Day 3 The impact of the pandemic on protection gaps

Anna Sweeney, Chair of the UN Sustainable Insurance Forum gave the opening address on climate risk challenges, with a particular focus on the emerging economies.

Anna started by saying that climate change is an existential and present threat. The most recent IPCC report[1] catalogues how its effects are already being felt. The pace of climate change, the need to manage its consequences and reverse its consequences requires a challenge and an opportunity for the insurance industry. The industry has a fundamental role in underwriting new risks and financing new long-term investments in climate adaptation and mitigation measures. The challenge is particularly severe in emerging economies. A 2016 report by Moody's[2] estimated the annual average loss (from 1980-2015) from natural disasters was 1.5% of GDP in emerging economies, but 0.3% in developed economies.

The gap between what is required of insurance and what is delivered remains largest in emerging economies. A 2018 report[3] found that the value of assets not covered for damage created by catastrophe was US$2.5bn in developed economies but much higher, US$160bn, in emerging economies.

Emerging economies are the most vulnerable because of their low preparedness and their lack of financial resources to invest in infrastructure and build resilience. 97% of the world's population growth in the next ten years is expected to be in emerging economies. 83% of global urban population growth from 2020-2040 is expected to come from Asia and sub-Saharan Africa, where much of the urban infrastructure was hastily constructed and is more at risk from disasters.

As global temperatures rise and natural disasters become more frequent, more destructive and less predictable emerging economies will be particularly at risk. Poor insurance coverage reduces an economy's ability to recover but the potential gains from more insurance are large: each one percentage point increase in insurance penetration reduces response times to disasters by 12 months.

Emerging economies also face the greatest difficulties and threats from transition risk. Much of the technology which the developed world relies on for its own transition to net zero relies on extracting raw materials from emerging economies. Lithium mining in Chile and cobalt mining in the Democratic Republic of Congo have both been linked to environmental damage. These minerals are vital components in the development of new technologies (especially batteries and clean energy) but without more sustainable ways of sourcing them, emerging economies will garner only a small share of the benefits while suffering climate damage.

Insurance protection gaps must be closed to ensure the most at-risk industries and individuals are not left behind. However, there are a number of obstacles to overcome. There is a lack of data, tools and knowledge to assess risks so that insurers can price and offer products, which is particularly the case in emerging economies. The UN SIF, Anna's organisation, provides a platform to address sustainability issues and works closely with other related organisations. The SIF's projects include: the Climate Training Alliance, an open knowledge sharing platform focused on building insurance capacity worldwide; research into emerging environmental risks; and promoting the role of the actuarial process. Anna concluded by saying that the climate crisis affects the whole world but emerging economies are often not in a position to take the drastic action which is demanded. A collective response is needed to tackle climate change: everyone needs to play their part.

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1 https://www.ipcc.ch/site/assets/uploads/2021/08/IPCC_WGI-AR6-Press-Release_en.pdf
2 https://legacy-assets.eenews.net/open_files/assets/2016/11/30/document_cw_01.pdf
3 https://www.lloyds.com/~/media/files/news-and-insight/risk-insight/2018/underinsurance/lloyds_underinsurance-report_final.pdf

Panel discussion

The panel members were:

Arup Chatterjee, Principal Financial Sector Specialist, Asian Development Bank

Monique Goyens, Director General, European Consumer Association

Ruth Lux, Head of Public Sector EMEA, Guy Carpenter

Kai-Uwe Schanz, Head of Research & Foresight, The Geneva Association

Justin Wray, Head of Policy Department, EIOPA

and the Moderator was:

Alexander Ludwig, Chair, Public Finance & Macroeconomic Dynamics, ICIR, Goethe University.

How has the pandemic increased pre-existing protection gaps?

Arup began by commenting that Covid has brought discussions on protection gaps to centre stage. In developing Asia, protection gaps existed even before the pandemic. Arup sees them as manifestations of unresolved development problems. Public insurance schemes do not exist or are underdeveloped. Such a situation constrains the ability of governments to respond to and mitigate shocks. Consequently, contingent liabilities gradually build up on governments' balance sheets. Also, governments are increasingly making businesses, households and individuals responsible for managing the adverse financial consequences of risks to assets, lives, incomes and livelihoods without paying as much attention to developing insurance markets. As a result, millions are either uninsured or underinsured: there is a significant protection gap.

Governments have absorbed a significant impact of the health and economic effects of the pandemic but there has often been a “double or triple whammy” as these have been compounded by natural calamities and cyber-related losses.

