Is Microinsurance a Priority for the Poor? Understanding the Demand for Risk-managing Financial Services

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Introduction

The microfinance industry is particularly keen to learn more about insurance these days. Microinsurance is an increasingly common topic on conference agendas and a number of recent publications have documented emerging lessons in this nascent field (see the bibliography for a list of recommended reading).

The surge of interest reflects both the social and commercial objectives that embody microfinance. From the social perspective, many microfinance institutions (MFIs) have recognised that the vulnerability of low-income households is not eliminated by access to microenterprise loans alone. Microentrepreneurs remain vulnerable to a host of perils that insurance may help low-income households to manage. Furthermore, not all low-income persons are self-employed, so the provision of microinsurance, like savings services, can enable MFIs to broaden their impact in low-communities rather than just assisting microentrepreneurs.

From the commercial perspective, insurance can improve loan portfolio quality since bad debts can often be attributed to the death or illness of a client or a client’s family member. Microfinance institutions are also interested in developing new products like insurance to serve new markets, to enhance customer loyalty, and improve competitiveness. Cross-selling—the practice of providing one customer with multiple services—enhances efficiency by reducing the acquisition cost of each product. A multi-faceted relationship with the client can also strengthen customer loyalty (or reduce desertion by making it expensive or difficult for clients to leave). In addition, MFIs expect that the premiums or agent’s commissions from microinsurance could serve as a new source of capital or income.

Despite the persuasiveness of both the developmental and commercial arguments, critical questions remain unanswered: Do low-income people want insurance, and if so, what types of products are the most important to them? Is it appropriate to try and persuade insurance sceptics that premium payments are an appropriate use for their extremely finite resources? For which segments of the market might insurance be an effective means for managing risks, and for which risks?

To better understand the potential demand for microinsurance, it needs to be seen in the context of the alternatives, namely accessible savings and emergency loans. This paper first considers the circumstances under which insurance might be preferable to other financial services that enable low-income persons to manage risks and concludes with practical suggestions for improving all three types of risk-managing financial services.

Understanding the Demand for Risk-managing Financial Services

There are three categories of risk-managing financial products: liquid savings accounts from which clients can draw down to reduce the effects of an economic stress; emergency loans;
and microinsurance, which might include coverage for death, illness, disability, theft and possibly drought or disasters. To explore the circumstances under which low-income persons or households might prefer one to the others, it is necessary to consider a range of social and economic issues including:

1) Alternative coping strategies  
2) Type of risk  
3) Planning propensity  
4) Poverty level  
5) Cash flow  
6) Social conditions  
7) Education, biases and risk tolerance

I) Alternative Coping Strategies

The demand for risk-managing financial services is partly a function of the supply. In general, the poor do not have access to savings facilities, emergency loans or insurance from formal or semi-formal institutions. So while they may have a need for the support provided by these services, they are unlikely to articulate a significant demand because they do not maintain any expectations that a bank or insurer would willing or able to address their needs. The demand for risk-managing financial services therefore has to be inferred based on the cost and effectiveness of current risk coping strategies employed by the poor, including their reliance on informal financial services.

Informal “insurance” usually refers to mutual support strategies that are either bilateral or multilateral (see Platteau 1997). Multilateral support strategies tend to be responsive. If an obvious risk event occurs, like a death in the family or the business burned down, then community members might assist the stricken household, usually with in-kind support such as food, or labour and materials to rebuild the business. The only type of advance premium payments in this example would be the participation in mutual support to other families in their time of need: in a sense, paying out a claim today is the same as paying a premium against future claims.

Reciprocal gift is an example of a bilateral support strategy whereby gifts are given to family and friends almost as a premium payment. Should a risk event occur, then one might be able to cash in on an “insurance policy” by requesting (or expecting) the assistance of gift recipients. Where this bilateral relationship is between someone who persons of different economic classes, it may represent a patron-client relationship, which could exacerbate a dependency or come at a considerable cost. Bilateral support strategies are useful to address smaller economic stresses, such as a short downturn in the business, or to help with cash flow if a business investment goes sour.

