

BEYOND BANKING: CRISIS RISK FINANCE AND DEVELOPMENT INSURANCE IN IDA19

DISCUSSION PAPER



Authors: Daniel Clarke & Stefan Dercon

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The Centre for Disaster Protection works with developing countries to find better ways to manage the risks of disasters and to deliver earlier, more cost-effective support for people when disasters occur. One element of the Centre's work is influencing global policy on financing responses to disasters. This series of papers was commissioned to provide analysis, ideas and recommendations for the upcoming nineteenth replenishment of the International Development Association. The series comprises Discussion Papers and Policy Briefs, all available at www.disasterprotection.org.

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● EXECUTIVE SUMMARY

This paper reviews the evolution of the World Bank's approach to crisis risk financing, focusing especially on the International Development Association (IDA) and its Crisis Response Window (CRW). We acknowledge the significant progress made in recent years in this area of policy, but we also argue that as IDA and its partners prepare for the 19th replenishment of IDA, they have an opportunity to make important changes that would deliver both better outcomes for the poorest living in high-risk contexts and better value for shareholders. In particular, we examine how reform of the existing instruments could accelerate IDA's proposed 'pivot to prevention (when crisis risks can be mitigated) and preparedness (when they cannot)' (World Bank 2018a). Reform would also significantly improve the effectiveness and efficiency of financing responses.

In its review of its Crisis Response Window, IDA argued that IDA19 should shift towards focusing on prevention and preparedness (World Bank 2018b). However, five challenges make it hard to develop a structure in which efficient crisis prevention and preparedness are the central virtues:

- 1. Governments lack incentives to invest in preventing and preparing for crises.** In fact, typically they reap few political rewards from preventing hazards and shocks from becoming crises. The result is underinvestment in the right sort of planning.
- 2. The current crisis finance instruments do not strengthen prevention and preparedness incentives— and even may undermine them.** It doesn't help that most of the existing crisis finance instruments treat crises as though they are surprises. Although some crises may stem from 'unknown unknowns'—risks whose occurrence and potential consequences could not have been foreseen—many are 'known unknowns'—risks that can be managed and planned for beforehand, even if it is not known when they will arise. If cheap resources are available after a crisis, including from the CRW and humanitarian aid flows, why invest scarce resources from one's own budget or from IDA in preparedness or prevention?
- 3. The world needs development insurers, not just risk pools, but they (mostly) don't exist yet.** Amazingly, relative to development banks (which offer governments loans and grants for development purposes), almost no development insurers (which offer governments insurance-like protection tied to explicit development objectives) are open for business. Some sovereign risk pools have been set up, but too

often these are designed only to assist with capital management and pay too little attention to their impact on development. To become development insurers, they will need to step up and focus on their actual impact, ensuring that spending is going to the purposes intended and promoting transparency, participation, and preparedness planning.

- 4. The mature development insurance system needed to allow development banks to deliver more for less is missing.** Crisis insurance products are imperfect, and yet they can provide good value for money if they are cheap. Achieving this will require paying special attention to financial efficiency—that is, how development banks and development insurers work with private reinsurance and capital markets and how they structure their offerings to countries.
- 5. Poor countries need last-resort sources of crisis finance.** When unknown unknowns strike, such countries have to respond, but a development insurance system will not always be able to deliver when needed. The CRW is well structured to meet this need for country-led responses. And yet it could do better, setting standards for transparency and speed of delivery.

We propose three ways in which IDA could increase its effectiveness and efficiency in responding to these challenges:

- **Make finance for crisis preparedness and a crisis-contingent early response available on the same terms as the Crisis Response Window** so that a country would get the same deal from IDA if it arranged contingent finance and response capacity for crises in advance as it would if it asked the CRW for funding after a crisis. Funding would rebalance the incentives for preparing in advance through two specific objectives:
 - *Provide the incentives and rewards needed to improve preparedness efforts for country-led responses to all crises.* Better preparedness planning across countries, and not least in fragile states, will increase the effectiveness and efficiency of all crisis finance flows, including for the CRW and humanitarian aid.
 - *Support government efforts to turn unmanaged unknown unknowns into proactively managed known unknowns*—that is, reward those countries that stop treating crises as surprises. A small-scale option for this would be allowing countries to pre-apply for contingent finance from the CRW for shock-

responsive social protection systems or arrangements to restore damaged lifeline infrastructure. Larger-scale use of this option would involve financing development insurer premiums. Either way, pre-committed finance should be linked to consultation and communication with protected communities and other crisis responders about the design, implementation, and evaluation of CRW-linked projects.

- **Shape and work with development insurers in a ‘bancassurance’ relationship** to help countries proactively manage known unknowns. In the short term, IDA would shape and finance development insurance products as part of a broader package of prevention and preparedness for countries. In the medium term, the World Bank Group might set up its own development insurer.
- **Ensure that financial firepower remains for fast, transparent, and reliable country-led responses to unknown unknowns.** The Crisis Response Window should continue to play this role even though there is room for improvement. It should strive for more objective assessments and faster disbursements, and yet it should not compromise on development impacts. It might also reflect on achieving a more efficient financial design. For example, it could set a minimum threshold at which an automatic replenishment or a capital injection funded by IDA borrowing occurs.

By implementing these changes, IDA19 can contribute to putting the global crisis finance infrastructure, across development and humanitarian partners, on a better footing. Gains in effectiveness and efficiency will emerge by giving governments incentives to strengthen their crisis response systems so they are better used during crises, including by their humanitarian partners. Furthermore, by better managing known unknowns, such as through insurance-like products for earthquakes or climate shocks, governments should be able to reduce the burden on humanitarian finance and operations. Meanwhile, a better-functioning CRW could make it the main source of last-resort finance for country-led responses, allowing the UN humanitarian system to concentrate on non-country-led responses.

