In focus: Public and private support in risk financing

For crisis-prone communities, financial preparedness against risks is preferable to a reliance on post-crisis assistance – allowing people greater resilience and control in the face of disaster. It can reduce the impacts of a disaster as well as create incentives to further reduce risk and bring greater confidence to invest – bringing potential to stimulate economic growth and reduce poverty.

Such financial preparedness requires multiple sources and instruments because ODA and humanitarian assistance are not always sufficiently resourced, nor best placed to support these initiatives. In certain contexts, complementary approaches can come from the increasing range of market-mediated financial and insurance products, for which there is growing demand and political commitment. Extending risk financing (such as savings, reserves and credit facilities) and risk transfer products (such as insurance or catastrophe bonds) to developing countries is now feasible on a scale unthinkable 10 years ago due to developments in the products and payment distribution, as well as technical innovation in measuring and modelling risk.

Financial preparedness is a core element of a comprehensive approach to risk management. It involves identifying exposure to and the financial consequences of risk, then putting in place strategies to reduce risks and manage residual risk (that which cannot be practically or cost-effectively reduced).

Managing residual risk typically involves a layered set of options to directly manage and meet the financial cost of the most frequent and low-impact risks (such as sickness) through a combination o f savings or reserves and access to credit. For less frequent but potentially high-impact risks (such as droughts or floods), against which it might not be feasible to retain sufficient reserves, the cost of meeting post-disaster financing can be met through insurance, risk pooling and catastrophe bonds, effectively 'transferring' the cost to others – such as the private sector. Paying premiums spreads the cost of risk over time, while combining the premiums across multiple fee-payers spreads the risk itself across space.

Risk financing and risk transfer requires the expertise, technological and financial capacity of a broad range of actors across public and private sectors and civil society. The role of donors and other international actors is typically catalytic, providing seed-funding to test and scale up initiatives. They can also support domestic governments to develop their own sovereign risk financing strategies and invest in public goods to build understanding of risk and demand for risk financing and enable markets to function better.

The 'enabling' conditions for risk financing and risk transfer to function effectively and sustainably may require significant and sustained investments over many years, and in specific contexts. This means that in practice they have limitations: risk financing and transfer mechanisms have largely focused on providing financial preparedness against natural disaster risks and are not likely to be feasible in protracted, conflict-related humanitarian crises. In such instances, internationally financed humanitarian preparedness and response will remain critical to meeting the needs of people at risk of crisis.

But as outlined in Chapter 9, even where risk-financing and risk-transfer models are not possible, more 'risk-informed' humanitarian action, which invests in preparedness and responds to early indicators of a deteriorating situation, would confer some of the benefits of better financial preparedness for disasters. These include a more timely and cost-effective response, improved humanitarian outcomes and protection of livelihoods.

Risk financing involves taking measures to ensure that adequate funds are directly available to meet financial needs should a disaster occur. Such financing can be established internally through the accumulation of funds set aside for future use or obtained externally through prearranged credit facilities. The banking sector, capital markets and international lending institutions are all sources of risk financing.

Risk transfer involves shifting of the cost of risks to others who, in exchange for a premium, provide compensation when a disaster occurs, ensuring any financing gap that might emerge is partially or fully bridged. Risk transfer may be obtained through insurance policies or capital market instruments such as catastrophe bonds. The insurance and reinsurance sectors are the main sources of risk transfer, although capital markets provide an alternative source. The pay-outs of risk transfer instruments may be calculated on the basis of an assessment of actual losses sustained (indemnity-based), or a pre-agreed payment based on the occurrence of a particular trigger, such as reduced rainfall over a defined period of time (parametric and index-lined insurance). The advantage of the latter is that assessments are not necessary, so expediting pay-outs and reducing administrative costs.[16]