STUDY

Climate Risk Financing

A Brief Analysis of Financial Coping Instruments and Approaches to Close the Protection Gap
RISK FINANCING

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Executive Summary

The paper presents new and established climate risk financing instruments and approaches and underlines how they could contribute significantly to the protection of vulnerable populations and countries who are exposed to climate-induced loss and damage. Climate risk financing instruments, such as climate risk insurance and risk pools, would be important approaches to support the reduction of the climate protection gap that developing countries and especially small island developing states (SIDS) face. Where there is climate risk financing, there is potential for an increase in resilience to climate-induced loss and damage.

Climate-vulnerable countries should establish climate protection mechanisms and build their resilience. An improved understanding of the assets and the economics of climate change adaptation and development needs of countries would help to identify the most vulnerable and support them in their efforts to adapt to climate change. New, innovative climate risk financing instruments, such as innovative climate risk insurance and the introduction of innovative climate risk financing instruments and approaches, would be important in reducing the climate protection gap.

The mobilization and proceeds of climate risk financing instruments, such as climate risk insurance and ex-ante disaster financing instruments, such as the Caribbean Catastrophe Risk Insurance Facility (CCRIF-SPC) and the African Risk Capacity (ARC), are becoming more accessible. However, the protection gap remains, especially in SIDS and least developed countries (LDCs), and the “polluter pays” principle is not being appropriately applied.

The InsuResilience Global Partnership and its partners, such as Bread for the World, have supported the development of a fund listed under the “polluter pays” principle that provides for climate-induced loss and damage in areas of instability, such as in the Caribbean, Central America, South and Southeast Asia, Sub-Saharan Africa, and South Pacific. Significant financial resources are still required to support the mobilization of post-disaster finance solutions to compensate for climate-induced loss and damage.

As a consequence, sustainable development in developing countries, especially small island developing countries and landlocked developing countries, should be given a permanent agenda item, for instance at international climate conferences. In contrast, the priority of international climate treaties should be to reduce the protection gap in vulnerable countries.

Regulatory harmonization towards one Vulnerable 20 (V20) market for financial services and products should be achieved. Enhanced climate risk financing instruments, such as climate risk insurance and catastrophe bonds, could also be important in reducing the climate protection gap.

More needs to be done to increase climate risk financing instruments. New, innovative climate risk financing instruments, such as climate risk insurance and catastrophe bonds, would be important approaches to support the reduction of the climate protection gap. New, innovative climate risk financing instruments, such as climate risk insurance and catastrophe bonds, would be important in reducing the climate protection gap.

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Climate-Induced Economic Risks and the Relevance of Risk Financing

Introduction

Economic loss and damage related to weather-related disasters have increased in recent years. According to data provided by the Munich Re NatCatService (2015, 2010, 2005, 2000, 1995), the cumulated economic losses as a result of natural catastrophes and the extent of economic losses. According to the latest scientific research, climate-related extreme events have become a more recurrent one-in-50-year event, implying that disaster risk prevention and reduction will become a more pressing topic, and disaster risk financing strategies to reduce these risks and to protect vulnerable countries from losses that go beyond their risk absorption capacity. The role of comprehensive climate risk management and disaster risk financing strategies is to ensure that losses are mitigated

Figure 1: Direct economic loss and damage caused by extreme events (1980 – 2017)
Worsening capital market access caused by climate risks leading to higher indebtedness and lower investment.

Worsening conditions in terms of access to international capital have become another huge concern, particularly for climate vulnerable countries and SIDS. They feel they are being penalized by the financial markets for being vulnerable. Research findings from Buhr and Volz (2018) conclude that for every US$ 10 paid in interest by these countries, an additional dollar will be spent due to climate vulnerability. The study further shows that over the past decade alone, a sample of developing countries have had to pay US$ 40 billion in additional interest payments just on government debt. Econometric modelling suggests that climate vulnerability has already raised the average cost of debt in a sample of developing countries by 1.17 percent and a further increase is almost certain, given that the underlying climate risks will intensify. Accordingly, it is estimated that climate change-induced additional interest costs are set to rise to between US$ 146 billion and US$ 168 billion over the next decade (ibid).

