninsured. This uninsured loss has significant consequences. The immediate shortage of resources can result in an increased death toll from disasters. In the long term, the burden of the uninsured costs of a disaster delays economic and social recovery, thereby reducing the capacity to build resilience to meet future disasters.

The burden of the uninsured costs of a disaster tends to fall on the people and governments least able to afford them. According to Aon’s Weather, Climate & Catastrophe Insight: 2019 Annual Report, some 409 natural catastrophes in 2019 caused economic losses of USD 232 billion but only 31 percent of these were insured, leaving a protection gap of 69 percent.

Of those countries assessed by Lloyd’s, the four with the highest levels of underinsurance relative to the size of their respective economies – Bangladesh, Indonesia, the Philippines and Nigeria – are all emerging economies that are highly vulnerable to natural disasters, exacerbated by the impacts of climate change.

The role of insurance

The insurance and finance sectors have a major role to play alongside the development sector in delivering immediate disaster relief and building long-term resilience.

Closing the protection gap means more than simply transferring risk from government balance sheets to global financial markets. There is real value in the budgeting certainty that arises when a government replaces unknown and potentially huge disaster recovery liability which cannot be budgeted for, with predictable insurance payments which can. However, more important than the balance sheet impact, effective disaster insurance also provides opportunities to increase the speed and effectiveness of disaster relief and improve risk management and mitigation.

Insurance products designed to rapidly inject capital into a community following a disaster can save lives and protect fragile economies. For example, the pay-out on Mauritania’s drought insurance policy in January 2015 enabled the Mauritanian government to distribute food stocks through a critical phase of the drought. This not only saved lives, but also forestalled forced migration and distressed asset sales, thereby reducing the long-term economic damage of the disaster.

The insurance sector’s depth of experience in risk management and mitigation can be employed by governments to develop a comprehensive risk strategy including investment in risk prevention, transfer of residual risk to the markets, and disaster response. Insurance is not just about transactions; the insurance industry can bring technical assistance in risk analysis and understanding, as well as contractual, regulatory and operational advice.

At the macro level, governments are increasingly working together with insurers to deploy parametric instruments that pay out during and immediately after an event occurs, before any damage assessment takes place. However, help is also available at the meso level (for example, protection of critical public assets) and the micro level, where small-scale inclusive insurance schemes can protect farms, SMEs and citizens.

However, more cooperation and innovation is needed to address the problem at scale – both in the understanding of risk mitigation and the design of instruments tailored to address the specific challenges faced by each country.
Barriers to success

The importance of insurance and the private sector in building resilience and recovering from disasters was recognised in the Sendai Framework for Disaster Risk Reduction 2015 -2030, which set an aim to:

Promote mechanisms for disaster risk transfer and insurance, risk-sharing and retention and financial protection, as appropriate, for both public and private investment in order to reduce the financial impact of disaster on Governments and societies.

Significant behavioural, political, economic and technical barriers prevent rapid progress. A number are highlighted in this paper. A key barrier is inaccessibility, or unfamiliarity – the private sector is not a homogeneous entity but a confusing array of highly competing organisations with a wide range of capabilities and roles. The creation of the Insurance Development Forum (IDF), with support from the United Nations and all sectors, provides a necessary portal to this powerful set of resources.

Another barrier to collaboration is economic – the cost of insurance can simply seem too high for many governments to consider it worthwhile. Affordable access to international capital and market development can be much improved, however, through a more rigorous understanding and pricing of risk. This risk conversation between nations and markets should be on an equal footing and based on an accessible and transparent understanding of risk. Coupled with this is the need for better understanding of what is the most appropriate risk transfer or risk management mechanism in individual circumstances. It is important to acknowledge that often it is a blended approach that can yield the most effective results.

