



### Innovative Market-based Risk Management Framework

#### Module 1

##### Session 1 - Risk Management Challenges in Lower Income Countries

The first presentation identifies the link between risk, livelihoods, and development. It introduces the different types of risks, their impact and the appropriate risk management strategy. The session reviews the typology of risks facing poor households in lower income countries, highlighting the predominant role of two kinds of risks: 1) adverse weather events, including natural disasters and 2) commodity price fluctuations. In both cases, these risks can create large losses as many households are likely to be affected by the same event at the same time. To better address these risks, the session presents a conceptual framework for selecting suitable market-based risk management strategies at the micro, meso, and macro levels. The session illustrates why a variety of existing coping strategies may be ineffective and presents the rationale for an *ex ante* risk management with distinct developmental benefits.

##### Case Study 1 - Malawi: Focus on Livelihoods and Poverty

The case study illustrates the main messages of the first session through the example of Malawi. After a brief introduction of the main economic indicators of the country it presents the impact of drought and price fluctuations on the food security. It analyzes the responses of households and public actors to food insecurity and the long lasting effect of these responses on agricultural investments and productivity. It concludes that while it is important to seek for solutions at national and intermediate levels, it is equally important to mitigate the risks at the household levels.

#### Module 2

##### Session 1 - Key Concepts and Applications of Innovative Market-based Risk Management

This presentation introduces the tools that can be used to finance economic losses from weather risk and adverse commodity price movements. Such risks cannot be effectively managed by traditional approaches of formal and informal risk pooling since many households are likely to be affected by the same event at the same time. The presentation begins by analyzing the limitations of risk financing exercised by many developed countries and explains why these solutions are not feasible for lower income countries. Against this background, the session presents a new risk management approach, emphasizing 1) *ex ante* over *ex post* risk management; 2) the importance of risk transfer, 3) the benefits of market instruments for risk transfer; and 4) the significance of targeting end users at micro, meso, and macro levels. The innovations presented in the session can be well applied in lower income countries where the domination of small producers can result in high transaction costs for traditional insurance approaches. The session concludes with country examples of how market-based instruments have been applied to weather and price risk solutions at the micro, macro, and meso levels.

##### Case Study 1 - Malawi: The Use of Price and Weather Risk Transfer Instruments

The case study looks at two different programs to deal with price and weather risk in new and innovative ways. Both programs were implemented in Malawi. The first part of the case study reviews the program of the Government of Malawi to use international commodity markets in managing price volatility of maize imports during the 2005 drought. The second part of the case

study discusses a pilot scheme where farmers are managing weather risk through an index-based weather insurance contract in order to access to finance. Both programs are a departure from traditional attempts to manage risk, and demonstrate how risk can be transferred from governments, institutions, and individuals into markets.

### **Module 3**

#### **Session 1 – The Role of Government and Donors in Developing and Using Market-Based Risk Transfer Instruments**

The first part of the session reviews the process of designing a risk management strategy and identifies the necessary key actions to support the emergence of risk transfer markets. The main principle for government and donor policies in supporting innovation in risk transfer markets should be “crowding in” markets instead of “crowding out” or substitute for markets. The clear separation between the role of markets and the role of the public in risk financing facilitates these policies. The conceptual foundation for separating the roles is laid out in the risk layering segmentation principle presented in the second part of the session. The presentation concludes that the implementation of innovative risk management strategies should be first piloted with well-designed programs to field test the approach. Much can be learned via pilot programs when they are well conceived, adequately supported, and include a rigorous evaluation component.

#### **Case Study 1 - Mexico: Government Strategy and the Use of Risk Transfer Instruments**

The case study reports on the establishment of a specialized natural disaster fund (FAPRACC) to provide a productive asset safety net for farmers in Mexico. The use of a weather index financial instrument to support the productive safety net program is a clear example of what can be achieved with an effective public/private partnership. While public sector involvement of both the federal and regional governments has been very important in creating an appropriate institutional framework for the FAPRACC program, the participation of the private sector through high quality risk capital from the international markets was key to guaranteeing solvency, and therefore the sustainability of the initiative. In addition, the potential facilitator role of the government in providing a transparent regulatory environment, open access to weather data and investment in infrastructure are instrumental for the further expansion of the program to cover more risks and locations.

### **Readings**