Recognizing the importance of greenhouse gas mitigation and of resilience building through adaptation in order to minimize climate disaster risks, the credit rating agency Moody's has developed six indicators to assess the possible climate risks of credit borrowers. They include the share of economic activity that comes from coastal areas, hurricane and extreme weather damage as a share of the economy, and the share of homes in flood-affected areas. In 2016, Moody's published assessment results, signaling that small islands could have GDP levels four percent lower by 2030 (Climate Analytics 2018) compared to a world with no man-made climate change, which would impact these countries' economies as a whole. For example, Fiji's recent credit profile was determined by not only assessing existing debt and political stability, but also by including vulnerability to climate events and gradual climate change trends (Libanda 2018). Many small island states are already rated below investment grade by Moody's, making it difficult to maintain and attract new investments, including for climate risk management and adaptation.

Because of the climate risks they face — for which they are not responsible — poor and climate vulnerable countries have to contend with lower credit ratings and are thus forced to make higher interest payments. They are the ones having to cover these additional costs, not the polluters, which further reduces their financial scope to invest in sustainable development. Simon Zadek, Co-Director of the UN Environment Inquiry into the Design of a Sustainable Financial System, calls it “… blindingly obvious they’ll pay more. We’ve been pushing finance to recognize climate change as a risk. Now it has resulted in increased costs to climate vulnerable countries” (Jackson 2018).

Jackson (2018) pointed to the fact that climate disasters “can both cause governments to spend more than they ideally should (i.e. more or less as much money as they collect in tax over the long term) but can also reduce growth.” He called it a “double-whammy effect on credit-worthiness, as debt levels increase and with lower growth, the ability to service that debt decreases” (ibid). He criticized that developing countries would be highly disadvantaged while developed countries stand to receive high ratings on their bonds simply because they are less vulnerable and have the technology, institutions and means to rapidly recover from climate shocks (ibid). The more climate change accelerates, the higher the risk of being downgraded will become for climate vulnerable developing countries. Escalating climate-induced financial risks will eventually erode their ability to attract needed climate investments.

Figure 2: World Map of the Global Climate Risk Index (1998–2017)

Source: Germanwatch 2018
Instruments of Climate Risk Financing

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Figure 3: Elements of existing comprehensive climate risk management

Figure 4: The frequency of tropical cyclones and king tides since the average height of the islands is less than two metres. The frequency of tropical cyclones and king tides has increased due to climate change, making it more crucial to establish comprehensive climate risk management strategies in the region.

Risk transfer to attract the investments necessary to overcome poverty. The higher the risk, the higher is the price to absorb the risk. The higher the risk, the higher is the price to absorb the risk. The higher the risk, the higher is the price to absorb the risk.
Domestic climate risk financing sources

- Calamity funds/disaster risk reserve: If a qualifying catastrophe or event occurs, the insurer, guaranteeing a payout should a certain disaster trigger has been breached. The World Bank Group provides such contingent credit lines through their IFC. Mexico's National Disaster Fund was the world's first regional risk pool to use parametric insurance, see glossary. Catastrophe bonds were first issued in the 1990s after Hurricane Andrew. They take on the risk of a specified catastrophe or event occurring in return for attractive rates of investment. Cat bonds are capital market-based, risk-linked securities that transfer an ex-ante defined set of risks (for instance extreme wind speed, is breeched) or a pre-defined parameter for instance Mexico's National Disaster Fund or the Caribbean Catastrophe Risk Insurance Facility (CCRIF).

- Contingent credits: Also known as cat bonds. These are market-based, risk-transfer instruments that are triggered automatically if a predefined parameter is met, for instance extreme wind speed. These were first issued in the 1990s after Hurricane Andrew. They allow for contingent financing programs, allowing borrowers to raise money to cover their losses (for reinvestment in reconstruction or to meet financial requirements in case of a disaster) provided that certain pre-defined events (e.g. a hurricane) occur. The World Bank Group guarantees a certain amount of the loan to cover the borrower's losses if a specified event occurs. The borrower pays a premium to the insurance company in return for this insurance. The insurance company then pays the borrower if the event occurs. The advantage of cat bonds over other forms of insurance is that they do not require the borrower to purchase insurance policies directly, but instead pool the risks of multiple borrowers into a single pool. This reduces the cost of insurance for each borrower, as the risks are spread across the entire pool. However, cat bonds are only available to companies with a high credit rating, as they are considered high-risk investments. They are also only available to companies that are willing to accept the risk of losing their investment in the event of a disaster.

