MICRO INSURANCE CENTRE

"Developing partnerships to insure the world's poor"

MicroInsurance Centre Briefing Note # 3

Making Microinsurance Work for Clients[1]

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With informal and self-insurance mechanisms already a part of the daily lives of many urban and rural poor, what are the opportunities for microinsurance providers entering the market? Research findings from East Africa shed light on several possible options.

How Clients Reduce Vulnerability

To assess market opportunities for sustainable microinsurance products, field studies in Kenya, Tanzania and Uganda examined client perceptions and preferred mechanisms for reducing vulnerability. Three key criteria emerged as a basis for assessing the effectiveness of insurance mechanisms:

- Coverage
- Accessibility
- Timeliness

Using these criteria, the studies found that few existing mechanisms fully cover losses. Faced with cash shortfalls poor people 'patch' together multiple resources to cover losses and incur high transaction costs. When it is possible, people often prefer to borrow rather than draw down hard earned savings, especially if they are earmarked for something else. Some people have access to formal insurance but its effectiveness is mixed. In some cases the claims processes are burdensome, particularly for the illiterate. In other cases, formal insurance is linked to credit, raising the effective cost of premiums. By contrast, the popularity of informal and self insurance mechanisms is explained by readily understood terms, flexible premium payment systems, trust in reciprocity, and timely payouts.

Building on the Positive Attributes of Self and Informal Insurance Mechanisms

Most poor people agreed that shocks and crises are part of their daily lives and that they hardly ever have enough money to fully cover the losses that result. People usually cope with shocks after they occur through self-insurance, that is, borrowing from friends, relatives, moneylenders, or other sources, using up savings or drawing down other individual and household resources. Informal insurance mechanisms, which involve reciprocal exchange through informal groups, work reasonably well for some risks despite the disadvantages of moral hazard and free riding.

Understanding the strengths and weaknesses of these mechanisms provides the basis for two things: identifying how they can be used as an alternate option for delivering insurance; and how their positive attributes can be incorporated into the design of appropriate microinsurance products.

To date, formal microinsurance has tended to reach a narrow band of MFI clients who tend to be better off to start with. It usually is linked to credit and provides coverage only when the loan cycle happens to overlap with a crisis. Among the poor, insurance often is viewed with distrust, largely out of lack of knowledge. Few understand the basic concepts of insurance, the details of their insurance policies, or its effective cost. People often confuse the difference between a savings product and a premium.

> Some FINCA-Uganda clients had not joined Microcare because they … "had heard that even if a cycle was completed without falling sick, one was not given a refund of the money and it was not carried forward." (Sebageni, 2002)

Recommendations for Product Design

The early lessons of the microinsurance experience, as with microcredit, suggest that poor people will continue to use a mix of risk management tools. Because none of the existing strategies provide 100 percent coverage, microinsurance potentially can play an important role in filling the gaps. To do so successfully and sustainably, microinsurance providers need to address a variety of challenges. Providers of microinsurance need to:

- understand the range and effectiveness of the risk management mechanisms currently used by clients to protect themselves against risk ahead of time and to cope with shocks after they occur;
- learn from the advantages and disadvantages of reciprocity and social obligation in informal group-based mechanisms;
- separate the different risk elements of health or life/funeral/loan insurance;
- learn from the advantages and disadvantages of reciprocity and social obligation in informal group-based mechanisms;

[1] This Briefing Note is based on a synthesis report by Monique Cohen and Jennefer Sebstad. "Reducing Vulnerability: The Demand for Microinsurance." *MicroSave-Africa*, 2003. The full report is available on the MicroInsurance Centre website: www.microinsurancecentre.org

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- provide differentiated products that meet different needs;
- time premium payments to match income flows;
- match household financial flows to payment cycles;
- assess the range of formal and informal insurance options to better understand effective demand;
- de-link microcredit and microinsurance;
- de-link savings from insurance; and
- focus on protective mechanisms for property loss rather than *ex post* insurance.

Types of Insurance

Death, sickness and protection against theft and fire probably are the best candidates for microinsurance. While microinsurance can help to reduce the stress of secondary shocks associated with these shocks, such as coping financially after the death of a spouse, these will not be fully addressed. Emergency loans could help to fill this gap. All microinsurance providers should recognise the specific needs of women and consider those that can be met with other financial and non-financial services. Legal assistance and financial education were two services identified in the study.

Life Insurance

To cope with death, the poor will benefit if major costs can be covered through three types of insurance or other financial products:

- Life insurance (taking a loan should not be a mandatory requirement)
- Loan insurance (lump sum to cover MFI obligations)
- Funeral insurance

Health Insurance

With many people exposed to ill health and few insured, the potential for microinsurance is clear. We identified six component areas of coverage. They include:

- Outpatient services
- Hospitalisation
- Long-term illness and related care
- Transport to health service provider
- Drugs
- Other risks (mosquito nets)

The findings suggest that each may be best served with a different risk management product, e.g. transport costs with emergency loans, hospitalization provided by the state and outpatient and drug services with insurance.

What risks can be covered and at what price is perhaps the biggest challenge for microinsurance and requires context specific research. Insurers also need to think about ways to balance the risk pool. For example, private health insurance cannot meet all costs. One possible option might be to link informal insurance associations with formal insurance providers and other services.

Formal insurance providers could explore introducing health insurance among members of informal association. Informal associations could serve as access points for insurance company agents and carry out functions such as facilitating the provision of information on policyholders, collecting premiums, and verifying payouts.

Asset Protection

While asset protection seems like an obvious market for microinsurance, the problems of moral hazard and fraud suggest that risks to the insurer are likely to be far too great for property insurance to be viable. Nevertheless, demand for this type of insurance is high. People cope with these losses as individuals and, as a result, often face serious setbacks. Given the challenges of property loss risks, perhaps the emphasis should be on precautionary strategies, campaigns, and public policies to protect assets ahead of time.

Role for non-financial services

To increase the success of any microinsurance initiative, the following range of non-financial services should be addressed:

1. Insurance education for both clients and staff within MFI who work as insurance agents (microinsurance concepts and practices, i.e. submitting claims, etc.).
2. Legal services (women's property rights upon the death of their husbands).

It is also important to consider the role of the state in protecting citizens against risks. The state has a role to play in protecting homes, businesses and other assets from theft and vandalism through systems that enforce the rule of law and promote safe communities. Regulatory systems that set building codes to reduce the risk of fires and public safety systems that provide fire and other emergency services are other areas where the state has a role to play.

Conclusion

Poor people will always depend on a mix of mechanisms to manage risk, some already in existence and others still to be developed. While insurance is not the answer for all shocks, there is wide scope for developing new microinsurance products and services. Without question, insurance can help poor people avoid serious setbacks when faced with shocks. There is a clear demand for it and it is key to poverty alleviation. To be effective, the design of microinsurance products and services should begin with an assessment of demand. This market-led approach differs markedly from the more common product-led approach of downscaling formal insurance products, which works for a few poor people, but not most. Market analyses of how people use existing formal, informal and self-insurance to manage risk and their preferences can contribute to the design of more effective microinsurance products and services.