Our proposals do not solve the fundamental financing challenges of the humanitarian system. For its part, IDA19 can take an important step towards helping governments play a more effective and efficient role in crisis preparedness and prevention—not by mobilising vast new resources but by increasing how well the existing ones are used. Some of the world’s most vulnerable populations in the world will benefit.

● INTRODUCTION

In 2017 some 124 million people faced crisis-related food insecurity or worse. In some cases, the driving force was economic shocks. Mostly, however, the driving force was conflict, insecurity, and climate shocks. Nearly 52 million children under 5 were acutely malnourished (Food Security Information Network 2018). And the total economic cost of natural hazards alone was estimated at US\$330 billion (Swiss Re 2018). Climate change will only intensify these natural hazards. Worldwide, humanitarian and other organizations remain committed to supporting countries in times of crisis, and yet the financial commitments are often insufficient. Countries are then left holding the bag and likely finding that a response to an extreme event is undermining their fiscal position. If a country cannot fully commit to a response, the poorest will suffer.

This paper reviews the evolution of the World Bank's approach to crisis risk financing, focusing especially on the International Development Association (IDA) and its Crisis Response Window (CRW). In it, we document and comment on the significant progress made in recent years in this area of policy, but we also argue that as IDA and its partners prepare for the 19th replenishment of IDA, they have an opportunity to make important changes that would deliver both better outcomes for the poorest living in high-risk contexts and better value for shareholders. In particular, we examine how reform of existing instrumentation could accelerate IDA's proposed 'pivot to prevention (when crisis risks can be mitigated) and preparedness (when they cannot)' (World Bank 2018a). Reform would also significantly improve the effectiveness and efficiency of the financing response.

Although we do not question the progress represented by IDA's current set of crisis finance instruments, it was designed as a backstop for when other options are not available. In what follows, we propose a better way of structuring incentives and finance for those contingencies. In doing so, we outline how such a structure would fit more strategically in the global development insurance landscape as part of the overall humanitarian and development funding infrastructure.

THE EVOLUTION OF THE WORLD BANK'S APPROACH TO CRISIS RISK FINANCE

As the institution in the World Bank that helps the world's poorest countries, IDA has been at the forefront

of experiments with instruments that specifically aim to help protect developing countries against shocks. In practice, because IDA is essentially a bank, most of these instruments are used to reallocate IDA budgets to a crisis response after a shock, either within country IDA allocations or from its global Crisis Response Window. IDA also has a contingent instrument that governments can arrange to engage in advance. The IDA Catastrophe Deferred Drawdown Option (Cat DDO) provides general budget support in the event of an emergency.

Beyond these budget reallocation and loan instruments, IDA has been quite active in shaping and supporting complementary financial mechanisms that offer countries insurance-like protection. For example, IDA's Pandemic Emergency Financing Facility and its Famine Action Mechanism each have a component that provides such protection. And the World Bank has been instrumental in setting up both the Caribbean Catastrophe Risk Insurance Facility (CCRIF) and the Pacific Catastrophe Risk Insurance Company (PCRIC), which provide small island state sovereigns with insurance cover.

DEVELOPMENT INSURERS?

It is increasingly clear that countries seeking to protect people or parts of their economy against particular shocks need access to development institutions that work with governments and think and are regulated like insurers. One option is fairly basic: risk pools could become primarily financial entities, paying claims to countries based on pre-agreed rules, but with no accountability for how such financing would affect development. The other option is more ambitious: it would embed in financing arrangements a much stronger commitment to development impacts. Indeed, insurance-like instruments, by their very nature, provide the time needed to set up systems for the kind of transparency, scrutiny, and participation of people that is not possible for instruments in which funding decisions are made in the throes of a crisis. This factor gives insurance-like instruments a big advantage. Insurance-like institutions that are able to deliver on these would be more than just risk pools—they would be development insurers.

Worldwide, plenty of insurance companies are offering insurance in and for developing countries, but that does not make them development insurers. Their status becomes clearer when recognizing that development banks, such as the World Bank, are not ordinary banks. The products they offer, such as concessional and non-concessional loans, are all tied to specific development objectives. When such banks work with governments, their focus on development is guaranteed not only through the choice of programmes funded but also through the extensive technical assistance and supervisory support offered to help achieve development impacts.

The distinguishing feature of development insurers should be that they are run using insurance principles, being clear about which risks are protected and which are not, but their products are tied to specific development objectives. They would be supervised by their owners using capital requirements and risk controls set in line with modern prudential insurance regulation. And just as development banks have expanded their services well beyond financial products by offering high-quality technical support, development insurers would need to expand their offerings to countries to include complementary analytical and advisory services.

KNOWN AND UNKNOWN UNKNOWN?

Many crises are not surprises. They are ‘known unknowns’—that is, it is known they may happen in a particular country, what their consequences may be, and what an effective response would look like, but it is not known when they will happen. Examples are climate shocks, earthquakes, and epidemics. Other crises are more of a surprise. They are ‘unknown unknowns’—that is, the kind of crises that arise rather unexpectedly, or for which responses would have been very difficult to plan in advance. Examples are conflict or insecurity-related displacement, certain economic shocks, or perfect storms of what should have been independent shocks previously thought impossible or remote.

In all cases, it pays to be prepared. However, there are fundamental differences in how governments should prepare for known and unknown unknowns.

For unknown unknowns, less can be done in advance. Having in place a risk governance structure with a fast, flexible decision-making process for a response can be

useful, as can investments in general-purpose delivery systems able to adapt or expand key public services in the event of a crisis. Meanwhile, backstop financial mechanisms such as IDA’s Crisis Response Window act as a risk-sharing arrangement among countries to pay in part for unknown unknowns.