Neither of these informal insurance mechanisms resembles the risk pooling mechanism of formal insurance. Informal approaches might be more effective than formal insurance in tight-knit communities with strong traditions of mutual support, but less so in newer or more transient communities. With informal approaches, there is always the concern that the “insurers”, the community members, might not uphold their end of the bargain. Another limitation is that mutual or bilateral approaches are not effective with covariant risks that might affect a whole community.

In the absence of formal savings facilities, low-income persons usually rely on two primary savings approaches: savings groups and “under the mattress.” While savings groups create a
degree of discipline that encourages the poor to accumulate assets, they are often not effective in responding to risks since the need for and the availability of cash are often not synchronised. Participation in a savings group may, however, facilitate access to the mutual or bilateral response mechanisms described above. Under the mattress savings has very low transaction costs and is available any time of day, but it represents a security risk.

2) Type of Risk
With regard to formal and semi-formal financial services—if such services were available to the poor—savings and emergency loans would be considerably more flexible than insurance because they can ameliorate the effects of numerous economic stresses. A life insurance policy will not help if one’s house burns down or if the business was robbed. Indeed, only a few risks are insurable—those that are easily observable and idiosyncratic—and therefore insurance must be complemented with other means of managing risks. Savings might be slightly more responsive than credit since it is possible to use one’s savings for any purpose, not just risk management. This advantage of savings over credit, however, depends on the design of the loan product; some all-purpose or consumption loans are equally as flexible.

The risk pooling aspect of insurance works best for both provider and consumer when: a) the loss is relatively large and b) there is a low likelihood that the risk will occur (Brown and Churchill 1999). Insurance is therefore useful to cover funerals, expensive medical treatments or rebuilding a burnt house. If the loss were relatively small or likely, then savings or credit would probably be more appropriate.

For poor persons who believe that insurance is an appropriate response for selected risks (and not all do), they would have to identify which of the unlikely risks that insurers are willing to cover are the most likely to occur to them, and if the risk(s) did occur would cause the greatest financial hardship. This analysis often points to a potential demand for life insurance, since death is a fairly certain event¹ that causes significant hardship, including the initial funeral expenses and the recurring loss of income if the deceased was a breadwinner.

Using these criteria, the demand for health insurance is somewhat less clear. In some environments, even in developing countries, low-income persons have access to reasonably inexpensive (although poor quality) health care. In these circumstances, potential demand for health insurance is more likely to come from the upper poor who might want to take advantage of better facilities in private clinics or hospitals, but not from the poorest. In other environments, particularly in rural areas, health care infrastructure would need to be in place before health insurance would make sense.

Complicating the demand for health insurance, and to a lesser extent for life insurance, is that people’s perceptions of their vulnerability vary widely depending on their age, their current health, their marital and family status, etc. Consequently, the demand for insurance is not static; it fluctuates considerably as one ages, has children or becomes ill—i.e., as individuals perceive that they have become a higher or lower risk, the demand for insurance varies accordingly.

3) Planning Propensity
Another factor influencing the respective demand for risk-managing financial services is planning. For saving or insurance to be risk-managing options, the decision to protect one’s

¹ Uncertainty has three different elements: if, when and how often? Although it is certain that we will all die at some point, the uncertainty arises from not knowing when.
household from risk needs to be made in advance, to start paying premiums or to build up a savings reserve. Savings in particular requires a long-term perspective in which one is willing to forgo current consumption (or investment in income generating activities) to build up a sufficient buffer.

For persons who do not plan ahead, like the grasshopper in Aesop’s fable, emergency loans may be the only choice—although even that option may require some planning to put oneself in a position to be eligible for an emergency loan. If an MFI were to offer emergency loans, credit may be restricted to current (and perhaps past) customers with clean credit record. Without these eligibility conditions, persons seeking emergency loans would have to rely on informal sources such as family, friends and moneylenders.

The poor are sometimes perceived as spendthrifts who splurge when they have extra cash or, worse, use consumer credit to live beyond their means. Indeed burgeoning over-indebtedness among the aspiring middle class is growing problem in many countries, which raises the issue that household cash management and risk preparation are not necessarily intuitive skills. For effective risk management, it might be necessary to complement financial services with relevant non-financial interventions.

