What role for disaster risk financing and insurance in the UN Central Emergency Response Fund (CERF)?

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Around 26 million people are forced further into poverty each year by extreme natural events like hurricanes, typhoons and severe drought[1]. When the costs of these disasters exceed a country's ability to respond, they often turn to international humanitarian aid. The UN's Central Emergency Response Fund (CERF) provides vital funding for life-saving humanitarian action. The CERF receives contributions from donors, mainly governments, into a single fund. This money is set aside for immediate use at the onset of emergencies, in rapidly deteriorating situations and in protracted crises that fail to attract sufficient resources. This model replicates some of the features of insurance, in that it attempts to pool risk and minimises the need for large cash balances among the agencies.

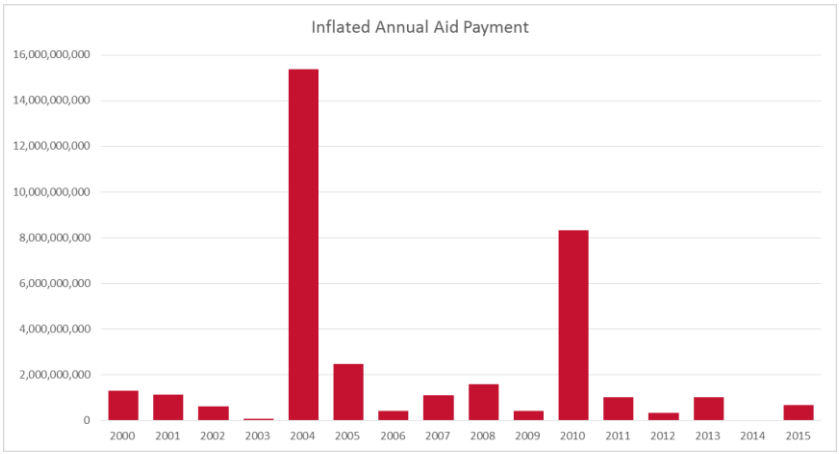

Figure 1: Reconstructed International Humanitarian Aid Expenditure on Natural Disasters (RMS, 2017)

Looking globally, natural disasters account for around $1.5 billion (12%) of international humanitarian aid each year but this varies significantly year to year and can spike to well in excess of $8 billion. However, global humanitarian funding falls far short of appeals and the CERF has operated at a flat cash level since 2008. This is partly due to the way in which donors have chosen to fund the CERF, which means it is not automatically topped up in response to particularly high needs. As a result, it is difficult for CERF to act as a financer of last resort or insurer for the system, even if this was part of its initial conception. Adding some form of insurance to the CERF, which recognises and responds to peak needs, could make sense.

New analysis by the Government Actuary's Department in the UK estimates **that the CERF currently disperses about $120 million per year for natural disaster related assistance[2]** (Fig 2). A natural question is whether the CERF could and should increase in size to help plug the gap. At the World Humanitarian Summit in 2016, the UN Secretary General proposed to increase the size of the CERF to $1 billion and this was supported by several world leaders.

[1] Hallegatte et al. 2017 "Unbreakable: building the resilience of the poor in the face of natural disasters" World Bank
[2] UK Government Actuary's Department, 2017 "A Disaster Insurance Finance Facility for the CERF"

What is interesting from comparing total international humanitarian aid for natural disasters year to year (Fig 1) and the CERF expenditure (Fig 2) is that CERF expenditure is relatively smooth. It does not rise and fall each year so much as one might expect from looking at the total levels of international aid. In the last 10 years, CERF's annual expenditure has only spiked once, in 2010, the year of the devastating Haitian Earthquake, major floods in Pakistan and several other disasters globally. This could be a result of constraints on CERF's current budgetary model. For example, a ceiling on annual levels of funding that CERF could provide. **It raises the question of whether CERF could or should be re-positioned to absorb more of the annual volatility in funding needs for natural disasters.**