For known unknowns, more can be done in advance. It is often possible to go further in preparedness planning, including arranging contingent financing that empowers responders to act immediately rather than having to wait for funding and approval after a crisis.

IDA’s Crisis Response Window and other crisis budget reallocation instruments are designed as last-resort protection for unknown unknowns. They currently do not give countries any direct economic incentive to pursue prevention or preparedness, nor is it easy to see how they could do so without being fundamentally changed.

In the next section, we describe the five key challenges that increase the exposure of IDA countries to crisis risk. We also assess how well the World Bank, IDA, and the CRW are currently contributing to overcoming these challenges and what more needs to be done. We then lay out specifically what this means for IDA and propose three steps to increase its effectiveness and efficiency. In the final section, we discuss how the CRW and the World Bank, as well as the emerging development insurance system, would complement the humanitarian system as part of an overarching development and humanitarian financial architecture.

1

SECTION 1: FIVE CHALLENGES AND WHAT TO DO ABOUT THEM

Few would doubt that preventing extreme circumstances from emerging or escalating into crises is better than trying to mitigate them when they are in full swing. Still, crises can develop, and when they do it is better to have planned in advance than be taken by surprise.

Five challenges make it hard to develop an architecture in which efficient crisis prevention and preparedness are the central virtues. Overcoming these challenges is essential for the emergence of a more effective system of protection for IDA countries.

1.1 CHALLENGE 1: GOVERNMENTS LACK SUFFICIENT INCENTIVES TO INVEST IN PREVENTION AND PREPAREDNESS FOR CRISES

This well-known challenge has been studied widely by political scientists and economists (Healy and Malhotra 2009; Reeves 2011; Gasper and Reeves 2011; Cole, Healy, and Werker 2012). Governments understand that there is little political gain from investing in prevention and preparedness to respond to crises. It is no surprise, then, that they tend to underinvest in both.

Within the context of development finance, much attention is already being given to investing in prevention, ranging from broad-based development—the most reliable way to prevent extreme events from turning into humanitarian crises—to incorporating prevention in development investments.¹ Although it is not easy to prove how well (or poorly) this is done, prevention should be the bread and butter of IDA. Anything that can be done within IDA to strengthen incentives to incorporate risk analysis into public expenditure decisions would be good.

Investment in preparedness planning is a less obvious part of usual IDA business. It is about spending before a crisis occurs.² Preparedness planning itself is about identifying who or what might need to be protected during a crisis, and how this support will be provided. It is about what to prioritise and how to do it. The plan could be to adapt or expand services (such as education, health, social protection, nutrition, and water and sanitation services) in response to a drought, for example, in a pre-agreed way to protect the most vulnerable people (Hallegatte et al. 2016). Or it could be to quickly repair or rebuild key infrastructure (such as main roads, bridges, communication networks, and health facilities) in the aftermath of an earthquake to get the economy back up and running quickly and provide much-needed public services. Either way, preparedness planning typically requires upfront investment in the specific delivery systems that would be needed to respond to a crisis. And it can have very high returns.

¹ The emerging practice within CRW-funded programmes is heading in this direction: spending in Nepal (post-earthquake) and in small island states (post-weather-related extreme events) has included elements of 'build-back-better' and resilience.

² This is different from, for example, IDA's Contingent Emergency Response Component and Immediate Response Mechanism, both of which make it easier to reallocate IDA spending once a crisis has occurred.

A recent study suggested that for every \$1 invested in preparedness, the average (or expected) return was \$2.10, with some projects yielding returns of \$18.70 (UNICEF/WFP 2015).

It is not obvious that such planning would be a priority for development finance sources such as country-based allocations of IDA. In any event, few countries seem to be going this route. The standard incentives apply: governments do not like to prioritise preparedness planning, and instead they tend to focus on development investments with more certain returns. Meanwhile, they leave what and how to respond in a crisis to be dealt with after the fact. Furthermore, because crisis finance is not assured, line ministries are unlikely to do a good job in undertaking any preparedness spending. Here, two factors are at work. First, if a delivery system is built but then not used for crisis responses, the investment in the system could end up being of very poor value. For example, why invest in ensuring that a school feeding programme can be scaled up quickly in the event of a drought if the ministry of finance might instead provide drought response funding to transport water and fodder to affected communities? And why invest in a better system for transporting water and fodder if the government may choose not to respond and instead leave it up to the humanitarian system to respond using its own parallel delivery channels? Second, even for delivery systems that certainly would be used in a crisis, the budget for preparedness would likely be insufficient for anything other than the most basic types of preparedness activity.

In conclusion, the limited incentives to invest in preparedness for a crisis would benefit from a mechanism that provides funding for preparedness planning beforehand, on top of the standard development finance instruments. In other words, stronger incentives to prepare well would profit from linking some forms of crisis finance to efforts to prepare. That said, the current crisis finance instruments, rather than providing these incentives, make this problem even worse, leading to the second challenge.

1.2 CHALLENGE 2: THE CURRENT CRISIS FINANCE INSTRUMENTS DO NOT STRENGTHEN AND MAY EVEN FURTHER UNDERMINE PREVENTION AND PREPAREDNESS INCENTIVES

IDA has a long list of specific crisis finance mechanisms on IDA terms, but most of them are essentially just ways for governments to reallocate part of their IDA envelope to a crisis response once a crisis is in full swing. These mechanisms are helpful—the World Bank tends to carry out budget reallocations faster and more effectively than governments themselves—but they require joint approval by both the World Bank and the country’s ministry of finance once a crisis is under way and are designed to be used only as a last resort. The result? They can be slow and unpredictable. Spearing (2019) estimates the average historical time from crisis to Crisis Response Window commitment is 216 days; the time from crisis to first disbursement is 398 days (excluding the exceptional case of Haiti). Most of these instruments also provide no incentives to invest in prevention or preparedness. IDA currently only has one instrument that is pre-agreed before a disaster strikes: the Development Policy Loan with a Catastrophe Deferred Drawdown Option. This instrument provides incentives for a government to improve its policies on disaster risk management, which is useful. Moreover, it is available for something akin to a discount: for every \$1 of country-based IDA allocation a country assigns to one of these instruments, it will receive an additional \$1 from the Crisis Response Window, effectively topping up its country IDA allocation.

