Transferring public-held risk to the private sector

Fiscal constraints are increasing across many developed and emerging economies amid growing catastrophic loss potential brought on by the geopolitical climate, demographic trends and global climate change.

As a result, heads of government, international trade organisations and private sector risk bearers are increasing their calls to re-examine the roles and responsibilities of society to better manage these complicated risks.

If the (re)insurance industry continues to be a leader in innovation, collaboration will be critical in efforts to make use of new sources of capacity and technological advances, leverage insights from outside the industry and attract creative talent.

The World Economic Forum's 2014 Global Risks report stated that "the damage to economic assets, such as city and industrial infrastructure, agriculture and key global supply chains, caused by extreme weather events is becoming more evident". Twenty of the 30 most expensive insured catastrophes worldwide since 1970 have occurred since 2001 and all, save for one, were natural disasters.

Historically, less than 30 percent of the cost of natural catastrophe events is covered by insurance, according to Swiss Re. Much of the financial weight of catastrophic events falls on public entities. At the same time, the financial burden on governments is growing. The Economist Intelligence Unit has estimated that total global public debt stands at $56.3tn in 2015.[1] The rise in public sector debt is constraining governments' ability and willingness to respond to major losses.

In recent years, these developments have occurred as convergence capital has multiplied the market's ability to diversify public-held catastrophe risk, reduced (re)insurance pricing and pushed the growth of more customised product offerings available to public sector entities.

The reinsurance industry has considerable opportunity to lead in the development of the channels and means to facilitate the transfer of risk from public balance sheets to private sector markets. The facilities are rapidly evolving to meet the needs of unfunded exposures for catastrophe loss and also for disasters stemming from man-made and other emerging risks.

Utilising these facilities and coupling them with expanded private sector pre-loss financing options would not only relieve the burden on public finances and taxpayers, but would migrate the management of these catastrophes to companies with expertise in claims handling and risk management.

> "The boundaries of insurability can be moved by promoting public-private partnerships, managing adverse selection and leveraging risk mitigation and prevention affordability"

An example of an innovative way for public entities to transfer risk is through catastrophe bonds. The groundbreaking MetroCat Re bond, sponsored by the New York Metropolitan Transportation Authority (MTA), completed in 2013, showcased an innovative approach to managing catastrophe risk. Not only was MetroCat the first catastrophe bond ever to protect solely against storm surge risk, it was also unique in that it transferred the risk directly to the capital markets.

Meanwhile, the World Bank, on behalf of the Caribbean Catastrophe Risk Insurance Facility (CCRIF), provided three years of protection from hurricanes and earthquakes affecting the countries participating in the CCRIF with a catastrophe bond issued in 2014.

Special reinsurance funds and mutual reinsurers through agreements with or guarantees from governments or treasuries are another way that the insurance industry aids public entities in transferring risk. These arrangements may provide insureds with affordable cover for flood – for example, the UK's Flood Re – or guarantees to insurers in the event that funds are insufficient to pay terrorism claims, such as with Pool Re, also in the UK.

Closing the protection gap

Arguably, the conditions exist to move towards more private sector pre-financing options that will not only relieve the burden on public finances and taxpayers, but will also bring into focus fundamental risk management and loss mitigation that supports the goal of greater community resilience.

Convergence capital and technology have positively shifted the limits of insurability for public-held exposure, but product innovation is lagging behind. To close the protection gap, market penetration can be increased by creating more consumer-friendly risk transfer products — such as microinsurance initiatives — that stimulate demand via incentives and affordable premiums and promote risk awareness.

By providing individuals and small businesses in developing countries with customised risk products and solutions, microinsurance is a unique opportunity for the insurance industry to enter new markets and also help the underserved. Guy Carpenter, along with Marsh & McLennan, American International Group, Aspen Insurance, XL Catlin, Hamilton Insurance Group, Transatlantic Reinsurance Company and Zurich Insurance Group, formed a microinsurance consortium and venture incubator, which was joined later by Old Mutual.

The boundaries of insurability can be moved by promoting public-private partnerships, managing adverse selection and leveraging risk mitigation and prevention affordability. Guy Carpenter has recently launched a Public Sector Specialty Practice, focused globally on the unique risk management needs of government agencies and entities. The practice was created to address the issue of unfunded exposure by delivering reinsurance and capital market solutions and by supporting risk analytics.

[1] Economist Intelligence Unit, 18 June 2015. Debt figures are based on national definitions and therefore may vary from country to country.

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