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DONOR BRIEF
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Helping to Improve Donor Effectiveness in Microfinance

MICROINSURANCE: A RISK MANAGEMENT STRATEGY

Over two billion people worldwide lack any type of formal social security protection. Poor people are the least likely to benefit from coverage, yet they are the most vulnerable to risk and economic stress. Responding to this situation requires the involvement of a range of actors, including national governments, communities, the private sector, and development agencies. Currently in the spotlight, microinsurance is one of many financial services that helps manage risk; others include emergency loans and flexible savings. Donor agencies should approach this promising but untested field with caution.

What risks do poor people face?

Poor people confront many of the same risks faced by the non-poor, but these risks have greater financial impact and occur with greater frequency. Moreover, the vulnerability of poor people is exacerbated each time they incur a loss, creating a vicious cycle that precludes lasting improvements in human and economic welfare. Key risks include death, illness or injury, loss of property (e.g., theft, fire), and natural disaster (e.g., earthquake, drought).

How do poor people protect themselves from risk?

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) to prepare for and cope with such risks as the death of a family breadwinner, severe illness, or loss of livestock. Very few low-income households have access to formal insurance for such risks.

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, particularly among young children. Using family networks to identify business opportunities is another such mechanism. The imperative to avoid risk often leads to conservative decision making in the lives of 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 more for the protection of the lending institution than of 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, microfinance institutions (MFIs), and/or banks. They may also deplete savings, sell productive assets, default on loans, and/or reduce spending on food and schooling.

Relative Complexity of Different Insurance Products

HIGHLY COMPLEX ↑

- **Crop insurance**
- **Health and disability insurance**
- **Annuities and endowment** (retirement provision)
- **Property insurance**
- **Term life insurance** (payment to beneficiaries on death)
- **Credit life insurance** (debt paid on death of borrower)

SIMPLER

What is microinsurance?

Microinsurance is the protection of low-income people against specific perils in exchange for regular monetary payments (premiums) proportionate to the likelihood and cost of the risk involved. As with all insurance, *risk pooling* allows many individuals or groups to share the costs of a risky event.

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To serve poor people, microinsurance must respond to their priority needs for risk protection (depending on the market, they may seek health, car, or life insurance), be easy to understand, and affordable.

What are some of the difficulties in providing insurance to poor people?
Existing microinsurance schemes that provide more than simple credit life insurance find it difficult to become sustainable. Suppliers—whether governments, savings and credit societies, private-sector insurers, or other financial institutions such as MFIs—face the following difficulties:

Technical specialization. Insurance requires specialized actuarial capacity, which uses mathematics to place a monetary value on future risks. Actuarial analysis for microinsurance is complicated by claim volatility and lack of reliable data characteristic of low-income, informal markets. Often, actuarial expertise resides with one type of institution (i.e., formal insurers), while distribution networks to poor customers lie with another (i.e., MFIs or NGOs).

Marketing and sales. Most poor people do not understand insurance or are even biased against it. Many are skeptical about paying premiums for possible future benefits, when the insured event may not occur. Creating awareness about the value of insurance is time consuming and costly. In addition, the wording of insurance contracts is often too complicated for the poor, many of whom are illiterate.

Distribution channels. Microinsurance requires a distribution system that can both efficiently handle small financial transactions in convenient locations and engender trust. Existing distribution systems of this kind are hard to find; creating a new system to collect premiums and pay claims is expensive and often ineffective.

In East Africa, the insurance company American Insurance Group (AIG) has entered into partnerships with several microfinance institutions to overcome these three challenges.

What are some dos and don'ts for donors?
At present, the ability of donors to facilitate linkages and share knowledge on microinsurance is more important than providing funds for specific programs.

Donors should…	Donors should not…
• Carefully consider client demand and the full range of financial services for managing risk before determining that insurance is an appropriate response. • Encourage commercial insurers to serve the poor by brokering relationships with distribution channels such as MFIs. • Work only with strong institutions (insurers and MFIs) and conduct a careful analysis of their capacity to manage microinsurance products. • Coordinate microinsurance efforts with other donors, private-sector insurers, and governments. • Involve technical expertise in microinsurance operations and take a patient approach (several years), but define a clear, time-bound exit strategy. • Be careful about supporting unregulated insurance schemes that lack expertise, access to *reinsurance* (insurance for insurers), or consumer protection oversight. • Closely monitor performance of microinsurance partners. • Invest in educating poor people on the benefits of insurance. • Provide access to technical assistance for specific technical problems.	• Push institutions to offer microinsurance—the demand for risk protection should come from clients, not donors. • Fund new microinsurance providers without sufficient technical capacity. • Provide grant funding to cover claims costs. (Subsidies for claims lead microinsurers to subsidize premiums, an unsustainable practice.) • Attempt to influence government policies before there is more experience with microinsurance.

Authors: Alexia Latortue, with inputs from Monique Cohen, Michael J. McCord, Craig Churchill, and CGAP staff. **Sources**: CGAP Working Group on Microinsurance, "Donor Guidelines for Funding Microinsurance," Geneva, 2003; *Microinsurance: Improving Risk Management for the Poor*, nos. 1 and 2 (Luxembourg: ADA, August and November 2003); W. Brown, C. Green, and G. Lindquist, *A Cautionary Note for Microfinance Institutions and Donors Considering Developing Microinsurance Products* (Bethesda, Md., USA: DAI, 2000); C. Churchill, D. Liber, M.J. McCord, and J. Roth, *Making Microinsurance Work for Microfinance Institutions: A Technical Guide to Developing and Delivering Microinsurance* (Geneva: ILO, 2003); W. Brown and C. Churchill, *Insurance Provision to Low-Income Households: Parts I and 2* (Bethesda, Md., USA: DAI, 1999, 2000).

Websites: Microinsurance Centre– www.microinsurancecentre.org; Microinsurance Focus– www.microfinancegateway.org/section/resource centers/microinsurance; USAID MBP publications– www.usaidmicro.org/pubs/mbp-res.asp#npm.

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