The 'property protection gap' of the impact of natural hazards and climate change risks is US$134 billion for Asia alone today, but this is just the tip of the iceberg. Asia's mortality protection gap stood at US$83 trillion in 2019, with three in four households in financial danger if a breadwinner dies. The health protection gap is US$1.8 trillion in 2019 (or 10% of the average annual household income). The pensions protection gap stood at US$70 trillion in 2015 and is forecast to grow by 5% each year. With the increased use of digital technology, Asia's cyber-risk protection gap is US$27 billion in indirect economic losses.

The infrastructure financing gap, according to ADB estimates, is US$26 trillion for hard infrastructure alone. The social infrastructure funding gap is a similar size. Closing these gaps is vital for socio-economic prosperity. The insurance industry can contribute by offering affordable and fit-for-purpose risk-sharing and long-term financing solutions.

Monique felt that the response to Covid had generally been handled well by the existing system. The same, however, is not true when looking at natural disasters. In Europe, there is a big insurance protection gap. Only 46% of German consumers are insured against natural disasters. In Belgium, the authorities have decided to help the uninsured that were affected by recent floods.

Prioritisation of risk management is, however, necessary. Consumers need to protect themselves against risk, but there are too many barriers. In particular, they may not be aware of the need or, if they are, the price may be too high. When it comes to natural disasters, those who are less able to pay generally live in high risk areas.

Ruth noted that threats do not stop at borders and are too great to be addressed by individuals, companies or even countries. The Global Risks Report produced each year by the World Economic Forum, with Marsh McLennan as a strategic partner,[4] identified two sources of concern. First, that we are facing a still unknown and very complex fallout from COVID-19. The pandemic has significantly impacted lives, livelihoods and the health of global economies and societies. It is causing enormous structural challenges for governments, the private sector, and communities. As a result, the recovery will most likely be uneven and there will be surprises. Second, there is an acceleration of pre-existing critical global risks affecting businesses and society such as digital dependency, cyber, civil unrest and geopolitical interactions, and there will be narrowing opportunities for action on many of them. Vulnerable societies and economies put at risk our efforts to address long-standing issues such as climate change and the loss of biodiversity.

The report also highlights how incredibly difficult it is to handle these risks alone. Ruth said that is why it is vitally important to come together in forums like this, to exchange views and build together the right support mechanisms, allowing all of us to better anticipate and address emerging threats.

The insurance losses from Covid amount to around US$45bn, mainly from event and trip cancellation. This amount (relatively small compared to the economic losses) highlights the huge protection gaps we had pre-pandemic and has brought other protection gaps – such as large scale cyber and climate change losses – to the forefront.

Kai-Uwe highlighted the three protection gaps which are best understood and quantifiable: healthcare expenditure, mortality risk and natural disaster risk. The three gaps together amount to around US$1.4 trillion in terms of premium equivalence.[5] So, if all three were closed the global insurance market would expand by 20%. Of course, there are two ways of reducing protection gaps: increasing coverage or reducing losses through prevention and mitigation.

Covid has clearly exposed the health and mortality protection gaps. In India, 60% of healthcare spending is out of pocket. Latin America has one of the highest mortality protection gaps and is most affected by excess mortality from Covid.

The "real black swan event" was not the pandemic itself but the public response to it. Economies shut down and global GDP contracted by US$5 trillion, but insurance payouts were much less than US$100bn. This gives a preliminary indication of where we stand in terms of protection gaps.

Cyber security risks were highlighted by the pandemic and here, also, the figures are daunting. Estimated global losses from cyber-attacks are estimated at about US$1 trillion but global cyber insurance premiums are only around US$10bn pa.

Justin commented that protection gaps have always existed and we should avoid considering them all as inherently bad. There may be good reasons why individuals do not want to insure against all of their economic vulnerability. Justin underscored Kai-Uwe's point that, in terms of solving protections gaps, increased insurance is one method but mitigation is the other. The pandemic illustrated that in order for the recovery to be solid, insurance can provide a vital role, but the existence of protection gaps shows this is not straightforward. The pandemic has increased awareness of protection gaps, has raised issues for public policy and has encouraged the search for new solutions.

Alexander commented on the common themes that were emerging from the panel discussion: that the pandemic has made clear there are huge risks, but that we can simply not define the protection gap as the amount that is uninsured. There may not be the demand to insure all these.

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[4] https://www.marsh.com/uk/risks/global-risk/insights/global-risks-report-2021.html

[5] https://www.swissre.com/dam/jcr:ca784019-cd41-45fb-81ed-9379f2cd91e3/swiss-re-institute-sigma-resilience-index-update-june-2021.pdf

Protection gaps and government intervention

In response to an audience opinion poll, 79% thought that the pandemic had persistently increased pre-existing protection gaps; and 79% thought there was a need for the government to play a more positive role. The poll showed the environmental risks protection gap was considered the most important one to close.

