The Role of Microinsurance as a Social Protection

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Abstract

All households in developing countries, whether better or worse off, are exposed to a variety of risks, such as illness, disability, death, unemployment, crop failure, natural catastrophes, or crime. Low-income households, however, are less able to prevent and mitigate risks than others; and in the case of shocks, they are less able to cope with the consequences. Aim of this paper is to understand the nature of micro-insurance products and their relation to social protection systems and instruments.

In order to be workable, solutions will have to address the very practical issues that have arisen repeatedly in discussions of micro-insurance. The first is the need for reinsurance, the second is having data on which to base premiums, and the third is the ability to cut the costs of dealing with many small transactions.

Keywords : microinsurance, protection, risks

1. Introduction

Crises are recurrent in the lives of the poor. Such crises - personal, social, or natural often involve high expenditures and drive poor families deeper into poverty. Most common crises are accidents, sudden hospitalization, and death of a bread earner, and loss of crops or assets. Expenses incurred during such crises are met either by borrowing form money lenders, sales or mortgaging of assets or by drawing on scarce saving resulting into a simultaneous reduction in income and saving, and an increase in debt and expenditure. Each crisis leaves a poor family weaker and more vulnerable. All households in developing countries, whether better or worse off, are exposed to a variety of risks, such as illness, disability, death, unemployment, crop failure, natural catastrophes, or crime. Low-income households, however, are less able to prevent and mitigate risks than others; and in the case of shocks, they are less able to cope with the consequences (Churchill, 2006). They are therefore more vulnerable to risks, i.e. they are more likely to experience a significant decline in wellbeing when a shock occurs (World Bank, 2001).

Social protection measures, which include ‘all interventions from public, private, voluntary organizations and social networks, to support communities, households and individuals, in their efforts to prevent, manage and overcome vulnerability’ (CPRC, 2008), are thus essential to prevent people from falling (deeper) into poverty (Jacquier *et al*., 2006). One such measure is micro-insurance, which promises to be an effective strategy for people, both currently poor and non-poor, to mitigate risk and reduce their vulnerability to shocks (Dercon *et al*. 2008; Siegel *et al*. 2001).

In many countries around the globe, microfinance institutions (MFIs), cooperatives, (rural) banks, service providers, commercial insurance companies, as well as informal groups, have started to provide the low-income population with micro-insurance. On the one hand, this has happened in response to the fact that poorer segments of society generally do not have access to formal insurance mechanisms, provided by either the state or private insurers, and instead rely on imperfect informal insurance. In many developing, particularly the poorest, countries, public social security systems cover employees of the formal sector, civil servants and the military but not informal sector workers, who make up the majority of the population. Market-based insurance is often non-existent, and where it exists, it is only accessible to the better-off, as premiums are beyond low-income people’s capacity to pay. On the other hand, the emergence and expansion of micro-insurance were encouraged by the now extensive experience and widespread success with the provision of loans and savings products to the poor. In fact, many micro-insurance products are closely linked to MFIs, partly because existing networks make it less costly to deliver new products, and partly because these institutions have started to tie their loans to insurance against the death of the borrower.

Even though there is a large and still growing literature on social protection and its many facets (Barrientos and Hulme, 2008), the question of micro-insurance in the context of social protection has so far received only limited attention from the international research community (with the exception of e.g. Jacquier *et al*., 2006; Dercon *et al*., 2008). Micro-insurance schemes can be crucial components of more comprehensive social protection systems. For instance: (1) micro-insurance schemes may achieve redistribution through internal cross subsidies or by channeling public subsidies to their members; (2) micro-insurance schemes may have a significant socio-economic impact on members and non-members; and (3) micro-insurance schemes can play a role in the empowerment and participation of their members (Jacquier *et al.*, 2006).

Aim of this paper is to understand the nature of micro-insurance products and their relation to social protection systems and instruments. Since it appears highly interesting to investigate the interrelation between social protection and micro-insurance in countries with completely different socio-cultural backgrounds. In the following section, this paper is provide a short overview of micro-insurance provision worldwide. Finally, recommendation of this paper is to relate micro-insurance with the overall social protection goal.

2. How do Poor People Manage Different Risks

Most poor people manage risk with their own means. Many depend on multiple informal mechanisms (e.g., cash savings, asset ownership, rotating savings and credit associations, moneylenders, etc.) to prepare for and cope with such risks like death of a family breadwinner, severe illness, or loss of livestock.