4) Poverty Level

There are two dimensions to planning: the willingness and the ability to prepare for future risks. Besides having sufficient skills, the ability to plan depends largely on poverty level. For the poor, asset accumulation in the form of savings and/or insurance necessitates forgoing consumption today for greater security tomorrow. Therefore, for savings and insurance to be good options, the household will have to have some net income so that it can put money aside, in a bank or under a mattress, to buy an asset or pay a premium.

The poorer you are, the stronger the sense of immediacy and urgency, more difficult to plan or have long term outlook. For example, during adverse circumstances, credit constrained parents tend to withdraw children from school and put them into income earning jobs, essentially substituting present consumption over future consumption (Jacoby 1994 cited in Zeller 1999). The same situation may apply to the demand for insurance among the poorest, whereby the urgency of present consumption takes precedence over protection against future risks. So instead of paying premiums on policies providing coverage for risks that you do not even know will occur, perhaps those resources would be better spent today to pay for a very real and immediate need. The poorer the household, the less able it is, even if it is willing, to set money aside in lieu of consumption today.

Recent research by the ILO among low-income microentrepreneurs around Lusaka, Zambia found that only 23 percent of the respondents had a favorable impression of insurance. In general, there was a strong belief that insurance was either not applicable or affordable for the poor. Representative comments from this research, highlighted in the following box, show the type of the reservations that are linked to poverty level.
Insurance Reservations: Affordability and Applicability

“Insurance should be accessed by all who can afford to pay the premiums to protect themselves and their property against fire, theft, accident, disease and death.”

“Insurance is something that needs a lot of money.”

“Insurance is good when you have a big business, but when the business is small, it becomes a big burden.”

“If you don’t have valuable assets and money, it is not important to insure.”

*Manje and Churchill (2002)*

In Europe and North America in the early to mid 20th century, insurance was ironically seen as a financial service for the poorer classes. Wealthy persons preferred to use their money to achieve greater returns, and because they had a high net worth, they were less vulnerable and less in need of protection. The growth of insurance policyholders came mainly from risk averse working poor who sought secure yet low-return investments like insurance.

There are two explanations for this apparent contradiction between the historic and current demand for insurance by the poor. First, how poor is poor? The historical working poor had low paying but regular wages that enabled them to pay their weekly penny premiums; the same would probably be true today for low-income, salaried workers if insurers were interested in their business. But for the self-employed and persons with irregular and unpredictable incomes, insurance may not be a top priority. The second difference is that the insurance sold to yesterday’s factory workers accumulated value, so that it combined insurance with savings, albeit for a fairly low return. If these whole life or endowment policies were available to today’s poor in developing countries, then there very well may be a demand since accumulating value policies overcome a major obstacle preventing the poor from demanding insurance—not having anything to show for the premium payments unless something bad happens to you.

5) Cash Flow

The potential demand for risk-managing financial services is not related just to absolute poverty, but also to the level of income and expense variability. Saving and borrowing enable persons to allow consumption to be somewhat independent of income (Murdoch 1995). For the non-poor, the ability to smooth consumption often results in access to material possessions, such as a car or a house. For the poor, the emphasis is less on buying things—although that is certainly an objective—and more on risk and cash management, spreading expense spikes over time.

Irregular income makes it difficult to save or pay regular insurance premiums, but these circumstances also make savings all the more important to have a buffer for the weeks or months with little or no income. Emergency loans might help fill this gap, reducing the need to sell off assets by allowing people to borrow against future earnings. Credit is only a possible solution, however, if prospective borrowers can convince lenders that they will have a) future earnings to repay the loan and b) sufficient security to guarantee the loan.

The choice between relying on savings versus borrowing depends partly on whether the economic stress decreases income or increases expenses, as shown in the Figure below. Drought, for example, decreases income in the same way that a microentrepreneur would experience poor market conditions. In both cases, the preferred response would be to reduce... 

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Manje and Churchill (2002)
consumption and/or draw down on savings. Credit is a less desirable coping strategy in this situation because the reduction of income means that it will be difficult to service the loan. In these circumstances, a loan could worsen the situation rather than ameliorate it since a bad debt or even late payments could damage the household’s ability to borrow in the future.

Alternatively, if the shock creates an increased expense but does not adversely affect one’s gross income, then an emergency loan could be a reasonable solution. For example, the death of a child would create an unexpected funeral expense, but not affect income (unless the child was working). So rather than draw down on savings, which should be reserved for a time when a peril hits household income, the person may find that an emergency loan for the additional expense would be appropriate (unless of course they had life insurance for the child).

