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Disaster Risk Finance and Financial

Disaster risk finance and the participation of financial institutions at various stages of the PPP project lifecycle can also support resilience in infrastructure PPPs. Risk mitigation and risk transfer measures are indispensable for both public and private parties.

A well-developed insurance market can enable public authorities and private operators to effectively transfer risks and ensure the availability of sufficient cash flows to continue operations following a disaster. The cost-effectiveness of insurance products must be carefully analyzed during feasibility study and project planning, however, as insurance costs may result in reduced profitability and undermine project viability in the absence of additional government measures to assume disaster risks. Government can support the development of insurance and reinsurance markets to develop effective risk transfer options while assuming some key risks in the interim to avoid placing excessive disaster risk on the private sector.

The global reinsurance market also plays an important role in helping insurance companies expand capacity to bear disaster risks through additional transference of risk. Beyond the insurance and reinsurance markets, disaster risks can be transferred to the capital markets through Alternative Risk Transfer (ART) products. ART products do not require claim settlement, which can facilitate prompt payment release when a disaster occurs. Catastrophe bonds (also known as Cat Bonds), resilience bonds, weather derivatives, parametric insurance, and captives are key ART products that may be available to transfer disaster risks. Some donor-funded contingent lines of credit can provide immediate liquidity when a disaster occurs.

To secure cash flows to meet additional costs incurred by disasters, it can be useful to establish government financing mechanisms at the national and local levels to fund necessary actions. Such mechanisms can enable rapid liquidity to operators to ensure continuity of service and facilitate recovery.

In addition, disaster and climate risk due diligence by lenders can help parties assess key risks and motivate private operators to incorporate resilience into PPP project plans. Comprehensive assessments by lenders can contribute to the development of bankable projects, even if private entities take on disaster risks, as the extra scrutiny can provide additional information and alleviate uncertainties that may otherwise affect commercial viability.

Key recommendations for policy makers with respect to disaster finance and leveraging the services and skills of financial institutions include discussions of both insurance and disaster finance. While decisions about insurance are often not in the hands of government in a PPP, decisions regarding insurance are discussed to inform project planning and to help governments decide where they might take action to encourage the effective use of risk transfer mechanisms. Governments can also play a key role in facilitating disaster finance arrangements to support recovery in the aftermath of a disaster.

Key recommendations regarding risk transfer and disaster finance are as follows:

- **Make use of risk transfer mechanisms, including insurance, to transfer disaster risks in PPP projects:**
  - Transfer disaster risks borne by private entities with available insurance.
  - Set terms of insurance claims, including priority of claims, to reduce uncertainty in financing arrangements.
  - Conduct a due diligence on insurance contracts to ensure that a payout will be properly made to private entities.
  - Consider developing a regional or infrastructure sectoral risk pool to enable private entities possess sufficient collective purchasing power.
  - Consider ART financial products in addition to insurance to reduce private entities' disaster risk exposure.
  - Consider waiving VAT payment on premium in the event of hardening market and subsidize high deductibles for large claims to make the project profitable and allow for dispensation of placement into the international market beyond a certain size of the project (for example, US$250 million), to avoid stacking of premium costs through several unrated insurers participating while charging participating fees and making the premium expensive.
  - Allow only rated insurers for a threshold on the value of the project to avoid distress situations in case of a large claim.

- **Prepare mechanisms to make funds available to cover the costs of emergency response and reconstruction:**
  - Develop a risk retention program (which may include specialized government reserves, a contingency budget, or reconstruction funds) and related access mechanisms to enable private operators to quickly attain funding needed to restore assets and operations.
  - Establish a regulatory framework for swift insurance claim settlements to enable quick post-disaster recovery and reconstruction.

- **Enable development of viable projects despite risks borne by private entities:**
  - Encourage financiers to conduct due diligence on disaster risks before financial close and ensure that the private entities prepare and implement a disaster risk reduction plan and a business continuity plan.
  - Enable the procuring authority and financiers to directly discuss plans to ensure business continuity and sustainability in case of significant business disruptions.

Useful Tools and Resources

Disaster Risk Financing and Insurance (DRFI) Program https://www.gfdrr.org/en/drfip
InsuResilience Global Partnership https://www.insursesilience.org/

BOX 4

Insurance Requirements in Kenya PPP Contract

Disaster risk insurance is available in Kenya to cover risks of drought and flood, among other natural hazards, in infrastructure PPP contracts. Government has implemented requirements for mandatory disaster risk insurance coverage. As extracted from a sample power purchase agreement (PPA), for example, the seller (the project company) shall "at its sole cost and expense, obtain and maintain, in full force and effect, for the periods specified in Schedule 8, the insurance policies set forth in Schedule 8, in the amounts stipulated (provided that, having regard to the level of cover generally taken out by international independent geothermal power producers acting in accordance with Prudent Operating Practice, such insurances are available on commercially reasonable terms), with reputable insurance companies. Notwithstanding the foregoing, the Parties agree that Schedule 8 sets forth minimum requirements and that the foregoing, therefore, shall not preclude the Seller from increasing the amount of coverage obtained under any type of insurance coverage referred to in Schedule 8."

Source: PwC Advisory; Extracted from a signed PPA.