

Invest to prevent



disaster

Microfinance is a tool that has successfully been utilized to improve livelihood options and reduce poverty. It has hardly been used yet as a tool for reducing risk vulnerability to natural hazards. Leading up to the International Day for Disaster reduction (12 October 2005), the ISDR secretariat will promote dialogue with the microfinance community on the possibility of using these tools to reduce disaster risk and increase community resilience to disasters.





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Microcredit is widely recognized as a useful tool to help reduce poverty. The possible benefits of microfinance to abate the impact of natural disasters, however, have not been fully explored. The new and promising concept of microfinance for disaster reduction deserves increased attention. As the applicability of the microcredit is still somewhat experimental, it merits further investigation.

Despite a current lack of conclusive results, the financial community has concrete examples that demonstrate that microfinance can be an effective tool for reducing the impact of disasters on certain populations. In Bangladesh, for instance, those who were already benefiting from microfinance were more able to recover from the 1998 floods. Microfinance helped develop greater coping capacity and reduced community vulnerability. In addition, through post-disaster loans, microfinance can help poor households recover more quickly.

So far, microfinance institutions have been involved mostly with post-disaster recovery. There is a need, however, for microfinance to be perceived as a potential tool to better prepare communities before natural hazards strike. Some pre-disaster microfinance projects are underway and working very well. We asked experts and colleagues from various backgrounds including microcredit institutions, UN organisations, commercial and development banks, re-insurance companies, NGOs, academics and disaster risk institutions to share their point of view on the issue.

The potential of microfinance for disaster risk management is enormous. The consultative Group to Assist the Poor (CGAP) estimates that microfinance institutions have reached more than 80 million clients. At the Microcredit Summit, the potential market for microfinance was estimated at about 3 billion people.

Although microfinance can help protect communities from disasters, many challenges remain. These are often linked to the traditional mandates and organizational structure of microfinance initiatives. The initiatives are often at risk themselves and not sufficiently strong financially to survive large natural disasters. When a disaster strikes they may not be able to respond adequately to a large volume of claims and may not have sufficient liquidity. The use of microcredit for investment in disaster risk management also requires that the community is aware of the positive impacts of preventive measures and a degree of confidence in financing and insurance institutions, both of which are often lacking.

In short, microfinance has great potential for reducing the impacts of disasters but must be further developed for this purpose. Microcredit can complement other disaster recovery mechanisms to rebuild the lives of people affected by catastrophes, as well as help make communities less vulnerable and more sustainable. The current Indian Ocean tsunami recovery provides an opportunity to verify that microfinance is a strong tool to help alleviate the suffering of the poor.



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A Non Governmental Organization Perspective

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1. From your experience, can microfinance be a tool to reduce disasters?

Access to microfinance facilities is increasingly becoming relevant for both the vulnerable poor and humanitarian sector. Relief and compensation efforts are useful but not enough; they do not fully compensate or adequately help the poor recover all the incurred losses. Thus, in addition to relief or compensation, victims also need access to microfinance. Financial services enable the poor among victims to leverage their initiatives and accelerate the process of rebuilding lives and livelihoods, as we have learned from our Livelihood Relief Fund (LRF), which reached 15000 small businesses after a 2001 earthquake. Microfinance can help the poor in moving out of poverty and the vulnerable in moving out of risk. Similarly, promotion of microfinance as a risk reduction investment can significantly reduce the total cost of financing post-disaster relief and reconstruction. Microfinance has helped victims of disasters accelerate their recovery and diversify their livelihoods with more productive sources of income. Microfinance as an emergency loan has also promoted a culture of preparedness as victims use it mainly to recover after a disaster.

2. What are the main limits or constrains of this tool in this context? What are the best conditions for its optimal functioning?

Though microfinance is an effective tool for risk reduction and risk mitigation, it has limitations. Firstly, microfinance cannot provide complete protection against disaster risks resulting in a loss greater than what a household can save or repay. A majority of microfinance programmes do not combine risk transfer or risk mitigation strategies along with microfinance. Secondly, microfinance services cannot immediately translate into a stand-alone successful disaster recovery enterprise. Thus, providing a range of other services for accessing basic amenities, relief compensation and business development services, including marketing after a disaster are crucial for the swift recovery of the poor. Thirdly, microfinance programmes have emerged in response to the needs of the poor. However, when it comes to financing disaster losses of the poor; commercial banks and microfinance institutions are unwilling to finance such losses. Thus, the poor remain marginalized. It is a common myth that disaster victims are unable to save and that they are unreliable borrowers. However, random and unreasonable flows of relief discourage savings and repayments. Fourthly, the economic losses of disasters are relatively higher for the poor. Loss estimations mostly bypass their loss of income and livelihoods. They usually suffer the longest and the most compared to other social groups. However, a vast majority of disaster victims in India have limited access to microfinance services, especially after a disaster or during recovery. In addition, they do not have any say in deciding the level of interest rate or other terms of financial agreements. Market penetration in the lower income strata of India is low and even lower in disaster-prone areas. The spread of SHGs and vulnerable areas do not overlap. Thus, the role of microcredit demands a cautious approach. Fifthly, a majority of financial institutions prefers dealing with large loans in small numbers to minimize administrative costs. However, a large number of small loans are needed to serve the poor among victims.