These and other barriers can only be overcome through collaboration and the building of shared experience. Success lies in combining the efforts of governments in developed and developing countries, multi-lateral agencies, non-profit organisations with a wealth of on-the-ground-experience and the financial sector with its capabilities in pricing, distributing, and managing risk.
Chapter 2: Insurance vs. Guarantees in mobilising sustainable developmental finance

Often, private sector hesitance to invest in developing countries is based on significant risk factors. Insurance and guarantees can contribute to the balancing of the risk to return, enabling projects with sustainable development benefits to go ahead. They are very different products but can effectively also work alongside each other.

Insurance can be used as a risk management tool to provide relatively quick infusions of capital to developing countries following natural disasters similar on the surface to guarantees however with important and significant differences. In this section we will also explore how insurance and guarantees can be used to assist countries in achieving their sustainable development goals.

Simply put, guarantees are often financial in nature and result in payment by a guarantor in the event of non-payment by a guaranteed entity to a third party. That is if Party A does not meet its obligations to Party B those obligations can be covered and paid for by Party C or an insurer, bank or any other entity serving as a guarantor. Insurance policies can serve the exact same function, but often include additional conditions that must be met before payment takes place. These conditions can often take the form of particular perils, situations, types of damage and contingent damages and losses. Insurance policies are also more flexible in the variations of causes that can trigger payment to the insured. They can range from natural catastrophe events and fire, to more complicated events such as political violence and expropriation. They can and often are tailored to the needs of an insured rather than the standardised structure for a guarantee and are not necessarily related to an obligation to fulfil a service or payment. However it is important to acknowledge that due to the conditions imposed in insurance contracts, they can be more cost effective than an guarantee.

Guarantees and insurance can also play roles individually or alongside each other as effective policy tools available to governments in risk management and resilience development. The private sector can be equally effective in facilitating their use. Enabled by these products, private finance can flow to sectors and regions that would not otherwise receive it.

The development community has a broad mission, and guarantees and insurance can be applied to a myriad of situations—from serving as collateral for small businesses so that they qualify for commercial credit to backstopping large-scale infrastructure projects. Risk-mitigating products can be further tailored to take only specific risks in an otherwise bankable infrastructure project (such as construction period risk or the risk of breach on the concession needed for the project or the non-payment by a sovereign guarantor of the project). Such uses have particular developmental or social impact as they facilitate the mobilisation of a large amount of financing by taking only a specific portion of the total risk involved.

This is a key area where insurance and guarantees can work alongside each other. Insurance can help leverage the financial contribution made by investors to enable better efficacy out of each invested dollar. This in turn protects the return of the guarantees targeted
investment. According to OECD data, out of the 156.7 Billion USD mobilized from the private sector in 2012-2017, 40 percent was mobilized through guarantees and insurance schemes. Out of the total, 62 percent of the amount mobilized targeted economic infrastructure and services, particularly energy generation, distribution and efficiency, banking and financial services. Data for guarantees will commonly be cited, as data regarding guarantees is more readily available, even though insurance can be used in many of the same cases.

In 2017, guarantees played the most significant role in attracting private finance to Banking and Financial Services with USD 5.9 Billion mobilized and the Energy sector with USD 4.5 billion. In terms of regional dispersion, the Americas were the most successful in mobilizing the private sector through guarantees with 37 percent - of the total. Argentina was in fact the top recipient with USD 3.9 billion. Asia was the next most significant region with 23 percent. Despite many of the largest gaps in the Sustainable Development Goals being in Africa, the region only mobilized USD 2.8 Billion or 20 percent of the total in 2017. In fact, lower middle-income countries only managed to mobilize USD 2.8 billion through guarantees. The most effective in mobilizing guarantees was upper middle-income countries, which mobilized USD 8.1 billion. Though guarantees have been successful in mobilizing private finance the statistics suggest that this success varies widely between different countries and sectors of the economy. Guarantees managed to mobilize only USD 737 million in the least developed countries in 2017 out of a total amount of USD 14.2 billion or 5%. It suggests the question can insurance serve a purpose in protecting the guarantor so that more funds can be mobilised for countries that are in greater need.

