For Financial Institutions: The Loan Portfolio Cover

**CONTEXT** When extreme weather events affect many borrowers at the same time, financial institutions (e.g. credit unions, cooperatives, etc.) often experience the double blow of heavy withdrawals from savings accounts and the inability of borrowers to repay their loans. Climate shocks are thus one of the leading causes of high loan default rates experienced by financial institutions. These loan defaults can lead to portfolio-level problems that may erode their equity base and liquidity.

In the Caribbean, the ability of financial institutions to provide credit is often impeded by recurring extreme weather events (e.g. hurricanes), which leaves them reluctant to lend to climate vulnerable individuals who need it most. The management of portfolio risk needs to be improved to allow financial service providers expand their funding base, and increase lending capacity to vulnerable, low-income individuals and micro, small and medium enterprises (MSMEs). This is critical for ensuring that these groups have access to credit to withstand environmental stressors and invest in their livelihoods.

**SOLUTION** Unmanaged exposure to climate risk limits economic growth and increases the cost of providing financial services. The Loan Portfolio Cover (LPC) is an insurance instrument that transfers risks arising from natural catastrophes to international risk pooling markets. As a parametric insurance policy designed to protect loan portfolios from climate shocks and eventual loan default, the LPC helps financial institutions better manage their credit risk. The simple and flexible structure of the policy allows financial institutions to select the level of insurance cover to be applied to their overall exposed loan portfolio – a payout is triggered when predetermined threshold values for wind speed and/or rainfall are exceeded, irrespective of any proven loan default the financial institution may have suffered.

**OUTCOME** Transferring the risk of a financial institution’s weather-related loan default means the financial position of these institutions continues to be stable after an extreme weather event, enabling them to avoid curbing their lending activity or instituting unfavourable terms of credit. The LPC can help overcome the reluctance to invest, improve access to lending and contribute to reducing the cost of providing financial services.


*Current annual losses from natural disasters in Latin America and the Caribbean is an astounding US$3.3 billion; up from US$700 million two decades ago.*
Financial institutions/financial cooperatives (FI) in the Caribbean cater to a wide cross-section of society, many of whom are vulnerable to natural disasters (e.g. small scale farmers). In addition to encouraging savings, they provide credit at favourable interest rates to enable clients to make investments in their livelihoods (e.g. buying greenhouses). However, a modest equity base means that these FIs are vulnerable to weather-related shocks, which compromise their financial position and leave them reluctant to grant loans to vulnerable individuals during times of stress. This was the case in 2007 after hurricane Dean.

**HOW THE FIs WERE IMPACTED**

**Before the hurricane** The FIs have no forewarning of the approaching hurricane. The number of withdrawals increases exponentially as clients need funds to rebuild their lives and livelihoods.

**Immediately after** As the number of withdrawals increases exponentially the FIs do not have enough liquidity to honor withdrawals.

**Medium-term** Loan default rates increase as borrowers are unable to repay their loans on time. The FIs equity base is eroded, forcing them to curb lending activity.

**Long-term** The FIs institute less favourable terms of credit, which reduces access to credit to those who need it most (e.g. hurricane survivors). Investments are postponed or cancelled, carrying direct consequences for long-term economic growth. Clients are unable to recover fully, leaving them more vulnerable to subsequent hurricanes and driving them deeper into poverty.

**HOW LPC COULD HAVE HELPED**

**Before the hurricane** The FIs receive an SMS to alert them of an approaching hurricane. By being aware of the burden such a weather event would place on their clients, the FIs are in a better position to manage exposure to default risk.

**Immediately after** The FIs’ equity base will not be significantly impacted, as the LPC is likely to ensure that they continue to have access to new credit.

**Medium-term** The FIs’ equity base remains stable. There is no immediate need to curtail credit operations; therefore, clients can rebuild their livelihoods with their savings.

**Long-term** The LPC strengthens the FIs so that they are able to provide access to credit to enable their clients to rebuild their lives following a disaster. In general, when local FIs manage their risk more effectively, they do not have to curtail lending operations and can lend at lower interest rates. The FIs are even able to write-off some defaulted loans and absorb these losses during critical times, leaving clients in a better position to recover.

---

**THE LPC AT A GLANCE**

**GOAL:**
To provide portfolio level protection against weather-related loan default for lender institutions

**WHO IS COVERED:**
Financial institutions with a nationally distributed portfolio of risk

**PERILS COVERED:**
High wind speed and excessive rainfall (triggers)

**TYPE:**
Trigger-based parametric index insurance (based on observed values of wind, rain)

**HOW IT WORKS:**
The policy pays out the pre-agreed amount if a certain wind speed and/or rainfall amount is exceeded, irrespective of any proven losses to the insured loan portfolio

**BENEFITS:**
- Secure the equity base of financial institutions by managing exposure to weather-related shocks
- Provide access to credit to enable people exposed to weather risks to invest in their livelihoods and strengthen their capacities to cope with future events
- Restructure or even write-off defaulted loans of individuals who had suffered from extreme weather events

**WEATHER DATA MONITORING:**
Rain is monitored by the DHI (formerly Danish Hydraulic Institute) and wind is monitored by the Caribbean Catastrophe Risk Insurance Facility (CCRIF)

**THE LPC AT A GLANCE**

**GOAL:**
To provide portfolio level protection against weather-related loan default for lender institutions

**WHO IS COVERED:**
Financial institutions with a nationally distributed portfolio of risk

**PERILS COVERED:**
High wind speed and excessive rainfall (triggers)

**TYPE:**
Trigger-based parametric index insurance (based on observed values of wind, rain)

**HOW IT WORKS:**
The policy pays out the pre-agreed amount if a certain wind speed and/or rainfall amount is exceeded, irrespective of any proven losses to the insured loan portfolio

**BENEFITS:**
- Secure the equity base of financial institutions by managing exposure to weather-related shocks
- Provide access to credit to enable people exposed to weather risks to invest in their livelihoods and strengthen their capacities to cope with future events
- Restructure or even write-off defaulted loans of individuals who had suffered from extreme weather events

**WEATHER DATA MONITORING:**
Rain is monitored by the DHI (formerly Danish Hydraulic Institute) and wind is monitored by the Caribbean Catastrophe Risk Insurance Facility (CCRIF)