

# ***Interactive comment on “When is it beneficial for insurers to engage in climate change adaptation – a cross country comparison” by Isabel Seifert-Dähnn***

## **Anonymous Referee #3**

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Review of the paper “When is it beneficial for insurers to engage in climate change adaptation - a cross country comparison”

This paper discusses the role that insurers can play in climate change adaptation. It starts with an overview of different flood protection measures, it gives a general introduction to the functioning of insurance markets and then examines insurers’ activities in relation to natural hazard risk reduction, which I think is the core of the paper.

In principle the topic is of interest as is clearly argued in the introduction, but I think the title and the abstract do not well reflect the content of the paper. The paper mainly focusses on floods instead of climate change risk in general. Moreover, climate change

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adaptation is interpreted as being similar as disaster risk reduction. Most of the paper tends to focus on disaster risk reduction measures and insurance activities in relation to these, and not necessarily on climate change adaptation which implies adaptation to changing risks. This distinction is important because insurance contracts are usually focused on one year, which implies that premiums, deductibles and coverage conditions etc. are determined for the current risk in that year, and not for future risk in a changing climate. So many of the insurance activities in relation to risk reduction discussed in the paper, such as risk based premiums to incentivize adaptation, apply to current risk and may incentivize measures that reduce current risk, but not necessarily apply to adaptation to a changing climate. Also I feel that the promise in the abstract that “it is discussed under which conditions it becomes profitable for them to engage in climate change adaptation” is not really fulfilled in the end, at least not in an in-depth manner.

A general suggestion is to revise the title and abstract so it is better in line with the contents of the paper. Moreover, I suggest to explicitly clarify the research method in the introduction. The literature review used is selective and the paper mainly discusses existing studies of flood insurance systems in a few countries: namely, by mainly focusing on the UK, Germany, France, Norway, and the US. This is in principle not a problem, but this focus and the literature review approach should be clarified upfront. Some of the discussion of these flood insurance systems in these countries is still on a quite general level. It could be considered to provide a more in-depth analysis of a few of these countries to arrive at a more detailed understanding of how insurance contributes to risk reduction there, or not, and how these insurance systems can be improved.

Moreover, I suggest to clarify the innovation of this paper compared to the existing literature on this topic. The main contribution of this paper seems to focus on the relation between flood insurance and risk reduction, but this has already been discussed in several of the studies cited in the paper. Moreover, the main topics addressed and

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messages of the paper seem to be very similar to the review paper by Surminski (2014) on the same topic, which is not cited in the paper. In its current form I feel that the paper does not add much new insights to this existing academic literature on the topic of natural disaster insurance and risk reduction. I suggest to clarify in a revision how the paper builds upon existing studies and explicitly indicate what the new lessons are that we learn from this paper.

In addition to these general comments, I list several specific suggestions for improving the paper below.

Page 9: Catastrophe risk models are often used to assess natural hazard risk and determine premiums, instead of only relying on historical loss observations as the text states.

Page 8: Adverse selection results from an information asymmetry; if the individual has better information than the insurer about her/his risk type then the situation may arise that many high risk individuals demand insurance, while insurers do not recognize these high risk types and charge too low premiums to them. It is not trivial in practice that individuals have more knowledge about the natural hazard risk they face, because these are generally low probability events with which individuals have little experience. Moreover, recent advances in catastrophe risk modelling imply that insurers have access to sophisticated risk assessment methods.

Page 8: The French system can also be seen as a public-private natural hazard insurance systems, since there is public reinsurance but private primary insurance.

Page 8: Moral hazard is a term that is often used as a market failure in insurance markets; individuals with insurance coverage may take fewer risk reduction measures if there are information asymmetries and premiums are not risk based. Empirical evidence shows that moral hazard in natural disaster insurance markets is minor; in the contrary the insured tend to prepare better for natural hazard risk than the uninsured (see Hudson et al. 2017). What you call moral hazard is usually defined as charity haz-

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ard; due to government compensation of disaster damage people have a lower incentive to insure and take risk mitigation measures (see Raschky and Weck-Hannemann, 2007 for a literature review on charity hazard, and several empirical papers have been published on this topic the last years).

Page 9: “Theoretically, special conditions could be formulated for every individual policy-holder.” I think this is a surprising statement. Of course to limit problems with adverse selection and moral hazard theoretical studies have advocated the use of some form of risk based pricing and monitoring of policyholders’ risk types, but this does not imply that special conditions have to be formulated for every individual policyholder. Insurers generally work with risk classes for which different premiums and coverage conditions can be specified.

Pages 9-10: I find the discussion in 5.1.1 unclear. A main issue with many large scale structural adaptation measures, like the example of flood protection used in that section, is that they have public good characteristics of being non-rival and non-excludable. It is well known in economics that private markets, including insurance markets, under-supply public goods, which is why their provision is primarily a government task. Of course insurance can stimulate its provision, for example by sharing data and knowledge about high risk areas that need protection or provide lower premiums or better coverage conditions to policyholders in areas where protection measures are installed. However, the section seems to mainly focus on insurance financing and provision of these measures, which is not a logical starting point given our knowledge about public goods.

Section 5.1.2: A main issue with hazard modification measures is the uncertainty of their effectiveness. I don’t think these are fully proven or generally accepted methods, which makes it unsurprising that insurers are not involved in this on a large scale. This should be discussed much more critically.

