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New Approaches to Social Protection: Microinsurance

Microinsurance has become a very popular concept in the international development debate. It is an arrangement whereby the members pool their risks, but at contribution levels that even people on low and fluctuating incomes can afford.

This concept can be realised for life and disability insurance and even, under certain conditions, for pension insurance and insurance that gives protection against the effects of the weather and natural disasters, provided that professional insurers assume responsibility for product design and risk management, but cooperate in product marketing and customer servicing with agents who operate close to target groups, such as

self-help groups, non-governmental organisations and cooperatives.

Health and liability insurance, on the other hand, can be offered only with substantial limitations.

Microinsurance schemes help to close the gap that the informally employed often face in the overall set of social protection schemes in developing countries. Compared to social insurance, however, they are only a second-best solution and should be used primarily when the state is unable or unwilling to extend social insurance coverage to informal-sector employees. In no case are they a substitute for social transfer schemes that support the extremely poor.

Microinsurance schemes help to close a gap that exists in the overall set of social protection systems in developing countries

The word “microinsurance” refers to social protection schemes that compensate their members in the event of certain risks (sickness, disability, etc.) and are financed from members’ contributions, which even low-income earners can afford. It is of secondary importance who organises these schemes: a self-help group, a non-governmental organisation (NGO), a cooperative, a government agency or a commercial insurance company.

The microinsurance approach emerged almost simultaneously in two areas of development policy practice: self-help groups and NGOs were trying to meet the demand from poorer households for life, health and crop loss insurance, which is ignored by private and social insurance funds in most developing countries. At the same time, microfinance institutions began offering insurance as well as credit to safeguard themselves against losses due to the death or disability of their clients. (The result is that in many donor countries the organisational units in charge of social policy and the development of financial systems still contest responsibility for microinsurance schemes.)

The aim of microinsurance schemes is to close the gap in the overall set of social protection systems of most

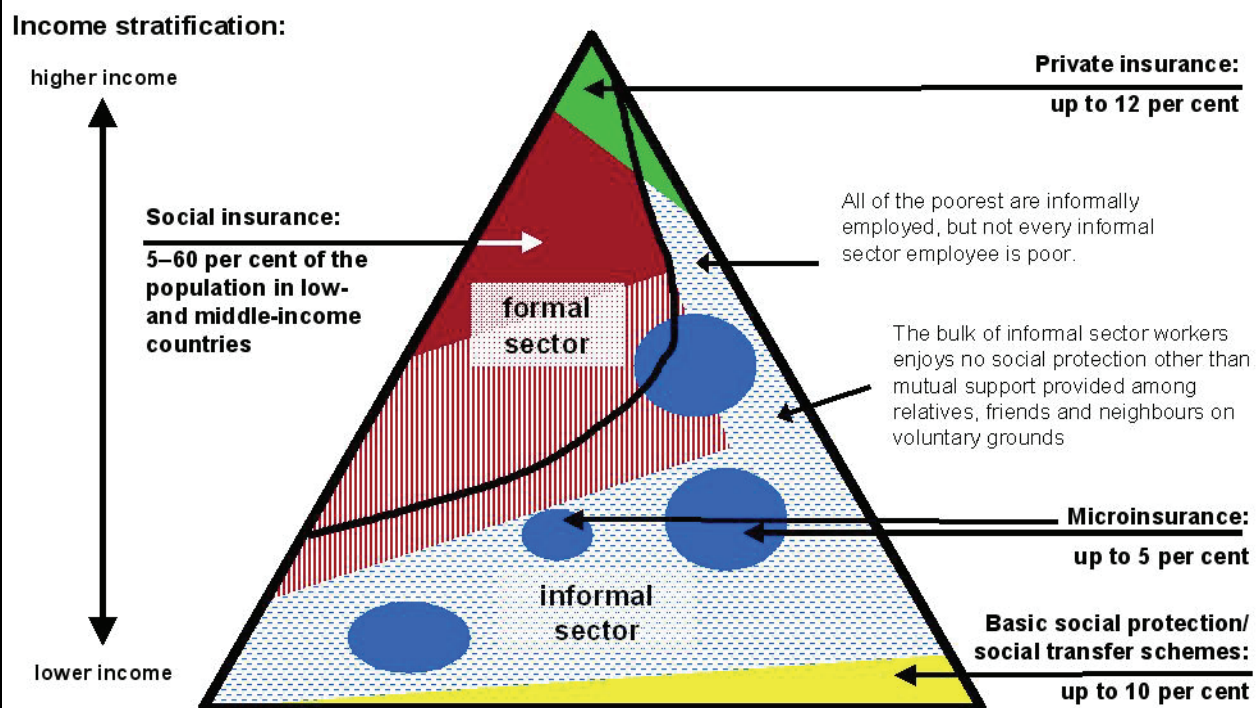
developing countries that primarily affects the informally employed (see Figure 1). Very wealthy households can afford to take out private health, life and liability insurance. Many civil servants are entitled to tax-funded pensions and free medical treatment in state hospitals. Other formal-sector employees are covered by social insurance in many places. Some of the extremely poor benefit from social assistance. And the inhabitants of rural areas where traditions are upheld are protected to some extent by mutual support from relatives and neighbours. However, none of these options is open to the majority of workers in the urban informal sector.