Some of the best conditions for optimal functioning of microfinance for disaster risk reduction and risk mitigation at grass roots level include, a) convergence of microfinance with microinsurance and micromitigation, b) adaptation of demand driven and decentralized approach, c) microfinancing on a cost-recovery basis and d) increased investment in community-based microfinance initiatives. Microfinance has worked when: a) institutions installed financial discipline through savings and demonstrated a matching value themselves before lending; b) disaster-affected communities governed the design and implementation of schemes (by deciding rates of interest, amount, and repayment period); relief or savings preceded credit; c) microfinance programmes worked more closely with women; d) programmes were conceptualised, localized, and monitored closely; e) programmes leveraged maximum funds from formal markets; and f) a facilitative environment and enabling regulatory regime contributed to its success.

3. Did this work in India in the context of disasters? Could it be used for deducting the impact of floods in other countries like Philippines? What would be required to achieve that? What are the future prospects for microcredit?

India has mainly two sets of institutions offering microfinance, which are formal and informal institutions. Traditionally, the formal-sector banking institutions in India, such as commercial banks, housing finance institutions (HFIs), NABARD, rural development banks (RDBs), land development banks and co-operative banks (CBs), have served the needs of the commercial sector only. It is difficult to assume that formal-sector banking institutions in India have shown enough application of microfinance in the disaster context. We do not have any data or studies to prove in what way and at what scale or level formal sector institutions have played their role in disasters risk reduction through microfinance.

The Disaster Mitigation Institute (DMI), a small and informal microfinance institution that provided microfinance to small businesses after the Gujarat Earthquake of 2001 and the 2002 riots with Kheda Association, has had a fascinating and satisfying experience with microcredit. Disaster victims of both riots and earthquake used the provided loans for multiple purposes, including business recovery, housing reconstruction, insurance protection, education, including mitigation and physical security. Similarly, Self Employed Women's Association (SEWA) gave a major proportion of its loans to its women members immediately after the Gujarat earthquake. The loans were again used for multiple purposes to recover from the earthquake and reduce future vulnerabilities. DMI has learned that loans that are made available immediately after a disaster are more valued, repaid on time, strengthen trust and contribute toward risk reduction at the household level.

4. What would the next steps be to expand the effectiveness of microfinance for disaster risk reduction? What is needed for microfinance to develop into a sustainable product for disaster risk reduction?

Firstly, microfinance services have not penetrated deeply enough into rural, isolated and vulnerable areas. There is an urgent need to replicate, develop and expand innovative products and set-up service networks that can function at break-even. Secondly, there is a need to recognize the fact that microfinance products can only become sustainable from a disaster risk reduction perspective when they are perceived as risk-transfer investments and converged with micromitigation and microinsurance in order to pull a greater variety of risk and recovery initiatives. Microfinance alone cannot remove poverty; it must include mitigation. Thirdly, there is a strong need to develop a stabilization fund for microfinance institutions to help them respond to the overwhelming demands for loans and services immediately after a disaster. A majority of microfinance programmes to date in India take a supply-side and grant-based approach. There is a need to help them develop a demand-driven approach and to make them self-sustaining. Fourthly, it is critical to link the poor and microfinance institutions with a formal financial system. We must strengthen links between microfinance institutions for the poor in the informal sector with formal sector institutions. In order to ensure the sustainability of investments in microfinance products, capital formation must take place at the community level with the active participation of the poor. Poverty removal and disaster risk reduction are not two separate issues. Development cannot be achieved unless both of them are simultaneously addressed. Fifthly, microfinance programmes must combine the developmental and disaster recovery needs of the poor. Victims work hard, recover, save, repay and are willing to pay interest at market rates. Thus, lending should be grounded on market principles because large-scale lending cannot be accomplished through subsidies.



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A Microfinance Institution Perspective

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1. From your experience, can microfinance be a tool to reduce the impact of disasters?

Microfinance has proved to be an effective tool for reducing poverty and helping poor people improve their lives. In the immediate aftermath of a disaster, access to financial services can reduce the vulnerability of affected populations and help people faster cope with losses and rebuild their livelihoods. In the long run, microfinance—understood as a diverse range of financial services including loans, savings, insurance, leasing, and money transfers—can play a critical role in reducing poor people’s vulnerability ahead of a disaster. For survivors who feel a cash crunch having access to their savings will help them to get back on their feet without falling back on a new debt in an uncertain environment. Money transfers—a vital source of income in many developing countries even exceeding bilateral aid and foreign investment in some of them—become even more vital when people do not have alternative income sources in times of disaster. If survivors have crop or life insurance, they will have more resources to restart their lives. Housing loans, another microfinance product, not only help the poor repair and rebuild their homes but they also provide essential resources to ensure that their homes will be more disaster-resistant in the future. When offering a wide range of products tailored to their clients’ needs at a large scale and on a sustainable basis, microfinance institutions are best placed to reduce the immediate losses and minimize the future damage on their clients’ properties and lives.

2. What are the main limitations and constraints of this tool in this context? What are the best conditions for its optimal functioning?