Very few low-income households have access to formal insurance for such risks. These means include (i) prevention and avoidance, (ii) preparation and (iii) coping.

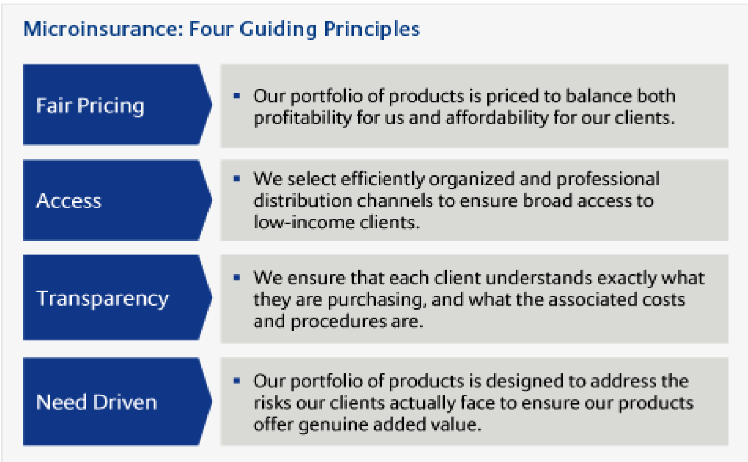
Prevention and avoidance: When possible, poor people avoid and/or actively work to reduce risk, often through non-financial methods. Careful sanitation, for example, is a non-financial way to reduce the risk of infectious illness. Using family networks to identify business opportunities is another such mechanism. The imperative to avoid risk often leads to conservative decision making by poor people, especially in business considerations.

Preparation: Poor people save, accumulate assets (such as livestock), buy insurance, and educate their children to handle future risks. For certain risks, informal community systems (e.g., Ghanaian burial societies) offer protection. However, such systems generally do not adequately protect against costly and unpredictable risks, such as the debilitating illness of a family income earner. Formal insurance products are beginning to be offered to low-income markets, such as simple credit life insurance, which covers an outstanding loan balance in the event of a borrower's death; but these insurance products sometimes appear to be designed to protect the lending institution rather than its clients.

Coping: *Ex post coping* can result in desperate measures that leave poor households even more vulnerable to future risks. In the face of severe economic stress, poor people may take out emergency loans from moneylenders, micro-finance institutions (MFIs), and/or banks. They may also deplete savings, sell productive assets, default on loans, and/or reduce spending on food and schooling. In general, prevention and planning are far less costly than coping strategies for the individual.

3. Micro-Insurance Schemes

Micro-insurance is the 'protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved' (Churchill, 2006). In equivalence with regular insurance, micro-insurance serves as an instrument to isolate fluctuations in consumption from fluctuations in income and wealth (consumption smoothing). Traditional micro-finance schemes do not address such vulnerabilities and the necessity of risk reduction for the ultra poor.



Source: Allianz / GIZ PPP, 2011

Picture 1.
Microinsurance Guiding Principles

The informal coping mechanisms offer limited protection and are less available to poorer households and break down when most needed. Formal financial services can offer greater benefits at a lower cost than informal mechanisms but there is vulnerability to risk is reducing effectiveness and financial performance of micro-credit. The central underlying principle is the pooling of risks, which implies that financial contributions are collected from the members of an insurance scheme, and the loss of one individual is spread among all members in case of risk occurrence. The main difference between micro-insurance and regular insurance is that the first is specifically targeted at low-income people, who have limited financial resources and often irregular income flows. Thus, the product design is adapted to these people's needs and financial capabilities.

The global outreach of formal micro-insurance still appears to be rather limited, as a recent study of the Micro Insurance Centre – a consultancy for micro-insurance – shows (Roth *et al*., 2009). Out of the 100 poorest countries in the world, micro-insurance could be identified in 77. The number of micro-insured people was estimated to amount to 78 million, which is not a particularly high number, given that China and India are both among the 77 countries with micro-insurance. Due to the high population numbers in these two countries, the Asian region accounts for 86 percent of the global outreach of micro-insurance. Nevertheless, only 2.7 percent of the poor population in Asia were covered by micro-insurance; and the coverage of the poor in Africa and Latin America was 0.3 percent and 7.8 percent, respectively.