- Post-disaster assistance: Post-disaster assistance is provided by international donors for relief, recovery, and reconstruction. It is usually provided through multilateral agencies such as the World Bank or bilateral donors such as the United States or Japan. The amount of post-disaster assistance provided is often dependent on the severity of the disaster and the amount of damage caused. In the case of a particularly severe disaster, post-disaster assistance may be provided in the form of a contingency loan or a financial package. However, post-disaster assistance is usually only available for a limited time period, and once the funds have been disbursed, the recipient nation is expected to take responsibility for rebuilding their own infrastructure.

Bilateral donor assistance: Grants or concessional loans, e.g. for financing coastal protection, water conservation (e.g. German International Climate Initiative). Donor assistance:

- Sovereign (regional) climate risk pools:
  - Risk transfer to third parties
  - Mutual risk financing, particularly in the case of poor and vulnerable countries with low credit ratings (see above).
  - Sovereign risk capital markets, i.e. the most expensive form of climate risk financing, particularly for poor and vulnerable countries with low credit ratings (see above).

Resources mobilized

- Multilateral climate funds: Grants or concessional lines (e.g. for a ministry for disaster management) or set up national climate change funds (e.g. the Bangladesh Climate Change Trust Fund – BCCTF). The Climate Risk Transfer Facility (CRTF) is an example of a new approach to climate change financing, which seeks to link climate change adaptation and climate change mitigation.

- Transfer of climate risks to an institutionalized insurance mechanism, either through the purchase of insurance (i.e. indemnity-based insurance) or through the use of parametric insurance (i.e. catastrophe bonds). The latter is more costly. However, indemnity-based payouts are complex and do not always apply for recurrent, low to medium risk events.

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Instruments of Climate Risk Financing

- Climate risk insurance: Can be an effective protection mechanism against loss and damage caused by extreme events that are not very likely to occur; insurance premiums to be paid by the policyholder reflect the risk: The higher the probability of a certain disaster, the higher the premium. However, indemnity-based payouts are complex and do not always apply for recurrent, low to medium risk events.

- Contingent credit lines: These are capital market-based, risk-linked securities that transfer an ex-ante defined set of risks (for instance extreme wind speed, is breeched) or a pre-defined parameter for instance Mexico’s National Disaster Fund or the Caribbean Catastrophe Risk Insurance Facility (CCRIF). The latter ensures a better fit, i.e. the higher the probability of a certain disaster, the higher the premium. However, indemnity-based payouts are complex and do not always apply for recurrent, low to medium risk events.

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Climate Risk Financing in the Context of the InsuResilience Global Partnership

The InsuResilience Global Partnership (http://www.insuresilence.com) is a multi-actor partnership that is working to enhance the role of risk financing in adaptation and disaster risk reduction strategies. The partnership brings together governments, insurance companies, civil society organizations, and other stakeholders to develop innovative solutions for financing climate-related risks. The partnership aims to bridge the gap between mitigation and adaptation, and to ensure that vulnerable communities have access to the financial resources they need to build resilience.

The partnership has been working on a range of initiatives to support climate risk financing, including the development of new instruments and the provision of technical assistance to governments and local communities. These initiatives have been designed to address the key challenges faced by those seeking to finance climate-related risks, including the lack of suitable insurance products, the high cost of risk transfer mechanisms, and the difficulty of accessing traditional financial markets.

The partnership has been at the forefront of efforts to develop new risk financing instruments, such as resilience bonds and catastrophe bonds, which are designed to provide governments with a range of additional options for managing climate-related risks. These instruments are intended to help governments mobilize finance from a wider range of sources, including the private sector, and to enable them to respond more effectively to the challenges posed by climate change.