Microfinance is not a silver bullet in fighting poverty. Provision of financial services to low-income people requires a minimum level of cash flow and economic, income-generating activity. In the wake of natural disasters, grants can be vital for emergency safety nets; they can also help prepare people without income or livelihood for the eventual use of financial services. But grants should not be administered in a way that distorts markets and undermines financial discipline among clients. Whenever possible, organizations delivering grants should not offer loans. When engaging in relief efforts, microfinance initiatives (MFIs) should carefully assess their institutional capacity and be ready to assume additional burdens on their infrastructure, financial resources, and staff without harming their regular activities. Microfinance institutions should independently and, whenever possible without pressure from governments, donors, and other stakeholders, decide whether to embark on relief activities. In order to contribute to long-term recovery, MFIs should ensure their own survival so that they are able to help the poor to cope with new emerging risks. The primary focus should be on the sustainable delivery of financial services at market rates, and the provision of non-financial emergency-relief services should be secondary to this goal.

3. What are the future prospects for microcredit?

Offering loans at a very early stage in the wake of a disaster may aggravate the cycle of poverty if the survivors cannot repay the debt. Microlending, therefore, has its limitations in assisting people to obtain cash and return to their normal lives. When clients lose property and production assets, thus eroding their capacity to repay and absorb debt, a MFI's portfolio quality and liquidity position are put at risk. Natural disasters increase vulnerability of both MFIs and their clients. Also, MFIs may choose to "reserve" loans offered immediately after the disaster to their current clients because new clients bear higher risk if they do not have previous experience in managing loans. Development and roll out of new products in a short timeframe, in the immediate aftermath of the disaster, impose additional risk on MFIs' capacities. Alternatively, MFIs that offer a wide range of products—savings, house improvement loans, leasing, insurance, and money transfer services—long before the disaster are better placed to reduce their clients' vulnerability in the face of the disaster.

4. What would the next steps be to expand effectiveness of microfinance for disaster risk reduction? What is needed for microinsurance to develop into a sustainable product for disaster risk reduction?

Only financially strong and well-prepared institutions can ensure sustainable access to financial services amid crises. An unprepared institution will be unable to respond to its clients' needs with emergency and long-term assistance. Not all microfinance institutions need to carry out detailed plans to prepare for natural disaster even though all institutions should assess their vulnerability to disasters. Microfinance institutions operating in disaster-prone areas should develop complete plans on how to respond to emergency and recovery situations, how to manage their liquidity and keep records of their transactions, how to train and manage staff, and how to act in coordination with other organizations to improve the effectiveness of reconstruction and recovery efforts. Microfinance should not focus only on credit: microfinance institutions need to design and offer a whole range of services, especially savings and insurance, in addition to loans that help build long-term productive assets. New tailored products may also be needed to better serve clients in the changed environment.

Insurance products are more difficult to manage than other products especially when microfinance institutions operate in disaster-prone areas where many policyholders could be affected at the same time. In this case, re-insurance could be a solution. In general, introducing insurance products to respond to a natural disaster in particular is a challenging task.

5. Figures on microfinance: How many people are using it? What are the prospects?

The real challenge facing the microfinance industry today is scaling up services to reach the estimated three billion people of which two-thirds still lack access to financial services. In developing countries, financial service providers—banks, microfinance institutions, credit unions, and other institutions that cater to the low-income populations below the socio-economic level normally served by mainstream commercial banks—serve around 500 million low-income clients.

There is greater consensus than ever before on what is needed to make microfinance sustainable. A major bottleneck to the development of sustainable microfinance is limited institutional and managerial capacity. There is also a marked shortage of organizations that can provide safe-savings facilities for the poor and that can sustainably mobilize these domestic savings for on-lending. While much remains to be done, the new vision of a world in which the poor have access to a wide range of financial services is within reach. Many of the necessary elements needed to scale up microfinance are already in place and a great deal of the knowledge about the requirements of sustainable microfinance already exists. High-performing microfinance institutions have developed innovative methodologies to extend credit, savings and other services to poor clients. A number of banks and other institutions with nationwide distribution systems are beginning to take active interest in reaching poorer clients. Advances in information technology offer the opportunity of lowering the cost and risk of providing microfinance to the poor. The challenge is to mobilize this knowledge and apply it on a much vaster scale, creating financial systems that work for the poor and boost their contribution to economic growth.



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A Microfinance Institution Perspective

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1. From your experience, can microfinance be a tool to reduce the impact of disasters?

I do believe that microfinance (MF) is an effective tool to minimize the impact of disasters under certain conditions. A community that is being served by a microfinance initiative (MFI) prior to a disaster would have access to a range of financial services, including emergency loans. Whilst in some cases "emergency loans" may be appropriate, it is certainly unwise to issue credit to people that have just experienced a significant disaster, as the infrastructure may be so damaged that their clients are unable or unwilling to purchase from them. Any lending post-disaster will need to be undertaken very carefully. Those previously benefiting from MF would at least have their prior credit-worthiness based on repayment before the disaster. The real benefit of MF, however, is the provision of access to savings and insurance. If the community has been able to save cash through MF, after a disaster it will have access to the funds required to rebuild. If the community has access to insurance, it can be compensated monetarily for lives lost and property can be replaced. Insurance is essential: one poor woman once told me that her life was "like a game of snakes and ladders", the children's board game. A loan is a ladder out of poverty but events such as a death or a house fire had caused her to spend her capital and so life was like a snake. Insurance can protect communities from slipping back into poverty after a disaster; it cannot replace lost husbands, wives and children but it can help. If a MFI did not exist prior to a disaster then you have to be careful when setting one up post-disaster. It could be argued that the community may be better served by relief agencies until it recovers and then the MF programme can assist. The risks of lending to those without savings and insurance are very high.