The most significant provider of guarantees is the US with USD 4.4 billion followed by France with USD 324 million. The largest multilateral provider was MIGA with USD 3.3 billion followed by the World Bank (IBRD/IDA) with USD 2.9 billion. The products provided by these institutions were mainly in the form of guarantees, but some, such as MIGA’s sovereign non-honouring cover, are in the form of comprehensive risk insurance cover.

The significant role of guarantees in mobilizing the private sector despite the small amounts of development finance allocated, underlines the demand for insurance like products and services. According to a Milken and OECD reports the private sector buyers of cover for development instinctively prefer guarantees over insurance products based on concerns relating to proving causation between the insured risk and the payment default with insurance. This issue can be resolved by insurance products that cover both commercial and political risk (comprehensive insurance) or products which have failure to pay as the insured risk (e.g. sovereign non-honouring covering for payment obligations) can address causation concerns and work just as effectively as a guarantee.

The OECD data on mobilization does not make a distinction between Guarantees and Insurance, resulting in definitional issues with guarantees often being essentially insurance-like products. If greater recognition were given to insurance there is increased likelihood that donors would increasingly work with insurance products and the private sector in order to mobilize further private finance towards the UN Sustainable Development Goals. More, needs to be done to engage and explore the role that insurance products and services and play in addressing the SDGs.

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1 The International Finance Corporation (IFC) provided data at an aggregate level (with no sectoral and geographic distributions) due to confidentiality constraints. The IFC mobilisation figures which account for 15% of the 2017 mobilisation total could therefore not be included in the geographic and sectoral analyses in this chapter.

Chapter 3: Risk Management

This report makes the case for a joint response to the global protection gap, particularly where the need is as acute and urgent as in the V20/Climate Vulnerable Forum group of states.

To address the protection gap at scale the global community must first tackle the risk management gap. This requires a disciplined, coherent approach to the whole risk challenge at sovereign and sub-sovereign levels, and across government departments, development agencies and the private sector. With some notable exceptions this is not common practice as, due to political and other pressures, a government may first concentrate on reaction to crises in the near term, hazard by hazard. However, only a risk management plan that emphasises resilience over reaction can accelerate progress towards protection and growth at scale. Such a plan must include cross-sector investment in risk prevention and create the conditions for development of insurance and risk finance markets. The most effective way to do this is to utilise the expertise of both the private sector as well as the public and civil/humanitarian sectors.

Risk management should therefore encompass all responses to risk:

- **Risk prevention and adaptation**: At the policy level, prevention and adaptation priorities should be informed by an understanding of the relative effectiveness of different measures (for example investment in resilient infrastructure, building codes, zoning, control of informal settlements) and adaptation measures such as built and natural coastal defences (grey and green/blue infrastructure). These measures either directly involve investment or create positive conditions for investment, but also protect economic and social development gains and create jobs.

- **Residual risk transfer**: As discussed in previous chapters there are many options for the risk owner to transfer any risk to international markets, thereby reducing potential impacts to the fiscal balance sheet. It is notable that the humanitarian sector is now joining other sectors in this area by introducing ‘anticipatory finance’ instruments, and that the term ‘Climate Risk Insurance’ is now in common usage across all sectors. Insurance has a major part to play in a wide range of risk finance solutions, which also include financial securities, risk pools and the building of emergency reserves. The sector can bring many capabilities to bear in this area including risk analytics, legal and regulatory advice, risk engineering and operational systems such as claims management.

- **Event response**: The risk management plan must include emergency measures to maximise resilience, if and when a catastrophe occurs. This may include disaster liquidity measures such as contingent credit.

Each type of response brings an opportunity for collaboration. The multi-lateral development banks have worked in these areas for many years and have an in-depth understanding of how and what makes a difference in building resilience. The private sector is also increasing its involvement by bringing comprehensive risk management expertise and access to capital markets.

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3 Mexico’s Natural Disaster Fund (FONDEN) is noted for an increasingly sophisticated risk layering approach, including risk retention and risk transfer in a single structure. The risk prevention budget is still smaller than the disaster response budget, but the intention is firmly there to move from ex-post thinking to ex-ante.

