"Developing partnerships to insure the world's poor"

MicroInsurance Centre Briefing Note #6

Financial Risk Management Tools for the Poor

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Growing household income, building assets, and managing risk are integral to poverty alleviation. For the poor who lack formal insurance and primarily depend on informal and self-insurance mechanisms, crises can rapidly erode their hard won gains. Microinsurance offers a valuable vehicle to reduce the vulnerability of the poor while offering insurers and their agents the potential to expand their markets to low-income households.

Insurers, donors, and microfinance institutions are investing in financial instruments to meet the needs of the low-income market. While formal risk-pooling mechanisms for this market are still in early stages of development, evidence suggests that appropriate microinsurance services for this population can be offered on a financially sound basis.

Key Risks Poor People Face

Microinsurance is a system of protecting poor people against specific shocks using risk pooling in return for regular affordable premium payments proportionate to the likelihood and cost of the risk involved.[2] Appropriate delivery mechanisms, procedures, premiums, and the coverage, define microinsurance policies that respond to the limited and variable cash flow of low-income households, and the often unstable economic environment in which they live.

Risk is ever present. As a microfinance client from the Philippines noted, "Life is one long risk." Each shock brings immediate consequences, frequently including the loss of income (see figure).

Risk Event
Death, Illness, Property loss

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Consequences of Shocks
- Income loss
- Asset loss
- Need for lump sum of cash

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Selected Responses
- Draw on formal and informal group mechanisms
- Use savings
- Borrow from formal or informal sources
- Sell assets
- Default on loans

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Secondary Shock Impacts
- Reallocated household resources
- Depleted assets and financial reserves
- Indebtedness – claim on future income flow
- Loss of income
- Loss of access to financial markets
- Untreated health problems

Microinsurance Products and Models

To date, interest in microinsurance has mostly focused on credit/life, life, and health insurance. A few institutions have introduced property insurance. New experiments with weather insurance for crops are showing promise. Livestock insurance has long existed in Nepal and other countries. Delivering these insurance services has involved a range of models, with and without commercial insurers (see box).

- **Partnership model**: Insurers, with products, are pairing with MFIs and others, with low-income markets, to provide microinsurance, as AIG does with MFIs in Uganda.
- **Community-based model**: Local communities form groups that capitalize and manage a risk pool for their members. ILO STEP and CIDR deliver health services using this model.
- **Provider model**: Hospitals and clinics create prepaid or risk pooling coverage for people at their facilities. MFIs such as ASA and Grameen use this model but manage their own clinics.
- **Full service model**: Regulated insurers downsizing insurance services like Delta Life (Bangladesh), which offers a long-term savings product (annuity) with life insurance and a premium affordable by the poor. Some MFIs also assume the role of insurers. Most of these offer only basic credit life insurance to protect their loan portfolios.
- **Social protection models**: National governments often underwrite cover for certain risks through social insurance programmes such as with health care, crops and livestock, and covariant risk.

These models are differentiated by which party absorbs the insurance risk: local villagers, MFIs, health care facilities, or regulated insurance companies. The litmus test for success is the entity's ability to manage the insurance risks.

Microinsurance is a young financial service with few proven best practices. Demand is strong and indicative of an important potential market. Along with savings and emergency loans, microinsurance has a role to play in poor people's risk management. In offering microinsurance, there are important considerations for MFIs and insurers, as well as for international institutions in terms of their support. Working together, microinsurance can be both a successful business venture and advantageous to the poor.

MFIs and Microinsurance

Insurers who have entered this new low-income market have benefited from working with an intermediary, such as microfinance institutions (MFI) or other organisations that are widely used by the poor. For those insurers wishing to partner with an MFI, an understanding of the potential role of these institutions as financial intermediaries is necessary:

- Today some MFIs offer risk management services in the form of savings and emergency loans. These can be effective tools. Together with existing non-formal insurance mechanisms,[3] they should be considered as options for risk management in the face of certain shocks. These products often fall within an MFI's core competencies, while insurance does not.
- Beyond acting as an agent, the provision of microinsurance can be treacherous for MFIs because the risk structure of insurance is significantly different from that of credit. MFIs do not have, nor should they develop such capacity. Insurance risk should be borne by professional insurers not MFIs.

> Not everyone prefers insurance to credit and savings. When members of CIDR in Uganda were offered the choice of continuing with a group managed insurance program or a credit program (both directly paid their hospital bill after discharge), virtually all members chose the credit over the insurance option. (McCord and Osinde, 2003)

- Microinsurance requires specialty management and technical insurance skills. Poor pricing and risk assessment, the responsibility of actuaries, can and do severely damage microinsurers. Bad pricing by UMASIDA in Tanzania meant that initial premiums covered less than 20% of their costs. The result is an erosion of confidence with repeated upwards price adjustments, lack of funds to cover care, providers refusing to provide "covered" care, and heavy non-renewals.
- Insurance regulations may impose special licensing requirements for MFIs and their employees acting as insurance agents. Microinsurance products for low-income markets frequently require insurance commission approval.
- MFIs often work within a different business culture from insurers. Maintaining clear communication is critical.

Making Microinsurance a Reality

Insurers, international donors, and MFIs all have roles to play in the development of the microinsurance sector.

- Insurers should approach microinsurance conservatively and take time to understand this new market and its supply and demand for risk management services.
- Partnership models can provide efficient and profitable access to huge low-income markets.

> AIG works with almost every MFI in Uganda, covering over 2.9 million lives with microinsurance.

- There are many high quality MFIs with large markets interested in developing microinsurance products with insurers. Conduct due diligence reviews with all potential partners.
- Microinsurance can be profitable, especially with life insurance, and is approaching profitability with others.
- Microinsurance should not be limited to only the downscaling of existing formal insurance products. Products need to fit the preferences of the market.
- International donors should approach microinsurance cautiously, but should support:
    - Short-term technical assistance to address specific issues like actuarial and market studies,
    - Client and staff education in concepts, policies, and procedures associated with microinsurance
    - Training of trainers to create additional local or regional resources to call upon for specialty training
    - Dissemination of the growing pool of information needed to inform the emergence of this market and the development of new market responsive microinsurance programs.

[1] Monique Cohen is the President of Microfinance Opportunities, and Michael J. McCord is the President of The MicroInsurance Centre.
[2] The CGAP Donor Working Group on Microinsurance: "Donor Guidelines for Funding Microinsurance." (2003)
[3] Monique Cohen, Michael J. McCord, and Jennefer Sebstad. "Reducing Vulnerability: Demand for and Supply of Microinsurance in East Africa" (MicroSave-Africa) 2003