Background

The exposure of developing countries to natural disasters is increasing. Due to a variety of factors, ranging from growing concentration of population and assets in risky areas to increasing climatic variability, the economic costs of natural disasters are on the rise.

Priority Action Number Four of the Hyogo Framework for Action’s five priority actions to reduce disaster losses is to reduce underlying risk factors. A key activity under this priority action is the promotion of the development of financial risk-transfer mechanisms. While this recommendation is only one among many, the need for innovative risk financing and insurance mechanisms is relevant to developing countries exposed to natural hazards.

Despite prevention and mitigation efforts, no country can fully insulate itself against losses from major natural disasters. Disaster risk financing and insurance (DRFI) solutions provide efficient means for countries to financially protect themselves from natural disasters as well as foster disaster risk management (DRM) efforts. DRFI strategies allow countries to increase their financial response capacity in the aftermath of disasters and to reduce the economic and fiscal burden of natural disasters by transferring excess losses to the private capital and insurance markets.

Financial Protection and Disaster Risk Management

It is often argued that financial protection strategies treat the symptoms but not the causes of disasters. Good strategies can help governments cope with the financial impact of calamities, but do little to shelter populations and assets from the destruction of cyclones and earthquakes. As such, it is important to underscore that financial protection is only one component of a comprehensive disaster risk management strategy.

Financial protection will help governments mobilize resources in the immediate aftermath of a disaster while buffering the long-term fiscal impact of disasters. A comprehensive risk management strategy, however, should cover many other dimensions, including programs to better identify risks, to reduce the impact of adverse events, and to strengthen emergency services (Figure 1).

At a glance

- The promotion of disaster risk financing and insurance is a key activity of the Hyogo Framework for Action’s Priority Activity Number Four: To reduce underlying risk factors.
- Disaster risk financing and insurance (DRFI) provides financial protection against financial losses from natural disasters, but it does not reduce the overall amount of losses; as such, DRFI is only one component of a comprehensive risk management strategy.
- Disaster risk financing and insurance can be classified into four broad categories: Sovereign disaster risk financing, property catastrophe risk insurance, agricultural insurance, and disaster micro-insurance.

Well designed disaster risk financing and insurance strategies can create financial incentives for governments and/or households to further mitigate their risks. For example, access to DRFI instruments can be made contingent upon implementation of a national disaster risk management plan or compliance with earthquake-resistance building codes. The simple fact that a Ministry of Finance is sensitized to a country’s exposure can help mobilize resources beyond disaster response in support of risk mitigation. Insurance programs can also be designed to discourage – rather than promote – risky behaviors.

DRFI ensures the availability of post-disaster resources and aims to minimize the cost of securing such financing. Any cost-effective disaster risk financing and insurance strategy first requires a detailed assessment of the economic and fiscal impact of natural disasters. Catastrophe risk modeling techniques, initially developed for the insurance and reinsurance industry, provide such tools to assess disasters’ likely impact based on frequency and severity.

Disaster risk financing and insurance can be classified into four broad categories: Sovereign disaster risk financing, property catastrophe risk insurance, agricultural insurance, and disaster micro-insurance (Figure 2). Although there is overlap among the categories, they are useful for distinguishing the objectives and the scope of DRFI projects. They can be defined as follows:
- **Sovereign disaster risk financing**: Financial strategies to increase the financial response capacity of governments in the aftermath of natural disasters, while protecting their long-term fiscal balances.
- **Property catastrophe risk insurance**: Develop catastrophe insurance markets and increase property catastrophe insurance penetration among homeowners, small and medium enterprises, and public entities.
- **Agricultural insurance**: Develop programs for farmers, herders and agricultural financing institutions (e.g., rural banks, microfinance institutions) to increase their financial resilience to adverse natural hazards.
- **Disaster micro-insurance**: Facilitate access to disaster insurance products to protect the livelihood of the poor against extreme weather events and promote disaster risk reduction in conjunction with social programs such as conditional cash transfer programs.

**Figure 1: Sovereign Disaster Risk Management Strategy**

- **Risk identification**: Hazard mapping, CBI, risk modeling; Social perception, priority settings;
- **Risk reduction**: Territorial and sectorial planning, building codes; Risk mitigation works, infrastructure retrofitting; Education, creation of a culture of prevention, etc;
- **Financial protection**: Reserve mechanism, budget planning; Risk transfer, insurance, ART, etc; Budget appropriation, execution in emergency;
- **Preparedness**: Alert and early warning systems; Response planning, training, equipment, logistics, simulations, etc; Response systems management;
- **Post-disaster reconstruction**: Institutional planning, strengthening; Recovery, planning reconstruction policies, etc; Rehabilitation plans, etc;

**Figure 2: Four Main Pillars of Disaster Risk Financing & Insurance**

**Further Reading**

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