



Climate and Disaster Risk Financing and Insurance: 25 key terms you need to know

Factsheet



The frequency and impacts of climate and non-climate related hazards are increasing, and they represent a significant risk to societies and economies around the world. In this context, Climate and Disaster Risk Finance and Insurance (CDRFI), one of the integral components of Comprehensive Disaster Risk Management by national governments, has gained significant importance. CDRFI refers to financial instruments and strategies that aim to improve the financial preparedness and resilience of individuals and societies against climate and natural hazards.

As interest in Climate and Disaster Risk Finance and Insurance grows within the discussion of climate change adaptation, a clear understanding of the language used by industry experts and practitioners is crucial. For an overview and better understanding, the list of terms below aims to provide concise, easy-to-understand definitions of the main concepts that are commonly used by the CDRFI community.

Climate resilience refers to the ability of individuals, societies, ecosystems and countries to withstand and recover from climate change and hazard impacts. This includes the ability to adapt to, cope with and protect themselves from the effects of climate change.

Natural hazard is a geographical event that occurs naturally and has the potential to cause injury/loss of life or property/environmental damage.

Disaster is an event that causes significant harm, damage or loss to people, property or the environment and disrupts the normal course of life in the affected area.

Extreme weather events are hazards that surpass the average weather conditions in a particular region or season, such as storms and storm surges, tornadoes, tropical cyclones, extreme rainfall, snowfall and hail and very long periods of heat and drought. Such events are difficult to predict.

Risk refers to the possibility of losing something of value (life or non-life). In the context of CDRFI, risk is the possibility of a climate-related event causing harm, damage or loss to people, property or the environment.

Risk transfer refers to the process of transferring the potential financial consequences of an adverse event from one party to another. One risk transfer tool is insurance.

Risk layering refers to the utilization of distinct risk financing mechanisms based on the expected severity and frequency of climate-related events. These mechanisms build on and complement one another effectively. Governments employ multiple risk financing instruments in combination (e.g., parametric insurance and catastrophe bonds) to protect against potential losses from hazards of various severity and frequency.

Protection gap in climate risk insurance refers to the uninsured portion of the population. This is particularly relevant in low-income countries due to the underdeveloped insurance markets, where the uninsured population is large, more vulnerable and at risk of slipping further into poverty after extreme weather events.

Disaster Risk Management means analyzing the risk factors of a society to reduce or remove existing risks and disaster losses as well as to strengthen resilience by applying different approaches and strategies.

Losses and damages (plural) refer to manifested impacts of climate change that have not or could not be avoided through mitigation or adaptation measures and which call for transferring those climate risks through insurance and other disaster risk financing tools. Loss and Damage (capitalized) refers to the international climate policy debate on how to avert, minimize and address losses and damages.

Insurance is a financial risk transfer tool based on a collective risk-sharing principle in which each insurance policyholder (which could be an individual, enterprise or a country) pays a premium and can receive a payout for specified losses based on the insurance contract terms.

Insurance products are different types of insurance agreements or policies sold by an insurer. For example, an insurer may sell car and home insurance, liability insurance, health care coverage, etc.

Climate Risk Insurance or CRI is a financial risk management instrument used to transfer economic losses caused by extreme weather events from individuals/organizations to insurers or other risk-pooling entities.

Insurance premium is the amount charged to an insured individual, organization or country for insurance protection. The terms of the payment (i.e., payment due dates, frequency and amount to be paid) are indicated in a contract, the insurance policy.

Insurance payout is a sum of money the insurance company pays to a policyholder.

Waiting period is the time between the purchase date of an insurance policy and the date that it comes into effect.

Parametric insurance is a type of insurance in which a payout is automatically triggered when certain predefined parameters (e.g., duration of a dry period, amount of precipitation, wind speed) are reached or exceeded. This type of insurance can also be referred to as “index-based insurance” as the triggers are thought of as indexes. These terms are used somewhat interchangeably. Some types of parametric insurance are based on a modelled loss approach in which a payout is triggered when the value of modelled losses, calculated based on the hazard parameters, exceeds a given threshold.

Basis risk refers to the challenges of parametric/index-based insurance when actual losses do not match with the estimated losses of a policyholder.

Residual risk refers to the disaster risk that remains even when measures to reduce disaster risk are in place. For this reason, emergency response and recovery resources need to be reserved.

Microinsurance provides affordable protection to low-income individuals against specific risks in return for low premium payments that are proportionate to the likelihood and cost of the risk involved. It primarily caters to people with limited access to traditional insurance services and other resources to manage risks effectively.

Mesoinsurance refers to insurance in which policyholders are associations or organizations. Those entities can include banks, small and medium-sized enterprises and also farmers' associations or cooperatives that purchase insurance policies to protect their member farmers.

Macroinsurance refers to sovereign or government level insurance in which payouts are made to states.

Macro-to-micro insurance mechanism refers to the allocation of public resources by governments to purchase insurance or to provide premium support to effectively reach the most vulnerable households after a hazard occurs. There are several ways in which a macro-to-micro level insurance mechanism can work:

1) The government pays the insurance premiums for individuals and/or households; the persons/households are the insurance policyholders and receive the payout directly from the insurance company.

2) The government buys insurance from a sovereign risk pool, acts as a policyholder itself and distributes the funds to individuals and/or households after a payout is received.

Catastrophe bonds or CAT bonds provide sponsors (e.g., a country or a company) with financial resources to cover losses from natural disasters against payment of interest. If no catastrophe occurs within a predetermined time period, the investors receive the capital back. However, if a disaster strikes, the country or company receives the funds and investors lose the entire invested capital.

Regional (sovereign) risk pools refer to entities that offer parametric insurance products for governments. Such institutions provide financial protection at reasonable costs. Current sovereign regional risk pools include African Risk Capacity (ARC) Group, CCRIF SPC (formerly known as the Caribbean Catastrophe Risk Insurance Facility), Pacific Catastrophe Risk Insurance Company (PCRIC) and the Southeast Asia Disaster Risk Insurance Facility (SEADRIF).

The presented list of terms has been developed as part of the **Pacific Insurance and Climate Adaptation Programme (PICAP)** which is jointly implemented by the United Nations Capital Development Fund (UNCDF), the United Nations University Institute for Environment and Human Security (UNU-EHS) and the United Nations Development Programme (UNDP), as well as the **Climate Risk Adaptation and Insurance in the Caribbean (CRAIC) project** implemented by the Munich Climate Insurance Initiative (MCII) and CCRIF SPC.

Both PICAP and CRAIC aim to develop affordable disaster risk financing instruments, including parametric climate risk insurance to increase the financial resilience of the most vulnerable people in the Caribbean and the Pacific regions.

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