Assistance programmed during crises such as from IDA’s Crisis Response Window, although well intentioned, can make prevention and preparedness incentives weaker. Indeed, once a crisis strikes, emergency aid tends to be grant aid, especially in the very poorest countries or when mobilised by the humanitarian system. Why prepare and even arrange finance beforehand if a country can wait and someone else will pay? Why spend IDA funds from the country allocation on preparedness or

response when the Crisis Response Window or humanitarian system can bail the country out for free after crisis, essentially extending its balance sheet? And yet last-resort funding and delivery systems are still needed. It would make sense, however, to rebalance the incentives by providing attractive finance to understand, prevent, and prepare for potential future crises and to strengthen country-led responses.

In short, IDA countries need better incentives and finance to prepare effectively for possible crises. They also need finance instruments that help them to implement such plans, ensuring that the finance is available to respond through previously prepared delivery channels if a crisis strikes.

For potential future crises that are fairly well understood—known unknowns—one thing the World Bank and the multilateral system itself currently lack is an instrument that gives governments the confidence and budget to develop well-constructed plans that, when a crisis strikes, they can implement without the need for any further approvals, including of finance.³ Such an instrument would change their default setting for responding to crises from ‘wait and see’ to ‘implement what is planned’. Some observers may argue that countries should be allowed to pre-apply to the Crisis Response Window for this kind of contingent finance, so that if a particular kind of crisis occurs, the CRW would automatically provide finance to implement a pre-agreed plan. This could be a viable option for small-scale experimentation with pre-committed contingent financing. However, we argue under the next challenge that a well-functioning development insurance system would be better situated than a global contingency fund to finance planned contingent expenditures at scale.

³ In our 2016 book *Dull Disasters*, we proposed three conditions for contingent expenditures: first, they should be linked to a plan and system for post-disaster action that is in place before a disaster strikes; second, they should be triggered by a fast, evidence-based decision-making

process; and third, they should be financed in advance, where the finance ‘acts as the glue that holds credible plans together and makes them strong enough to withstand the whirlwind of highly charged post-disaster politics’.

1.3 CHALLENGE 3: THE WORLD NEEDS DEVELOPMENT INSURERS, NOT JUST RISK POOLS, BUT THEY (MOSTLY) DON'T EXIST YET

It is striking that relative to development banks (which give governments loans and grants for development purposes), almost no development insurers (which provide governments with insurance-like protection tied to explicit development objectives) are open for business. Sovereign risk pools such as African Risk Capacity, PCRIC, and CCRIF are all part of the way there, and all seem to be developing in the direction of what we call *development insurers*.

One of the most difficult aspects of proactive crisis management in IDA countries is understanding who will ultimately take responsibility for what parts of crisis response, and therefore who effectively owns what risk. As already noted, crisis financing in the international system is predominantly last-resort funding, which means that decisions about who will pay and what delivery systems will be used are left until the onset of a crisis. Without commitments from others, vulnerable people are left not knowing what support they can rely on in times of crisis, and they may end up taking fewer productive risks, or even using some of their scarce resources to duplicate some of what government or humanitarian agencies will end up providing.⁴

Growing the parts of the system that provide pre-agreed protection could change this. It would mean a greater opportunity for wider and deeper transparency of decision-making and the participation of more people in that process than would be possible if all decisions were made in the throes of a crisis. Here, development insurers have a role to play by, for example,

- Ensuring wider and deeper transparency of decision-making before and during crises
- Facilitating the participation of people in robust, inclusive planning processes
- Helping governments, their partners, and people to understand what the risks are and who is responsible for managing what parts of the risks
- Helping companies, people, and the humanitarian system proactively manage the risks that will be left to them
- Tying insurance products to pre-agreed contingency plans and being accountable for achieving pre-agreed

⁴ For example, farmers in northern Ghana seemed to substantially increase their investment in their farms when explicitly protected from production shocks through insurance (Karlan and Udry 2014).

development objectives

- Setting up monitoring and audit systems that do not impose a major burden on project implementation and yet ensure a basic measure of accountability so that spending is going to the purposes intended

Risk pools vary widely in the degree to which they do these things. Some do not manage to clearly communicate how far their coverage can reasonably be expected to extend, and then they run afoul when expectations are not met (Muir-Wood 2017). Some do not share their in-house risk assessments or details of when they will pay out with governments or protected communities, leading to a missed opportunity to support risk-informed decision-making across all levels of society (Stein and Sridhar 2017). Most do not consult with outsiders about the design, implementation, and evaluation of projects (Hillier and Vaughan 2019). And some do not even track how governments spend claim payments (World Bank 2017).

These are all missed opportunities. For example, lack of monitoring can have consequences. Contingent financing that pays out just as budget support during a crisis is unlikely to be efficient or be used effectively, even if it arrives quickly. Such unallocated budget support could be used for political purposes, for ‘flag-planting’, or for other high-profile interventions, or it could end up stuck in government, with quick disbursement not an option (for examples, see Clarke and Dercon 2016). Some existing crisis finance instruments, such as the CRW, pay careful attention to how resources are used, but others are weakly monitored. Indeed, recently the World Bank Group’s Independent Evaluation Group (2017) criticised the World Bank for its very weak monitoring in its crisis response and resilience programming. By planning ahead, development insurers should have the time they need to set up monitoring systems that don’t impose a major burden on project implementation and yet ensure a basic measure of accountability.

