What is risk financing?

Risk financing comprises a set of measures designed to shift the mobilisation of funds away from ad hoc efforts in the wake of a crisis, and towards a risk-informed strategy to secure access to funds in advance of anticipated crisis events, effectively smoothing the financial impact of post-crisis response and recovery over time. Risk financing mechanisms include savings and reserves, access to credit and market-mediated risk transfer products such as insurance and catastrophe bonds.

Examples

Risk financing is a major growth area for multilateral development banks, for whom risk financing constitutes a means for governments to manage the risk of disaster-related fiscal shocks. Weather-related disaster insurance has also gained support within the agricultural sector as a means of protecting the livelihoods of small-scale farmers against weather-related shocks. Both applications are directly relevant to leveraging financing for crisis response and there are a growing number of examples of risk transfer mechanisms being applied to low-income settings against natural disaster risks.

Innovative insurance products based on the use of parametric indexes rather than on-site loss adjustment have enabled the design of affordable insurance products, in some circumstances allowing automatic payouts before a hazard has had a major negative impact.

R4 Rural Resilience programme. Oxfam America and the United Nations World Food Programme (WFP) launched the R4 Rural Resilience programme in 2011. R4 is a layered risk management programme for rural farmers, and includes a combination of risk management strategies including improved resource management (risk reduction), insurance (risk transfer), microcredit and livelihoods diversification (prudent risk taking) and savings (risk reserves).

In Ethiopia, the initiative is grafted onto the existing government-led Productive Safety Net Programme (PSNP) and uses PSNP’s local infrastructure and targeting mechanisms to identify and access clients. From just 200 households in the initial roll-out in 2009, over 25,000 households across 83 villages purchased insurance in 2014. The initiative reached a major milestone in 2012 when more than 12,000 drought-
affected households received an insurance pay-out of over USD320,000. The poorest farmers who cannot afford premiums are offered work on risk-reduction focused public works in exchange for an insurance premium.

Regional sovereign risk pools. Sovereign risk pools pool resources to spread risk and negotiate preferential insurance and reinsurance rates. The pool may retain part of the funds derived from subscriptions, may progressively accumulate reserves, and transfer higher levels of risk to reinsurance and financial markets at more favourable rates than individual states could otherwise achieve. Several regional risk pools protecting against natural disaster risks and using parametric triggers have been established since 2007 including Caribbean Catastrophe Risk Insurance Facility (CCRIF); the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI); and the African Risk Capacity (ARC). In addition to building the financial capacity of governments to meet post-disaster financing needs, there are also close connections between the ARC and humanitarian actors: WFP was instrumental in developing the Africa Risk View, a parametric tool to trigger cash payouts from the pool for early response to emerging food security crises, and it has been anticipated that humanitarian organisations may be designated as funding recipients and implementing partners in some member countries in areas where government safety-nets do not extend.

Considerations

Increasing technical feasibility. Advances in technology and the design of insurance products now mean that low-cost mobile weather stations and satellite data can remotely transmit risk data, reducing the need for costly on-site verification of losses and enabling the use of parametric indexes, which have dramatically cut the cost of premiums and brought insurance within the reach of low-income individuals and governments. The expansion of distribution channels, including private sector microfinance providers, co-operatives and mobile money transfer services as well as the expansion of state-sponsored social safety net schemes, also means it is increasingly possible to target and direct payments in some contexts.

Growing public and private sector support. The global insurance industry is increasingly interested in working in partnership with international actors to extend insurance products to developing countries, especially where this might otherwise have been considered unprofitable and excessively risky. Demand for technical assistance to develop risk financing strategies and access market-mediated risk transfer products is growing rapidly among developing country governments, particularly in middle and lower-middle income countries.

Not applicable or appropriate everywhere. There are a broad spectrum of contexts and risks for which the current suite of risk-financing and risk-transfer tools do not apply. Risk-transfer products in particular address risks that can be quantified and modelled and do not always match the reality of exposure to multiple intersecting risks. Parametric insurance products are not sufficiently sensitive to respond to highly localised risks or where multiple intersecting risks are present. Risk of political instability and conflict are typically considered too unpredictable and costly to insure, and extending insurance services into markets where rule of law and security are seriously compromised is not currently considered feasible or cost-effective from the perspective of many commercial insurers.

Added costs. Commercial risk transfer products come at a price and are therefore typically only appropriate for the highest levels of risk.

Long-term gain. The ‘enabling’ conditions for risk financing and risk transfer to function effectively and sustainably may require significant and sustained investments in supporting the development of markets.
over many years – for example it may take upwards of a decade for micro-insurance schemes to become sustainable. Figure 1 outlines some of the enabling factors required to support sustainable risk transfer markets.

Figure 1: Financial risk management strategies and partnerships underpinning finance at individual/community level.


1 UNISDR definitions can be found at: <www.unisdr.org/we/inform/terminology>.  
4 Adapted from Poole, 2014.  
5 Lloyds suggest for example that “Currently profits are modest, but there is the potential for significant returns in the future. And there are other benefits to the commercial insurer, ranging from developing innovative new policies to building a brand and client base in economies that have largely been untapped. Today’s low income communities in China, India or Latin America could be tomorrow’s affluent consumers.” Lloyd’s (2010). Insurance in developing countries: Exploring opportunities in microinsurance. See: <www.lloyds.com/~/media/Lloyds/Reports/360/360%20Other/InsuranceInDevelopingCountries.pdf>.  