2. What are the main limits or constraints of this tool in this context? What are the best conditions for its optimal functioning?

I have set out some limits above. In addition to these, I believe that savings and especially insurance are not best distributed by a MFI. The reason for this is simply that the method of collecting premiums and savings deposits is usually linked to loan repayment. This means that people can only access insurance and savings (to a lesser extent this is true for savings) when they have a loan. People need and want access to services regardless of whether they have a loan. More effort is needed then to look at how products are distributed to the poor to ensure that we, the MFI community are serving the maximum number of potential clients.



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A Microfinance Institution Perspective

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Most microfinance organizations offer packages of credit, savings, training and insurance services. Opportunity International's client assessments reveal that most first-time borrowers do not usually possess assets or appropriate accommodation. Some may be living in unsanitary and risky areas, such as wetlands and floodplains. With microfinance, in time these clients produce enough income to generate savings and savings allow them to eventually buy property such as houses in flood-free areas. Those without access to such resources remain in flood-prone places.

In cases where people have been affected by a disaster such as a flood or an earthquake, public resources are often insufficient for people to restart their lives. Microcredit allows entrepreneurs to begin their lives with dignity. Moreover, microcredit clients transfer their business skills to their children more than nonborrowers. Consequently, if the parents are killed in a disaster, the children will be better equipped to look after themselves.

Insurance products are especially effective in providing resources to families deprived by a disaster of their breadwinners. Payouts from short-term insurance help families start a business or acquire property. Due to the small sums insured, these products are usually not available to clients on an individual basis. By developing group life policies, microfinance organisations attract insurers willing to offer rate discounts given the economies of scale. Loan-protection insurance relieves bereaved families and their group members of the burden of repaying the deceased's loan obligations, thereby helping them to rebuild their lives more quickly.

Microfinance is most effective for entrepreneurs. It often works well for semi-urban and urban populations. Rural populations mostly depend on agriculture, which itself depends on weather conditions. Not many financial institutions are willing to lend to rural farmers although these are the people most vulnerable to weather catastrophes. The effectiveness of microcredit in rural areas can be improved by packaging it with weather-index based insurance, which provides payouts contingent on the occurrence of a given weather problem. This approach can make lending to rural people more attractive, thereby making microcredit an effective pre-and post disaster mechanism. Such loan-insurance packages can serve as pre-disaster mechanisms by enabling farmers to finance houses that are more resistant to floods and other weather disasters. A limitation of microfinance is that children and those without entrepreneurial skills cannot directly benefit from microfinance. Other products must be provided to serve these populations. In short, microcredit can be used with other disaster recovery mechanisms to rebuild the lives of people affected by disasters.



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A Commercial Bank Perspective

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1. From your experience, can microfinance be a tool to reduce the impact of disasters?

The Indian experience demonstrates that microfinance is a potent tool to abate the impact of disasters. Research indicates that the more diversified its asset base, the greater the resilience of a household to shocks. Loans invested in productive assets increase income that is then re-deployed in livelihoods, used to improve household consumption and facilitate savings. Formal opportunities to save through a microfinance initiative (MFI) provide better safety and insurance for clients. Microfinance, by its very nature, is a disaster mitigant. When disaster strikes, clients have first recourse to assets and savings built through their association with the MFI. During the Gujarat earthquake, for example, affected clients withdrew their savings (safely stored with the MFI) to purchase small household items that had been destroyed. Similarly, fishermen in Kerala and Tamil Nadu, who lost all their belongings to the tsunami, approached MFIs to help them make claims on microinsurance provided to them by the MFI-Insurer partnership. Another very important, though often overlooked benefit of microfinance, is the relationship and client-servicing network that MFIs make available to the relief and rehabilitation effort in times of disaster. Within days of the tsunami, India's largest NGO coordination cell had been established in Tamil Nadu by a MFI. The cell is the hub of all relief work undertaken in the state of Tamil Nadu and for the mobilization of volunteers and funds from across the globe.

2. What are the main limits or constraints of this tool in this context? What are the best conditions for its optimal functioning?

The role of individual financial services is a function of the time lapsed since the disaster. In the immediate post-disaster scenario, as mentioned, the withdrawal of savings provides urgent relief, followed by insurance (due to processing lag) and then finally, credit. Disaster-affected markets are typified by an overarching supply of free money (grants, donations, relief funds), virtually eliminating the demand for priced-funds. Furthermore, the prevailing instability and unfavorable attitude toward credit makes it imprudent for agencies to extend loans. It is only when relief funds dry up and/or recovery is underway that interest in credit emerges. However, a conducive situation may not necessarily mean a familiar one. MFIs in Tamil Nadu seeking to provide loans in the post-tsunami period gauged a palpable change in the needs of the affected poor and therewith the services required.

