



KOBE REPORT draft
Report of Session 4.4, Thematic Cluster 4

Reducing and managing disaster risk through financial services

1. Summary of the session's presentations and discussions

Actors from the private and public sectors, international organizations, and research institutes identified **concrete steps that need to be taken** (and by whom) to improve disaster finance. The purpose of this parallel session was to discuss the experience of using tools provided by the private sector, such as insurance and other financial services for disaster risk reduction and risk transfer. The presentations outlined concrete steps to use insurance and financial services for disaster risk reduction in developing countries.

Thomas Loster, Munich Reinsurance Company:

Insurance and reinsurance have been active in disaster risk financing activities and have made risk transfer tools and products available at the large, medium, and small scale to their clients. Such products include catastrophe bonds, weather derivatives, micro-finance and micro-insurance, in addition to traditional insurance policies. Insurance and reinsurance companies also provide technical services such as maps of natural hazards, building quality research, hazard models, index products, loss potential communication, etc. The global insurance industry needs

- A large group of insureds (solidarity principle, also positive pricing effect)
- Commitment to minimize/mitigate losses (deductibles)
- Avoid "anti selection" (negative risk selection)
- Hazard and loss assessment, claims handling system
- Long-term business and wide geographical spread
- Long-term trustful business relationship
- Stable distribution system
- Clear Rules and regulations (government, administration)
- Demand (clear interest of the affected)

Public Private Partnerships could provide a solution. What is needed is:

- Strong commitment and dialogue between all involved groups
- Political (and economic) stability, long-term involvement
- Visible win-win-situation

IDB: Mr. Toshio Kobayashi

In Latin America and the Caribbean, as in much of the world, international donors assume part of the risk for the governments, and governments assume part of the risk of the private sector when disasters occur. Risk is insufficiently transferred through insurance. Markets for disaster risk financing face significant supply and demand side challenges, with specific characteristics in individual countries. For example, in El Salvador the two main obstacles to expand coverage are the low purchasing power of most of the population and a lack of insurance culture and

knowledge for covering disaster losses. In Peru, over 60% of the economy is not formal, and low-income people living in marginal areas take disaster risks without coverage. **Good practice:** To address these challenges, the Inter-American Development Bank assists governments to address underlying constraints that hinder the private sector from engaging in risk financing through:

- Helping remove market barriers to entry,
- Strengthening property valuation and titling,
- Improving the application of building codes, and
- Assisting in risk assessments, including support land use planning.

AIR-Worldwide: Ming Lee

In order to design and implement disaster financing schemes, background information about the hazard, the building stock, and economic costs beyond property damage is needed. For developing countries, often the weakest part of hazard modeling is lack of data on exposures, by geographical regions, including the numbers of people, numbers of properties by construction type, and infrastructure.

The use of cat bonds is emerging as a viable alternative for financing disaster risk and one means of private sector participation. A prerequisite for issuing a cat bond is quantification of the risk (for evaluating, pricing and rating the risk). Catastrophe modeling is a standard technique for global risk assessment and management by the private sector (insurance industry and capital markets), and is one of the primary tools for national Disaster Risk Managers, too. To facilitate future use of modeling tools, developing countries should institute appropriate data collection programs.

SLF: Stefanie Dannenmann

There is a high awareness of the need for disaster prevention. However, current incentives persuade decision makers to favour emergency response and reconstruction over disaster risk reduction activities. One of the principle incentives for this choice is the availability of resources immediately following a disaster, and the lack of interest in pre-disaster funding. About 80% of all disaster-related spending is ex-post, and insurance penetration in the region is low. International finance institutions increasingly devote resources to projects for disaster risk reduction. Yet when disasters occur, it is common practice to divert funds from existing development projects—including those with disaster reduction components—to pay for emergency response and reconstruction.

The main obstacles for disaster risk reduction and finance appear to be institutional and political, reinforcing the message that underlying incentives for risk reduction like disaster finance must be addressed.

