Linkages between Credit and Insurance

Results from Projects and Literature Review

Panos Varangis, Global Lead, Agricultural Finance and Agricultural Insurance, World Bank Group

Global Index Insurance Facility
MANAGED BY WORLD BANK GROUP

DAKAR2017
Global Index Insurance Conference

Context of this Work

- Linking insurance to credit aims to unlock agricultural lending for farmers by underwriting some of the systemic risks that plague agriculture.
- This presentation is based on a review of several projects in the field and a review of empirical literature.
- Main authors: Peter Hazell (consultant, formerly with WB and IFPRI), Richard Meyer (Ohio State University) and Panos Varangis (WBG)

Background

- Linking insurance to credit is not new, and several past attempts faced challenges and proved expensive for governments. These mostly involved publicly owned agricultural insurers insuring loans of publicly owned agricultural development banks, typically using multiple peril crop insurance (MPCI).
- Still several countries do link insurance (mandatory) to credit from public programs: e.g. Brazil, India, Mexico

There is new hope today because of:

➢ The emergence of index based insurance products for addressing systemic risks in agriculture, and

➢ Greater private sector and NGO involvement in the supply of insurance and credit to farmers, either directly or through value chains.

What happens to credit without insurance

- Banks may require higher collateral or pick low risk borrowers
- Banks may exclude certain "risky" borrowers
- Banks can restructure loans if borrowers are not able to repay because of exogenous factors/systemic risks…but the problem does not go away:
  - The Net Present Value (NPV) of restructured loans is below 100%
  - Borrowers may exceed their borrowing limits with unpaid loans but need a new loan to re-start their activities following a bad crop/disaster
  - Borrowers' credit standing maybe lowered even when the repayment problem is not their own fault
  - Restructured loans are riskier: higher provisions
- Insurance enables farmers to collect on insurance and repay the loan; or banks receive the indemnities and apply them towards the loan repayment. Farmers' good credit standing is maintained.
- Insurance may also reduce the "urge" of governments to forgive loans if something catastrophic happens to production.

Types of credit linked insurance

There are several types of credit linked insurance:

- Farmer buys individual insurance and uses it as a form of collateral to secure a loan.
- The lending institution buys insurance on behalf of borrowers to cover their individual loans. This is often compulsory insurance.
- The lending institution buys insurance to cover its own aggregate loan portfolio risk (meso level coverage).

Our paper reviews the merits and challenges of each type of credit linked insurance, assesses the available evidence about their performance and impact, and draws some good practice lessons.

Key findings

- There are situations where insurance may unlock credit, but often there could be several other problems in agricultural finance that prevent insurance from becoming a silver bullet for the credit constraint problem.
- Credit linked insurance is most likely to be effective in credit constrained environments where:
  - a) farmers have weak collateral to offer;
  - b) systemic risks are a main cause of loan defaults; and
  - c) and indemnities from insurance products (especially for index insurance) are very well correlated with actual losses (low basis risk).
- There are important set up problems and market failures that hinder the emergence of credit-linked insurance, and which often require interventions by governments or other supportive agents to overcome.
- There has been little comparative work on how well credit-linked insurance stacks up against alternative policy instruments for achieving the same purposes, such as credit guarantees or public reinsurance of lenders portfolios. And how insurance could be designed to complement these?
- There is a need for more rigorous evaluations and impact assessments that look at the broader impact of credit linked insurance on lending practices, farmers' access to and use of credit, and the consequent economic benefits. For sustainability, it would also be important to evaluate the impact on the insurer, and whether the insurance is profitable enough for them to continue to offer it to lenders and/or farmers.
- Relatively very little is known about meso level interventions and their impacts.

Policy implications

- Enabling environment. If credit-linked insurance is to work then governments must help create an enabling regulatory environment for finance and insurance, and invest in basic public goods like promoting agro-climatic information and data systems; supporting agro-meteorological research leading to product design; educating farmers about the value of insurance; and establishing other mechanisms to lower credit related risks in agriculture.
- Complementarity with other policies. Agri-insurance programs should be designed to complement other policy instruments to promote agricultural finance, like partial credit guarantees, credit subsidies, etc.
- Financial incentives. There is a need also for financial incentives to drive the early growth of insurance and credit. Often such incentives take the form of premium subsidies.
- Subsidies might also be warranted when credit-linked insurance enables small holder households to access credit and game changing technologies that can lift them out of poverty and promote sustainable agricultural practices.
- Care is needed in the design and implementation of subsidies to avoid long term financial commitments and to avoid inadvertently creating disincentive problems that lead to significant economic costs and inefficiencies. These issues and good practice guidelines are discussed in a companion paper "*When and how should agricultural insurance be subsidized?*"

Some key challenges to address

- Added costs. Insurance, even subsidized, could add costs on top of potentially high interest costs of agricultural credit. Insurance also may have small impact on reducing interest rates (because the cost of risk in interest rates covers many other credit risks). Can insurance increase credit to otherwise excluded farmers because of high production/climate risks? Can they pay the higher costs?
- Possible adverse selection. Banks and borrowers may still prefer higher collateral and may demand insurance only for riskier borrowers without adequate collateral. Would this expose insurance to the adverse selection problem? Insurance only applies to riskier farmers?
- Would insurance be mandatory or voluntary?
- Incentives for risk reduction? Can insurance, particularly if subsidized, be structured in such way as to incentivize farmers to invest in reducing risks?
- If meso-level coverage by banks/lenders, should borrowers know about this?