Financial innovations for social and climate resilience: Establishing an evidence base

Market-based risk financing mechanisms such as index insurance, etc., have the potential to play an important role in reducing vulnerability and building resilience to climate change impacts. A number of important initiatives have demonstrated great potential, but also a number of challenges before they can provide an inclusive, sustainable mechanism that can be applied at a large scale and contribute to climate change adaptation and poverty reduction. This brief describes an initiative being led by the World Bank in collaboration with partners to examine the challenges and advance the development of sustainable climate risk management models that can reach the poorest to strengthen climate resilience.

BACKGROUND

According to the World Bank, “of the estimated four billion people worldwide who live on less than $2 a day, fewer than 10 million currently have access to formal insurance from a regulated financial institution.” With little access to formal insurance mechanisms, poor households make use of other consumption-smoothing and coping strategies when disaster strikes, such as taking emergency loans from microcredit institutions or moneylenders, or relying on family or community support. Community support measures can break down in times of disaster, which affect entire communities. Reliance on government or donor assistance is often inadequate, as this support can be ad hoc, poorly targeted, and slow in disbursing. Other risk management strategies include taking out high-interest loans or defaulting on existing loans, selling assets and livestock, or engaging in low-risk, low-yield farming to lessen their exposure to extreme events. These sub-optimal coping strategies often leave poor households locked into the poverty cycle.

The potential of market-based risk financing for climate resilience and poverty reduction

Insurance and other market-based instruments can help to break this cycle by providing low-income households, farmers, and businesses with rapid access to post-disaster liquidity, thus protecting their livelihoods and providing for reconstruction and recovery. As insured households and farms are more creditworthy, insurance also has the potential to promote investments in productive assets and higher-risk/higher-yield activities. In addition, insurance can encourage investment in disaster prevention if insurers offer lower premiums to reward risk-reducing behavior. The combined effect of promoting higher income opportunities to build assets in addition to livelihood and asset protection and incentives for risk reduction holds the potential of transformational power for low-income households.

The role of insurance-related instruments in an adaptation regime

The Cancun agreements that emerged from the COP16 in December 2010 include the development of a work program on insurance related instruments for adaptation, including the “possible development of a climate risk insurance facility to address impacts associated with severe weather events; and, options for risk management and reduction; risk sharing and transfer mechanisms such as insurance, including options for micro-insurance; and resilience building, including through economic diversification.”

The international community can play an important role in ensuring the financial robustness of developing country insurance schemes. By providing technical assistance and financial support to help make these instruments affordable to the poor, both international donors and recipients stand to gain, especially if the instruments can be designed to encourage preventive measures. Such pre-disaster assistance could leverage limited disaster aid budgets, free recipient countries from the vagaries of post-disaster assistance, increase funds for disaster recovery, and provide incentives for risk reduction.

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2 Draft decision /CP.16, Outcome of the work of the Ad Hoc Working Group on long-term Cooperative Action under the Convention, para. 28
A few specific options for including insurance mechanisms as part of an adaptation financing regime are being discussed within the UNFCCC process. However, these discussions have not focused on the role of insurance in the context of poor households’ risk management strategies. In addition, what is lacking is a politically and market-neutral, evidence-based analysis of the broader policy and operational context from a social perspective to determine how well market-based risk financing instruments are helping poor households manage risk.

**THE FISCR INITIATIVE**
The promise of market-based risk financing instruments is their potential to break the poverty cycle and build climate resilience through: (i) by enabling productive investment; (ii) protecting the livelihoods and assets of the poor; and (iii) promoting investment in risk reduction. Yet, there are still significant unanswered questions about balancing affordability and utility for households struggling to meet daily needs and maintaining the long-term viability of these programs especially in the face of increasing losses due to climate and disaster risks.

The World Bank’s Social Development Department has a cluster focused on Social Resilience which examines the social dimensions of climate change. Within this context, the Social Resilience cluster is leading the initiative on Financial Innovations for Social and Climate Resilience (FISCR) to establish an evidence base of experience to date with market-based risk financing instruments that aim to target poor households related to access to coverage, sustainability, poverty reduction/resilience building impacts, and value for money. Focusing on the perspective of the poor household, the research would aim to answer the following questions:

- **Coverage and inclusion**: Are market-based risk financing mechanisms affordable and accessible to the poorest? What are the program characteristics that promote accessibility of the poor?
- **Sustainability and scale**: What contributes to an enabling environment for effective risk financing schemes? How can market-based mechanisms be upscaled? What are some good examples of upscaled programs? What contributes to the financial viability of market-based schemes?
- **Transformational impact**: What is the evidence regarding livelihood transformation, poverty reduction, and long-term resilience building in the face of disaster risk? Does access to market-based risk financing instruments lead to shifts in higher-risk/higher yield activities? Can these mechanisms be effectively combined with incentives for risk reduction investment?
- **Value for money**: How do market-based mechanisms compare to other types of interventions in relation to impact and value for money? Are they more effective when combined with other social protection/promotion mechanisms?

The lessons and recommendations that emerge from the initiative will serve two purposes: (a) to inform the development of policies and programs related to disaster and climate risk management for poor households; (b) to inform the global dialogue and decision making processes related to climate adaptation financing for the poor. The learning from this initiative aims to develop recommendations that would ensure that market-based mechanisms for climate risk financing form part of an integrated risk management framework that contributes to the long-term resilience of the poor by strengthening their capacity to accumulate assets, protect their assets during extreme events, and recover quickly from extreme events.

The initiative will engage a variety of stakeholders for analyzing and pioneering market-based risk financing programs to develop a sustainable model for reaching the poor, including NGO/community groups, government regulators, entrepreneurs, academics, donors, IFIs, and private insurers, etc. In order to facilitate inputs from other partners, a multi-stakeholder Advisory Group has been established to guide the activities.

Deliverables will include a conceptual framework paper, a literature review, several country case studies, and a synthesis of findings. Findings of the study should be available by the end of 2012.

For more information, contact Margaret Arnold, Senior Social Development Specialist at the World Bank, marnold@worldbank.org.