Arup said he was "a bit surprised" by the latter result. The longevity risks and pension protection gaps are more pronounced than the environmental risks gap but less visible, certainly in emerging markets where there is a large informal sector without access to basic social protection. He also thought that rather than pre-existing gaps having increased, they could more correctly be seen as having attracted greater attention.

Monique said she was not surprised by the results, especially the importance attached to environmental risks: these (especially floods and wildfires) are very much in the spotlight at the moment and also impact many other risks. Although cyber risk has also attracted much attention, Monique said there were many ways of protecting against this. Simple password protection techniques often received too little attention. Prevention and cooperation would be a way of mitigating the outcomes. "The precautionary principle is an investment, not a cost" she said.

Arup responded that he was mainly concerned about the contingent liabilities on governments' balance sheets which can become actual liabilities. Parts of Africa and Asia are not saving adequately for their future. Governments' budgets are already under strain and this could increase further if old age income security, as part of a social protection obligation, must be provided.

Ruth said it was crucial to look at the pandemic and learn from it as "the government is the insurer of last resort." Government can back an insurance solution or provide financial support to those directly in need. Insurance solutions can be seen as generally preferable, not least because government support can often be arranged hastily in the midst of a crisis. An insurance solution can provide *ex ante* transparency and certainty on the level of benefits that will be provided. It can also leverage the existing claims payment infrastructure to deliver benefits quickly, particularly if the trigger for claims is simple.

Kai-Uwe echoed Arup's surprise that the natural disaster gap was ranked as the most important. The global natural disaster protection gap of US$150bn per year pales in comparison to the economic losses from the pandemic. It is also small in relation to the cyber risk losses we might see. A super solar storm that knocks out the global internet for a few weeks could well involve trillion-dollar losses for the global economy. Such risks mean the insurance industry may have to be more proactive in dealing with government. In conclusion, "post-pandemic, the private sector will have to live with big government".

Justin said he was not that surprised by the results. He agreed with Arup's comment that what the pandemic had done was increased awareness of the other protection gaps although, of course, we do have to be careful about correlations. For example, during the pandemic cybercrime had increased. The other point is that we simply do not know where the next protection gap will arise. Rather than emphasise the rankings of the three main risks considered in the poll, Justin thought it was more appropriate to look at what all three have in common: they involve risks which are hard to pool and geographic diversification does not help. So, insurance solutions on their own are unlikely to be sufficient; a role for government will be needed.

In response to a question, **Arup** commented that environmental damage may well raise concerns about healthcare and longevity. All three risks are interrelated. Contractual savings institutions like insurance companies and pension funds can tap a vast pool of savings that they use to finance a diverse range of infrastructure investments that meet climate adaptation and mitigation targets and reduce the residual risk, In response to another question, **Monique** supported greater use of the alternative dispute resolution (ADR) system as a way of settling disputes between customers and their insurers. Such disputes can be a 'David versus Goliath' situation and ADR may level the playing field in favour of the consumer. Currently, insurance companies are not obliged to use ADR: accepting its greater use could make dispute resolution easier.

A second set of questions surrounded the issue of whether the private sector could manage to insure all risks itself or whether there was a need for much more public-private partnership.

Ruth commented that the pandemic had created recovery and resilience challenges which need to be addressed. The magnitude of global economic losses, judging government action and assessing changes in consumer demand all make pandemic insurance impossible for the private sector to insure without government backing. We have seen that property and liability insurance contracts are severely limited in the way they can respond to losses. Most policies now explicitly exclude pandemic risk and are expected to continue to do so. Insurers generally take the view that property, casualty and other insurance policies are designed to cover losses suffered by individuals that are insured but not the aggregate economic impacts from the pandemic.

Despite these challenges, **Ruth** does believe that parts of pandemic risk are insurable. It is the global nature of pandemics that means there is not enough capacity in the insurance industry to take on the risk unless there is a public-private partnership.

There are many examples of public-private partnerships working well to restore insurability. After 9/11, terrorism risk was perceived to be uninsurable. But the passing of the US Terrorism Insurance Act and the establishment of the Department of Homeland security meant that the obstacles were overcome and terrorism insurance was possible. Indeed, that market is now functioning well (Ruth cited the example of Pool Re in this respect).

Kai-Uwe was more circumspect, noting a fundamental difference between natural disaster and terrorism risk, for example, and pandemic risk. A global pandemic means the scope for risk sharing is very limited. This, however, is an actuarial consideration and there are broader considerations. If the insurance industry withdraws from certain risks, this may adversely affect the perception of the industry. Even if some form of insurance against pandemic risk were possible – if insurance companies had some 'skin in the game' – Kai-Uwe though this would not be enough to have a material impact when faced with multi-trillion dollar losses.