A disaster has a pervasive effect, destroying all assets including those generating income such as boats, small machinery, looms and raw material. This has serious implications for microfinance product design. The typical microfinance loan size (below USD 200), repayment structure and pricing are unsuitable to assist in rebuilding livelihood assets. For example, the amount required

to purchase a new boat—a requirement for most tsunami-affected fishermen—is approximately USD 2,800, which is more than 10 times that of an average microfinance loan. Moreover, this loan would have to be priced low (3-6% vs. the average 18-24%) perhaps with a moratorium (3-4 months in the case of fishing) to allow for the stabilization of income streams necessary for repayment. Such a loan is not micro finance and would be a very high-risk loan by any standards. A MFI whose client base has been only marginally affected by a disaster may offer such restructured loans on a small scale and case-by-case basis without any additional financial management burden. However, an organization that has lost a large part of its portfolio may have to take another look at its asset liability management (ALM) structure as well as its client appraisal and management systems. It would, in all probability, need to align its product tenor and price with its re-financiers; that is, financial institutions would have to restructure their loans to the MFI in line with the new product terms. Financial institutions with appropriate mandates might also have to provide long-term soft loans and grants for bringing in this change.

3. What are the future prospects for microfinance and disaster reduction?

Despite its potential there has been a limited use of microfinance as a disaster management tool. The prospects are, however, enormous and MFIs are increasingly considering converting disaster threat into opportunity. Studies suggest that groups formed under post-disaster circumstances exhibit stronger cohesion and a better credit culture. Minimally investing in those affected can provide substantial benefits, whereas lack of investment can push them deeper into the poverty abyss. In the aftermath of the Indian Ocean tsunami disaster some of the leading MFIs made a significant contribution in relief and rehabilitation. MFIs working in the areas as volunteer relief agencies noticed the need for MFI. They built community groups, undertook rudimentary client appraisal and are now preparing to offer loans. This work has led to the development of new microfinance markets in areas that were not served by MFIs. In effect, emergency assistance for many has been the entry point for rehabilitation through microfinance. In conclusion, a caveat: post-disaster environments are extremely volatile and easily influenced, and while undertaking microfinance is not impossible, it is certainly not an easy task.



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An International Technical Cooperation Perspective

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In many parts of the world, natural disasters pose a serious problem that can enormously hamper human development. When a disaster strikes, its impact is usually more devastating for poor households as they have fewer options to cope with the impacts. The destruction of income-generating assets or of trading stock seriously affects poor households' ability to earn a living and leads to the quick depletion of financial savings. In such cases, microcredits represent a suitable instrument to assist poor people in coping with the impacts of a disaster. However, these needs have to be quickly met, otherwise the secondary negative impacts of disasters (such as deteriorating health conditions, lack of income, among others) start to weigh in. Microcredits can also represent a viable option for reducing the impact of disasters, as members of the population affected by a disaster and other poor people often lack the capital to introduce preventive measures, such as earthquake-resistant housing.

Although microcredits are receiving more and more attention in responding to disasters, many challenges still exist that have to be taken into account when deciding in their favour in the context of disaster risk management.

For example, there is the risk that the next disaster will strike before the loan borrowed can be reimbursed, especially in regions where natural disasters are a frequent threat. This would have negative impacts on both microfinance institutions (MFIs) and their clients. MFIs, especially in the case of geographically widespread disasters, such as floods or droughts, often undergo severe liquidity crises. On the one hand, this is due to the high number of clients affected at the same time. As an entirely sensible reaction, these clients are likely to withdraw their savings, stop depositing money and reduce their repayments to the minimum required. On the other hand, liquidity crises can be caused by MFIs not possessing abundant capital; moreover often they reduce their reserves to a bare minimum to allow the maximum possible lending outreach. This can lead to a serious situation: in times when demand for financial support is highest, MFIs often struggle to survive the crisis themselves.

To lower the risk of being bankrupted by a disaster, MFIs have to work together to spread their risks regionally as well as in terms of hazards. In addition, microcredits should be tightly bound to making households significantly less vulnerable, for instance by reinforcing houses to make them more resistant against earthquakes or floods. This will enhance the probability that the creditors will be able to repay their loans. However, the process needs some support from powerful institutions, which in the first few years can act as reinsurers, especially in poor regions.

Despite some progress on this issue, obstacles remain. The allocation of microcredits for investment in disaster risk management requires a certain awareness of the positive impacts of preventive measures among the population. Experiences from a Deutsche Gesellschaft für

Technische Zusammenarbeit (GTZ) GmbH project in Peru dealing with the contribution of a low-cost construction technique for earthquake-resistant houses show that many people still lack this awareness. Although the construction technique is only slightly more expensive than the ordinary one, many people refuse to spend any extra money on preventive measures, as this does not result in direct benefits and the money is moreover needed to repay the loan.

A solution to this problem might be to ensure loans combining both productive and preventive issues. Loans provided for productive investments should be connected to incentives that encourage clients to reduce their vulnerability related to natural disasters by making the loan contingent on the client moving to less disaster-prone location or rebuilding a dwelling in a more disaster-resistant way.

Microcredit programmes also require a certain degree of confidence in financing and insurance institutions. In the past, people in many countries trusted more the support of family and friends than finance institutions. In many parts of the world, existing informal microcredit and saving systems indicate that people are aware of the need to cover unforeseen events. One example of such an informal scheme is the so-called "Arisan" system, which is found in Indonesia and takes the form of neighbourly help or help among colleagues at work. Such well-established structures can be useful for MFIs in promoting their credit systems and in creating trust between the institution and the client.

