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A Practitioner's Perspective on Disaster Risk Management in Latin America & the Caribbean

The Caribbean and Central American Partnership for Catastrophe Risk Insurance: Creation of a Regional Partnership for Financial Resilience

"For Nicaragua, it is an honor to be the first member of COSEFIN[1] countries to join the CCRIF.[2] This insurance will allow us to strengthen financial resilience to natural disasters and continue our efforts to reduce poverty and respond to climate change challenges as part of our National Human Development Plan."

–Ivan Acosta, Minister of Finance of Nicaragua

Challenge

In 1998, Hurricane Mitch swept across Central America causing unprecedented damage in its wake. In Nicaragua, over 3,000 people lost their lives and hundreds of thousands were left homeless due to related flooding and mudslides. Estimated economic damage in the country totaled US$ 1 billion. In Honduras, the transportation infrastructure was decimated, leaving more than 90 bridges and nearly all secondary roads severely damaged or destroyed.

"We have 75 percent…of our major infrastructure destroyed, damaged or torn apart. Our agriculture is in shambles. All of our major crops, our export products…gone," said Honduran President Flores in 1998 in the aftermath of Hurricane Mitch.[3] Damages and losses in Honduras amounted to approximately 81 percent of the country's GDP.[4]

Countries in Central America are highly vulnerable to the adverse effects associated with earthquakes, tropical cyclones and excess rainfall. Since 1980, several countries in the region have experienced a disaster event that had an economic impact above 50 percent of their annual GDP. Damages incurred to assets in the agriculture, education, health, housing, infrastructure, transport, and water sectors subsequently contribute to large fiscal deficits and debt accumulation requiring public debt restructuring, while at the same time limiting countries' abilities to finance risk reduction activities.

Although countries in Central America are able to distribute disaster risk over a wide geographic area and maintain some borrowing capacity for reconstruction purposes, catastrophic shocks still exceed the capacity of national economies. Disaster response frameworks continue to rely heavily on *ad hoc* budget reallocations, emergency calls for donor assistance, and simply not replacing or repairing damaged capital stock.

Given these realities, Central American countries determined[5] that a cost-effective solution to strengthening their financial resilience to disasters was imperative and, through the Council of Ministers of Finance of Central America, Panama and the Dominican Republic (COSEFIN), approached the United States Department of the Treasury and the World Bank for assistance.

Intervention

At the request of COSEFIN Ministers and in partnership with the US Treasury, a multi-disciplinary World Bank team including members of the Social Urban Rural and Resilience's Disaster Risk Management (SURR DRM) Unit, the World Bank Treasury and the Finance and Market's Disaster Risk Finance and Insurance (DRFI) Program analyzed various financial risk transfer options for states to manage their fiscal vulnerability to disasters. However, of the possible options and solutions, which would prove most beneficial and effective for COSEFIN countries? And could these countries come to consensus on the optimal solution?

To thoroughly assess the possible options, the team:

I. **Prepared technical notes** that explored the various types of insurance options available to Central American countries that would assist in providing immediate liquidity to finance emergency expenses:

- **Traditional vs. parametric insurance.** While traditional insurance requires on-the-ground loss assessments following a disaster and is well suited for reconstruction purposes, parametric insurance makes payments based on the intensity of the event or the amount of loss calculated in a pre-agreed model. Therefore, for these purposes, parametric insurance is deemed more appropriate.

II. **Developed a comparison of various initiatives** that would facilitate COSEFIN's goal of reducing countries' fiscal vulnerability to natural disasters, arising from emergency expenses. These options included:

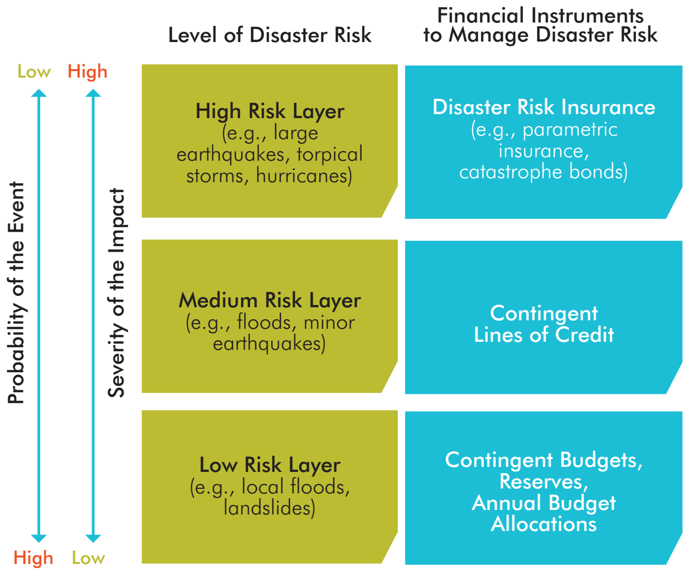
- **Creating a new catastrophe risk insurance facility,** like CCRIF SPC[6] (formerly the Caribbean Catastrophe Risk Insurance Facility), for Central American countries.
- **Developing ways for Central American countries** to work with Mexico's National Disaster Fund to jointly transfer catastrophe risk to the international reinsurance/capital markets.
- **Preparing a path for Central American countries** to join Caribbean countries under the umbrella of the existing CCRIF.
- **Having Central American countries** independently transfer their catastrophe risk to the international markets.