Page 10: I think the main insurance advantage of constructing levees in the US is that

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this allows for being mapped out of the 1/100 year flood zone if the levee fulfils that safety standard, which implies that the flood insurance premium declines. This is independent of whether the community participates in the Community Rating System that is described in the text, for which indeed communities can receive premium discounts by engaging in other risk reduction activities than only levees.

Page 10: For the discussion of the UK insurance system it is important to point that insurers regarded flood insurance in high risk areas unviable at current rates if no additional flood protection was installed. Due to the Flood Re agreement indeed insurance is still offered in such high risk areas, but it is not immediately obvious to me why rates should fall if they were initially viewed as being too low given insufficient spending on flood prevention.

Page 11: A few points are relevant to note at the description of the example of Bräuninger et al. (2011). Indeed if the insurance premium is 400 euro, you need a large percentage discount to incentivize risk reduction measures before the discount is sizable in an absolute monetary amount. However, flood-proofing measures are usually only cost-effective in cases when flood probabilities are relatively high (see e.g. Kreibich et al., 2011; Poussin et al., 2015) and in such areas premiums would be a lot higher than 400 euros a year (which would be equivalent to a risk of suffering a 40,000 loss only once in 100 years if premiums are actuarially fair, which they are usually not which implies an even lower flood probability). So in an example where risks are low and flood-proofing measures are not cost-effective, why would one want to incentivize these measures if the objective is to maximize societal welfare? It is only welfare enhancing to do this for policyholders who face a high risk and, hence, pay high premiums in the absence of risk reduction measures, if premiums are partly risk based. An advantage of a premium discount in that case over the mentioned deductible is that the premium discount is a tangible benefit that the policyholder would receive every year. In contrast, the benefit of a lower deductible only occurs when a flood happens which may receive less weight in individual decision making when people underestimate flood

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probabilities, as we know is often the case.

Page 12: I don't fully understand why giving a loan for implementing risk mitigation measures would require multi-year insurance contracts. Of course a loan could be combined with a multi-year insurance contract, but couldn't such a loan be equally effective with an annual contract? I think in that case the loan could be equally effective to overcome short term budget constraints of households for investing in risk reduction and spread mitigation costs. The relation of this text with the Bräuninger et al. (2011) example is unclear to me, also given the issues with this example discussed in the comment above.

Page 12: "In private systems, approaches to strengthen private adaptation seem to be in their infancy". I agree this applies to many property insurances for households, but this may be very different for insurances for commercial properties for which it is more common to have on-site inspections to assess risk of insured industries and adjust premiums on the basis of risk management practices. I suggest to be more specific on the basis of which evidence this general claim is made or to make it more nuanced.

Page 13: Another example of the sharing of risk knowledge by insurers may be the Zurich Flood Resilience Alliance in which the insurance company Zurich finances the measurement of flood resilience in communities. See <https://www.zurich.com/en/corporate-responsibility/flood-resilience>

Page 13: Insurers mainly use pricing on the basis of risk classes to avoid negative selection instead of the awareness campaigns mentioned in section 5.2.2. If awareness is raised then negative selection may still occur if premiums do not sufficiently reflect risk and it is mainly attractive to insure for high risk individuals.

Page 14: "To my knowledge there are no insurers that are currently engaged in emergency response activities." It would be useful to know how exactly this was researched since this general claim seems to contradict the next sentences about insurers giving advice about how to limit damages during/shortly after disasters.

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Page 15: “In private insurance systems, I found no evidence for insurers exerting influence on land-use planning or building plan.” Also here it would be useful to know on which kind of research this general claim is made. It is surprising since, for example, in the Flood Re system in the UK mentioned before in the paper insurers do not provide coverage to new constructions in high risk flood zones, which aims to steer development away from high risk areas.

Section 5.3.2. I suggest to provide a more in-depth discussion of what role insurers could or should play in liability lawsuits with regards to flood damages. I doubt whether the legal literature on this topic is well reviewed here.

Section 5.5.3. The Flood Re system in the UK is given as an example of insurance agreements with state actors, but not discussed in much detail. As said before in the paper, there are various public-private flood insurance arrangements in different EU countries, which entail different forms of agreements between the state and insurers. I suggest to discuss these in more detail; e.g. what are the key lessons we can learn from these systems for improving insurability and risk reduction?

Section 5.4.1 overlaps to a large degree with the discussion of risk based premiums and deductibles in 5.1.3. I suggest to integrate these texts so the topic is discussed in a more in depth manner. The current text focusses on challenges with incentivizing risk reduction using risk based premiums, which certainty exist. However, the opposite situation may be useful to point out as well; how can one effectively incentivize policyholders to implement expensive risk reduction measures when premiums are not risk based, meaning the policyholder pays the mitigation cost and the insurer receives the benefit in terms of lower expected claim payouts? It is difficult to see the benefits for policyholders to take risk reduction measures in such an insurance system. So even though working with general risk classes for different groups of policyholders and giving premium discounts for some effective measures, like elevation of homes as is done in the US, may not give the perfect signal for risk mitigation, it may be a better alternative than having flat premiums.

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Section 5.4.3 overlaps with the earlier discussion about grants for mitigation on page 12. I suggest to integrate these text parts.

#### References

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