Climate Change Risk in Microfinance

A rating agency perspective on how financial institutions can help

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Rating agency perspective

- Rating – particularly financial rating – is about creditworthiness in the context of financial instruments that cover the short to medium term – normally up to 3 years; due diligence for investors
- Climate change is a creeping process with long term impacts over decades
- As a result, public consciousness is yet to register fully the impact of climate change on our lives and livelihoods
- Even those who encounter weather related disasters are helpless due to the global nature of the causes of those disasters
- Adoption of climate-smart technologies is consequently slow and unlikely to affect short term credit worthiness
- We can attach value to climate-friendly lending but it will have limited immediate impact on the performance of portfolios

The climate-poverty link

- Widely acknowledged that climate change is affecting the poor more than better off people – there is a lot that is being said about it at the macro level
- What is needed is to identify specific impacts on the lives and livelihoods of poor people if we are to determine how inclusive finance can help
- What can inclusive finance service providers (IFSPs) – including MFIs, SFBs and commercial banks – do to design products that support the coping strategies of the poor and, if possible, enable the leveraging of opportunities emerging from the development of climate smart technologies

What are the issues – high concern, low specifics

- It is generally agreed that the poor are less able to cope with the adverse changes in the economy and living conditions resulting from climate change and environmental deterioration

But specifically what are those effects?

- The debate on the environment covers the rise of the oceans due to global warming and changes in weather patterns resulting in less predictable rainfall (floods and drought) and increasing cyclonic activity in coastal areas as well as displacement of coastal people resulting from the rise of the sea level

Adverse impacts

How do these changes impact the poor?

- High risk in agriculture – long term decline in productivity due to issues in
  - Water management – irrigation (low rainfall) & drainage (due to flooding)
  - Soil erosion due to high winds or heavy rain washing away topsoil
  - Crop destruction and disruption of other livelihoods resulting from cyclone damage in some areas
  - Damage to dwellings from unexpected heavy rainfall
- Migration – temporary or permanent – to urban areas or to safer ---areas for shelter or for livelihoods – temporary or permanent.

Creating a coping environment

What can financial institutions do about it?

- Design products specifically to enable the poor to cope with these issues by providing credit to enable
  - Promotion of hh solar energy devices to prevent deforestation
  - Drip irrigation devices for efficient delivery of water to crops
  - Land development to prevent soil erosion – tree plantation and building of bunds
  - Restoration of dwellings, re-building of livelihoods
  - Recovery of livestock
  - Enabling relief or resettlement for migrant families

Creating a coping environment*…continued*

- The problem here for financial institutions is that the risk in lending for such activities is high – who is to bear that risk from small loans to low income families?
  - Inclusive finance/microfinance has traditionally avoided direct lending for agriculture precisely for this reason – very few IFSPs offer agriculture-related loans – less than 5% of lending is directly for agriculture
  - Rebuilding of livestock assets as opposed to lending for addition to the stock also entails large outlays
  - Lending for housing depends on land ownership or similar collateral and has traditionally been focused on home improvement not rebuilding (partly to limit loan size)

Creating a coping environment*…continued*

- Ultimately disaster response is a humanitarian problem dependent on relief action and grant support from governments and humanitarian agencies – domestic or international
- It is not a situation that financial institutions can take a lead in within their for-profit business models and without adequate insurance cover for the borrower and/or lender
- Nevertheless, financial institutions can and should work with government and relief agencies to provide low income families with **supplementary capital** using carefully crafted products to respond to climate risk
- This would entail designing and promoting products for renewable energy, land management, irrigation, livestock and other livelihoods in disaster prone areas and for supplementary housing

The response of financial institutions

- Presently there are sporadic climate-friendly efforts by some financial institutions in limited areas where disasters occur – weather-based insurance in drought-prone areas, promotion of off-grid solar
- But these are not systematically geared to respond (nationwide) to the specific challenges of climate change discussed in this meeting

It is time to start planning for the future in conjunction with insurance companies, on the one hand, and with humanitarian agencies, on the other; as the pattern of portfolios evolves towards climate-smart lending it will inevitably affect the creditworthiness of financial institutions