In the near future, efforts have to be made to solve the above-mentioned problems by developing a broad range of microfinance schemes that meet the individual needs of poor people in disaster-prone regions. Together with other microfinance products, such as saving programmes or microinsurance projects, this can make a fruitful contribution to reducing poor people's disaster risk.



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A Re-Insurer's Foundation Perspective on Microfinance

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1. From your experience, can microfinance be a tool to reduce the impact of disasters?

Microfinance is regarded as an important tool to reduce poverty and experience shows that poor people are usually extremely vulnerable to disasters. Since there is a link between poverty and vulnerability, there is consequently a link between microfinance and vulnerability. However, microfinance alone is not sufficient as a disaster reduction tool; it needs to be supplemented by microinsurance. The products needed are those tailored to the different populations affected by disasters and targeted at various levels—from the individual (small scale) to government (large scale). Furthermore, microinsurance and other tailor-made insurance products have to be strengthened by reinsurance.

2. In this context, what are the main limits or constraints of this tool?

There are a number of challenges for using microinsurance as a disaster reduction tool. Several of these apply equally to microfinance.

Identifying clients can be difficult as often they lack education or are illiterate, and infrastructure may be inadequate. Therefore, innovative approaches to raising awareness and new channels of product distribution are necessary. For example, street theatres might be useful to explain the mechanisms of insurance. A community representative or organization should organize the premium collection as it would have better access to the local people. Another constraint is that the premiums are often paid irregularly (because of poor harvests, for example). Furthermore, poor people often do not understand the purpose and benefit of insurance. They often question why they do not receive their money back if they make no claims. Another very important concern is the necessity for adequate consumer-protection regulations (especially for illiterate populations). It should be kept in mind that in some cases humanitarian concerns and commercial concerns are at cross-purposes.

Understanding local conditions is vital as the administrative costs are very high and can only be reduced by close cooperation among all stakeholders. Another obstacle to overcome is that often microfinance initiatives do not have enough insurance knowledge. Partnerships between local organizations and insurance companies are therefore ideal. Also, political and legal frameworks may be unstable or even inexistent. Other concerns include that reinsurance is scarcely available, products are often difficult to understand and lack of data (e.g. no claims history) requires innovative quotation tools.

To overcome these obstacles, it is essential to include the insurance industry, which holds important experience, in the process of developing microinsurance solutions. Frequently the financing (development) of microinsurance is a challenge.

3. What are the best conditions for the optimal functioning of microinsurance?

Products should be easy to understand. In addition, premiums should be low (depending on the size of the solidarity community) so that only a small proportion of income is attributed to the insurance premium. Small but frequent payments (e.g. weekly) are necessary. The insured population should be aggregated in order to attract professional insurers and reinsurers, as group insurance is most cost efficient. Above all, it should be clear who benefits from the insurance (the insured or the financial institution).



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UN Organisation Perspective

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1. From your experience, can microfinance be a tool to reduce the impact of disasters?

The microfinance and disaster reduction communities have the potential to build on each other's expertise to benefit clients affected by disasters. Microfinance is a community-driven financial tool requiring a regulatory framework as well as institutional and technological capacities. Microfinance initiatives (MFIs) should, therefore, gain awareness of the links with disaster risk management and consider inclusion of relevant measures in their operations.

2. What are the main limits or constraints of this tool in this context? What are the best conditions for its optimal functioning?

Based on meetings and Blue Book consultations, the main limitation is that MFIs at the moment are most concerned with creating a regulatory framework that enables their operations to continue and to capture deposits from the people to whom they already offer microcredit. There are clear rules on "financial intermediation" in most countries yet often these rules do not apply to MFIs, thus limiting the amount of business MFIs can do. The challenge for MFIs is that in order to create sustainable financial mechanisms they need to be able to obtain other sources of funds to distribute microcredits. For this purpose they wish to be included within the formal financial system and be regulated in a special manner.

A second constraint is that MFIs currently lack the institutional capacity to build such tools without the help of financial institutions, specialized agencies or both. Partnerships could be useful in this area. Another limitation is the lack of technologies and infrastructure to enable MFIs to identify specific disaster risks in their own setting. MFIs should gain awareness of how disasters risk management can be included into their operations.

3. What are the future prospects for microcredit?

Microfinance has been on the rise for the last 5 years. Whether the current rate of growth will continue depends, however, on its integration into formal financial systems. Microfinance is an important means to address the needs of the world's poorest for basic financial products but it requires assistance from policy makers and other financial institutions. UNEP Finance Initiative, a partnership between UNEP and 200 financial institutions, often receives questions about microfinance. Many of our signatories have launched their own microfinance schemes (for instance, Citigroup, Deutsche Bank, among others). More information is needed about the functioning of microfinance and on the necessary steps to further develop it.

4. What would the next steps be to expand the effectiveness of microfinance for disaster risk reduction? Under this same question, what is needed for microinsurance to develop into a sustainable product for disaster risk reduction?

The next steps are to build capacity among MFIs, both institutionally and technologically. This means creating tools that can serve as a basis for integrating disaster risk management. A next step would be to seek partnership between disaster risk specialists, MFIs and commercial banks to bring technologies into everyday operations at MFIs.