IDA has a long history of finding ways to balance country-based ownership with rewards and incentives for good policy. Its allocations reward success in economic management, and its lending emphasizes broad-based growth. It is, then, not a big step to suggest that IDA countries also be rewarded for their preparedness to deal with crises and that IDA support in crises would favour the kinds of transparency, scrutiny, and participation of people that will lead to better prevention and more inclusive and broad-based crisis recovery. IDA already does this to some extent through its Development Policy Loan with a Catastrophe Deferred Drawdown Option, which provides incentives for government to improve its policies on disaster risk management. Such efforts are typically much easier to implement through pre-planned approaches than through last-resort approaches such as the Crisis Response Window.

All this suggests an important role for the World Bank in the entire development insurance space. First, because a good crisis response requires investment in preparedness, the Bank should provide further incentives for preparedness planning. The Bank could fund such planning through earmarked IDA resources beyond the country-based allocation, as argued earlier, and bring the Bank's expertise to the table to help design and implement these preparedness investments.

Second, the World Bank and other development banks should play a central role in the emergence of development bancassurance (a concept discussed in more detail under the next challenge). They could serve as key links between client countries and development insurers, helping those insurers to refine their offerings so that they're increasingly useful as part of a package of prevention and preparedness investments. Among other things, the World Bank could require development insurers and client countries to stick to commitments made on how resources will be used. Via IDA, it could reward client countries that are keen to acquire these investment products not only with support for preparedness, but also with finance to acquire the products (such as through premiums at concessional terms⁵). Just as for preparedness, finance on IDA terms should be outside the country-based allocation, but closely tied to pre-committed spending plans and delivery systems during a crisis. Even if it does not provide the insurance on its own balance sheet, the World Bank should play a key role in monitoring the behaviour of both client countries and development

insurers tied to its IDA support, just as it would do with other lending.

Over time, a development insurance system will allow more pre-planned and pre-committed resources to be deployed quickly and effectively to respond to crises. This system would likely go well beyond the offerings of the existing development insurers. Private sector insurers could participate as well, provided they can credibly commit to acting like development insurers.

A well-designed system would also allow much more experimentation in how protection works. The current insurance-like solutions are mostly based on parametric risk transfer, in which financial flows are triggered by observations from the natural world (rainfall, wind speed, etc.). Well-run development insurers with room to innovate may be able to do much better—for example, by developing products whose trigger is based on economic or human outcomes such as 5,000 refugees arriving in a border town; 150 cases of a highly infectious disease; a 50 percent loss in the average yield of an area; substantive damage to 50 percent of properties in an area; a 30 percent reduction in the relative price of meat and grain in pastoralist communities; or a jump of 20 percent in the number of malnourished children presenting at a feeding centre.

Development insurers should require investments in prevention and preparedness to serve as pre-conditions for their insurance products, but they probably should not directly finance them. To be able to offer countries a package of prevention, preparedness, and insurance, development insurers will need to work with development banks.

⁵ Recently, the Global Risk Financing Facility emerged as a multi-donor trust fund. It was also given a brief to explore concessional insurance through premium subsidies. Although this was a positive move, bringing this task

inside the core activities of IDA would be more constructive, offering better integration and coherence in line with the discussion.

1.4 CHALLENGE 4: A MATURE DEVELOPMENT INSURANCE SYSTEM SHOULD HELP DEVELOPMENT BANKS DELIVER MORE FOR LESS

In recent times, the World Bank has been moving towards providing insurance or insurance-like instruments. For example, the Pandemic Emergency Financing Facility consists of a cash layer for relatively small payouts and larger resources based on a parametric trigger if a pandemic becomes a reality. Similarly, the Famine Action Mechanism provides insurance-like protection when large-scale food insecurity threatens.

Although the world likely needs more and better development insurance, it is not at all obvious that development banks are the right player to deliver it. After a crisis, banks can excel at moving money between accounts, but they are generally too expensive for financing insurance-like contingent expenditures.

The typical approach taken by development banks wishing to deliver insurance-like cover to their client countries is to purchase fully collateralised market risk transfer products and then pass the costs and benefits on to countries. This arrangement is totally safe for the development bank but financial theory suggests that it will probably provide poor value for money for two reasons.

First, when one purchases a health insurance product with a sum insured of \$20 million and then asks the insurer to hold \$20 million in an escrow account for the duration of the contract, the cost of the contract rises significantly because it removes the main way insurance companies are able to offer low prices: diversification. Well-regulated insurance companies would not *totally* eliminate the risk of default, but they would reduce it down to a very low level. For example, the European Union's Solvency II requires a confidence level that insurers can meet their claims as they fall due with a probability of at least 99.5 percent, not 100 percent. Most developing country risks are easy to diversify in

international reinsurance markets, leading to a very low capital charge, and so the cost saving from well-regulated insurance is likely to be substantial, without introducing systemic risks (Cummins and Trainor 2009; Thimann 2014; Bobtcheff, Chaney, and Gollier 2016).

Second, if countries cared enough about insurer default to want to purchase fully collateralised protection, coverage would also come with very low levels of basis risk—that is, the risk that a product may not pay out when it is most needed because coverage rules do not precisely match need. Instead, sovereign risk transfer products tend to come with high levels of basis risk, which is inconsistent with the claim that countries are willing to pay to eliminate credit risk.⁶ This suggests that when countries are purchasing fully collateralised market cover from development banks, they are doing so because they lack of other options.

