Lending a Hand when Catastrophe Strikes

A new cost efficient emergency relief instrument helps countries face natural disasters: the Development Policy Loan (DPL) with a *Deferred Drawdown Option for Catastrophe risks (Cat DDO)* – DPL with a Cat DDO

A contingent loan for recovery and reconstruction

When natural disaster strikes developing countries are confronted with the urgent need to implement emergency relief processes and to reconstruct roads, hospitals, electric power supply and other crucial infrastructure facilities. A new World Bank instrument can help middle income countries in this situation with a loan that provides immediate liquidity to finance these recovery and reconstruction operations.

Recent catastrophes such as Hurricane Mitch in the Caribbean and Central America, Cyclone Nargis in the North Indian Ocean Basin and Myanmar, the Sichuan earthquake in China or the Indian Ocean tsunami have not only killed thousands of people but also demonstrated the great importance for governments to have quick access to recovery funds to reestablish critical government services, structure the reconstruction phase and minimize business interruptions.

A new instrument in support of sustainable development

Historically, natural catastrophes have often been overlooked in policy planning as they were considered unpredictable "acts of God". As a consequence, developing country governments were in many cases confronted with a shortage of liquidity in the aftermath of a natural disaster because emergency funds were not immediately available. In this dire situation, government responses were sub-optimal because of:

- insufficient emergency relief financing, and/or
- resort to overly expensive debt instruments, and/or
- the diversion of resources from scarce development funds

When governments re-allocate budgets from longer term programs in policy sectors such as health or education to finance short term emergency relief operations important social issues and poverty alleviation efforts are adversely affected.

The new risk financing instrument, developed by the World Bank, called the *Development Policy Loan (DPL) with a Deferred Drawdown Option for Catastrophe risks (Cat DDO),* helps prevents such budget re-allocations or hasty resort to inadequate and expensive debt instruments, which hurt long-term development goals.

The DPL with a Cat DDO aims at promoting continuity of national development planning and it is considered to be one of the most flexible and cost efficient risk retention instruments currently available. As the liquidity is provided in form of a loan the DPL with a Cat DDO incurs much smaller up-front costs than a risk transfer instrument would typically entail – for example insurance based risk transfer solutions.

Origin of the contingent loan

The DPL with a Cat DDO builds on a lending instrument that was first introduced by the Bank in 2001, know as *Development Policy Loan with a Deferred Drawdown Option (DPL DDO)*.

The *DPL DDO* provides a source of liquidity to be used in case of adverse events. When countries are confronted with additional financing needs the DPL DDO offers borrowers access to long-term IBRD resources to maintain ongoing structural programs. It also provides a formal basis for continued policy-based engagement with the Bank when the borrower has no need for immediate funding but values the World Bank's advice. Under the *DPL DDO*, the IBRD country borrower has the option of deferring disbursements for up to three years, renewable for an additional three years with the Board's approval. A precondition for the granting and the renewal of a DPL DDO is that the borrower's overall program implementation and macroeconomic policy framework remain satisfactory to the World Bank.

The DPL with a Cat DDO instrument uses a similar mechanism as the *DPL DDO* but serves a different purpose: to develop and enhance the capacity of IBRD-eligible countries and "blend countries" to manage natural hazard risks. The DPL with a Cat DDO provides a source of bridge financing until other sources become available and while they are being mobilized. These post-disaster financing sources include for example concessional funding, bilateral aid, or reconstruction loans.

Conditions of DPL's with a Cat DDO

In order to draw down funds upon the occurrence of a natural disaster the borrower has to have declared a state of emergency. As the scope and procedures for declaring the state of emergency varies from country to country, the Cat DDO trigger is defined on a case-by-case basis, taking into consideration the borrower's national disaster risk management legal and policy framework. Disbursement occurs only after the natural disaster has taken place.

In line with the World Bank's emphasis on ex-ante disaster prevention – as opposed to ex-post disaster response – the presence of an appropriate country macroeconomic policy framework and disaster risk management program are prerequisites for making a DPL with a Cat DDO available to an eligible country. During the drawdown period, frequent monitoring by the World Bank intends to ensure and verify that the disaster risk management program is being implemented in a satisfactory manner.

The maximum amount available under a *Cat DDO* is 0.25% of the country's GDP or USD 500 million, whichever is smaller.[1] This amount can be drawn down upon the occurrence of a disaster within three years from loan signing. The drawdown period can be renewed up to four times and each time for additional three years. The adequacy of the macroeconomic framework and the hazard risk management program would have to be reconfirmed and updated upon renewal, which would take place no earlier than one year before, and no later than 6 months before the expiry date.