The main question, then, is whether and how it is possible to design insurance schemes which, though their benefits are fully funded by contributions, people in the informal sector on low and fluctuating incomes can still afford.

It is crucial for the microinsurance provider to be reliable and have a favourable cost structure

What may seem impossible at first glance can be achieved under certain conditions if the goal is to insure risks that lead to losses of income or assets: disability or premature death of a family’s main earners, loss of crops due to drought or flooding, theft or loss of property due to fire, flooding or storm. Insurance against

Figure 1: Coverage of different classes of the population of a typical developing country by various social protection systems



Source: own design; percentages indicate the range for some 90 per cent of developing countries

such risks must, above all, compensate for lost income or assets.

The necessary sum insured thus depends on the level of the income or the value of the assets of the insured person. Consequently, the greater her/his income and assets, the higher her/his contribution must be. Conversely, payments and contributions may fall in proportion to income if the insurer does not need to finance his administration and transactions costs and his mark-up from contributions received; and these items are fixed in each policy (see Figure 2).

Those costs may be even higher if the people insured are poor and live in informal settlements on the outskirts of towns and cities, where the insurer has difficulty in contacting them. In such cases, the administration and transaction costs of commercial or state-owned insurance companies can even exceed contributions.

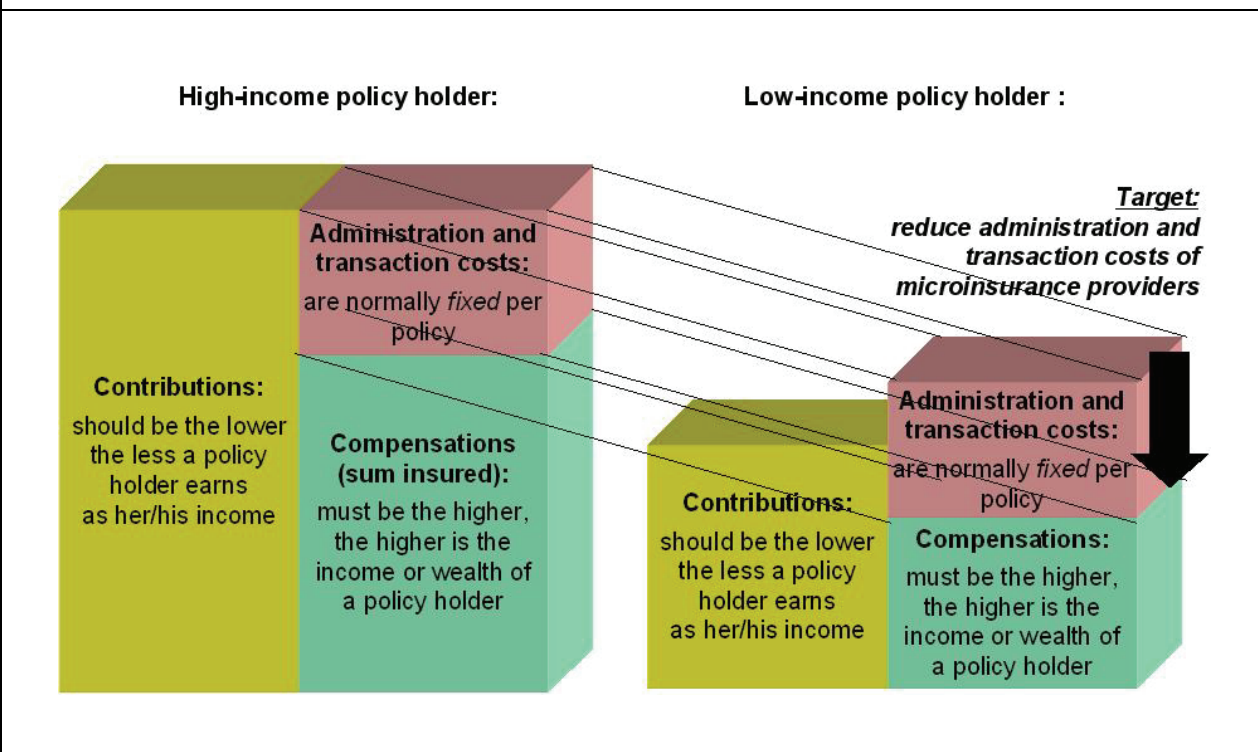
Insurers also find it particularly difficult to obtain crucial information on low-income households. Before a policy can be issued, they have to know, for example, whether an inquirer already has health problems, so as to rule out the possibility of eventually having only clients with an especially poor risk profile (adverse selection). Insurers must also be able to form a picture of their clients' behaviour if they are to avoid situations where the latter merely pretend that the insured event has occurred or, knowing

that they have insurance protection, act less carefully than before (moral hazard). For conventional insurers it is almost impossible to obtain such information on the informally employed, unlike workers who have formal contracts of employment, are registered with the authorities and occasionally go to the doctor when seriously ill.

