Catastrophe Insurance Policy for China

1. Introduction.

The vast majority of China’s population lies to the southeast of a line running from Beijing to Sichuan. This entire region is subjected to major floods each year, while typhoons affect the south and eastern coastal areas and major earthquakes affect the western and northern margins. The average annual direct property damage is estimated at approximately USD 15 billion, and together with other immediate economic losses, including business interruption, disaster relief and other costs, are considerably larger.

As with other sectors, insurance in China is growing rapidly, with a compounded annual growth rate of 25% since 2001. However, the property insurance industry is still underdeveloped. Total property premiums in China are about $15 billion, whereas the losses from the Wenchuan earthquake are likely to exceed USD 100 billion. According to most estimates, only 5% of property in China is insured, with most of insurance coverage falling on commercial and industrial users. When it comes to private dwellings it is estimated that only 1 out of 100 is currently insured against natural hazards. Clearly, the current property insurance market in China is dwarfed by the nation’s need for catastrophe risk protection - at the current level of insurance penetration China’s insurance industry cannot currently provide significant compensation for large natural hazards losses.

2. China Catastrophe Insurance Needs. Given the magnitude of potential loss, the adverse social and economic consequences of large natural catastrophes for millions of people and considerable fiscal strain imposed on the government budget by natural disasters, China can benefit very significantly by putting in place a national catastrophe insurance system that would seamlessly combine disaster risk insurance with risk reduction and mitigation efforts. While such a system can take any of several forms, in the end it should achieve the following objectives:

- reduce the financial vulnerability of homeowners and SMEs to natural disasters by providing them with access to affordably priced catastrophe insurance;
- reduce government fiscal risk exposure to natural disasters through a country-wide transfer of financial responsibility for losses to private assets to the private insurance industry;
- create economic incentives for homeowners and SMEs to reduce their physical vulnerability to natural disasters overtime by engaging in pro-active ex-ante disaster risk management.
- provide for immediate post disaster fiscal support for provincial governments to support the indigent and fund critical post disaster infrastructure needs.
An additional related objective and benefit would be fostering the growth of the domestic insurance industry.

3. China Catastrophe Insurance Policy. Since a need for disaster insurance clearly exists in China, and the insurance industry’s capacity is too small to take this task on by itself, the GoC should consider the creation of a national catastrophe insurance scheme – the China Catastrophe Insurance Pool (CCIP). The specific details for a CCIP will need technical analysis, but the outlines for an overall policy for China are emerging, as follows:

4. Fundamental policy:

The creation of a China Catastrophe Insurance Pool that either directly or as compulsory reinsurer, provides insurance for all private residential dwellings and SMEs for major natural hazards in return for a premium. This generic model is already used in a wide range of countries and states (Turkey, California, Japan, New Zealand, France etc) and has been successful. CCIP shall be

1) A public corporation managed by an independent board of directors with exemplary insurance industry, financial and related experience. Directors shall be independently nominated by several government ministries (e.g., MOF, MOCA…), private industry, and the China National Academy of Sciences.

2) Privately funded and financially self-sustainable, and managed according to sound actuarial practices and subject to government insurance regulations.

3) Effective in promoting ex-ante risk reduction by individuals and whole communities.

4) Established in a timely manner according to a schedule specified by the State Council.

5. Elaboration

1) Participation. Catastrophe insurance will be compulsory for every registered homeowner and SME. The most appropriate premium collection mechanism will need to be determined.

2) Risks covered. CCIP will provide earthquake (and earthquake initiated hazards such as tsunami, landslides and fire) coverage at the earliest opportunity, as fast as a program can be practicably created. Flood, wind and other natural hazard covers are dependent on development of technical data, and will be added in a timely manner on a schedule to be specified by the government. Flood, because of its unique characteristics, including scope for immediate post disaster mitigation

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In recognition of the different nature of catastrophe insurance from ordinary property insurance, there exists a need for a specialized separate regulatory framework, to be implemented by specially trained professional regulators.

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action and use of soft loans, could be handled through a separate arrangement but under the same administrative umbrella.

3) **Policy terms and conditions.** Coverage will be provided for damage to private residential dwellings and possibly contents; as well as for damage to business premises. Several options exist, including (i) policy limits similar to traditional insurance, with values to be set by the owner and confirmed by the underwriter; (ii) a flat minimum cover (e.g., C¥ 100,000) for all insureds, with higher limits at their option; (iii) an insured limit based on median property values in each participating province (or similar formula). The best option should be identified by further study within the time limits specified by the government.

4) **Risk rating.** Risk-based pricing approach to the risk, where the premium rates charged to homeowners will vary based on the location, size and construction quality of their dwellings.

5) **Risk underwriting.** The compulsory insurance policies will be issued by participating insurance companies and backed by the CCIP, which will act as a special insurance entity established for the purpose of underwriting residential catastrophe insurance risk in the country. The pool will act as a national aggregator of catastrophe risk acquired from the sales of compulsory residential insurance policies. All aspects of the pool’s management and insurance operations will be outsourced to the private sector. The pool will be managed by a professional insurance services company hired through an open tender.

6) **Claims settlement.** Property damages in the aftermath of natural disasters will be adjusted by participating insurance companies. To ensure consistency in loss assessments, adjusters which will receive special training.

7) **The role of government.** The key elements of government participation include introduction of special catastrophe insurance legislation, enforcement of the compulsory insurance requirement as well as provision of a backstop contingent capital facility to the program to ensure its solvency in case of highly unlikely catastrophic events.

8) **Risk financing.** The pool will heavily rely on private reinsurance and its own reserves, which will be built over time from the pool’s own earnings. The government will be required to provide a backstop liquidity facility to the pool to pay claims from highly unlikely catastrophic events.

9) **Incentives for mitigation.** To encourage individual communities to engage in risk mitigation efforts, each local government will be required to adopt a disaster risk management plan. The insurance premium rates will reflect the progress achieved by communities in implementing their risk management programs.

10) **Subsidies.** The World Bank’s accumulated knowledge of and experience in a wide range of countries indicates that inappropriate use of subsidies can easily undermine effective insurance arrangements. If subsidies are applied they should be explicit (i.e. the full price of risk should be transparent) and well targeted to the truly needy.

Experience here points to a need for completely separate arrangements to those for the private sector. Both financial instruments (Mexico, Ethiopia, Malawi) and sovereign regional structures (Caribbean Facility) have been employed to meet governments’ post-disaster fiscal needs. The fiscal post-disaster needs of the provincial governments and ways to address through modern risk hedging instruments should be addressed in a special piece of legislation that will deal exclusively with the disaster funding needs of the public sector.

7. Next step. Given the need for a national catastrophe insurance scheme for China, the government should consider promulgating framework *Catastrophe Insurance* legislation which states the fundamental principal for a catastrophe insurance program and appoints a special Working Group composed of key Ministries, private industry and technical experts, to develop the specific operating procedures and norms for CCIP according to a timely schedule.