Similar to *DPL DDO's*, the pricing of a DPL with a Cat DDO reflect the IBRD's loan pricing structure in the sense that a front-end fee is applied to the approved loan amount (0.25%) upon effectiveness. The interest rate to be charged on disbursed and outstanding amounts will be the rate for variable spread or fixed spread based loans, respectively, in effect at the time of withdrawal. Any subsequent revision in the pricing of IBRD loans will be reflected in the pricing of DPL's with a Cat DDO.

[1] CAT DDO volume limits for small states will be considered on a case by case basis.

Country examples:

Costa Rica

Due to its geographic location and geotectonic characteristics, Costa Rica is exposed to a large variety of natural hazards, including floods, hurricanes, earthquakes, volcano eruptions and landslides.

In September 16 2008, The World Bank Board approved the first DPL with a Cat DDO to Costa Rica with a maximum loan amount of US$65 million to ensure that affected populations receive assistance as soon as possible in case of a natural disaster.

The Costa Rican DPL with a Cat DDO will support two key areas of the country Disaster Risk Management Program: (a) strengthening of the institutional and legal framework, and (b) mainstreaming disaster risk management in the National Development and Investment Programs, directed to alleviate and reduce poverty.

The US$65 million loan amount constitutes 0.25% of Costa Rica's 2007 GDP. The loan has a variable interest rate approximately equal to the six-month LIBOR and is repayable in 29.5 years, including a five-year grace period. Amounts repaid prior to the closing date would be available for drawdown.

On January 8, 2009, a 6.1-magnitude earthquake hit Poas Volcano National Park north of the capital San Jose. At least 20 people were killed in this area and many people were injured. Several buildings were damaged and landslides blocked roads in the area. The Government of Costa Rica declared a state of emergency in San Jose and surrounding areas. Under these circumstances, the disbursement of the available DPL with Cat DDO funds could be requested as soon as the government considers it necessary.

Colombia

Colombia has the highest rate of recurrent natural disasters in Latin America, with an average of over 600 reported disasters every year. In the past 30 years, Colombia has suffered from six major earthquakes, four volcanic eruptions, annual major landslides, and extensive flooding. According to the Global Hotspots Analysis, 85 percent of its population and 87 percent of its assets are located in areas exposed to two or more natural hazards.

This Colombian DPL with a Cat DDO will replace an existing contingent line of credit included as a component in the disaster vulnerability reduction adaptable program loan (APL). It will improve risk identification and mitigation, increase prevention measures, reduce vulnerability to natural disasters, and improve the services provided by the National Disaster Prevention and Management System.

The DPL with a Cat DDO aims at strengthening the Government of Colombia's program for reducing risks resulting from adverse natural events. The maximum loan amount of US$150 million provides the assurance of immediate access to Bank funds that may be drawn down upon the occurrence of a natural disaster. The pricing is in line with standard IBRD terms repayable in 24 years, including an eleven-year grace period. Amounts repaid prior to the closing date would be available for drawdown.

Recognizing that disasters are most effectively dealt with before they happen, Colombia has over the past two decades institutionalized a system for comprehensive disaster risk management that, among other things, seeks to reduce vulnerability by investing in risk mitigation and strengthening the integration of disaster risk management in urban and territorial planning.

GFDRR-funded projects helped both Costa Rica and Colombia to design and implement comprehensive national disaster risk management programs, which are required to have access to CAT-DDO operations.

Further countries that plan the implementation of DPL's with a Cat DDO

There is growing interest from middle income countries to benefit from this innovative risk financing instrument. For example Guatemala and Albania have requested technical assistance from the World Bank in support of the development and future implementation of a DPL with a Cat DDO.

A number of projects supported by the Bank and GFDRR currently assist these countries in strengthening their disaster risk management frameworks so that they will fulfill the Bank's requirements for the implementation of this contingent loan.
In Guatemala, one supported project aims at strengthening risk identification at the municipal level by developing scientific information on flooding, vulnerability, and risk maps for land use and urban zoning – and by providing scientific information for emergency plans.
In Albania, a funded disaster risk management activity will help to understand the current and projected vulnerability caused by climate change and asses and improve the level of preparedness and institutional capacities for disaster risk management.