The partnership has also been working to promote the use of existing risk financing mechanisms, such as insurance and reinsurance, and to encourage the development of new tools and approaches to risk management. This has involved working with governments and other stakeholders to develop new financing strategies, as well as providing technical assistance and capacity building to support the implementation of these strategies.

The InsuResilience Global Partnership is committed to working with governments, civil society organizations, and other stakeholders to develop innovative solutions for financing climate-related risks. The partnership is working to ensure that vulnerable communities have access to the financial resources they need to build resilience, and to support the development of new risk financing instruments that can help to address the challenges posed by climate change.
The German government, however, still sticks to the view that V20 countries. The G20 Group of Finance Ministers was founded in October 2015 as a high-level platform to act on climate change and climate risks, as a follow-up to the climate action plan provided by the COP21 in Paris in 2015. The InsuResilience Global Partnership (IGP) was established in 2014 with the purpose of strengthening cross-sectoral collaboration among government agencies, donors, and the private sector towards the financing of climate resilience. Together with the German government, the IGP is currently developing the Sustainable Insurance Facility (SIF), which aims to create an effective and efficient mechanism to channel climate risk financing to developing countries. The SIF is expected to be launched in 2018 and to provide a significant boost to climate resilience financing in developing countries.

At least at the discourse level, the acceptance and recognition of the need for enhanced cooperation between V20 and G20 countries is a positive sign. This is particularly relevant in the context of the ongoing political transition in the European Union, which is expected to result in a more integrated and coordinated approach to climate change and disaster risk financing. However, the road ahead is not without challenges. The current political climate in many V20 countries is characterized by uncertainty and instability, which could impact the success of the InsuResilience Global Partnership and the Sustainable Insurance Facility. Moreover, the financial resources available for climate resilience financing are limited, and there is a need to find innovative solutions to bridge the financial gap.
as well as coastal communities and cities in other emission cuts as demanded by the IPCC (2018). SIDS, Resilience Global Partnership, amongst others, should consequently, conflicts and migration are rising. The insurance solutions. In addition, the use and benefit of combined insurance with other risk financing approaches is a prerequisite to massively scaling up insurance in the most vulnerable countries, as the experience gained from the first regional risk pools (e.g. ARC) shows. The InsurResilience initiative of sudden and slow onset events (e.g. sea level rise) are especially important and fair solutions. Not only do these countries suffer from civil society and the business sector to overcome the protection gap. Therefore, it is another important issue to be addressed by national political decision makers and stakeholders in the international finance system in the region. The protection gap, particularly due to InsurResilience. Climate risk insurance has become the most promoted instrument for the transfer of climate extreme event risk, with the support of climate risk insurance, contingent debt facility), prototype V20 countries, own – a – a mechanism (WIM) could mobilize several synergies that exist between so the protection gaps. This is an issue that must be addressed when the burden across many shoulders, and if access and affordability are ensured, it might even be the most efficient way to paving the way for the introduction of the polluter pays principle into climate risk financing. Therefore, there is the need to examine the main climate protection gaps at scales that far exceed the current climate finance levels. This is an issue that must be addressed when these countries require financial support to build their resilience. Better linking of social protection with climate resilience building: It is a fact that climate vulnerable countries already pay significantly higher interest rates solely because they are economically affected by climate events and the larger that economic loss and damage associated with climate events become. It is a fact that climate vulnerable countries already pay significantly higher interest rates solely because they are economically affected by climate events and the larger that economic loss and damage associated with climate events become. The more frequently extreme events occur, the more disasters further increase, as forecasted. There are a number of options to extend affordability and coverage of climate risk insurance in the protection gap. This is an important instrument, yet it remains unimplemented in most climate vulnerable countries. It may have the potential to avoid humanitarian disasters in the aftermath of a climate-related extreme event. The main challenges are economic loss and damage associated with climate events, severe flooding and disastrous cyclones may further worsen their credit rating by an average of 20 percent according to the results of the insurance firms in the region. The main challenges to avoiding stranded assets that will impact their entire infrastructure significantly to maintain the feasibility and potential of insurance and other risk financing approaches is an important instrument, yet it remains unimplemented in most climate vulnerable countries. It may have the potential to avoid humanitarian disasters in the aftermath of a climate-related extreme event.
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Concluding Policy

New Options to close the Climate Protection Gap

Concluding Policy Recommendations

Recommmendations

Concluding Policy

"Climate Protection Gap"
by carrying out careful and robust risk financing analysis, including regional risk pools and their financial implications, protection schemes and other mechanisms.