"After exploring options for engaging in sovereign disaster risk financing, Central American countries concluded that joining the CCRIF SPC facility was the most efficient and cost-effective insurance mechanism to pool our risk."

–Martín Portillo, Executive Secretary of COSEFIN

Joining CCRIF was identified as the most cost-effective option for delivering

Conceptual framework to build a cost-effective disaster risk financing and insurance strategy



low-cost high-quality catastrophe risk insurance, with the purpose of financing emergency costs, because it is:

- **Quick.** It will allow Central American countries to build on the successful experience of a facility that already exists.
- **Efficient.** CCRIF provides cost-effective and fast-disbursing liquidity (offering payouts in 14 days or less) and is an efficient way to finance a liquidity gap arising in the immediate aftermath of a disaster.
- **Flexible.** Central American countries would have the flexibility of choosing their coverage parameters, including which perils they would like coverage for and their premium amounts every year. In addition, not all Central American countries would have to join CCRIF at once for the initiative to work.
- **Proven.** Since its founding in 2007, CCRIF has made twelve payouts amounting to US $35.6 million to its Caribbean members and these payouts have proven useful in managing budget volatility in the immediate aftermath of a disaster.
- **Financially beneficial for both sub-regions.** Joining CCRIF also affords Central American countries savings of approximately 36 percent of the total premium volume and allows Caribbean countries savings equivalent to 25 percent if the countries approach the reinsurance market and capital markets together through CCRIF.

After determining that joining CCRIF was the best solution, the team then had to decide how to execute such a partnership so that it would be beneficial for both the Caribbean and Central American regions. Following consultations with the major stakeholders involved, including CCRIF, COSEFIN and Caribbean governments, these elements were agreed to:

- **Participating countries would pay an annual premium** commensurate with their own specific risk exposure and there would be no cross-subsidy between countries as is currently the case with Caribbean members, or between sub-regions.
- **CCRIF would restructure itself as a Segregated Portfolio Company (SPC)** in order to segregate the risk and capital of the two sub-regions under different portfolios. This prevents the segregated portfolios from drawing capital from each other in the event that payout obligations of an underwritten policy exceed that portfolio's own capital and reinsurance lines.
- **Donor support would enable COSEFIN countries to build** the reserves of their segregated portfolio at an accelerated pace. Such donor support was also instrumental in the establishment of CCRIF in 2007.

Outcome

On April 18, 2015, COSEFIN members and CCRIF SPC gathered together to formally sign a Memorandum of Understanding allowing Central American countries access to low-cost, high-quality sovereign parametric catastrophe risk insurance through CCRIF SPC. During the ceremony, the Government of Nicaragua also signed an agreement to become the first Central American country to formally join CCRIF SPC. Other COSEFIN countries are expected to join CCRIF SPC in 2015 and 2016.

The benefits associated with the new CCRIF SPC for Central American and Caribbean countries are significant. Apart from lower premiums for all participating countries, anticipated benefits include:

- **Cost-savings** associated with risk dispersion, size of aggregate portfolio and gains in technical and administrative efficiency.
- **Increased access** to reinsurance and capital markets.
- **Enhanced regional collaboration** and cooperation.
- **Access for new members** to the know-how and expertise of CCRIF SPC.

Why was this intervention successful?

- The challenge of adopting parametric insurance was broken into surmountable steps and agreement was obtained for each stage in the process.
- Any uncertainties and concerns that arose throughout the process were shared with the countries and organizations involved. This generated a sense of ownership and camaraderie.
- The dialogue with Central American and Caribbean countries was through their organizing/representative bodies – COSEFIN and the Caribbean Community (CARICOM). This greatly reduced the time and effort needed to contact and negotiate with each country separately.

However, although in joining CCRIF SPC, governments in the Caribbean and Central America have taken a significant step towards the goal of reducing their fiscal vulnerability in the event of disaster, disaster risk parametric insurance alone will not solve all of their challenges. COSEFIN countries ought to complement their catastrophe risk coverage through CCRIF with the use of other financial instruments in order to efficiently prepare financially for recurring disaster events and the cost of reconstruction. In addition, their Ministries of Finance ought to seek ways to enable and influence other technical line ministries to work to reduce their countries' exposure and vulnerability to natural hazards, through targeted risk reduction investments and better territorial planning.

Notes:

1 Council of Ministers of Finance of Central America, Panama and the Dominican Republic
2 Formerly known as the Caribbean Catastrophe Risk Insurance Facility
3 http://www.cnn.com/WEATHER/9811/06/mitch.02/
4 ECLAC, 1998. Honduras: Assessment of the damage caused by Hurricane Mitch, 1998. Main results available at https://www.gfdrr.org/hurricane-mitch-honduras-1998
5 Mandate of Central America Presidents SICA, 2011
6 www.ccrif.org

Contacts:
Niels Holm-Nielsen – Lead DRM Specialist - Urban and Disaster Risk Unit - Social, Urban, Rural & Resilience Global Practice (nholmnielsen@worldbank.org)
Ana Campos Garcia – Senior DRM Specialist – Urban and Disaster Risk Unit – Social, Urban, Rural & Resilience Global Practice (acamposgarcia@worldbank.org)
Nancy Chaarani Meza – Operations Officer – Urban and Disaster Risk Unit – Social, Urban, Rural & Resilience Global Practice (nchaaranimeza@worldbank.org)