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CASE STUDY | Disaster Risk Financing

LESOTHO

Building a Comprehensive Disaster Risk Financing Approach to Support Small and Medium Businesses

Street market with stalls in downtown Maseru. Credit: mtcurado | iStock

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Lesotho is highly vulnerable to recurring severe weather events, particularly droughts, floods, windstorms, and hail. The average annual cost of disaster response is estimated at US$19.3 million, or about 1.6% of the country's total 2019/20 budget expenditure. In years of severe shocks, these costs can be significantly higher. Drought is the most frequent and impactful hazard, affecting more people in Lesotho than any other disaster. A World Bank diagnostic found that, without the 2015/16 drought, which affected half the population, poverty reduction in Lesotho would have progressed twice as fast over the past 15 years.

Despite the heavy tolls disasters take, Lesotho has had limited financial instruments in place for effective disaster response. Until now, the government has largely relied on budget reallocations, borrowing, and humanitarian aid to finance disaster response. Without access to pre-arranged financial protection, households and micro, small and medium enterprises (MSMEs) remain highly exposed to shocks.

Because much of Lesotho's workforce operates outside official systems, these workers struggle to access government support, making these workers especially vulnerable to the long-lasting impact of disasters. MSMEs represent 85% of all firms in Lesotho and employ around 200,000 people, with women accounting for 59% of the sector's workforce. However, most are informal and lack access to government support systems. Surveys in both 2002 and 2017 show that over 80% of household businesses were unregistered, and a 2016 assessment found that out of a total of 76,000 MSMEs, 83% had no employees, and fewer than 3% employed five or more people. These small enterprises are disproportionately vulnerable to shocks. For instance, in 2020–21, Lesotho faced severe flooding after a period of heavy rainfall, prompting a second national emergency declaration soon after the COVID-19 crisis. Although the government rolled out support measures for MSMEs, delays

of up to a year in disbursement weakened effectiveness and placed additional pressure on public finances.

In recent years, Lesotho has taken important steps to strengthen its disaster risk response systems. Taking a comprehensive approach to risk financing, it has completed a national DRF diagnostic to inform policy, has developed its first DRF strategy (2024–29), and is increasingly taking a more systematic approach to risk financing. This includes scaling up safety net transfers in response to the 2019 and 2025 droughts and the COVID-19 crisis, and preparing a resilience fund for MSMEs. The government is also exploring sovereign insurance options. It has signed up with Africa Risk Capacity, completed a value-for-money study, and established a technical working group to advance analytics and financing options for disaster resilience.[1]

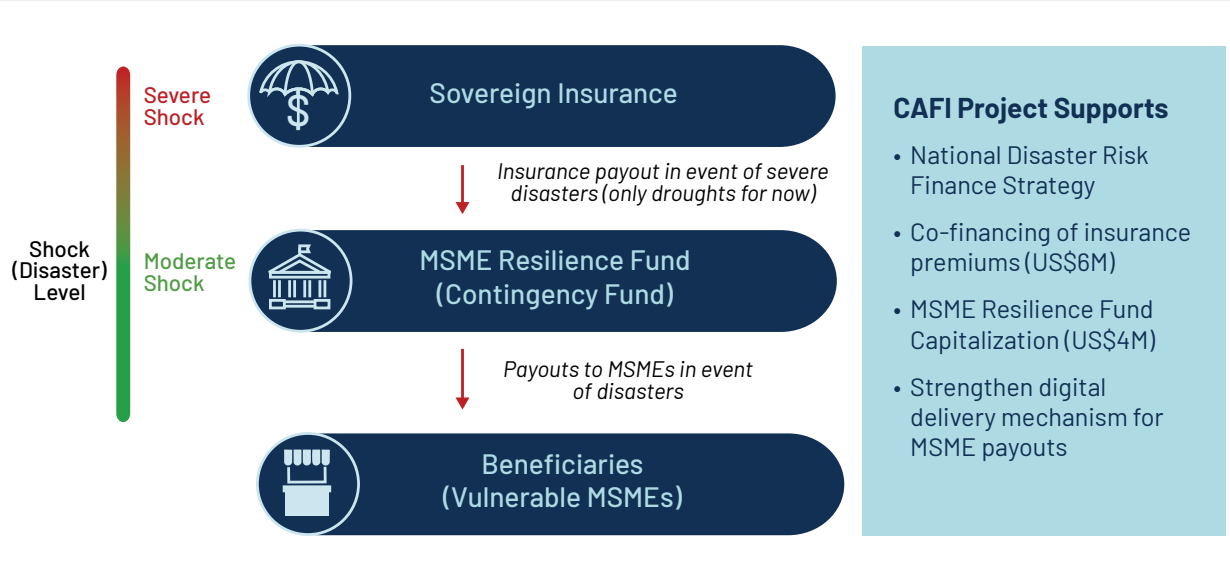
The DRF strategy is a crucial first step in enhancing the country's disaster response capacity, but challenges remain. The government's contingency fund is often depleted early in the budget cycle and relies heavily on ex-post instruments, reallocations, and humanitarian financing. Use of digital financial services is limited, hindering efficient and targeted payouts. Without stronger pre-arranged instruments and systematic planning, Lesotho's ability to respond quickly and effectively to future disasters will remain constrained.