If the World Bank simply helped its clients to purchase insurance from a well-regulated development insurer, or even a brokered insurance solution from well-regulated commercial insurers, economic theory suggests that the cost of the insurance would likely be substantially lower for its clients without a material difference in the degree to which the product protects development outcomes. Importantly, this could be done without threatening the World Bank's AAA rating.

What should happen going forward? Instead of just providing market insurance to countries when it is possible and cost-effective, the World Bank should be helping risk pools to deliver the right products cheaply, as part of the holistic packages of prevention and preparedness that ultimately protect people and economies. The World Bank via IDA is extremely well placed to do this.⁷

⁶ From a country perspective, what matters is the cost of the cover and the overall likelihood that the product won't pay when needed, where $Probability\ that\ product\ won't\ pay\ when\ needed = credit\ risk \times basis\ risk$. Credit risk means that a product may not pay out when it is most needed because the insurer defaults. For basis risk, the design of risk transfer instruments, particularly parametric instruments, means that a product may not pay out when it is most needed because, as noted, the coverage rules do not precisely match need. For a country, it does not matter whether a product is not paying out because of credit risk or basis risk. The country should be willing to pay as much to reduce the credit risk from 0.5 to 0 percent as it would pay to reduce basis risk from 20 to 19.5 percent or from 19.5 to 19 percent, and so forth.

⁷ Some argue that development banks should finance contingent expenditures through contingent concessional loans. This approach, however, can come with a high opportunity cost. If funding for the contingent loan is prepositioned, a country is essentially choosing to defer drawing down a very cheap loan, which has a cost. It is often better that any contingent loan be designed to avoid the potential opportunity cost of undisbursed cheap credit (Paterson 2019). Compared with that arrangement, insurance products, particularly parametric insurance ones, can be extremely cheap, even for coverage of high-frequency events. If funding for the contingent loan is not prepositioned, there can be costs and delays while resources from existing projects are reallocated to a crisis response.

The World Bank's potential role in putting development insurers and countries on the same page should not be underestimated. Here, lessons can be taken from the private sector. Banks and insurers work synergistically all the time in retail markets. In fact, such an arrangement is so common that it has a name: *bancassurance*.

Typically, the design of the protection solution arises from collaboration between the bank and the insurer. Both can contribute good ideas, and both have veto power—that is, the insurer can decide not to deliver the protection, and the bank can decide not to link its loan to that product. One option, then, is for IDA to shape and finance protection instruments as part of a broader package of prevention and preparedness for countries. This is our preferred outcome.

Such a relationship could work well in a development context, and it appears that the World Bank has been working this way with the Pacific Catastrophe Risk Insurance Company. Even though this kind of relationship seems to be the exception rather than the rule, it should be the future. It'll likely require, however, that the governance of concessional finance for contingent expenditures be conducted in a way that binds development banks and development insurers and allows them to trust each other. And in the medium term, the World Bank Group might need to set up its own development insurer, to fill gaps in the development insurance landscape.

In the end, however, we have to remain realistic. Last-resort finance will continue to be needed for crises that could not have been (or were not) foreseen. How to ensure that such resources are plentiful and effective is challenge 5.

1.5 CHALLENGE 5: POOR COUNTRIES NEED LAST-RESORT SOURCES OF CRISIS FINANCE

Because *ex ante* financial instruments cannot be designed for unknown unknowns, a backup option for accessing finance rapidly for such a crisis must always be in place. Moreover, too many countries are far from developing sufficiently strong preparedness and adopting the contingent finance products required to remove many known unknowns from their system. Meanwhile, no pre-agreed crisis plan and no rules will be perfect. Relatively affordable insurance-like products may not pay out when most needed. At times, triggers will fail or be imprecise. Or the measures laid out in the crisis plan will not be the most cost-effective. Meanwhile, some countries may have such limited absorption capacities that they are underprepared even when crises hit.

In short, substantial resources will continue to be required as a backup option of last resort. And delivery systems such as shock-responsive social protection, health, nutrition, and education systems will be needed to deliver a crisis response.

A backup option and finance of last resort are already in place through the humanitarian system. Its typical financing through *ex post* appeals is by no means effective or efficient, but it does go quite a way towards meeting the most urgent humanitarian needs. With its implementing partners, the humanitarian system is well suited to set up responses through non-governmental channels when government systems are underprepared or not functioning, or where a government is unwilling to use them to respond to urgent humanitarian needs. This is often the case in very fragile or conflict-affected settings.

Although the humanitarian system is likely the best option for financing crises when delivery is not forthcoming through government systems, development banks, through their close links with governments as clients, are well placed to provide last-resort crisis financing for a country-led crisis response. This is the current core business of the CRW, and we approve. The CRW provides *ex post* financing for disasters and economic shocks outside other allocations on IDA terms, while paying solid attention to development impacts.

Increasing the effectiveness of the CRW will depend on structuring the system so that it avoids letting crises become so severe that they would be eligible for CRW support. Over time, as the management of known

unknown risks improves, the CRW should become a fund that responds through country systems as effectively as possible to crises from unknown unknowns.

In principle, there are two possible approaches to restricting use of the CRW to unknown unknowns: (1) the carrot—making investments in understanding, preventing, and preparing for crises more attractive to countries; or (2) the stick—restricting access to crisis financing instruments for risks that should have been managed better beforehand. As observed in the World Bank's IDA review paper (World Bank 2018b), the carrot is likely to be more practical. In the next section, we describe how IDA and the CRW could move forward with these approaches.

These changes would also benefit the humanitarian system, which is continually under financial and other pressure. Better financing to respond to extreme events through country-based systems should take some of this financial burden off the books of humanitarian organizations. They can then focus more effectively on those places where government systems are failing or very weak, or where governments are not willing to respond.