Micro-insurance providers worldwide currently offer four types of insurance: life, health, accidental death and disability, and property insurance (Roth *et al*., 2007). Sixty-four million people are covered by life insurance, 41 million by accident and disability insurance, 36 million by property insurance, and 35 million by health insurance.

Clearly, life insurance is the most widely distributed product. Reasons for this are manifold. Life Insurance is one of the most demanded forms of cover (together with health insurance), it is easy to price, resistant to problems of fraud and moral hazard, and independent from the existence of other infrastructure, such as clinics and hospitals. Although health insurance is a highly demanded insurance policy as well, the actual availability is well below three percent, even in the best cases. Property insurance (including home, crop, weather index, livestock and other possessions insurance) is not very widespread either; only 0.7 percent of poor people are covered by property insurance. On the one hand, many micro-insurers, particularly non-profit insurers, ignore property insurance, as demand for property insurance is significantly lower than demand for life and health insurance. On the other hand, underwritings and claims validations are very difficult in the property policy. Compared to other micro-insurance types, the number of accidental death and disability insurance products is much smaller; the largest numbers of products and numbers of lives covered can be found in South Asia.

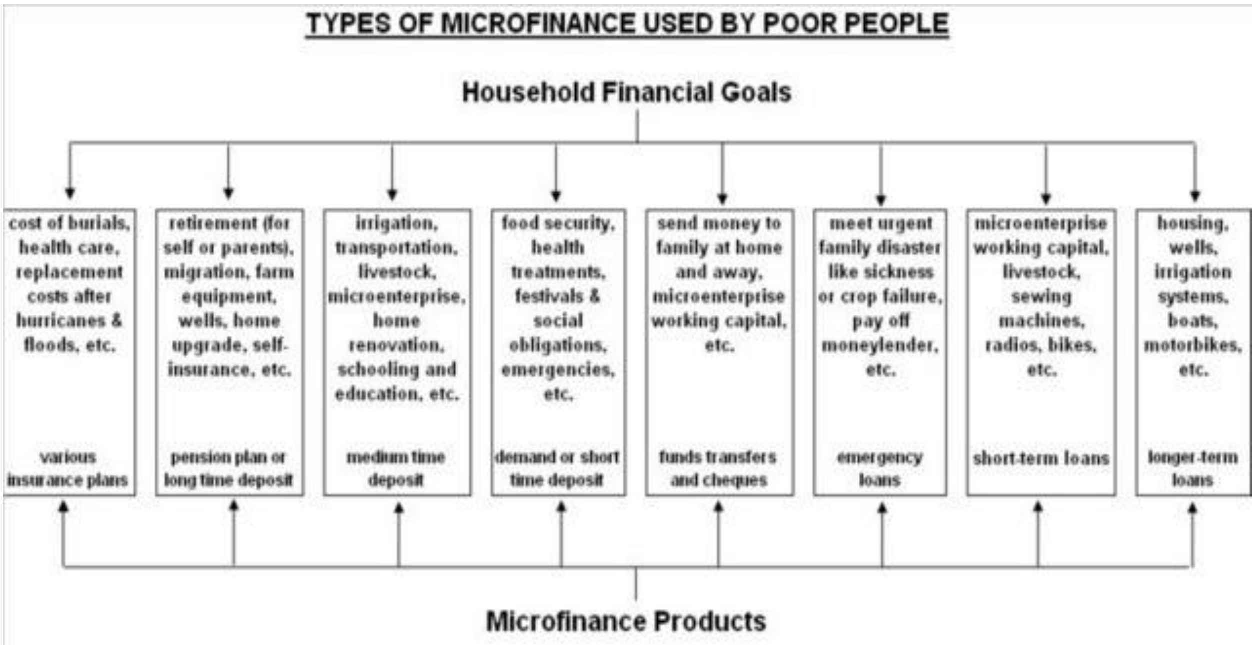
One major obstacle in the micro-insurance business is the relatively low level of experience of the target group with formal insurance. Many people do not understand the concept of insurance, let alone the terms and conditions of a contract, and are reluctant to pay in advance for a service they may not ever receive (Cohen and Sebstad, 2006). In East Africa, people have been found to confuse insurance with savings, and to believe that they must use the service for which they pay premiums, resulting in unnecessary visits to doctors' practices (Millinga, 2002). It thus appears that education on insurance, or, as some people call it, promoting financial literacy (e.g. Cohen and Sebstad, 2006) is one of the crucial areas where micro-insurance providers as well as donors should engage, in order to make micro-insurance a viable enterprise.