4 See for example Red Cross Anticipatory Finance, or the ARC Replica Senegal payout.
Over the last 30 years the re/insurance sector has remained competitive and effective through continuous improvement of its risk assessment and management; that operational experience brings an acute awareness of the value or pricing of risk. This understanding is essential regardless of whether it is investors’ or taxpayers’ funds at stake and provides the basis for the development of an effective risk management plan, including any disaster risk financing response.

A holistic risk management approach offers efficiencies for all stakeholders. Economics of Climate Adaptation studies⁵ use cost benefit metrics to rank adaptation investment projects alongside risk transfer mechanisms, identifying the most effective spend and the point at which it makes greater sense to transfer residual risk to the markets. A Lloyd’s Innovation Lab study⁶ suggested a number of blended instruments (using financing instruments and insurance together) for a connected approach. One example is loan payments for investment in adaptation being offset by attractive insurance premium reductions based on the reduced risk exposure.

The magic ingredients for public-private collaboration are trust and confidence. Trust in the motivations of the private sector should be met with trust in the experience of the governments and the humanitarian sector. Mutual trust can grow through positive collaborative experiences and well-written, reliable contracts, as well as a regulatory environment that favours risk finance and insurance market development. However investment by the private sector also requires confidence, or at least a controlled amount of fear; this can only be built on a foundation of risk science⁷, tempered by a seasoned understanding of risk model limitations⁸. These are survival skills in the private sector and there is value in applying them to public good programmes.

The following are just some examples of where cross-sector collaboration on risk management expertise and risk science have combined to support operational capability and make the development dollar go further:

1. Bangladesh and the Philippines:
   With support from the International Climate Initiative (IKI) of the German Federal Ministry for the Environment (BMUB), a cross-sector consortium is co-developing new catastrophe risk models for flood in the Philippines and cyclone in Bangladesh using the industry-funded open source Oasis Loss Modelling Framework platform. The breakthrough in this project is the merger of global and local research on an open risk platform for public good. Unlike most projects, which tend to source single-transaction metrics from the global north, this project is building local capacity to enable national agencies to develop their own view of risk in the long term.

2. Caribbean Catastrophe Risk Insurance Facility (CCRIF):
   More than 20 Caribbean and Central American governments created a regional pool which has paid out over a number of years (including USD 49 million in 2017, the year of Hurricanes Harvey, Irma and Maria). Private providers delivered reinsurance cover, placement services, and risk management expertise. CCRIF is regarded as an exemplar of collaboration for future regional risk pools.

3. Pacific Alliance Cat Bond.
   Sponsored by the international Bank for Reconstruction and Development (IBRD) and was led by Swiss Re, Aon and Citi. The USD 1.36 billion joint multi country transaction provides parametric coverage for each member country of the pacific alliance.

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⁵ See for example the joint Climada/Oasis case study on flood resilience in the city of San Salvador (Nov 2019)
⁷ The first recommendation of the Cass Business School report ‘Insurance for Climate Adaptation – Opportunities and Limitations’ (August 2019) is for open source, open access modelling under different climate change scenarios as a means to improve collaboration for disaster protection.
⁸ Risk models do not provide 100% certainty and consequently there needs to be clarity around the idea of a “mis factor” involved with risk models and the resulting solutions – especially in solutions for disaster risk financing.
Worldwide provided the modelling and has the role of the calculation agent. The design of the trigger structure has resulted in already a payoff to Peru during 2019. The World Bank issued the transaction as part of its broader work to support Chile, Colombia, Mexico and Peru—all member countries of the Pacific Alliance—in managing risk from natural disasters. By structuring the transaction as a joint issuance, countries benefited from cost savings for legal and other fees. As well as focusing on the successes of collaboration, it is just as useful to look at projects that have not been so successful and highlight some of the contributing factors that should be addressed. Sometimes that becomes more useful than the successes.

The Lloyd’s Disaster Risk Facility (DRF) is an interesting case study in this respect. Seven of the largest Lloyd’s syndicates offered USD 400 million per region in capacity in this context, but to date there has been almost no adoption. The Lloyd’s DRF was designed to be a vehicle to which all brokers could send submissions, with ease of access created via a consortium-style structure. In the regard that the “plumbing” is in place, this can be construed as having been a success.