A slight twist to this logic emerges when accessing savings means cashing in on productive assets. If someone’s primary savings strategy is to reinvest in one’s microenterprise, then drawing down on savings would contribute to a decrease revenue generation. In this situation, a loan might serve the household better than de-capitalising the business. And then, of course, there are risks that reduce income and increase expenses, which make the choice between savings and credit even more difficult.

### 6) Social Conditions

While a thorough opportunity cost analysis of the three risk-managing financial services would help to identify the best option from an economic perspective, the choice between credit, savings and insurance may depend more on social and cultural considerations than costs and benefits.

In some contexts, there are strong social pressures on people to use their limited resources in sub-optimal ways. For example, people may feel compelled to have marriage or funeral services that far exceed their means, or to pay for dowries that they cannot afford. They may feel the need to spend lavishly on religious ceremonies. This social pressure can be so strong that some people are willing to use themselves or their children as collateral, essentially becoming bonded labourers until such time that the loan is repaid, which could take years or even generations.

Social pressures influencing the poor’s choice of risk-managing financial service are not new. In Britain in the late 19th century, debt was associated with shame among the working class. If someone borrowed money, they went to great lengths to hide the fact from others. On the other hand, there were more positive social implications associated with savings and
insurance. Insurance premiums were collected by the insurance agent at the subscriber’s house, and these visits gave the household status by showing the neighbours that they could afford the premiums. Similarly, savings were often targeted to purchase status symbols, like a piano or Sunday clothes. Although the working class did not use financial services in a way that maximized their economic return, they bought products that maximized security and status (Johnson 1985).

Social pressures do not always result in an inefficient use of resources. Some analysts point to the strong culture of savings as a major contributor to the economic boom experienced by the Asian tiger in the 1980-90s.

7) Education, Biases and Risk Tolerance

On a personal level, the demand for saving, credit and particularly insurance also depends on one’s education, biases and tolerance for risk.

Although savings and credit are fairly familiar to most people, many low-income people are not familiar with the risk-pooling concept or they have an incorrect understanding about insurance. Research among microentrepreneurs in Lusaka, Zambia, for example, revealed that 38 percent of the sample had no understanding of insurance and an additional 30 percent had only a basic familiarity. The level of understanding was strongly correlated to levels of literacy and formal education, and men generally had a greater familiarity than women (Manje and Churchill 2002).

Both savings and insurance lend themselves to fraudulent schemes, which create negative publicity for legitimate products. Pyramid and Ponzi schemes in particular have given savings and investment a bad reputation in many countries. For insurance, even if there have not been any local scams, consumers often have unfavourable opinions of salespersons who may have incentives to oversell insurance and appear to profit from other people’s miseries. If the local insurance industry has a reputation for inappropriate selling, rejecting claims based on fine print technicalities or paying claims extremely late, the demand for insurance will certainly be suppressed.

The demand for savings is influenced by what else individuals could do with their money. Many microentrepreneurs, particularly men, prefer to reinvest excess cash into their businesses rather than having unproductive money under the mattress or in the bank in preparation for risks. For persons who adopt a business-first approach, there would probably be a significant demand for emergency loans.

The only source for emergency loans is often the local moneylender who brings his or her (usually his) own baggage and biases. The research in Zambia showed significant apprehension about borrowing from moneylenders, both in terms of the costs as well as the collection methods, although the concerns stemmed more from hearsay than experience. Men were much more willing to borrow from the moneylender than women.

