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Mobilize resources ex-ante through a DRM fund and financial protection strategy

Towards effective post-disaster public financial management

Highlights

- A Disaster Risk Management (DRM) fund is a central building block to a government's Disaster Risk Financing and Insurance (DRFI) strategy.
- A DRM fund allows the government to meet financial obligations while protecting the government budget from fiscal volatility.
- The DRM fund can be complemented by other risk retention or transfer instruments such as contingent credit, insurance, or cat bonds.

Background

A dedicated Disaster Risk Management (DRM) fund is the core budgetary instrument of a government's Disaster Risk Financing and Insurance (DRFI) strategy. An effective DRFI strategy allows governments to meet its financial liabilities as they fall due, enabling the timely execution of funds. Effective funding through a DRFI strategy is required for both emergency response and to help infrastructure and services recover as quickly as possible following a disaster. Such a strategy allows governments to better manage their budgets, reducing the need for reallocating resources away from social programs and investment to pay for recovery and reconstruction.

This note discusses the role of the DRM fund as the main budgetary instrument of a country's DRFI strategy. This is the fourth of a series of six notes that, together, reviews the process of an institutional mechanism to finance post-disaster recovery and reconstruction.

General Principles

The most common source of post-disaster expenditure is the government's own budget. Generally taking the form of a reserve fund, annual budget allocation, or contingency budget, it has the advantage of relatively low upfront costs compared to other financial instruments such as insurance policies, tax increases, and emergency loans.

Most governments do not have a reserve fund, annual budget allocation, or contingency budget dedicated specifically for natural disasters. In fact, countries frequently rely on budget reallocations or emergency loans in the aftermath of a natural disaster. This endangers development programs that have often required years of preparation, or may take a long time to negotiate and thus do not generally facilitate immediate resource mobilization.

Establishing a dedicated risk retention mechanism, in the form of a DRM fund, is an essential step in developing a DRFI strategy. It forms the foundational building block of a government's ability to retain part of its disaster risk. These funds will allow the government to respond efficiently in the aftermath of natural disasters to meet its financial obligations while protecting the government budget from the fiscal volatility that disasters potentially generate.

DRM funds should be used to finance recurrent losses and lower layers of risk. These resources are comparatively less expensive and readily available. Other financial instruments, such as contingent credit, insurance, or cat bonds, are available to finance infrequent but more severe events.

Neither the DRM fund, nor any single financial instrument is a stand-alone solution. Governments may develop a comprehensive DRFI strategy through an optimal mix of available risk retention and risk transfer instruments, each with its advantages, costs, and timing of availability.

Considerations for Implementation

A DRM fund can be established through a legal reform, an Executive Decree, or by enacting a new law, depending on the country's existing legal framework. Establishing a DRM fund may be one of the most important achievements in a country's DRM agenda. It requires recognition from the government on disaster risk management as a national priority and a strong commitment especially in the Ministry of Finance, and the Legislative branch to agree upon the budget amount.

Determining the budget allocation to the DRM fund is a highly political process and could potentially be met with opposition from existing programs facing budget cuts to free up resources. It may be useful for governments to work opportunistically, utilizing the political window provided by recent natural disasters, as the urgency can help create a political climate more favorable for budget negotiations.

Governments may consider prohibiting by law the use of resources from the DRM fund towards any other areas. Absent explicit legal prohibition, social and political pressure can often force policy makers to divert the resources to other areas (e.g., social and development programs, health programs, education initiatives, poverty reduction plans). Legal measures can preempt such a situation and foster the opportunity to grow ex-ante reserves during less costly years and smooth out public finance needs in peak years with numerous costly disasters.

Governments may also consider specifying by law an annual minimum amount or fixed percentage for budget allocation of the DRM fund. This could help avoid yearly negotiations, which may be subject to the fiscal position of the government and not necessarily correlated with the damages incurred by the country on an annual basis. Fiscal risk assessments clarifying the explicit contingent liabilities of the government can provide some leverage when negotiating the budget amount with the Legislative branch. These topics are discussed in-depth in Short Notes "Risk Assessment and Fiscal Disaster Risk Profile", "Clarification of Explicit Contingent Liabilities", "Shared Responsibilities with Local Governments".

International Experience

In Mexico, the devastating 1985 Mexico City earthquake was the catalyst for prioritizing the disaster risk management agenda. The Government of Mexico (GoM) gradually increased institutional changes to integrate disaster risk management into national planning, and in 1996 established FONDEN, a dedicated Natural Disaster Fund. FONDEN is the financial vehicle that facilitates the budgetary operations and the use and distribution of resource relating to the DRM strategy of the GoM.

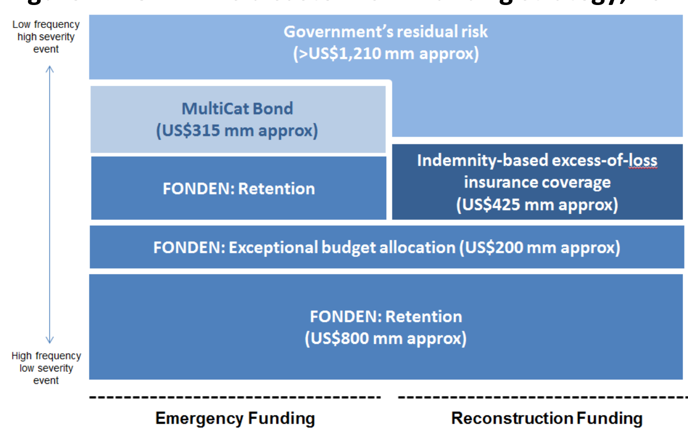
FONDEN is allocated a minimum of 0.4 percent of the annual federal budget (approximately US$800 million) according to Mexico's Federal Budget Law (Article 37). This amount, however, includes uncommitted resources from the previous fiscal year, preventing FONDEN from growing reserves. The GoM has introduced additional financial instruments into FONDEN's mandate to address this shortcoming and to further increase FONDEN's risk retention capacity.

As a trust fund, FONDEN has certain characteristics that distinguish it from other federal budgetary mechanisms. It can concentrate resources intended for future distribution in to one single entity, instead of across several programs, and allocate the resources across multiple years. Should resources prove insufficient in a given year, the Federal Budget Law (Article 19) allows FONDEN to receive reallocated resources from other budgetary programs, which has historically been from oil revenue surpluses.

FONDEN is also the vehicle through which the GoM contracts market-based financial instruments to transfer high-risk layers to the reinsurance and capital markets. In 2012, the GoM issued MultiCat Mexico 2012, a multi-peril cat bond covering earthquake and hurricane hazards up to US$315 million. It replaced the protection previously covered by the 2009 MultiCat transaction. The GoM was the first country in the world to issue governmental cat bond against earthquakes in 2006.

FONDEN also placed an indemnity-based excess-of-loss insurance contract since 2011. It was renewed in 2012 with coverage of US$425 million in excess of US$1 billion.

Figure 1. FONDEN's disaster risk financing strategy, 2012



Source: FONDEN (2012)

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