Should IDA and the CRW also finance the activities of the humanitarian system? This is already happening directly in countries such as Somalia, the Republic of Yemen, and South Sudan. The CRW and IDA should nevertheless remain primarily focused on country-led responses and strengthening, financing, and delivering through government systems. Setting standards for country-led ownership during crises is appropriate and useful. Much can be done in this area in terms of both preparedness and responses in line with the arguments in this paper.

IDA's role in contexts in which governments are not functioning or in control is trickier, and we do not suggest a new role for the CRW. Nevertheless, the direction of travel is right. As the recent experience in the Republic of Yemen has shown, IDA country allocations are bound to be underspent during the trickiest conflict situations and directing those allocations via the humanitarian system also seems right. However, this issue appears to be more of an overall IDA one than a new direction for the CRW. The CRW's core business should be country-led responses.

2

SECTION 2: PROPOSALS FOR IDA

We propose three ways in which the efficiency and effectiveness of IDA could be increased:

- Make finance for crisis preparedness and a crisis-contingent early response available on the same terms as the Crisis Response Window so that a country would get the same deal from IDA if it arranged contingent finance (and preparedness) for crises in advance as it would if it asked the CRW for funding after a crisis.
- Shape and work with development insurers in a bancassurance relationship to help countries proactively manage known unknowns.

- Ensure that financial firepower remains for fast, transparent, and reliable country-led responses to unknown unknowns.

In practice, tackling these issues encompasses three areas of evolution and reform.

2.1 MAKE FINANCE FOR CRISIS PREPAREDNESS AND A CRISIS-CONTINGENT RESPONSE AVAILABLE ON THE SAME TERMS AS THE CRISIS RESPONSE WINDOW

If IDA would like to see more and better preparedness, it will have to reduce significantly the financial cost incurred by countries to invest in preparedness.

First, IDA should provide the incentives and rewards needed to improve preparedness efforts for country-led responses to all crises. Better preparedness planning across countries, and not least in fragile states, will increase the effectiveness and efficiency of all crisis finance flows, including for the CRW and humanitarian aid.

Second, IDA should support government efforts to turn unmanaged unknown unknowns into proactively managed known unknowns—that is, reward those countries that stop treating crises as surprises. A small-scale option would be allowing countries to pre-apply for contingent finance from the CRW for shock-responsive social protection systems or arrangements to restore damaged lifeline infrastructure. Larger-scale use of this option would have to involve financing development insurer premiums, with the same ratio of the country contribution to that of the global window. Either way, pre-committed finance should be linked to consultation

and communication with protected communities and other crisis responders over the design, implementation, and evaluation of CRW-linked projects.

IDA's Crisis Response Window alone has financing available of US\$1 billion a year over that of IDA18. By comparison, the total amount of protection bought from sovereign disaster risk pools in 2016/17 was only US\$56 million. With a move towards development insurers, a substantial rebalancing seems possible.

The Asian Development Bank already has a similar window for Asian countries. Its Disaster Risk Reduction Financing Mechanism mostly focuses on prevention, but it is allowed to fund some elements of preparedness (ADB 2016).

2.2 SHAPE AND WORK WITH DEVELOPMENT INSURERS IN A BANCASSURANCE RELATIONSHIP

Ultimately IDA should not itself bear any known unknown crisis risk. It should pay premiums, but the claims should be paid by development insurers.

To finance contingent expenditures, we propose that IDA work with development insurers on a particular form of bancassurance, development bancassurance. It would serve as a key link in the relationship between client countries and development insurers. Together, IDA and development insurer partners would offer countries a joint package of prevention and preparedness, including contingent finance. Ideally, IDA would finance the pre-crisis expenditures such as on prevention, preparation, and risk information, and development insurers would finance the crisis-contingent expenditures. IDA could also provide financing to acquire the contingent finance from development insurers (for example, through premiums at concessional terms). Just as with preparedness, finance on IDA terms should be outside the country-based allocation, but closely tied to pre-committed spending plans and delivery systems during a crisis. Even though the World Bank should not provide the insurance on its own balance sheet, it should play a key role in monitoring client country and development insurer behaviour tied to its IDA support, just as it would do with other lending.

Such an arrangement would require close, trusted working relationships between development banks and development insurers. For IDA, this proposal would likely have certain implications for governance. For example, IDA or the Crisis Response Window may have to be part of the governance of those development insurers, and the development insurers may need to have a formal role in the Crisis Response Window.

2.3 ENSURE THAT FINANCIAL FIREPOWER REMAINS FOR FAST, TRANSPARENT, AND RELIABLE COUNTRY-LED RESPONSES TO UNKNOWN UNKNOWNNS

Finally, we support the broad direction of travel proposed by the World Bank for IDA19 (World Bank 2018b), in particular in the following three areas. First, where it is possible to do so, there is value in making the process for determining CRW allocations more objective. We support the proposal that the Crisis Response Window use the issue of food insecurity as an opportunity to experiment with this proposal. A slow-onset crisis response can gain substantially from an objective assessment because the urgency is often underestimated and some of the consequences (such as poor nutrition) emerge only later. We encourage IDA to think of this not just as an opportunity to increase its efficiency as a cooperative bank for the world's poorest countries, but also as an opportunity to engage with and set more objective standards for the humanitarian system as well.

Second, IDA may want to give more thought to the financial structure underlying its crisis financing. For example, the CRW is essentially an amount of grant funding that can be disbursed if it is not used. IDA could take inspiration from the International Monetary Fund (IMF) in all this. IMF conducts needs assessments in an objective, credible way, and it brings others on board to respond. The Fund has some financial firepower itself, but it is actually quite limited in the grand scheme of things. Its back end is structured as a risk-sharing agreement with clear rules, not insurance. Apparently, IDA already has a set of instruments available to it like those of IMF (including the ability to issue debt). It may be able to use these instruments to reduce the opportunity costs of having grant funding sit unused in a fund.

