Using NGOs to Advance Microinsurance for Weather Risks Among the Rural Poor

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Index Insurance for the Rural Poor

- Index insurance for weather risks is gaining interest as a cost-effective approach to agricultural insurance in lower income countries
- A major advantage of index insurance can be quick payments of cash to mitigate the crisis as it develops
- To date 25+ index insurance projects for have been tested around the world
- Introducing insurance and banking services can enable rural poor to improve resilience to risks
- There is value to these products but developing new insurance markets for the rural poor is still a challenge

Examples of Index Insurance

- Mexico- Drought Insurance
  - FONDEN (natural disaster fund)- index insurance for drought
  - Agroasemex- public reinsurance program
- Mongolia- Index-based Livestock Insurance
  - Sold to herders by local insurance agents from 4 companies
- India- Rainfall Insurance
  - Insurance sold to farmers through BASIX (MFI), underwritten by ICICI (insurer)
- Malawi- Drought Insurance
  - Index insurance covers loan to buy certified seed
  - Banks receive indemnity payments to cover the loan

Constraints to Using Weather Index Insurance as Microinsurance

- Many index insurance products have been crop specific
  - Difficult to design and complex
  - Exclude many sources of household (HH) income
  - Exclude the landless poor
- Cognitive Failure (low demand for insurance against catastrophic risk)
- Basis Risk with index-based products—indemnities may not provide complete coverage for loss
- Delivery Costs—challenge in providing affordable insurance to the rural poor: tradeoff between accessibility and transaction costs

Overcoming Constraints

- New Product Designs & Delivery Channels are needed that:
  - Address the needs and livelihood strategies of the rural poor
  - Account for the broad economic affects of catastrophic weather
  - Complement broader risk management strategies
  - Lower transaction costs
  - Convey greater value to rural HHs

Natural Disasters and the Rural Poor

- Natural disasters (e.g., drought and flood) devastate poor communities
  - Natural disaster risk is spatially correlated
  - Rural areas are disproportionately affected because they tend to be dependent on agriculture
  - Entire communities can suffer when there is major crop failure and food prices increase
  - Poor HHs experience longer-term effects than more prosperous HHs
- Farming, livestock, off-farm labor, selling crafts, etc.
- Disasters affect HH livelihood portfolios and communities
  - Rural HHs diversify across a portfolio of livelihood strategies
  - In rural areas many livelihood strategies are directly or indirectly related to agriculture
  - Informal risk-sharing relationships tend to break down when everyone is affected

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HH Consequences of Catastrophic Risk

- Catastrophic weather disrupts livelihoods (*ex post* impacts)
  - Crops
  - Livestock
  - Off-farm income (e.g., working on another farm, etc.)
  - Local food costs may increase
- Risk of catastrophic weather (*ex ante* impacts)
  - Low-risk, low-return livelihood strategies
  - Reduced investment
    - Durable productive assets
    - Less fertilizer use
    - Failure to adopt new technology
    - Less likely to use enhanced seed varieties

Responses to Shocks

- Responses of HHs to shocks push them into poverty
  - Smooth consumption→ Sell assets
    - Sell livestock, land, housing
    - Results in limited opportunities for enterprise growth
    - May push below critical threshold leading to poverty trap
  - Smooth assets → Lower consumption
    - Reduce spending on food, health care, school fees
    - Long-term health and developmental consequences
    - Limits future opportunities to escape poverty

Informal Risk Management

- Informal risk management tools
  - Reciprocity relationships within family or community
  - Semi-formal microfinance
- Poorest of the poor may be left out of these agreements
- Social norms may limit these tools
- Tradeoff for risk management partner:

Geographically Close Partner		**Geographically Separate Partner**
↓ asymmetric information		↑ asymmetric information
↓ transaction costs	VS.	↑ transaction costs
↑ covariate risks		↓ covariate risks

Product Concept: Livelihoods Index Insurance for Weather Risk

- Rural areas are vulnerable to catastrophic risk in many ways
  - Both on- and off-farm labor can be affected
  - Infrastructure damage can disrupt access to jobs, markets
  - Rural incomes often come from a variety of sources
- Insuring the overall "livelihood" rather than a single crop yield could have more value to more HHs
- Similar to business interruption insurance (our experience is that regulators are open to presenting index insurance as a form of business interruption insurance)

Livelihoods Insurance

- E.g.: HH purchases insurance for a level of liability that pays whenever the insured CAT weather risk occurs
- Over-insuring is unlikely to be a problem—experience has shown that HHs are more likely to underinsure
- Benefits over index insurance for a specific crop
  - Inclusive of HHs with diverse income sources
  - More inclusive of the landless poor
  - Straightforward, simple contract structure
  - Gives HHs more flexibility to adjust production strategies to changing conditions

Improving Delivery of Microinsurance

NGOs could play a significant role in advancing "Livelihoods Insurance"

- The goal of many NGOs is to support rural livelihoods
- Lots of interest among donors and NGOs about risk management and adaptation for climate change
- Linking weather insurance to mitigation and adaptation strategies can help HHs manage climate risk more effectively
  - Insurance is not a solution to climate change
  - Insurance can protect against weather extremes, but producers must adapt production strategies to changing climate trends

Advantages of NGO Linkages

Combining insurance with adaptation strategies can reduce risk exposure and protect livelihoods against severe events

- Complements NGO activities in risk mitigation and rural livelihoods
- Provide mutual insurance for community groups
- Can link to other services/benefits
- Encourage risk management *and* appropriate adaptation
- Smooth HH income following a disaster
- Targeted, timely payments
- Build on existing network for education and access

Delivery Structures

Existing models of NGO linkages:

- NGO as an intermediary delivery system
- NGO as the beneficiary for contingent financing for disaster relief

New model could provide direct, targeted benefit to HHs

- NGO co-finances or purchases an insurance contract on behalf of clients or a community group creating an informal mutual insurance association
  - Semi-formal risk sharing among clients could allocate indemnities to neediest households—mitigating basis risk problems
  - If individual losses are low, indemnities could also be used to invest in mitigation

Practical Considerations

- Insurance laws and regulations dictate what delivery structures are possible in any given country
  - Each jurisdiction is different
  - Any legal entity should be able to purchase an insurance contract (NGO, cooperatives)
  - The purchaser must demonstrate an insurable interest
- Sustainability of NGO commitment to support product delivery or co-financing

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Conclusions

- NGOs may be in good position to facilitate the use of index insurance for catastrophic events that impact a wide-range of livelihoods
- Index insurance can be used to protect programs of NGOs that are targeted toward improving the livelihoods of the rural poor
- Index insurance can be linked to climate adaptation strategies that are being promoted by NGOs
- NGOs can demonstrate the value of index insurance in the short term by co-financing and this can help create sustainable markets for products like the livelihoods insurance