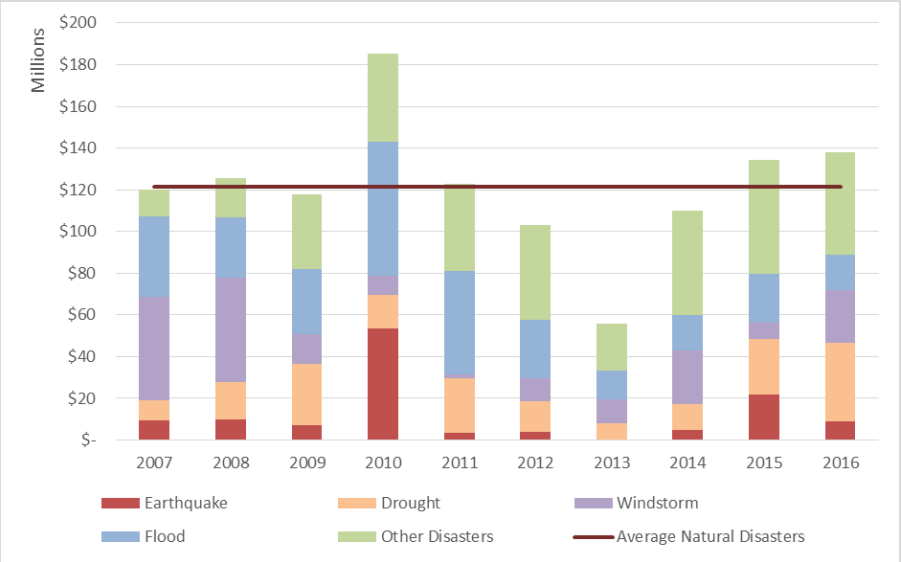

Figure 2: CERF Annual Expenditure on Natural Disasters (GAD, 2017).

This note focusses on the potential role of disaster risk finance for the CERF. **If CERF were able to use insurance or similar financial instruments, could it become even more of a cushion for the global volatility we see in financing needs for extreme natural events?**

Disaster risk finance can be defined as 'ex-ante' or 'pre-arranged' finance; that is, finance that is arranged in advance of a disaster, to cover the future costs of preparation, response, recovery and/or reconstruction. It could include insurance or catastrophe bonds but also budgetary instruments such as contingency budgets or contingent loans. **From a global perspective, the CERF itself is part of a global disaster risk financing strategy** – a form of global contingency fund and contingent credit line for the UN system for disasters. This note looks at what a risk financing strategy for the CERF itself might look like.

A first important point to make is that, by itself, insurance is not a way of raising new finance. In pure financial terms, it is one way of managing the volatility in financing needs – it would allow CERF to provide much more financing in years where there are intense or multiple disasters. But it is not money from nowhere. Someone has to pay the premiums.

Recent analyses by the **Government Actuary's Department appraised three potential risk financing options for the CERF, two of which were insurance-based, including one proposed by the Innovative Finance Foundation (IFF)**. This looked at the current situation, where CERF expenditure is relatively smooth. Both insurance options were shown to have higher cost than simply increasing donor funding to the CERF by an equivalent amount. In the case of the proposal from the IFF, the option was estimated to have between 4 and 15 times higher cost than donors simply putting equivalent funds into the CERF. In the other case, costs were around 1.5 to 2.5 times more expensive.

These results are not unexpected. The costs of insurance will always be greater than the sum of the expected payouts as an insurer needs to cover its administrative and capital costs. The key issue is whether this additional cost is justified versus other options. For example, for some countries and types of shocks, insurance is justified as it can be expensive to raise large amounts of capital quickly and setting aside enough capital to cover for rainy (or dry or windy) day can have significant opportunity costs. In the future, if CERF increased in size and began to absorb a much larger fraction of the volatility in international humanitarian aid needs for natural disasters, then insurance could begin to look like a more attractive option (though even in this case, the IFF proposal would always be more expensive).