In microfinance discussions, one critical issue seems to be regularly overlooked: Borrowing money is risky. The risk of taking a loan should not be underestimated. Although people have different tolerances for risk, generally they only want to take a loan when they know that they can repay it, unless they are so desperate that they do not have any other options, in which case they are probably bad credit risks. In general, the demand for savings and credit may to some extent be inversely correlated depending on an individual’s risk tolerance.
Conclusion: Improving Risk-managing Financial Services

This brief survey shows the complexity of factors that influence the demand for insurance and other risk-managing financial services. Perhaps the best way to really understand how persons in low-income communities would utilise these services is to make them available and see how different segments of the market juggle credit, savings and insurance. To date, microfinance has not been successful in helping persons to cope with risks after they have occurred. This conclusion provides some basic suggestions for providing better risk-managing financial services.2

Savings

Overall, the demand analysis suggests that savings is the preferred method for coping with most economic stresses. The two primary savings methods used by the poor—“under the mattress” and through savings groups—have significant limitations. To improve low-income households’ ability to manage risks, MFIs should consider offering savings services that are independent of their lending activities. Clients are reluctant to make additional deposits in MFIs that have forced savings because they fear that voluntary savings would be treated in the same way as their compulsory savings, which secures not only their own loan but also the loans of their group members. Another advantage of de-linking savings and lending is that it opens the door to provide savings services to persons who do not want a loan, assuming that this complies with the regulatory environment.

Inferring from their current behaviour, there would probably be a demand for two types of savings products. The first is a completely liquid facility or a passbook savings account that would allow clients to deposit and withdraw as needed. In effect, this product would try to replace the “under the mattress” savings by providing greater security and reducing the temptation to use the funds by making them just a little bit harder to reach. If the MFI wanted to use this product to meet clients’ needs for cash flow management, the product should have low or no minimum balance requirements and it should be locally available on a daily basis. Unfortunately, a passbook savings account is the most difficult and most expensive savings product to offer. To provide this service, it may be worth exploring the use of technology, like smart cards and ATMs, which may pay for themselves in lower transaction costs and reduced vulnerability to fraud (see Campion and Halpern 2001).

The second product would be a contractual savings facility that imitates the attractive characteristics of savings clubs, including discipline and the temporary inaccessibility of one’s funds. This “targeted savings” approach would be particularly effective for education savings, but it may also work for health care and other emergencies if an acceptable definition of an emergency could be worked out.

It is worth noting that women appear to be better savers than men. Women are more likely to have a bank account and to participate in a savings group, while men are more likely to invest excess cash in the business and rely on moneylenders if emergencies arise (Manje and Churchill 2002). Marketing of any savings products should therefore recognise that women might be more receptive.

Emergency Loans

While a microenterprise loan may help low-income households reduce their vulnerability by boosting income and assets, it is not an effective means to manage risks. Microenterprise

2 This section is adapted from Manje and Churchill 2002.
loans are not usually available when they are most needed, they require group guarantees, and there are several weeks of meetings and savings requirements before one is eligible. And while one is repaying a microenterprise loan, many MFIs do not allow clients to take out an additional loan until they have repaid the first one.

To cope with emergencies, in the event that someone has not built up sufficient savings reserves (or prefers not to deplete them), MFIs should consider offering a parallel or emergency loan product that allows existing borrowers (or the broader low-income community) to quickly access an additional chunk of money. Parallel loans would not necessarily be limited to paying for emergencies; they could also be used for consumption smoothing or even to take advantage of business opportunities. As a multi-purpose loan, it would be in great demand, especially if it was immediately available at a reasonable price and without pressing concerns about asset seizure.

An emergency loan product needs to respond to crises without over-indebting clients, and without worsening the MFI’s portfolio quality by throwing good money after bad. There are three basic approaches that an MFI might take toward controlling the credit risk of an emergency or parallel loan product:

- **Credit history as a collateral substitute**: Borrowers who have repaid 3 or 4 loans without a late payment could be eligible for a parallel loan no questions asked (as long as the loan amount is below a certain threshold). This arrangement creates a strong customer loyalty incentive, however the MFI will have a limited impact in helping low-income households to manage risks since only a handful of clients would be eligible.

- **Guarantor or co-signer**: Since vulnerable persons are already calling on the economic support of family and friends, a guarantor arrangement might be a way of institutionalising family or social obligations without upsetting the cash flow of the assistance provider. The challenge to controlling credit risk through social collateral is whether the legal system can easily and cost-effectively enforce the contract. If so, then the MFI would be able to extend emergency or consumption loans more broadly and provide a more valuable risk management service in the community, not just for existing borrowers.

