Briefing Paper

17

November 2011

Insurance products for the poor should not be poor products

Summary

Many recent attempts to provide insurance products to people on low incomes in developing countries have met with limited success as target clients appear not to be buying them in sufficient numbers. Recent research suggests that some of this low demand may be perfectly sensible, particularly if prospective clients believe that the insurer may not pay a claim when they need it the most. Such a belief can arise from fear of unscrupulous behaviour by the insurer or service providers, who may not honour justified claims. It may also stem from poor insurance product design. For example, a rainfall indexed insurance policy pays claims to farmers only if the rainfall index is sufficiently low. If there is a poor correlation between the rainfall index and a farmer's losses then purchasing insurance increases the potential downside to the farmer; the farmer could pay the premium and receive no claim payment despite having incurred a large crop loss.

Policy conclusions

- Improved regulations to ensure that insurance companies can be trusted to pay valid claims can benefit everybody, in particular the poorest for whom reliable, trustworthy protection is most valuable.
- Long term investments in better agricultural insurance indices which accurately capture local aggregate shocks, such as area yield indices, can benefit everybody, in particular the poorest for whom an increase in the correlation between indices and losses is most valuable.
- Subsidising insurance products is likely to increase demand, particularly from the relatively rich.

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Policy context

In theory, insurance products could help people on low incomes to reduce their vulnerability to key risks. However, in practice many insurance programmes in developing countries experience low voluntary demand. Previous research suggests that this low demand can be explained by poor decision making from individuals with low levels of financial literacy or by credit constraints.

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Project findings

Trust and demand

Dercon et al. (2011) argue that when insurers are not trusted to pay valid claims, demand *should* be low, particularly from the most risk averse. Data from a randomized, controlled trial of a composite health micro insurance product among tea growers in Kenya suggests that people on low incomes understand this, with low insurance purchase particularly from the most risk averse. Policies that increase potential clients' confidence in the enforceability of insurance contracts can increase insurance purchase, particularly from the most risk averse.

Basis risk and demand

Clarke (2011) finds a similar story for *indexed* insurance products, where claims are triggered by a cheaply observable index rather than a policyholder loss. For example, a number of insurers currently offer deficit rainfall indexed insurance, which pay claims only if the rainfall recorded at a particular weather station is sufficiently low. Such products do not offer perfect insurance, since the farmer could lose their entire crop due to pestilence, disease or localised rainfall even though the rainfall at the weather station was adequate. It is particularly important to note that such products can *increase* risk. The worst a farmer can do without indexed insurance is lose their entire crop, but the worst a farmer can do with insurance is pay the insurance premium, lose their entire crop and then not receive a claim payment. This *basis risk*, arising from the imperfect correlation between index and yields, can lead to low demand, particularly from the most risk averse. Investments in indices that offer higher correlation with farmer's losses can increase insurance purchase, particularly from the most risk averse.

Subsidies and demand

Insurance demand can be increased by subsidies, which reduce the price of insurance. However, this mainly benefits richer, less risk averse target clients; poorer, more risk averse target clients benefit more from improvements in trustworthiness or reductions in basis risk than reductions in price.

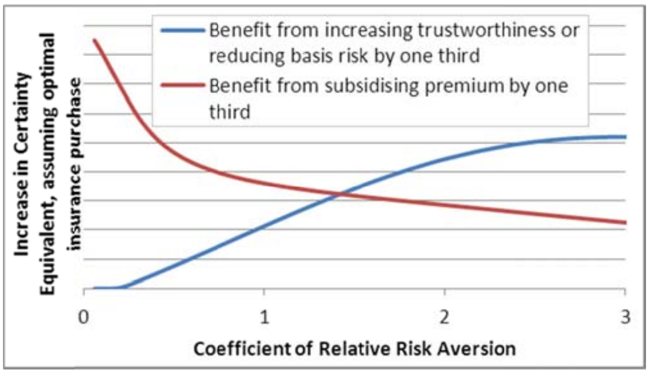

Figure 1 – Benefits from alternative policy responses

Ongoing and future research

Research is being carried out on designing and evaluating enhanced agricultural insurance products and delivery channels; pricing, reserving and regulation for microinsurance; and analysis of policy interventions into insurance markets.

For more detailed information

1) Stefan Dercon, Jan Willem Gunning and Andrew Zeitlin, (2011), 'The demand for insurance under limited credibility: evidence from a field experiment in Kenya', http://www.aae.wisc.edu/mwiedc/papers/2011/Zeitlin_Andrew.pdf

2) Daniel J. Clarke (2011) 'A theory of rational demand for index insurance', Department of Economics discussion paper 572: http://www.economics.ox.ac.uk/research/WP/pdf/paper572.pdf

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