- Create incentives for preventive, risk-reducing disaster finance mechanisms.
- Involve key players to lay groundwork for effective cooperation in disaster finance schemes.
- Develop institutional and legal capacity for disaster finance.
- Encourage ongoing assessment of disaster risk-management methods and socio-economic studies.
- Develop training programs and guidelines to incorporate the concept of integrated risk management.

Lessons learned

Experience with pre-event disaster finance mechanisms is limited, particularly so for schemes that involve the private sector. Lessons about involving both the public and private sector in

partnerships for disaster risk reduction and finance are still emerging. Partnerships for disaster risk finance are **opportunities for different actors** to play different roles. Experience indicates that each partner has a specific role to play promoting disaster risk reduction and finance in developing countries and stands to benefit from participation.

International organizations can offer stability and a forum for partner dialogue as disaster finance schemes are refined and implemented. International organizations have the technical and operational expertise needed to test pilot projects, gather and disseminate data, and engage partners with both short- and longer-term time horizons. These organizations can support governments in building legal and institutional frameworks for insurance, standardize the language and understanding of disaster finance concepts, and give training to fortify local risk transfer capacity.

Governments can create the legal and institutional framework for insurance services, especially the participation of formal reinsurance and insurance companies. Governments also can foster a culture of risk reduction and risk transfer. An appropriate framework will not be created without the political support to establish disaster finance schemes.

Community groups can share the cost of losses suffered by individual members; this encourages risk reduction activities by all group members. Disaster finance services can be directly linked with risk reduction that strengthen the solidarity between members of community groups.

The **private sector** can provide the core expertise needed to offer disaster finance and risk transfer products in developing countries. Today, however, the sector is strained and prefers selling products where insurance has core competencies. To retain private sector interest, products must be packaged in ways familiar to business and in collaboration with other institutions that have experience reaching clients. As an alternative, corporate social responsibility could motivate the private sector to contribute expertise. Companies can invest in building insurance competence in communities, and help them improve the risk management capacity of their societies.

NGOs can bring innovation and local knowledge to disaster finance and risk reduction among the poor. NGOs often have the trust and working relationships with community groups. This position allows NGOs to bring a degree of inventiveness in meeting client demands.

2. Primary issues

The session highlighted several primary issues that are central to the effective implementation of disaster risk reduction through disaster finance.

- **Disaster finance is a development issue.** Disasters destroy livelihoods, the infrastructure of development, and frequently exacerbate poverty. Challenges to developing more effective, efficient disaster finance schemes include a range of demand and supply side issues. To make disaster financing sustainable, the underlying incentives and framework for financial services must be addressed.
- **Legal framework.** Governments could develop further the necessary legal and institutional framework needed for financial services such as insurance. Such a framework would facilitate risk transfer schemes for natural disasters.
- **The tools for disaster finance schemes exist in the private sector** (such as insurance, CAT bonds, etc.) but have to be adapted to the special circumstances in developing countries (Design effective, appropriate disaster finance schemes). These tools should play a role in helping to reduce and transfer disaster risk. An opportunity exists to engage the private sector in disaster risk reduction through a call for corporate

- social responsibility. Shareholders are willing to invest in social responsibility. Doing so can benefit both people living in hazard-prone areas, as well as companies.
- **Solidarity.** There is a need to find balance between equity and efficiency in disaster finance strategies. Each country will have a different approach to finding this balance, but to achieve maximum risk pooling, citizens must be willing to share some part of each other's risks. Basic questions about how disasters affect society and how these effects are paid for should guide future disaster finance strategies.
 - **Capacity building.** Countries need assistance to build greater capacity to understand risk data, use disaster finance tools, and communicate the benefits and costs of alternative disaster finance schemes. In particular, policy makers must receive—in terms that match their budget timelines and the political cycle—a clear message about why disaster finance strategies should become a policy priority (reasons include enhancing economic performance, helping society recover faster from disasters, reducing poverty after disasters, etc.).

