KfW Development Research
Development in brief

Shock resilient loans – an innovative way of bolstering resilience to climate risks

One Pager

Issue 8, 5 November 2024

Authors: Suraj Sikand, Luise Richter (external), Dr Helke Wälde. Editor: Susanne Brösamle

For many developing countries, the consequences of climate change are devastating. Climate risk insurance is an innovative way of covering residual risks. It helps countries protect themselves against the effects of extreme weather events, some of which are unforeseeable, and remain able to take action. Such insurance can be combined with loans to further strengthen countries' resilience.

Climate events are on the rise, but protection is limited

Climate change-related dangers such as droughts, floods and storms present many countries with major challenges. A large proportion of the population and businesses at risk of experiencing such events depend on particularly climate-sensitive economic sectors such as agriculture and fisheries, or are in risk-exposed areas that are not adequately protected against climate risks.

So far, the steps taken towards adopting climate adaptation measures or increasing capacities for coping with extreme weather disasters have been small. However, the need for investment continues to grow rapidly in light of the increasing climate risks. If an extreme event occurs, the support provided usually comes too late and is insufficient to tackle the damage effectively. Consequently, the countries affected by such events are often forced to reallocate budget funds from other areas, which weakens their resilience elsewhere.

Shock resilient loans – the concept

One approach to increasing liquidity during a crisis and thereby strengthening borrowers' fiscal resilience is the concept of shock resilient loans (SRL[1]). These insured loans are used to finance necessary investments in climate protection and adaptation projects.

The loans are bundled with climate risk insurance so that in the event of a predefined climate event, the borrowers are guaranteed that the agreed payment obligations will be taken on by an insurer for a predefined period. The basis for this is a parametric insurance, i.e. the coverage of payment obligations is linked to a previously defined trigger. If this trigger occurs, for example when a certain number of days without rain have passed, the insurance payment is triggered. It is irrelevant whether the investment financed by the loan is directly affected by the event or not; payments are made immediately. The coverage of payment obligations by the insurance increases the financial scope of the insurance beneficiaries in the event of a crisis. This means that they do not have to use their limited funds to repay loans; instead, these can go towards emergency aid, reconstruction and mitigating the negative impacts of the shock. As the loan does not default, the insurance also protects the creditworthiness of the borrowers.

For example: the West African Development Bank

The SRL concept is currently being piloted with the West African Development Bank (BOAD). Together with MunichRe, an individual parametric insurance product adapted to the regional context has been developed. Standard BOAD loans extended to its member countries and refinanced by KfW are thus combined with insurance that is implemented with the support of the African Risk Capacity (ARC), a regional insurance pool. In the event of a drought or flood, the insurance covers the payment obligations of the BOAD member countries and thereby enables them to react to the event quickly and with sufficient liquidity. This makes them more resilient to crises.

Cooperation and joint learning

The complexity of the product, the current reluctance towards insurance solutions in some partner countries and the often rigid legal regulations in local insurance markets are challenging factors. German development cooperation can learn together with its partners and the private insurance industry to continuously develop new products and solutions to further strengthen partner countries with appropriate instruments and improve their resilience.

Shock Resilient Loans

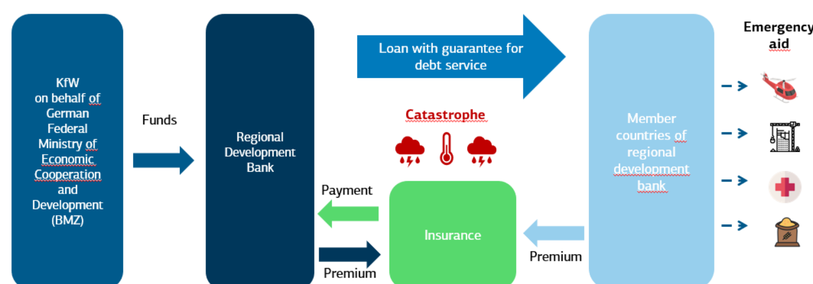

Figure: Own data

[1] In the context of developed countries, this concept has long been known as residual debt insurance for hedging loans in the event of unemployment and illness, for example.

ISSN 2195-1403 Note: This paper reflects the opinion of the authors and does not necessarily represent the position of KfW.