For CERF, could a well-designed insurance instrument deliver other types of benefits that might justify the costs? And are there other instruments with insurance-like principles that could deliver the same benefits at lower cost? There is growing evidence that if designed well, disaster risk finance, can lead to[3]:

a. Faster response –The CERF Rapid Response Window can already respond within 48 hours, once a proposal is received, but this doesn't always happen, particularly for slow onset disasters. Indeed, for rapid onset disasters, the absence of pre-agreed plans and pre-agreed triggers for action can slow down response (e.g. the case of Typhoon Yolande). Risk financing and insurance could improve the speed of financing, if it came with pre-agreed triggers for payouts and pre-agreed plans.

b. More reliable and better targeted response – risk financing creates certainty and would allow the UN agency to plan better in advance, invest in preparedness and ultimately lead to a more reliable response, better targeting and reduced impacts.

c. Cheaper response – earlier and more reliable response saves lives but can also more than double the impact of every $1 spent and help countries get back on their feet more quickly. Greater planning and preparedness has also been shown to further increase the impact of every $1 spent on humanitarian assistance.

d. Strengthened UN leadership - The combined benefits of a cheaper, faster and better targeted response can strengthen the role of the UN in humanitarian responses.

So, potentially, disaster risk financing could significantly reduce the immediate and longer-term costs of disaster response, allowing CERF to help more people with every $1 spent. Whether insurance is the right instrument is a question that needs further study. It may be possible to deliver the benefits above with other financial instruments at lower cost.

The majority of the applications of disaster risk finance to date have been with governments, and supported by development banks. **Around 30 developing country governments around the world currently purchase sovereign disaster risk insurance and more than 15 use contingent credit instruments such as the World Bank's Catastrophe Deferred Drawdown Option (Cat DDO)[4].** This includes 26 countries in the three regional risk pools in the Caribbean, Africa and the Pacific, purchasing aggregate coverage of US$870million.

The humanitarian community is also experimenting in this space. For example, WFP, FAO and IFRC are establishing early action financing mechanisms. The START Network's Anticipation Fund is able to use weather forecasts to trigger the release of early funds in advance of a disaster to NGOs working on the ground in developing countries.

[3] Based on Clarke and Dercon 2016 "Dull Disasters: How Planning Ahead will make a difference". Oxford University Press.
[4] Mahul et al. 2017 "Sovereign Climate and Disaster Risk Pooling: World Bank Technical Contribution to the G20". World Bank Group.

The only mechanism comparable in size to the CERF to date is the Pandemic Emergency Facility (PEF) that was launched in 2017; this is a World Bank initiative that effectively pools global pandemic risk and transfers this to the private insurance and capital markets. In that case, the insurance premiums/coupons are paid by donors.

What is clear from the learning to date is that the main benefits of risk financing come from the design of the system for financing, not just the finance itself. So what might this look like for the CERF? To maximise the benefits, a new CERF-window for early pre-committed response could have the following unique characteristics:

- Pre-agreed response plans to access the window.
- Pre-defined triggers to activate financial flows against the response plans.
- Opportunity for early funding, in advance of a disaster, based on forecasts.

The window could be paid for by donors, but have insurance-like triggers, with payouts made automatically to finance the pre-agreed response plans. This type of system could significantly reduce the costs of responding to disasters by enabling earlier and more efficient response, as well as reduce the administrative burden on the CERF and the humanitarian community in the heat of the emergency.

Requirements for pre-agreed response plans and triggers would create strong incentives for better planning and preparedness. Having these in place would make the CERF more efficient. The greater certainty of financing would it make easier to coordinate in advance, engage more local communities and NGOs in delivery, supporting the commitments of the Grand Bargain, and deliver immediate assistance.

An open question is how this would work alongside the parallel systems being discussed by some UN agencies, the IFRC and NGO networks and whether there would be opportunities to coordinate on plans to avoid repetition.

With this system in place, financial instruments like insurance could play an important role in enabling the new CERF window to provide larger amounts of financing after disasters, with high reliability, speed and efficiency, whilst also driving down the costs of response for UN agencies. But getting the system right really matters; the finance is the easy part.