Overseas Development Institute

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Crisis and risk

Risk affects almost every aspect of human enterprise, from the global to the household level. The global credit crunch can be seen as the result of a chronic 'underpricing' of risk linked to certain kinds of loan. Risk is a defining concept in the world's financial markets, just as it is in the gambling and insurance industries. It can also determine whether a country can plot a course for its own development, and whether a family can take the kind of chance that might lift it out of poverty.

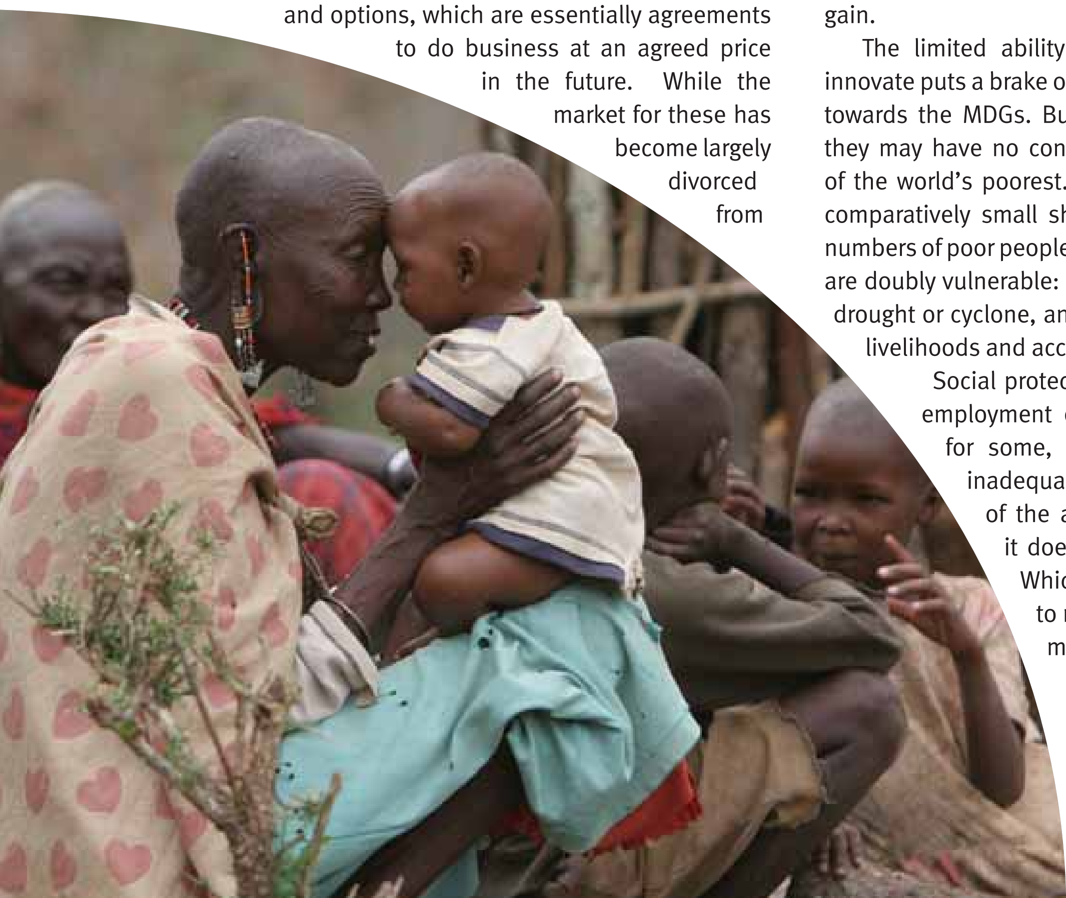
Fluctuations in commodity prices and interest or exchange rates create uncertainty (and hence potential risk) for governments, businesses and individuals alike. Uncertainty about the future and the need to hedge against adverse outcomes – for example a fall in commodity prices – has resulted in the growth of secondary markets trading not commodities or stocks but 'derivatives', such as futures and options, which are essentially agreements to do business at an agreed price in the future. While the market for these has become largely divorced from their original risk-hedging purpose, they still provide some certainty in an otherwise uncertain environment, allowing businesses to plan and invest with more confidence.

What does all this have to do with the humanitarian and development agendas? Far more than it might seem. At one level, the speculative trading of derivatives can have a sharp impact on both producers and consumers, and some argue that this has contributed to the current global food price crisis. At a more domestic level, the survival of farmers' businesses may depend on whether they can protect themselves against (say) a fall in maize prices by securing an agreement to sell crops at a fixed future price. Equally, their economic status may determine whether they can afford to take the risk of innovation. If you are poor, you may not be able to afford the potential loss of experimenting with new seed varieties, or new forms of livelihood, however attractive the potential gain.

The limited ability of poor people to take risks and innovate puts a brake on development and hampers progress towards the MDGs. But it is the effects of risk over which they may have no control that dominate the lives of many of the world's poorest. At this level of vulnerability, even a comparatively small shock can spell disaster. The growing numbers of poor people who face exposure to natural hazards are doubly vulnerable: to the direct physical impact of flood, drought or cyclone, and to the consequent loss of property, livelihoods and access to services.

Social protection measures – such as cash, food, employment or subsidies – provide a safety net for some, though current provision is grossly inadequate globally. Access to credit is part of the answer to bridge economic loss, but it does not fully address the issue of risk. Which raises the question: 'is it possible to make risk more manageable, and how might we do so?'

This sets an important research agenda for ODI over the next two years. We will investigate the means



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by which risk may be reduced, transferred or otherwise made manageable for poor and vulnerable people. We will look specifically at the risks associated with crisis, particularly natural disasters and their aftermath. Insurance provides one potential means of risk management here, based on the idea of risk transfer – but whether insurers accept the business, what premium they charge and whether this is affordable to those needing cover are major questions.

At the more modest end of the scale, micro-insurance and micro-credit provide potential lifelines to poor people in their attempts to manage the vicissitudes of fragile livelihoods. At the more dramatic end, global insurers and reinsurers are paying out increasingly large sums on disaster-related claims – but many people, particularly in the developing world, remain uninsured. To quote Swiss Re: ‘In 2005, economic losses from natural disasters hit a record high, with direct financial losses of about $230 billion ... Despite a record payout of more than $83 billion worldwide, uninsured direct losses of $150 billion had to be carried by individuals, companies and ... the public sector’.

New instruments, such as catastrophe bonds and weather derivatives, are being trialled to hedge against such events in developing countries, as well as mutual insurance schemes like the Caribbean Catastrophe Risk Insurance Facility. On the face of it, these may provide a more rational and affordable way of using finance for disaster responses – or for compensation schemes – than the more traditional use of aid instruments. Many have the added advantage of being index-based and of paying ‘up front’ rather than on the basis of loss assessment.

Some risks can never be transferred. No amount of compensation could bring back the 100,000 or more who died in the immediate aftermath of Cyclone Nargis in Myanmar in May 2008. However, many of these deaths could have been prevented with relatively modest investment in early warning and preparedness, as experience from Bangladesh shows.

The heart of the disaster risk reduction agenda lies in the prevention of catastrophic threats to human life and the reduction of people’s exposure to such events. At a time when populations are growing, people are inhabiting increasingly marginal land and the incidence of natural hazards is increasing because of climate change, this poses a massive challenge to the development and humanitarian communities. It is vital that risk reduction features more centrally in the development agenda if preventable death and impoverishment are to be avoided in the future.

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