3. Suggested targets and indicators

Disaster finance

- International target: Operational policies and strategies of international finance institutions should reflect disaster risk financing that complements risk reduction.
 - Related indicator: Evaluations of international finance institutions' loan activities (operations) whether and how client countries have the support necessary to pay for pre-disaster risk reduction and risk transfer activities.
- National target: Country governments should establish disaster finance strategies appropriate to their development goals.
 - Related indicator: Designated responsibility at the national level for the design and implementation of a national disaster finance strategy that specifies resources for pre-disaster activities in addition to emergency response and rehabilitation.
- Local target: Availability of risk transfer mechanisms for the risks of greatest concern for (micro) business owners: loss of life, loss of property, and loss of the ability to earn a living.
 - Related indicator: Availability of such risk transfer mechanisms at the local level (presence of micro-insurance, insurance, traditional risk transfer mechanisms within community groups, etc.).
 - Related indicator: Risk transfer products that can be shared by groups. Premiums that comprise a very low percentage of policy-holder's income.

Legal, regulatory, and institutional framework

- National target: Establish regulations for financial services such as banking and insurance which facilitate disaster finance at national and local levels.
 - Related indicator: Existence of rules or regulations for micro-insurance, insurance, and banking. Flexibility of capital and agent rules, expansion of professional, legal and broad insurance services.

Data and tools

- International: Cooperation and dialogue to design and develop tools such as insurance, catastrophe bonds, national and regional risk pools, etc. for developing countries.
 - Related indicator: Symposia, interest groups, and partnerships for risk finance schemes for developing countries.
- National and regional target: Establishment of systematic, standard data collection framework to record information such as hazard exposure, value at risk, and underlying socio-economic conditions. Further development of tools for risk analysis and assessment (appropriate to developing countries).

- Related indicator: At the minimum, pilot projects for systematic, standard data collection frameworks and development of tools for risk analysis and assessment (appropriate to developing countries). These pilot projects should be well documented with lessons learned and best practice.

Partnerships and solidarity

- National and regional: Establishment of public private partnerships for disaster risk financing.
 - Related indicator: Is there an action plan of potential partners that provides a common platform for collaboration, and vocabularies, time frames, and objectives? Are roles for potential partners clearly defined? A practical step to delineate roles would be to establish a memorandum of understanding among partners that would lay out roles, policies, and procedures.
- Local target: Facilitate cooperation between institutions providing disaster risk transfer tools (such as micro-insurance) at the local level.
 - Related indicator: Presence of local risk transfer tools for low income households.

Capacity building

- International: Development of guidelines for development of national capacity to implement disaster risk financing schemes.
 - Related indicator: Availability of handbooks, documentation of good practices in disaster finance, training modules for practitioners for disaster finance.
- National: Articulation of need for pre-event disaster finance mechanisms, clearly communicated in layman terms to national policy makers.
 - Related indicator: Media campaigns, lobby groups that articulate need for disaster risk finance strategies.

4. Partnerships

Effective partnerships present the most plausible way to improve disaster finance schemes in both developed and developing countries. To keep momentum moving, the process requires dialogue between partners such as the international community, governments, civil society and the private sector. Session participants agreed to establish an **Interest Group on Disaster Risk Financing (DRF)**. The goal is to provide a platform for all actors involved, in particular national initiatives, and to work on concrete pilot projects. SLF Davos, as session organizer, will take the lead and provide support for the first steps. For information about this Interest Group, please contact drf@slf.ch.

5. Additional remarks: Road map for the next steps

Before partnerships can be formed, specific actors should take the following actions in order to lay the groundwork for effective cooperation in disaster risk finance schemes. The international community should take the first steps to change incentives towards preventive, risk-reducing disaster finance mechanisms (instead of almost complete reliance on emergency aid and response). The international community should also help countries develop institutional and legal capacity for disaster finance as part of a comprehensive disaster management approach, including technical assistance to design appropriate financial mechanisms. Countries themselves can follow the first steps of the international community by establishing and supporting regulatory environment for financial services such as insurance, savings institutions, and other risk management institutions. Countries can also establish common risk-related data gathering frameworks. Once the legal, institutional, and regulatory framework, necessary value-at-risk-data, and markets for financial services are established, the private sector could feasibly become involved in helping manage and transfer disaster risk in developing countries.

6. Contact information

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