Microinsurance is a powerful and useful tool but it is more complicated than microcredit. The main reason is that microinsurance schemes are fairly new and do not yet have a track record. One example would be the Turkey earthquake case study. Although some important companies, such as Munich Re, have been looking into potential links, microinsurance is in at an early stage. Furthermore, developing countries need to experience a cultural shift toward insurance so that communities acknowledge the benefits of schemes that limits loss in assets (even if these assets are small). Public private partnerships must be created to tackle this important matter, as the Indian Ocean tsunami has taught us. Policy makers must realize the importance of microinsurance as tools to create sustainable livelihoods that can help communities reduce their disaster risk.



Invest to prevent disaster

An Academic Perspective

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Can We Insure Against Tsunamis?

Most of the discussion surrounding how to respond to Asia's tsunami disaster has focused on government relief programs and official schemes to implement early warning systems. Little discussion has focused on the promotion of private risk management institutions, notably insurance.

This is unfortunate. Insurance companies provide professional, finely detailed risk management that respects the complexity of the dangers to be hedged and responds creatively to individual needs. Promoting private insurance may seem an indirect response to the tsunami disaster, but it is a rational – and powerful – response.

Insurance companies have not penetrated many of the regions that suffered the greatest losses. According to a study by the Insurance Information Institute, expenditures on non-life insurance in 2003 amounted to only 0.83% of GDP in Indonesia, 1.19% of GDP in Thailand, and 0.62% of GDP in India, compared with 5.23% of GDP in the United States.

Foreign aid is no substitute for insurance. Charity inspires, reassuring us of our humanity, but it is often capricious. You wouldn't want to rely on it. Indeed, when deciding how much disaster aid to offer, countries often seem to be influenced mainly by their leaders' concerns about how others will view them. Charity responds to attention-grabbing events, often neglecting less sensational disasters.

Insurance, on the other hand, is a reliable and venerable institution, its modern form dating back to the seventeenth century. But insurance and other risk management institutions have been slow to develop, even in advanced countries. In the US, most people still do not have flood or earthquake insurance. In California, one of the world's most unstable geological regions, only one in six homeowners buys earthquake insurance.

A fundamental problem is that insurance is not a concept that comes naturally to most people. In fact, as psychologists Daniel Kahneman and Amos Tversky have shown, there is a systematic human tendency to downgrade the perceived probability of low-probability events, so that people go about their lives as if the probability of these events' occurrence is zero. Similarly, humans tend to accept large downside risks in order to avoid small certain losses, such as insurance premiums.

Insurance companies have faced a slow and difficult process in weaning the public from these tendencies. Moreover, designing new risk-management products is not easy. Insurance

companies face inherent difficulties in measuring risks, and they must tailor their policies creatively around the human foibles that limit uptake. Insurers must also be attentive to a wide array of possible moral hazards—perverse incentives to risky behavior—and to problems of selection bias in attracting clients.

To deal with disasters more effectively, countries must find the will to create an environment in which a much more developed private insurance industry can flourish. In the United States, the National Flood Insurance Program of 1968 made it mandatory for those financing construction or improvement of structures within Special Flood Hazard Areas to buy flood insurance.

If not made mandatory, insurance must at least be promoted effectively. Otherwise, people will build on flood plains in the belief that their government, or the governments of the world, will feel obligated to bail them out, thereby insuring, in effect, bad risks that should not be taken.

Many of the worst outcomes in Asia occurred in tsunami-prone areas, such as the low-lying coastal areas of Sri Lanka. Private insurance would discourage construction in the most dangerous locations, owing to prohibitively high premiums, while encouraging the adoption of tsunami-resistant building standards in marginal areas.

Fortunately, our international risk-management institutions are steadily improving. Various catastrophe bonds, covering earthquakes and other disasters, and weather derivatives have begun trading on financial markets in recent years. The Kyoto Protocol created a mechanism for trading carbon dioxide emissions, which promises to manage the risks of an even bigger potential disaster: global warming.

The markets for these products are still small, but they have strong growth potential, and their further development would enhance insurance companies' ability to cover risks of major international disasters.

Consider the absence of an early tsunami warning system in the worst affected countries. It is easy to blame people for lack of foresight, but none of the nine hardest hit countries had developed one. They can't all be bunglers. The problem is not individual error. The failure was caused by the absence of appropriate international institutions that would be alert to the broad spectrum of potential disasters.

Discussion of early warning systems for tsunamis has focused on government programs. But early warning means more than ocean sensors and satellites; it also implies directing construction away from disaster-prone areas and prodding private businesses to develop effective safety and evacuation procedures.

These are normal activities of insurance companies. Indeed, one of the more striking features of the tsunami disaster was that it caught some of the most glamorous vacation resorts completely unprepared. The lesson is clear: even high-class businesses are only as professional as the existing institutional infrastructure permits them to be. The ultimate reason for their lack of preparation is that our insurance industry was not covering their tsunami risks, and hence not offering up-to-date disaster-prevention guidance.

The insurance industry can, and should, respond to the tsunami disaster by accepting the moral imperative to take concerted action to expand risk coverage. To the extent that governments are involved, they can promote better risk management through responsive regulation and even subsidization of experiments with new private insurance products.