- **Pawn lending**: Another way to guarantee emergency loans is with non-traditional collateral such as jewellery or other small, valuable items. For this type of security to work, the MFI needs expertise to assess their value and a secure means of storing the items until the loan is repaid; and clients need to have something of value that they would be willing to pawn. If these conditions could be met, then the MFI would not require other credit risk controls, such as short loan terms or frequent repayments, which would make a pawn loan extremely versatile.

Alternatively, if an MFI offered a line of credit rather than a term loan, then clients would have the flexibility to draw down on that facility in case of emergency.

**Insurance**

Analysis of the demand suggests that insurance products may not be the top priority for many microfinance customers. Given the target market’s lack of familiarity with insurance, and the undercurrents of negative perceptions, developing and delivering demand-driven insurance...
products will be an uphill challenge. The market may be more receptive to targeted savings products for risk-managing purposes than insurance.

If an MFI decides to develop a microinsurance product, an important first step is to look closely at informal funeral funds that low-income people have designed for themselves. Although not prevalent, there are some true risk-pooling informal insurance schemes that have some useful design features, such as expedient claims processing and the use of groups to control adverse selection and deter premium lapses. With a larger risk pool and greater economies of scale, a formal insurer should be able to provide greater value at a lower cost than most informal schemes, especially if it could mimic their advantages and rely on existing distribution channels, such as market associations, church groups and MFIs, to minimise transaction costs.

Given the favourable perspective on savings, and the attractiveness of contractual savings, there may be potential demand for an accumulating value policy such as endowment or whole life. By building value, this type of policy would deflect the criticism that insurance is just another expense that can be avoided, because at the end of the day, if the insurable event does not occur, policyholders have something to show for their premium payments. If such a product allowed policyholders to borrow against the accumulated value, it would also overcome concerns about the inflexibility of insurance. Even though it would be a life insurance policy, and would only make a payout in the event of death, if policyholders were struck by a health care emergency, for example, they could use the policy as collateral to help pay the bills.

Certainly an education or social marketing campaign is needed to help low-income persons to understand how insurance works, and to demonstrate the potential value of insurance. While education is a starting point, it is insufficient if clients do not encounter positive practical experience with insurance. Although MFIs may be tempted to test the microinsurance waters by starting with a credit life product—which covers just the outstanding balance of the loan—that may not be the most productive entry point. Since credit life essentially benefits the MFI more than its clients, if this type of product is the clients’ first exposure to insurance, it could reinforce their ambivalent-to-negative perspective.

Furthermore, life insurance just for borrowers—even if the beneficiaries receive a payout besides the loan coverage—is also probably not sufficient to generate a broadly favourable public opinion of insurance. Since the customer has to die before experiencing any benefit, the MFI will only derive public relations value if the surviving spouse is or becomes a customer, and indirectly through any gossip that spreads through the community. For microfinance clients to experience the usefulness of an insurance policy without having to die, the policy should cover a number of people.

Given the fuzzy boundaries of what constitutes an extended family, and the fact that persons are obligated to contribute to the funeral costs of distant relatives, friends and neighbours, an important challenge will be to decide who the insurance policy covers. By covering many people under one policy, it creates pricing complications and opens to the door to significant problems of screening, adverse selection and fraud. Yet, if a policy covers a number of people, then policyholders are more likely to benefit from their insurance experience (or know people who did) and develop a positive attitude toward this financial service, especially if the claims process is quick and hassle free. One possibility is to develop a “friends and family” policy that allows policyholders to identify the ten people whose funerals one would most likely have to contribute to, and then specify the contribution amount one would be expected
to provide for each person. The premium rate would then be based on the total sum of coverage under the policy, as well as perhaps the ages and genders of the persons on the list.

If the MFI wants to enter the insurance field to provide a customer service, rather than as a potential money making exercise, there is an alternative to the preventative risk pooling approach. Rather than taking premiums upfront and then paying claims out of an insurance reserve, the organisation could deduct a certain amount from each customer’s savings account to pay for claims on an as-needed basis. This approach formalises the existing methods of reciprocity and mutual support, but because it is done over a bigger risk pool it reduces the burden on individual households.

**Bibliography and Suggested Reading**


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3 A key characteristics of insurance is that the policyholder has to suffer “adverse financial conditions” when the insured event occurs. Therefore proposed “friends and family” policy only makes sense if people are expected to make financial contributions to the deceased’s household.