4. Linking Micro Finance as a Micro-Insurance

Microfinance – provision of financial services to poor or low-income people who are not "bankable" – is advancing fast throughout the developing world. The advance has been such as to lead Yunus, the Nobel laureate pioneer of micro-credit, to warn last week against risks of a bubble-generating entry of big banks into the market (Jacquier, et al., 2006).

Not with-standing the booming features of microfinance, and micro-credit in particular, in a world where economic integration of poor people has been dynamic in many regions and has started to attract attention of opportunity-stripped traditional financial institutions, micro-insurance is still lagging behind.

According to Martin Buehler (2001), from International Finance Corporation (IFC), "Micro-insurance is now where microfinance was about eight to 10 years ago. Microfinance now is a multibillion dollar industry. Micro-insurance is probably not yet in the billion dollar premium area." Either to assist the provision of micro-loans or as a stand-alone product, the availability of low-cost micro-insurance to "un-bankable" people has an obvious potential to ameliorate life conditions and welfare. This is not the time and place to address perils and conditions under which microfinance, and micro-insurance in particular, must operate, but one can take for granted that financial exclusion of large population contingents cannot be a good thing.



Picture 2.
Type of Microfinance Products.

Although most Micro Finance Institution (MFIs) go for life insurance, it is myopic to focus on that only. It is wiser to target such weak areas where the poor suffer most, although it takes longer time to show impact (e.g., Health hazards). Micro credit sets an example for how a product can be altered to cater to the bottom of the pyramid. So far the commercial insurers haven't yet targeted the poor as clients due to their vulnerability. The premium for poor is supposed to be high since they are more exposed to risk and it is not possible to track them. But according to the concept of bottom of the pyramid (Prahlad & Hart, 2002), since targeting the poor will increase the outreach significantly, there is significant scope for risk minimization. The claims will be comparatively low and the scheme will be sustainable. Considering above condition, the partner-agent model can be recommended as a solution.

Partner-agent model gives facilities to develop a market product, which has higher probability of product customization. But this has to be supported by government initiative and policy making (Murdoch, 2002). According to this model MFIs who lack infrastructure facilities can go for strategic alliance with providers and insurers for synergy. The claims and premium will be handled by the MFI but still this will be exposed to lower risk. Most MFIs use the money collected from micro-insurance schemes as premium, to give micro credit. But this type of activity is strictly prohibited in the micro-insurance guideline for donors (CGAP 2003). The money collected, as premium should be invested in the welfare of the micro-insurance program. By giving free service to the ultra poor (*Embedded Services*) with the contribution from other actual insurance holders, the MFIs can ensure resource allocation for the poorest and therefore provides equity in the community.

The MFIs who have inbuilt healthcare infrastructure are more willing to offer MHI schemes. But they can also go for life insurance if they can achieve such expertise. Those who have such infrastructure facilities can go for partner agent model for reinsurance. This will increase their efficiency, decrease their part of risk and help to achieve synergistic benefits for both the parties. The prioritizing of the social agenda over financial self-sufficiency can lead to an adverse financial position. For financial sustainability, a Micro Health Insurance (MHI) scheme must have a large client base, low administrative cost and sound financial management. Cross-subsidy by adopting a sliding scale premium and co-payments is one of the models that can be used for meeting part of the operational shortfall (CGAP 2003b).

Donors should also question the opportunity cost of an MFI's focus on insurance product development, particularly if there exist problems with the institution's portfolio quality or operational efficiency. Non-MFI models for micro-insurance provision should also be considered, including community-based insurance schemes. Payment of premiums during periods of cash surplus is an important consideration for the success of the models. Introducing premium payments during an inappropriate time (when there is little cash in hand of the people) may reduce subscription and payment.

A comparison of all the surveyed MFIs with respect to their performance features and product features is made. It is evident that although the MFIs claim that they address borrowers part of risk, their institutional mission for introducing micro-insurance or product design is conflicting with that statement. In most cases the product was introduced as a tool for the credit risk management rather than ensure decrease in income erosion of the borrowers.

