UNIVERSITY OF CAMBRIDGE INSTITUTE FOR SUSTAINABILITY LEADERSHIP
Disaster Risk Financing & Insurance Program
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CENTRE FOR GLOBAL DISASTER PROTECTION
GFDRR Global Facility for Disaster Reduction and Recovery
UKaid from the British people

Procurement of risk transfer

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19 July 2018

Abstract

- The objective of risk transfer is financial protection. It is a risk management approach whereby a financial risk is taken on by another party at a cost
- The type of protection required to meet specific objectives will depend on a number of factors
- There are several stages to the procurement process and many parties involved

Types of risk transfer

- **Insurance**
- Alternative risk transfer – using capital markets
- Publicly owned insurance companies & sovereign risk pools

Procurement process and parties involved

1. Education and training on disaster risk finance
2. Technical assistance to understand the risks
3. Deciding between risk transfer options
4. Engagement and placement with risk carriers
5. Implementation, administrations, operation and claims management

- Development Banks
- Risk carriers (e.g. commercial insurers, sovereign risk pools)
- Brokers and intermediaries
- Donors and civil society

Summary of key considerations

- Which factors should be taken into consideration when placing risk with a carrier?
- Is the risk best placed through a broker, directly with risk carriers, or through a development bank?
- Should risk carriers be commissioned to provide additional support/expertise?
- Should public risk carriers be prioritised over others, even if more expensive?
- When might it be better to retain the risk?

Which factors should be taken into consideration when placing risk with a carrier?

- Price is often a primary driver of the selection when procuring risk transfer
- The price will reflect the risk an insurer is willing to accept – a contact that covers more regular risk events will likely be priced higher than a contract that covers a more extreme risk event
- An insurer will also likely charge more where there is more uncertainty - for example a lack of data to model the risk may lead to a higher price
- You get what you pay for – lower price may reflect exclusions, poorer claims management
- As well as price buyers should consider:
  - Reliability, quality and reputation
  - Experience and expertise
  - Solvency
  - Political influence, existing relationships

HS2 - UK public sector procurement

- High Speed Two (HS2) Limited is the company responsible for developing a new high speed rail network in the UK and is funded by grants from the UK Government
- The construction process presents large risks and so to provide certainty of protection against major events, they decided to purchase commercial insurance
- The key considerations in assessing an effective strategy were **value for money**, **logistics** and **support in risk reduction** from risk carrier
- Process:
  - An Owner Controlled Insurance Programme (OCIP), led by experienced international insurers, was set up to procure commercial insurance
  - An insurance broker was used to provide insurance advice and services for the OCIP tender process
  - The insurance was procured using a lead insurance structure – this is where a large insurer who is expert in the particular area leads on pricing and the process of managing claims, with a follow-on market taking on a smaller portion of the risk

Key takeaways revisited

- The objective of risk transfer is financial protection. It is a risk management approach whereby a financial risk is taken on by another party at a cost
- The type of protection required to meet specific objectives will depend on a number of factors such as price, reliability, quality, solvency, experience, expertise, existing relationships
- There are several stages to the procurement process and several actors involved such as development banks, specialist brokers, risk carriers

Annex – Additional slides on key considerations

Will risk be placed through a broker, directly with risk carriers, or through a development bank?

Use a broker or equivalent.	Selection of a broker should take into account both price and technical expertise. Brokers often have wide reaching networks which can increase competition and reduce premiums. Brokers will charge a fee which will vary.
Direct placement with individual carriers.	The Lloyd's model is for a lead insurer, which is an expert in the particular area, to lead on pricing and the process of managing claims. The follow-on market then takes on a smaller portion of the risk. Placing the risk directly with the market therefore allows for diversification. Engagement with the market as a whole may be reduced and so future value for money might be lower by virtue of fewer engaged parties (for example placing risk with the Lloyd's market reduces opportunities in international markets).
Place risk through an intermediary, such as a development bank	Using an intermediary, such as the World Bank Treasury, potentially reduces credit risk. Intermediation may allow for risk transfer methods to be used which are otherwise not practical (such as catastrophe swaps and catastrophe bonds). Working with such a party may also provide access to additional expertise, where there is less likelihood for conflicts of interest than might occur with expertise from market participants. However there may be conditions on the placement of risk which restrict who and how the risk is placed. For example, there may be strict credit restrictions on the creditworthiness of risk carriers, which limit competition significantly. For example World Bank Treasury have a pre-approved panel of only 12 carriers.

Should risk carriers be commissioned to provide additional support/expertise?

Commission support from risk carriers and provide preferential treatment in the placement of risk.	Some evidence suggests that the implicit cost of providing preferential treatment can be higher than explicitly paying for support. Given that some risk carriers have extensive experience of creating and marketing new products, particularly in the disaster risk market, their experience could add value.
Commission support from risk carriers and pay an explicit fee.	The value for money would of course depend on the specific fee charged. However, the increased transparency of pricing (relative to preferential treatment in risk placement) will likely drive better value. Given that some risk carriers have extensive experience of creating and marketing new products, particularly in the disaster risk market, their experience could add value.
Base the process primarily on support from specialist brokers, development banks and donors (along with other third party experts).	The use of specialist brokers can simplify the competitive process. Value for money would depend on the price charged by brokers and development banks. The level of expertise of these parties will be high, but some practical insight from risk carriers (from designing and writing new products in new markets, for example) may be lost.

Should public risk carriers, such as sovereign risk pools, be prioritised?

Prioritise public risk carriers	A risk pool brings the benefits of diversification and economies of scales, as well as offering individual countries access to the international insurance and capital markets. Where a public risk carrier meets their needs but does not provide the same value for money as alternatives in the market, the risk pool should be reviewed to ensure it is operating efficiently. If the public risk carrier remains efficient and effective, then it may be that the alternatives are being priced aggressively. In this case, it may be that an argument is made for using the risk pool, despite the inferior value for that individual transaction, with a view to the long term efficiency of the market. Sovereign risk pools can bring benefits over commercial alternatives, including: public sector oversight to ensure that customers are treated fairly and that coverage is of a high quality; and ownership by member countries, increasing engagement in the disaster risk finance agenda.
Allow disaster risk pools to be exposed to the same competitive process as other risk carriers	For a specific transaction, the value for money will be highest by competing amongst all available options based on price. Where a product provided by a public risk carrier does not meet the needs of a country, they should look elsewhere for a product which does.

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