Costa Rica Cat DDO

97465

DRFIP

DISASTER RISK FINANCING & INSURANCE CASE STUDY

Providing Countries with Rapid Access to Funds after a Natural Disaster

Background

Costa Rica is a small, middle-income country with substantial exposure to natural disasters, including earthquakes, floods, hurricanes, landslides, and volcanic eruptions. According to a World Bank funded natural disaster study, Costa Rica ranks number two in the world among countries most exposed to multiple hazards, with 78 percent of Costa Rica's population and 80 percent of the country's GDP residing in areas at high risk.

Costa Rica has built an efficient disaster response system and has established an effective system of building codes, environmental standards, and land use planning to mitigate the impact of natural disasters. It has also made substantial progress in strengthening its institutional and legal framework and mainstreaming catastrophe risk management in its national development program.

Objective

Natural disasters can derail important long-term development programs by diverting budgetary resources to respond to a crisis. Costa Rica needed to ensure access to funds immediately after a natural disaster to provide assistance to affected populations without hampering the continuity of other development programs.

Structure

The Development Policy Loan with a Catastrophe Deferred Drawdown Option (Cat DDO) is a contingent line of credit available to IBRD countries. Costa Rica sought the loan to enhance its capacity to implement its disaster risk management program for natural disasters. To qualify for the Cat DDO, Costa Rica had to have an adequate macroeconomic framework in place and its disaster risk management program will be periodically reviewed by the World Bank. In September 2008, the World Bank's Board of Executive Directors approved a US$65 million Development Policy Loan (DPL) with a Cat DDO for Costa Rica; it was the first country to request and to benefit from this type of loan.

Highlights

- The Cat DDO is a contingent line of credit offered by the World Bank to help IBRD countries take a proactive stand towards reducing exposure to catastrophe risk and access funds immediately after a natural disaster.
- Costa Rica was the first country to request a Cat DDO and to draw down on its loan after a 6.2 magnitude earthquake struck the country in 2009.
- The Cat DDO complements other financial instruments and disaster risk management measures in place in the country.

The Cat DDO provides immediate liquidity up to US$500 million or 0.25% of GDP (whichever is less) to IBRD member countries in the event of a natural disaster. Funds may be disbursed (partially or in full) when a state of emergency is declared by the government due to a natural disaster. The Cat DDO also has a revolving feature, that is, amounts repaid prior to the closing date are available for subsequent drawdown. Costa Rica has the flexibility to change the repayment schedule for each new drawdown before it is disbursed, which allows it to balance its need for a grace period and to select the loan's final payment maturity.

Outcome

In January 2009, just months after securing the Cat DDO, a 6.2 magnitude earthquake struck 20 miles north of San José, affecting more than 120,000 people. Cost Rica drew down US$24 million of the Cat DDO to rebuild damaged infrastructure.

Cat DDOs provide bridge financing while other financial resources such as bilateral aid and reconstruction loans are mobilized following a natural disaster. This financial product is most effective as part of a broader risk management strategy adopted by the country. The Cat DDO in Costa Rica complements other financial instruments and disaster risk management measures in place.

Lessons Learned

1. The Cat DDO is most effective as part of a broader disaster risk financing program, complementing other risk retention tools (such as reserves) and risk transfer instruments (including catastrophe insurance). The primary benefit of the Cat DDO is that it is quick-disbursing, providing the government with an immediate source of bridge financing following a natural disaster.

2. Specific institutional arrangements need to be in place to allow for quick disbursement of funds after the declaration of an emergency. Without a legal process in place that allows for approving the use of Cat DDO funds in a post-disaster environment, the government will not fully benefit from the quick-disbursing nature of the Cat DDO.

3. It is beneficial for the government to fully understand its fiscal exposure to natural disasters when requesting a Cat DDO. Fiscal impact studies can help the government understand its expected post-disaster short-term recovery funding gap, which the Cat DDO can help to close. This understanding will equip the government to make informed choices about what size of the Cat DDO will best suit its needs and will enable the government to quickly determine how much to draw down on the Cat DDO following a natural disaster.

Glossary

Exposure: In a natural catastrophe model, the value of the property at risk of being destroyed by a natural catastrophe.

Risk financing: The process of managing risk and the consequences of residual risk through products such as contingent loans, insurance contracts, cat bonds, reinsurance, or options.

Further Reading

Cummins, J.D., and Mahul, O. (2010). *Catastrophe Risk Financing in Developing Countries: Principles for Public Intervention.* Washington, DC: World Bank.

World Bank Treasury Disaster Risk Financing: http://treasury.worldbank.org/bdm/htm/risk_financing.html

Main Terms and Conditions: Costa Rica Cat DDO

Approval Date	September 16, 2008
Amount and Currency	US$ 65 million
Repayment Schedule	29.5 years of final maturity (incl. a 5 year grace period) with leveled amortizations of principal
Interest Rate	Based on 6-month LIBOR plus a fixed spread
Disbursement Period	3 years; renewable up to 15 years if original program remains in place
Fees	0.25% Front-End Fee[1]

[1] On August 5, 2009, IBRD increased the front-end fee for new DPLs with Cat DDO from 0.25 percent to 0.50 percent and introduced a 0.25 percent renewal fee.

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