As noted most of the MFIs follow the provider model. Some of them have their own infrastructure but they are not currently using the full capacity of such facilities, which they can. It is also found that the community-based services are not typically community based. Where there should be more community involvement in ownership of the scheme and in fund accumulation, the MFIs only target a group of same locality and they call the service community based since they address and serve this group as a whole.

Since current practices incur greater risk for the MFIs, they are not willing to diversify their product line. But if any mechanism can ensure risk management properly then many of the MFIs can go for other type of insurance (disaster or property). Due to obstacles faced by each organization in performing optimally all tasks on their own, insurance provisions models are most often based on partnerships between different actors. These alliances allow them to join resources and skills and provide better services.

Some key indicators for MFIs and insurers to successfully run micro-insurance programs are shown in table 1. It is evident that most MFIs tie up the micro-insurance product with micro credit and makes it a burden for the customers by making it mandatory. Their weakness lies in product designing and strategic planning. They have the network and credit recovery capacity but they lack integrated system that can give updates from the field and also help in better forecasting.

Table 1. Key Micro-insurance Performance Indicators

For MFIs	For Insurers
• Volumes of policyholders (% of women) • Premium and claim values • Loss ratios	• Annual reviews of premiums written • Loss and expense ratios • Claims reserves ratio

• Renewal rates • Average time for claim settlement, premium rate charged to clients • Administrative costs ratio	• Other reserves • Investment returns • Premium rate charged to the MFI • Net income, capital, and surplus

5. Conclusion

There has been much good economic work on risk and insurance, and it points the way to innovations that can provide better access for the poor. But constraints include more than the information asymmetries on which economists have focused most sharply. To be workable, solutions will have to address the very practical issues that have arisen repeatedly in discussions of micro-insurance. The first is the need for reinsurance, the second is having data on which to base premiums, and the third is the ability to cut the costs of dealing with many small transactions.

There is a potential role for public action with regard to the first two at least, with the first being most pressing. The more people that create insurance schemes, the thicker (and thus cheaper and more effective) will be the reinsurance market. But coordination failure may keep the market from getting that far. Public action to encourage reinsurers to develop products and protocols to deal with micro-products could be an important step toward expanding insurance access broadly.

The hope is that with those basic elements in place, innovations can be found to deal with both information asymmetries and transaction costs. The microfinance parallel offers cause for encouragement, but establishing widespread insurance will require more detailed regulatory architecture than the microfinance pioneers needed. Finding ways to cut costs will be best left to entrepreneurs, although there is scope for supporting pilot studies.

More than anything else, though, it will be important to keep the clients' views in mind. And doing that may mean taking a broad view of what providing "insurance" entails. Much vulnerability can be reduced through mechanisms that don't involve insurance *per share*. As with health insurance and rainfall insurance, both efficiency and equity may be enhanced by providing public education about the nature of risks, creating emergency funds to help households falling behind in their premium payments, and combining for-profit insurance provision with subsidized provision for poorer populations (Debraj Ray, 2000; a related example of "dysfunctional crowding out" in an insurance context is provided by Arnott and Stiglitz, 1993).

Being well-insured may also mean having a cushion of savings to fall back on. Researchers have showed that villagers in South India were mainly allaying risks through individual savings behavior (implemented by adjusting buffer stocks of grain). In Chinese studies, too, savings offered the main form of protection. In Bangladesh, Stuart Rutherford is piloting new savings products in Dhaka's slums, and is generating much interest. In Indonesia, savings facilities are in high demand from the poor (Robinson, 2001). Having savings allows households to manage their affairs more flexibly, and it cushions against losses that are fundamentally uninsurable. Economists have long argued that the poorer households are simply too close to subsistence levels to save much. That idea is right in principle, but in practice even households substantially below the poverty line are eager to stash away something for later–if given an appealing way to do so.

Practitioners have worked hard, sometimes against the odds, to get micro-insurance efforts started. A micro-insurance revolution could be a major step toward improving the well-being of the world's poor, but, it is important to design products with a full picture of how the products will fit into clients' lives (and possibly affect non-clients too). In that light, we should also bear in mind that micro-saving can be a key part of a household's best insurance strategy.

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