Invest to prevent disaster

A Development Bank Perspective

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1. From your experience, can microfinance be a tool to reduce disasters?

The main economic impact of a disaster is often the loss resulting from the prolonged disruption in production and distribution. Disasters temporarily alter the work of thousands of small businesses and microenterprises. It is important to a local economy, to the development prospects of local populations and indirectly to the well-being (health, nutrition, education) of the population that production and distribution channels are reestablished as soon as possible after a disaster. Microfinance institutions that are “healthy”—that is they comply with reasonable criteria for accountability and are well informed of their client base—are better situated to support most local production in developing countries due to their proximity to local businesses. This proximity ensures better understanding of the needs and capacities of businesses and, therefore, faster and more efficient financial allocation to resolve short-term liquidity needs in the wake of a disaster. Microfinance also reduces human suffering and welfare impacts of disasters by providing emergency loans to cover immediate needs.

Access to credit, insurance and savings services through microfinance helps alleviate chronic and transitory insecurity and, as such, is a mechanism for both ex-ante and ex-post risk management. In addition, well-run microfinance institutions are able to provide incentives for prevention and mitigation of disasters.

2. What are the main limits or constraints of this tool in this context? What are the best conditions for its optimal functioning?

One limitation is microfinance institutions’ access to emergency loans in the wake of a disaster. Large financial intermediaries are usually the high priority candidates for public-sector-sponsored emergency loans of last resort, including those obtained from international financial institutions. Large financial institutions have priority because suspension of their services could originate widespread systemic consequences. The result is that microenterprises, in Latin America, do not have permanent nor deep access to formal financial institutions. To address this situation, emergency credit facilities that work specifically with microenterprises can be developed. The size of the funding capacity of a liquidity facility must be proportional to its geographical coverage in order to diminish the risk that several simultaneous external shocks will exhaust the funding capacity. A liquidity facility should be setup to ensure it diminishes the risk of one severe crisis in a single country exhausting the funding capacity. One way to do this is to make sure that the process for additional lenders and donors to join once the facility is in place is sufficiently flexible. The Inter-American Development Bank funded a specific emergency liquidity facility for microenterprise recovery in the face of external shocks and emergencies. It is

a private entity operating in Latin America from Costa Rica. The total contributions of different funding sources are estimated at US\$13.6 million. The facility will be able to provide liquidity to microfinance institutions at a low cost and within days of a disaster, as compared to the weeks or months timeframe for larger agencies and external donors.

Another risk to the sustainability of microfinance is the possibility that the region affected by a disaster does not regain stability and that microfinance institutions are unable to recover so as to satisfy their loan-service agreements. The Mitch Hurricane in Central America affected many microfinance institutions, however, and all of them proved to be able to weather the emergency.

A third aspect that limits the applicability of microfinance as a tool to alleviate the impact of disasters is lack of awareness among microcredit entities and their clients concerning natural hazard risks, mitigation and prevention options, as well as financial-protection mechanisms. The Inter-American Development Bank prepared a manual for these entities on prevention and impact reduction (in Spanish, to be used in Latin America).

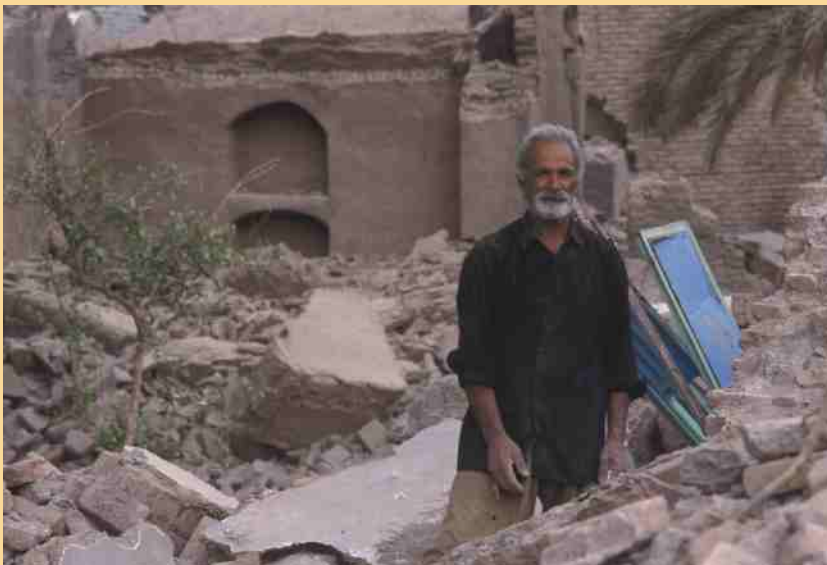
A fourth limitation is the quality of the microcredit institutions themselves. The ability of microcredit to alleviate the impact of disasters depends on the strength of these institutions and specifically on their administrative practices concerning accountability, transparency and their knowledge of their client base.

3. What are the future prospects for microfinance and disaster risk reduction?

If the above limitations can be successfully addressed, the prospects for microfinance and disaster risk reduction are good. Microcredit entities are often financially fragile. They need to improve their financial and administrative practices. The Inter-American Development Bank is working with the more established institutions throughout Latin America and the Caribbean.



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