Many early microinsurance schemes were therefore established by self-help groups, NGOs and cooperatives. Their administrative expenses are limited because their staff work in an honorary capacity or for low wages. Their transaction costs are similarly low because, being located in the midst of the target group, they do not have far to go. And they encounter few information problems because their staff often know clients personally and meet them regularly. They are consequently aware which potential clients have an unfavourable risk profile, who takes greater risks after taking out a policy and when the insured event has actually occurred.

For all that, self-help groups, NGOs and cooperatives also have serious weaknesses. They often lack the expertise to set appropriate contribution rates, to design sound policies, to manage insurance systems properly and to invest reserves lucratively. Nor, in many cases, do they have enough members for their risks to be pooled to the necessary degree. If an insured event affects several members at the same time, payments to them

Figure 2: Conventional providers of insurance products often have problems with microinsurance policies because their administration and transaction costs are too high



Source: own design

quickly exceed contributions and the schemes become insolvent. And finally, as some insurance institutions are unstable and unreliable, the insured cannot be quite sure of actually receiving benefits should the insured event occur.

How, then, to set up schemes with favourable cost structures that are nonetheless sufficiently professional, stable and reliable for their members?

Ideally, a number of actors will cooperate so as to pool their respective strengths

There are essentially three ways of setting up a microinsurance scheme. The best consists in comparatively different types of actors working together and sharing the tasks associated with operating an insurance scheme according to their respective strengths.

In this first 'partner-agent' model, a self-help group, NGO or cooperative (the 'agent') performs all the tasks in which low costs, a knowledge of the target group and the latter's trust are vital: the marketing of microinsurance policies and the service business (customer care, verification and settlement of claims). The 'partner' (e.g. an insurance company), on the other hand, takes on all the tasks requiring know-how, stability and professionalism: product design, risk management and investment management.

Alternatively, a professional financial service provider (insurance company or credit institution) will attempt

to keep down its marketing and servicing costs – by using such modern technology as mobile phones and ATMs, for example. Some microfinance institutions have succeeded in this respect. However, unlike successful representatives of the partner-agent model described above, they often reach only the middle class, not the poor. And they frequently offer no more than insurance against credit losses, which protects themselves rather than their clients against such losses.