- that raise the awareness of individuals, businesses and governments about the need for risk finance, risk transfer and improvement in the accessibility and affordability and of risk insurance to the most vulnerable.

- that take into account both the direct and indirect impacts of climate risks, such as a contingent multilateral debt facility or carrying out effective bundling and diversification across geographical areas to reduce costs such as premiums.

- that implement an enabling financial sector and regulatory framework and that ensure the necessary plans, processes and institutional capacity are in place to provide timely and fair compensation to disaster victims.

- that provide direct financing to civil society organizations through existing regional risk pools, such as the Caribbean Catastrophe Risk Insurance Facility, or through new mechanisms like the InsuResilience Solutions Fund.

- that strengthen the resilience and adaptive transformative social protection systems.

- that ensure effective bundling and diversification across relevant public and private sectors, investments into resilience building and high climate risk countries to mobilize risk capital for adaptation and that provide premium support and risk transfer, taking into account specific social, environmental and economic risks.

- that provide predictable and comprehensive risk financing to the climate vulnerable countries to mobilize risk capital for adaptation and that provide premium support and risk transfer, taking into account specific social, environmental and economic risks.

- that raise the awareness of individuals, businesses and governments about the need for risk finance, risk transfer and improvement in the accessibility and affordability of risk insurance to the most vulnerable.

- that take into account both the direct and indirect impacts of climate risks, such as a contingent multilateral debt facility or carrying out effective bundling and diversification across geographical areas to reduce costs such as premiums.
Concessional loans: Loans that are extended on terms substantially more generous than market terms. The concessional nature of these loans is achieved either through interest rate terms or substantial, risk-sharing guarantees from donors. Donors commit financial resources to a financial institution (typically a development bank) that will then provide the loan to the eligible borrower.

International financial institutions: Global financial institutions such as the World Bank, the International Monetary Fund, and the United Nations Development Programme. These institutions are often called multilateral development banks and provide concessional loans to developing countries.

Insurance is purchased by more vulnerable countries as a form of climate finance to cover the financial costs of adaptation and disaster loss and damage.

Insurance is a financial mechanism to transfer the financial risk of losses caused by sudden or slow-onset events to another party. Risk transfer can happen in three ways: risk sharing through insurance contracts, risk pooling through insurance facilities, or self-insurance (e.g. by governments).

Risk transfer involves the transfer of financial responsibility for some or all of the risk and any costs associated with the materialization of the risk. Risk transfer is an important part of adaptation, as it allows for the financing of adaptation measures, and it is important to calculate each country’s exposure to the risk exposed and the financial capacity to absorb these losses.

Risk exposure: The financial extent of a country’s potential risk, or the potential to bear losses, is determined by the degree to which the community is exposed to hazards to resist, absorb, accommodate changes in, reduce or live with the impacts of climate change. The risk exposure of a country is determined by the degree to which the community is exposed to hazards to resist, absorb, accommodate changes in, reduce or live with the impacts of climate change. The risk exposure of a country is determined by the degree to which the community is exposed to hazards.

Risk transfer: An approach to risk management that reduces the balance sheet risk of an insurance company by transferring risk to another party, typically another insurance company. Risk transfer is a key component of insurance and climate finance.

Risk assessment: An approach to risk management that involves the evaluation of the potential economic impact of a loss event, and the calculation of the probability of such an event occurring. Risk assessment is a key component of insurance and climate finance.

Risk of disaster losses: The risk of disaster losses is the potential for a disaster to cause financial losses to an insurance company. Risk of disaster losses is a key component of insurance and climate finance.

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