It is difficult to determine exactly why its adoption has been far below expectations however key stakeholders have pointed to several factors which contributed:

- The relative success or not of the DRF is reflective of the wider demand-side issues that are prevalent in this space, specifically public sector partnerships with the private sector. There is no shortage of capacity, as the consortium evidences. To that end, greater awareness of the power that (re)insurance risk transfer provides as pre-event financing needs to be extoled. In rebuttal it could also be suggested that the consortium was not the type of solution that was required or needed by buyers.

- Opportunities have flowed in to the DRF but not near the volume expected. Distribution is key and lack of knowledge and understanding the consortium by major distribution channels (i.e. brokers) and the strategic targets of the consortium muted potential opportunities.

- A misunderstanding of requirements of the private sector by governments and/or buyers – the need for underwriting analysis of risk and the resource commitment to do so, and the time that it requires.

- Demands of various tenders or submissions to the consortium have not been aligned with the business requirements of the supply side or the facility.

- There was not always a clear ability of countries or societies to finance the premium when deals were put forward to the consortium.

The Lloyd’s Disaster Risk Facility also highlights a question: what should collaboration look like? Should there be more collaboration across the demand chain in developing solutions? Which key stakeholders (i.e. underwriters, brokers, donors/governments/multi-lateral banks) should be collaborating and how?

The experience of this project suggests that a clear understanding of the roles and responsibilities of each stakeholder is vital to successful collaboration.

For some governments and multi-lateral development banks there may be an understandable apprehension about the
'crowding in' of the private sector in disaster risk finance. For a start, the sector is not a homogeneous body but a wide range of disparate, competing organisations. A confusing variety of roles makes it harder for the public sector to understand motivations. Transparent and commercially focused public procurement processes enable the private sector to illustrate their expertise and motivations.

The industry has recognised the need to address this and is creating mechanisms to facilitate effective engagement with the public sector. For example, the Insurance Development Forum® (IDF), brings together organisations from all sectors with the shared goal of reducing the protection gap. It provides a portal to private sector expertise, energy and resources. The IDF exists to support the SDGs through collaboration and is now focused on operational implementation9.

Another example is the large investment made by the private sector in the Oasis Loss Modelling Framework platform, which by design promotes open access to risk models for all sectors and provides the tools for countries to develop their own view of risk. The aim is a better informed and more equal conversation between countries and capital markets. The IDF proposes that a major public-private collaboration in development of country level risk insight, within UN frameworks10, could make a significant contribution to SDG outcomes. It does not have to be the case that the majority of risk modelling resource and capacity is locked up in the global north.

**In Summary:**

These are early days and many gaps remain. Some are regulatory – it is no good having a perfect risk management plan if rules on capital flight have the unintended consequence of preventing access to international capital, or if regulation does not yet allow use of innovative insurance solutions in the markets where they are needed the most. Also, the private insurance sector needs to build greater understanding of the needs of specific segments and communities into its risk management approach, to inform operational instruments at macro, and micro levels. This is where the trust and acceptance of public expertise is fundamental – which solutions have the greatest impact and how. For example, the models are perfectly capable of disaggregating data for women and girls, whose experience of disaster is significantly different to that of men. This is not yet common practice but is critical to SDG outcomes.

These, and other gaps, can all be overcome if the conditions are right for cooperation and a shared shoudering of the load.

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9 The IDF is a private-public partnership led by the re/insurance industry and supported by UN agencies, the World Bank and other international organisations.
10 For example in November 2019 a ‘tripartite agreement’ was announced between the German Federal Ministry for Economic Cooperation and Development (BMZ), the IDF and the UN Development Programme to provide risk management expertise and underwriting capacity to 20 countries by 2025.
11 For the UN’s Global Risk Assessment Framework (GRAF) launched 2019, see https://www.preventionweb.net/disaster-risk/graf
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