Finally, development cooperation can be used to provide self-help groups, NGOs and cooperatives with the know-how needed to run a microinsurance scheme or to establish a trust fund from which they may borrow money on market conditions if they encounter temporary payment problems. Once again, however, there are few successful examples of this type of microinsurance scheme.

Problems are posed primarily by health and liability insurance products

The partner-agent model enables affordable and reliable life and disability insurance to be provided. More stable institutions that have considerable experience and are considered very trustworthy can also offer pension insurance, with clients receiving payments in return for their contributions only after a long period. And even insurance against bad weather is now on offer, the insured being compensated, for example, if the rainfall in their region in a given year is so low that

the harvest is likely to fail. This naturally requires reinsurance beyond regional boundaries.

In contrast, health and liability insurance pose serious problems. They have to compensate for costs of a magnitude that does not depend (unlike those shown in Figure 2) on the income or assets of the insured. In any given indemnification package the insurer must expect to spend the same on benefits to each and every client. Consequently, he cannot sell the package to low-income clients at a lower price than to high-income clients. At best, he can offer poor clients a slimmed-down package that does not cover certain illnesses, excludes very expensive medical treatments or is restricted to a certain maximum annual amount. For the low-income client, this is better than having no insurance at all. However, insurance makes sense primarily when it compensates for very high expenditure, since it may be possible to make provision for lower expenses by saving. Most microinsurers active in the health sector take on only a few low-income clients if they are to be able to meet their expenses from revenue.

Microinsurance schemes are no substitute for social transfers

Microinsurance schemes are an efficient means of providing low-income households with social safeguards. But as they are financed from their members' contributions, they are not suitable for people on an income that does not enable them to meet the most basic of their current consumer needs, let alone make provision for future social needs. The extremely poor can be safeguarded only by means of transfers financed from tax revenue.

In other respects, too, microinsurance schemes are no substitute for tax transfer systems that redistribute funds from rich members of society to the poor and so help out when all other social systems have failed to prevent the impoverishment of households. Redistribution is not possible within microinsurance schemes because membership is voluntary. If they cross-subsidised benefits to poor members from the contributions made by the rich, they would be attractive only to the poorest of the poor; everyone else would withdraw from them.

Compared to social insurance, microinsurance is a second-best option under normal circumstances

For the same reason microinsurance schemes are also inferior to social insurance in most cases. Membership of the latter can be prescribed by law, making redistribution among the insured possible. The same health insurance package can then, for example, be sold to poor and rich members through the partial financing of payments to poor members from the contributions of the rich.

Furthermore, social insurance schemes give their members more legal certainty, since they are backed by the state, which must ultimately take responsibility for their liabilities.

The microinsurance approach can thus be recommended as the second-best solution primarily where the state does not have the capacities to give informal-sector employees access to social insurance – and where the decision-makers lack the necessary political will to go down this road.

In addition, microinsurance schemes can be used as a complement to social insurance (i) to safeguard population groups who cannot, even with the greatest commitment, be covered by social insurance, (ii) to give members of social insurance access to more extensive insurance (e.g. pension supplements) or supplementary insurance (for such added benefits as the reimbursement of travel expenses and the cost of drugs) and (iii) to provide security against risks not usually covered by social insurance (e.g. drought, animal diseases, earthquakes and flood disasters).

Development cooperation should promote microinsurance schemes, but not oversubsidise them

There are many ways in which development cooperation can be used to promote microinsurance schemes. First, they can be advertised, and exchanges of satisfactory experience can be encouraged. Second, infrastructure can be created for the approach: training centres and conflict settlement bodies. Third, microinsurance schemes can be assisted during their start-up phase with advice, training and grants. Fourth, reinsurance trust funds can be set up to solve temporary payment problems (see above).

However, long-term or permanent subsidisation is not to be recommended. Even microinsurance schemes are unlikely ever to reach more than a minority of the informally employed. As long-term or permanent subsidisation would therefore benefit only those who happen to have access to a microinsurance scheme, it would give rise to unfairness.



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