Third, the CRW needs to become faster at both approval and disbursements. A wait of more than a year for the first disbursement after crisis financing is approved is too long (Spearing 2019).

That said, we acknowledge that there may be limits to how much faster the CRW can become unless incentives are changed. We do not want the CRW to compromise on development (and humanitarian) impacts, nor on its ability to provide reliable backup when all else fails. It is right to set standards on development impacts and how crisis resources should be spent, even if triggers could become faster and more objective. As argued earlier, the lack of a focus on development (or humanitarian) impacts is a weakness of some of the fast parametric products, at least those released without being tied to defined delivery plans such as shock-responsive social protection programmes. The CRW would in any case be faster and more effective if more countries invested in preparedness.

● CONCLUSION

Development remains the best way of ensuring that hazards and risks do not escalate into crises for people and economies. IDA's core business will remain that of offering concessional loans to empower poorer countries to make development happen. Meanwhile, though, extreme events linked to climate change, pandemic risks, conflict, as well as economic shocks will continue to undermine development, putting lives and livelihoods at risk, not least for the poorest people. The humanitarian system has evolved over decades to provide ever-improving protection against loss of life and suffering in such circumstances. However, its finances are stretched. Multilateral development banks, not least the World Bank, have developed a set of crisis finance instruments that could complement these efforts. Lacking, however, is a clear-cut financial architecture that brings clarity and transparency to the respective roles of humanitarian and development actors, while also making the system more efficient.

Our proposals for IDA19 could be seen in this light for three reasons. First, although IDA does finance preparedness investments, globally there is a surprising lack of specific preparedness funding available for designing and strengthening country-based delivery systems that can adapt and expand in response to changing needs during and after crises. Such systems would make spending financed through its Contingent Emergency Response Component, the Crisis Response Window, or a government's own funds faster and far more effective than at present. In some situations, it should also enable humanitarian actors to use or complement (cheaper) government systems for delivery of assistance rather than relying exclusively on parallel delivery systems. Financing such responses through the development financing architecture would seem the most obvious solution. Moreover, bringing humanitarian partners into this preparedness work in some more fragile settings would have a high payoff. For example, building shock-responsive social protection systems or electronic transfer delivery systems that could be used for country-led responses, and as well by the humanitarian system if required, could offer considerable efficiency savings if a crisis were to develop.

Second, there are simply not enough insurance-like institutions for an efficient financial architecture. If one has a hammer, everything looks like a nail. Multilateral institutions are loaded with loans and grants, developed over decades. But sensible crisis finance involves risk finance instruments, not just

loans or grants. The World Bank has been at the forefront of developing some of these instruments, and yet banks, including development banks, are not the most efficient providers. Indeed, this is the crux of our push for a bigger role for development insurers in the financial architecture: greater efficiency. The World Bank should nurture the development insurance landscape and ensure it is focused on development by promoting a bancassurance business model. The main benefit? A series of risks would be taken off the books of the humanitarian system because more crises currently treated like unknown unknowns would gradually be turned into managed known unknowns. Examples would be recurring weather-related shocks in southern Africa, Malawi, or Ethiopia that, collectively, would increasingly be handled by strengthened shock-responsive, country-led systems, using pre-arranged finance through insurance.

Third, any crisis finance system will require backstops. Some crises (unknown unknowns) simply cannot be foreseen, and even the best insurance-based system will come with basis risk. Here, the Crisis Response Window fulfils a clear function for country-led responses to unforeseen crises in IDA countries. The global humanitarian system is likely to remain responsible for those contexts in which country-led responses are just not possible—for example, because of conflict or displacement. Nevertheless, a well-functioning CRW, as well as more investments in crisis response capabilities *ex ante* in fragile settings will help to reduce pressure on the humanitarian system. However, to play its role effectively as a backstop, the CRW will have to be faster, providing liquidity to support country-led responses within reasonable timeframes.

All this said, serious challenges remain in the global crisis financing architecture—challenges that are, however, beyond the scope of this paper. For example, IDA is able to issue debt and work hand in hand with development insurers, but the global humanitarian system faces challenges with both. Most of its crisis responses are financed through *ex post* grant instruments mainly financed in turn by humanitarian appeals, which are in a financial sense no more than begging bowls passed on to willing donors. And once money is in the humanitarian system, there is a sense that it must always be directed towards the greatest need at that moment rather than make use of medium-term planning and risk information to deliver more impact. Key questions surrounding how to improve

this situation are the role of the UN Office for the Coordination of Humanitarian Affairs (OCHA), and its relatively small contingency fund, the UN Central Emergency Response Fund (CERF). There is also no doubt a case for the humanitarian system to do better at preventing and preparing for known unknowns for which a country-level response is unlikely to be forthcoming.

Whether IDA will have a role to play in an improved humanitarian finance architecture is yet another issue beyond the scope of this paper. However, any investigation of this issue using, for example, the recent experience with the Republic of Yemen in which the country-based allocation has been used for delivery by the humanitarian system, should not distract from the World Bank's more fundamental role in the global crisis financing infrastructure discussed in this paper. By shifting incentives and rewards towards preparedness investments and pre-financed responses in line with the proposals in this paper, IDA19 can take an important step towards consolidating its role in the development and humanitarian financial infrastructure. It does not have to mobilise new resources—only increase the effectiveness and efficiency of existing resources. Some of the most vulnerable populations in the world will see the rewards of this effort.

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Cover image: A child stands amongst the remains of buildings destroyed by the floods in Sindh province, Pakistan, 2010.
Image: DFID/Russell Watkins