One questioner raised the issue of whether, if more risks were considered uninsurable that the insurance industry would start to lose relevance. **Kai-Uwe** though that this phenomenon was related to a shift in the composition of assets – with more of these becoming intangible rather than tangible. This is the key challenge for the industry's long-term relevance: to make more of the intangible assets insurable.

Justin reaffirmed the point that withdrawing from a market may prudentially be the best thing to do, but if a perception grows that "they're not there when you need them" this can damage the reputation of the industry.

Monique looked at the issue from a different angle: that a lot of small insurance (e.g., for smartphones or washing machines) had little value added: "Small insurance, big nuisance", in her words.

Justin noted that this, however, is more a conduct of business issue – whether insurers are putting customers' best interests first. **Kai-Uwe** also drew attention to the structural problems in the industry, such as the lack of capacity. If the German economy shut down for a month, the economic losses would be US$130bn, more than the capital base of the property and casualty insurance sector. “Balance sheets of insurance companies are finite but systemic risks are infinite”, he said. The balance sheet response has to be limited to protect all policy holders and shareholders. Incentivisation of protection and risk mitigation – a more collaborative approach – should be developed further.

Arup added that “insurance and capital markets go hand-in-hand”. The underdevelopment of capital markets can limit insurance provision, especially in emerging economies. Further expansion of contractual savings institutions hinges on capital market development. However, with some emerging economies, particularly the smaller ones, still far away from that prospect, regional solutions need to be considered. The critical role that community can play in managing disasters has been demonstrated during the pandemic. Community-based insurance models can provide important insights into reducing and sharing risk. However, such arrangements are well suited to idiosyncratic (within community) risks, but not systematic (affecting the community as a whole) risks. These models need to be explored further in the light of new technology to calibrate risk with more granular data, and ensure that insurance solutions become efficient, targeted and affordable.

Final thoughts

Kai-Uwe’s concluding remark was that how we define protection gaps is of crucial importance. It is the difference between what people and businesses do buy in terms of insurance coverage and what they should buy. What we should buy cannot and should not cover all potential losses: expectations of what insurers can cover need to be managed. Insurers need to make clear to the public what they can reasonably do and what they cannot do. Essential to this are unambiguous policy wordings – where much progress has been made but where there is further to go.

Justin said if risks exist they should be reflected in the balance sheet. Capital should reflect risks. If there is a risk which it is in the public interest for insurers to cover but it is not viable, then a public-private partnership may well be appropriate. Lowering capital requirements in order to increase insurers’ capacity would not be the right approach. The consequences of protection gaps will inevitably arise. This can be disorderly or, hopefully, orderly.

Arup concluded that if we need to bridge protection gaps, we need relevant products. Health insurance is no use if health systems do not work properly. Insurance markets cannot grow if capital markets are not developed. The government can help, but there are many government protection schemes which are not well planned. The private sector could help in improving these, especially with the use of new technology.

Monique said that protection levels could be increased by involving consumer organisations and having access to their data, helping to mitigate risks. There are many ways of increasing affordability: in some cases, compulsory insurance can be part of the solution, as it increases the risk pool.

Ruth made the point that there is no one size fits all solution. But a loss sharing arrangement between governments and insurers (and reinsurers) for future pandemics could make a big contribution. This would leverage the financial capacities of the insurance industry and capital markets and also support risk management and resilience. There is a huge opportunity for the industry.

Conference Concluding remarks

Petra Hielkema, Chairperson of EIOPA

With over 900 participants from 56 countries there was a wide diversity of participation in the conference. The main themes – digitalisation, regulation, resilience and protection gaps – are discussed everywhere. What has been clear is that there are different staring points, impacts and responses. Digitalisation has been accelerated by the pandemic which is a good thing, but also has consequences: whether we are ‘digital enough’, whether it can bring positive changes, equal treatment of digital and non-digital policy holders and changes in the forms of communication.

Some of the risks of daily life are now confronting extreme risks: from the pandemic, from cyber security and natural disasters. We need to prepare for more extreme events.

The green taxonomy is clearly important in helping to address the risks from climate change and, at a more practical level, to prevent greenwashing.

Capital standards for the insurance industry are still the focus of much work at a global level.

Protection gaps are not new. The last panel emphasised that not everything can always be insured, raising the issue of the role of government as a private sector partner and an insurer of last resort. For some of the new risks, like climate-related and cyber risks, we can no longer say they are once-in-a-century events: they therefore become relevant for the government as an insurer of last resort. The industry itself also needs to play a role: finding ways to offer products that protect and at the same time incentivise adaptation. In that way, the insurance industry can ensure that it remains relevant in this changing world.