Program

Lesotho is adopting a comprehensive approach to DRF, with a strong focus on enhancing the resilience of MSMEs. Central to this effort is the World Bank-financed Competitiveness and Financial Inclusion (CAFI) project, which aims to increase access to business support services and financial products for 20,000 MSMEs and entrepreneurs *(see Figure 1)*. The project is partially financed by an US$8.5 million grant from the Global Shield Financing Facility (GSFF), which also supports the development of Lesotho's national DRF strategy and the design of instruments to ensure longer-term financing for climate and crisis response.

CAFI places particular emphasis on building financial resilience among women-owned MSMEs, which are disproportionately vulnerable to climate shocks due to limited access to financial services. The project also enhances government-to-business services, enabling quicker, more targeted support and expanding access to financial tools during emergencies.

FIGURE 1. CAFI PROJECT: RESILIENCE-BUILDING COMPONENTS



1 The African Risk Capacity (ARC) Group helps African governments build resilience to natural disasters by providing capacity building, early warning systems, contingency planning, and risk pooling and transfer services with a commitment to inclusivity and gender equality.

DRF activities are closely aligned with broader government interventions that will strengthen MSME access to financial services. A key innovation is the establishment of a dedicated MSME Resilience Window within the government's contingency fund. This pre-arranged financing mechanism ensures that funds are available during crises to support MSMEs, especially informal enterprises in which nearly 60% are led by women. In its early phase, the window will issue grants rather than loans, allowing for swift disbursement to MSMEs. This approach reflects the need for quick, predictable disbursement in an environment where more complex program delivery has historically faced implementation challenges. Over time, the system may evolve to offer concessional loans as implementation systems mature.

To complement these efforts, Lesotho is designing a sovereign insurance backstop and co-financing for insurance premiums to provide more coverage for severe climate events. The policy will trigger payouts based on satellite-derived data on drought conditions under a parametric insurance scheme and help replenish the MSME Resilience Window during large-scale disasters, ensuring uninterrupted financial support.

Further DRF components include ongoing technical support to structure the MSME Resilience Window and contingency fund. While the window's permanent design is still being finalized, either as part of the contingency fund or as a standalone mechanism, payouts are already being managed through the CAFI project, allowing the window to function in practice even before its institutionalization. Complementary efforts include the creation of an integrated MSME business registry to enable faster and more targeted disbursements. Building on data collected during a World Bank–supported COVID-19 relief scheme, the registry aims to capture both formal and informal MSMEs. Instrument design incorporates gender considerations, with eligibility criteria and targets for women-owned enterprises, while beneficiaries will also receive financial literacy and digital payment training to strengthen resilience and ensure equitable access to resources.

Results

Lesotho's DRF agenda remains nascent but is evolving rapidly. In March 2025, a government technical working group adopted the national DRF strategy, and preparations for the MSME Resilience Window advanced with the payout handbook and eligibility criteria finalized. Importantly, the country piloted its first sovereign drought insurance policy with ARC Ltd., placed in November 2024 with AfDB financing. The policy was triggered when a national drought was declared in June 2025, providing nearly US$2.8 million in payouts to more than 30,700 farms and vulnerable households across all ten districts. The government is now evaluating the effectiveness of the pilot, including whether less frequent payouts could provide greater value for money, with renewal of the policy expected by September 2025.

At the same time, groundwork for longer-term resilience is advancing. The development of a consolidated business registry, inclusive design features, and gender-sensitive targeting within the MSME Resilience Window demonstrate a commitment to equitable delivery mechanisms from the outset. These measures aim to ensure that women-owned MSMEs can access timely support, while the integration of a parametric insurance backstop will provide additional protection for households and businesses. Together, these results illustrate how Lesotho is transitioning from reactive disaster response toward a pre-arranged, layered risk-financing system.

A value-for-money analysis finds that a layered risk financing approach – combining a reserve fund, limited budget reallocations, contingent credit, and sovereign insurance – offers the most cost-effective protection for MSMEs in the face of recurrent drought. The analysis evaluated the relative cost efficiency of various instruments and their combinations, underscoring that a pre-arranged and diversified risk financing strategy will help Lesotho protect its economy and vulnerable communities more sustainably over time.

Key Takeaways

Lesotho's experience highlights several early lessons for countries seeking to develop disaster risk financing systems that are inclusive, fiscally sound, and responsive to the needs of vulnerable businesses:

1. **DRF is largely a new concept in Lesotho, and the country needs solid and comprehensive capacity building.** With limited technical expertise in government and the Disaster Management Authority, advancing complex concepts such as sovereign insurance and value-for-money analysis remains a challenge. Targeted capacity building, combined with clear and transparent rules for fund management and payouts, will be critical to building trust and ensuring that DRF systems are effective and equitable.

2. **A robust DRF strategy also reinforces fiscal discipline.** In past crises, emergency spending has diverted resources from essential services like health and education, slowing poverty reduction and economic growth. By pre-arranging financing for different levels of disaster severity (low, medium, and high), the DRF strategy aims to help the government respond more efficiently while protecting its broader development goals in the midst of a crisis.

3. **Finally, protecting the real economy, including MSMEs, is essential to ensure faster post-disaster recovery and stronger resilience.** While disaster responses often prioritize households, MSMEs play a key role in sustaining jobs, income, and access to basic goods and services. Without timely support, many viable MSMEs risk permanent closure, undermining long-term recovery and economic stability. A DRF approach that protects these businesses can significantly reduce post-disaster disruptions and accelerate rebuilding efforts.

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