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Prepared for the Expected: Insurance in Disaster Risk Management

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Author: Dr Veronika Bertram-Hümmer
Editor: Dr Julia Sattelberger

Many developing countries face the risk of natural disasters without being sufficiently prepared. When a disaster strikes, the current way how Governments and humanitarian organisations respond is based on *ex post* risk management approaches which does not address the needs of the poor and vulnerable: Disaster plans are often uncoordinated and in lack of guaranteed funding. When a disaster strikes, activities are unpredictable, delayed and insufficient in scope, leading to avoidable damage and suffering.

How to Better Prepare for Disasters

At the World Humanitarian Summit in Istanbul in May 2016, a paradigm shift towards *ex ante* risk management and incentive-compatible risk response has become visible. The international community has come to the common understanding that hardship and loss of life can be significantly mitigated, if Governments, humanitarian organisations and financial institutions change the way how disasters are managed in three ways:

- *Coordinated Pre-Disaster Plans:* Within an iterative dialogue among politicians, implementers, scientists and financiers, credible pre-disaster recovery plans should be developed. Stakeholders should agree jointly on the trade-offs between who and what will be protected, and who will pay for it in the disaster case. This joint agreement should include precise and focused commitments to a credible set of actions. A coordinated plan provides incentives to prepare for and reduce risks and clearly defines responsibilities, so that everyone knows what to expect and to do when a disaster occurs.

- *Clear Decision Rules:* Every pre-disaster recovery plan needs to be complemented by a well-defined system for post-disaster decision-making. Clear decision rules, with adequate triggers for different sets of actions, need to be set to ensure that plans are realized. The triggers should be based on data which are resistant to manipulation and strike a good balance between cost, speed, and reliability. A clear and credible command and control system ensures that as little as possible must be decided ad hoc when a disaster occurs, allowing for fast and timely actions.

- *Predictable Funding:* The key condition to be able to implement carefully designed disaster plans is predictable funding. Governments, humanitarian organisations and financial institutions need to ensure beforehand that the right amount of money is available at the time it is needed. This involves careful *ex ante* decisions on the share of risk to be retained or transferred to third parties, and on the respective budgetary and financial instruments to be used (see Table 1). Adequate and well-tailored instruments ensure that incentives for disaster risk reduction and preparedness are kept.

Table 1: Instruments for Financing Disaster Risk

	ex ante	*ex post*
Risk Retention	Contingent Fund/Credit Budget Allocation	Budget Reallocation Tax Increase Post-Disaster Credit
Risk Transfer	Insurance Derivatives Capital Market Instruments	Post-Disaster Aid

Source: adopted from Clarke & Dercon (2016).

How Insurance Approaches Can Help

Insurance approaches can help to improve and shape the way how disasters are prepared in different ways:

- *Disaster Funding:* Insurance can be used to ensure liquidity of Governments, humanitarian organisations and financial institutions after a disaster by transferring risks *ex ante* to third parties (e.g. reinsurers or capital markets). Insurance payouts can help to mitigate the financial consequences for risks that are characterized by low frequency and severe losses. If well-designed, insurance can provide liquidity fast and timely when a disaster hits.

- *Setting Incentives:* Insurance contracts can create incentives for efficient risk management and risk reduction. E.g., with index-based products, moral hazard is minimized as payouts depend on unambigious, exogenous parameters such as temperature or precipitation measures. Furthermore, insurance contracts can include conditions that reward risk reduction activities (e.g. premium discounts) or ensure that the payout will be used in an efficient manner to address losses and damage.

- *Learning from the Insurance Industry*: Politicians, implementers, and financiers can learn from the insurance industry on how to deal with risks before a disaster strikes, e.g. how to specify and price disaster risks, to define triggers for their action and funding, and to decide *ex ante* on whether to retain or transfer the respective financial risks.

Call for Action

The need for a shift towards *ex ante* disaster risk management of the global humanitarian system has become visible. Politicians, implementers and financiers need to reassess their activities and learn from insurance approaches how to prepare for disasters and to reduce avoidable hardship and loss of life in the future. ■

Note: This paper reflects the opinion of its author and does not necessarily represent the position of KfW.